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THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

APRIL 30, 2010.—Ordered to be printed

Mr. DODD, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany S. 3217]

The Committee on Banking, Housing, and Urban Affairs, having considered the original bill (S. 3217) to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

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I. INTRODUCTION

On March 22, 2010, the Senate Committee on Banking, Housing, and Urban Affairs marked up and ordered to be reported the "Restoring American Financial Stability Act of 2010 (RAFSA)." RAFSA is a direct and comprehensive response to the financial crisis that nearly crippled the U.S. economy beginning in 2008. The primary purpose of RAFSA is to promote the financial stability of the United States. It seeks to achieve that goal through multiple measures designed to improve accountability, resiliency, and transparency in the financial system by: establishing an early warning system to detect and address emerging threats to financial stability and the economy, enhancing consumer and investor protections, strengthening the supervision of large complex financial organizations and providing a mechanism to liquidate such companies should they fail without any losses to the taxpayer, and regulating the massive over-the-counter derivatives market.

II. PURPOSE AND SCOPE OF THE LEGISLATION

FINANCIAL STABILITY

Title I establishes a new framework to prevent a recurrence or mitigate the impact of financial crises that could cripple financial markets and damage the economy. A new Financial Stability Oversight Council (Council) chaired by the Treasury Secretary and comprised of key regulators would monitor emerging risks to U.S. financial stability, recommend heightened prudential standards for large, interconnected financial companies, and require nonbank financial companies to be supervised by the Federal Reserve if their failure would pose a risk to U.S. financial stability.

The Federal Reserve would establish and implement the heightened prudential standards and would have additional authority to require (with Council approval) a large financial company to restrict or divest activities that present grave threats to U.S. financial stability. With respect to bank holding companies, the heightened prudential standards would increase in stringency gradually as appropriate in relation to the company's size, leverage, and other measures of risk for those that have assets of $50 billion or more. This graduated approach to the application of the heightened prudential standards is intended to avoid identification of any bank holding company as systemically significant. These heightened prudential standards would also apply to the nonbank financial companies supervised by the Federal Reserve.

A new Office of Financial Research within the Treasury Department would support the Council's work through financial data collection, research, and analysis.

When Treasury Secretary Timothy Geithner presented the Administration's financial reform proposal at a Committee hearing on June 18, 2009, he highlighted several shortcomings of the current supervisory framework that left the government ill-equipped to handle the recent financial crisis: overall capital and liquidity standards were too low; regulatory requirements failed to account for the harm that could be inflicted on the financial system and economy by the failure of large, interconnected and highly leveraged financial institutions; and investment banks and other types of nonbank financial firms operated with inadequate government

oversight.[1] FDIC Chairman Sheila Bair testified on July 23, 2009 that the "existence of one regulatory scheme for insured institutions and a much less effective regulatory scheme for non-bank entities created the conditions for arbitrage that permitted the development of risk and harmful products and services outside regulated entities. . . . The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the needs to assess emerging risks using a system-wide perspective."[2]

These and other witnesses at Committee hearings relating to the financial crisis and financial reform have made the case for the type of framework established in this title to promote U.S. financial stability. Treasury Secretary Geithner called for the creation of a council of regulators chaired by the Secretary to identify emerging risks in financial institutions and markets, determine where gaps in supervision exist, and facilitate coordination of policy and resolution of disputes. He argued for new authority for the Federal Reserve to set stricter prudential standards for large, interconnected financial firms that could threaten financial stability, including financial firms that do not own banks.[3] Federal Reserve Chairman Ben Bernanke called for a new prudential approach focusing on the stability of the financial system as a whole, with formal mechanisms to identify and deal with emerging systemic risks, and for more stringent capital and liquidity standards for large and complex financial firms.[4] FDIC Chairman Sheila Bair recommended establishing an interagency council that would bring a macro-prudential perspective to regulation and set or harmonize prudential standards for financial firms to mitigate systemic risk.[5] At the July hearing, SEC Chairman Mary Schapiro also testified in favor of establishing such a council with similar membership and authorities.[6] Federal Reserve Board Governor Daniel Tarullo testified at the same hearing that there was substantial merit in establishing a council of regulators to conduct macroprudential oversight and coordinate oversight of the financial system as a whole.[7] Former Comptroller of the Currency Eugene Ludwig argued at a September hearing that no single regulatory agency would be well suited to handle this function alone.[8]

At a February 12, 2010 hearing, several witnesses spoke in favor of the creation of an independent National Institute of Finance (Institute). While the Office of Financial Research (Office) would be established in the Treasury Department under this title, the Office is very similar in key respects to the proposed Institute. Like the

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[1] Testimony of Timothy Geithner, Secretary of the Treasury, to the Banking Committee, June 18, 2009.

[2] Testimony of Sheila Bair, Chairman of the Federal Deposit Insurance Corporation to the Banking Committee, July 23, 2009.

[3] Testimony of Timothy Geithner, Secretary of the Treasury, to the Banking Committee, June 18, 2009.

[4] Testimony of Ben Bernanke, Federal Reserve Board Chairman, to the Banking Committee, July 22, 2009.

[5] Testimonies of Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, to the Banking Committee, May 6 and July 23, 2009.

[6] Testimony of Mary Schapiro, Chairman of the Securities and Exchange Commission, to the Banking Committee, July 23, 2009.

[7] Testimony of Daniel Tarullo, Federal Reserve Board Governor, to the Banking Committee, July 23, 2009.

[8] Testimony of Eugene Ludwig, former Comptroller of the Currency, to the Banking Committee, September 29, 2009.

Institute, the Office would support the council of regulators charged with monitoring emerging risks to financial stability. The Office would not supervise financial institutions but would have regulatory authority with respect to data collection. The Office's structure is modeled on the proposed Institute, with two main components to fulfill its primary functions—the Data Center and Research and Analysis Center. The structure and funding of the Office are intended to ensure that the Office, like the Institute, would have the resources and ability to provide objective, unbiased assessments of the risks facing the financial system.

ENDING "TOO BIG TO FAIL" BAILOUTS THROUGH THE ORDERLY LIQUIDATION AUTHORITY

Title II establishes an orderly liquidation authority to give the U.S. government a viable alternative to the undesirable choice it faced during the financial crisis between bankruptcy of a large, complex financial company that would disrupt markets and damage the economy, and bailout of such financial company that would expose taxpayers to losses and undermine market discipline. The new orderly liquidation authority would allow the FDIC, which has extensive experience as receiver for failed banking institutions, including large institutions, to safely unwind a failing nonbank financial company or bank holding company, an option that was not available during the financial crisis. Once a failing financial company is placed under this authority, liquidation is the only option; the failing financial company may not be kept open or rehabilitated. The financial company's business operations and assets will be sold off or liquidated, the culpable management of the company will be discharged, shareholders will have their investments wiped out, and unsecured creditors and counterparties will bear losses.

There is a strong presumption that the bankruptcy process will continue to be used to close and unwind failing financial companies, including large, complex ones. The orderly liquidation authority could be used if and only if the failure of the financial company would threaten U.S. financial stability. Therefore the threshold for triggering the orderly liquidation authority is very high: (1) a recommendation by a two thirds vote of the Board of the Governors of the Federal Reserve System; (2) a recommendation by a two thirds vote of the FDIC; (3) a determination and approval by the Secretary of the Treasury after consultation with the President; and (4) a review and determination by a judicial panel.

In order to protect taxpayers, large financial companies will contribute $50 billion over a period of 5 to 10 years to a fund held at the Treasury. This fund may only be used by the FDIC in the orderly liquidation of a failing financial company with the approval of the Treasury Secretary, and may not be used for any other purpose. The FDIC must first rely on these industry contributions if liquidity support is necessary to safely unwind the failing financial company and prevent a "fire sale" of assets that could further threaten financial stability. The fund would help avoid damaging "pro-cyclical" effects by allowing large financial companies to contribute gradually when they can most afford to pay, not when a crisis has already erupted. If additional liquidity is necessary, the FDIC may obtain financing from the Treasury but only if such financing can be repaid by the proceeds of the assets of the failed

financial company. Additional assessments on large financial companies may be imposed if necessary to ensure 100 percent repayment of any funds obtained from the Treasury, and any financial company that received payments greater than what it otherwise would have received in bankruptcy will be assessed at a substantially higher rate. Taxpayers will bear no losses from the use of the orderly liquidation authority.

The Committee hearing record provides significant support for establishing an orderly liquidation authority for large, complex bank holding companies and nonbank financial companies. On February 4, 2009, former Federal Reserve Chairman Paul Volcker gave the recommendations of the "Group of 30" (an international body of senior representatives from the public and private sectors and academia dealing with economic and financial issues), which included a call for U.S. legislation to establish a regime to manage the resolution of failed non-depository financial institutions comparable to the process for depository institutions. The recommendations called for applying this regime "only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system."[9] On June 18, 2009, Treasury Secretary Timothy Geithner presented the Administration's financial reform proposal, which called for a new authority modeled on the FDIC's existing authority for banks and thrifts to address the failure of a bank holding company or nonbank financial company when the stability of the financial system is at risk.

In testimony submitted on July 23 of 2009, FDIC Chairman Sheila Bair noted that large financial firms have been "given access to the credit markets at favorable terms without consideration of the firms' risk profile. . . . Investors and creditors believe their exposure is minimal since they also believe the government will not allow these firms to fail." In her July statement and in testimony on March 19 and May 6, Chairman Bair discussed the limitations of current bankruptcy procedures as applied to large and complex bank holding companies and nonbank financial companies, and advocated for a new statutory authority for the credible orderly unwinding of such companies modeled on the FDIC's existing authorities. Chairman Bair argued that the resolution authority must be able to allocate losses among creditors in accordance with an established claims priority "where stockholders and creditors, not the government, are in a first loss position." The testimony also discussed the merits of building up a fund over time in advance of a failure to provide working capital or to cover unanticipated losses in an orderly liquidation.[10] This type of "pre-funding" would enable the government to impose charges on large or complex financial companies consistent with the risks they pose to the financial system, provide economic incentives for a financial company against excessive and dangerous growth, and avoid large charges during times of economic stress that would have undesirable "pro-cyclical" effects.

In his July 23, 2009 testimony, Federal Reserve Board Governor Daniel Tarullo also argued for a new resolution authority as a

[9] Testimony of Paul Volcker, former Federal Reserve Board Chairman, to the Banking Committee, February 4, 2009.

[10] Testimonies of Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, to the Banking Committee, March 19, May 6, and July 23, 2009.

"third option between the choices of bankruptcy and bailout." The testimony argued that allowing losses to be imposed on creditors and shareholders "is critical to addressing the too-big-to-fail problem and the resulting moral hazard effects."[11] Former Comptroller of the Currency Eugene Ludwig also urged the Congress at a September 29, 2009 hearing to create a new resolution function for large, complex financial companies with financing provided by large financial companies.[12]

LIQUIDITY PROGRAMS

Title XI eliminates the ability of either the Federal Reserve or the Federal Deposit Insurance Corporation to rescue an individual financial firm that is failing, while preserving the ability of both regulators to provide needed liquidity and confidence in financial markets during times of severe distress. That is to say, this Title ends the potential for either regulator to come to the rescue of a future AIG, while reconfiguring the weapons in their financial crisis arsenals to increase accountability without diminishing their effectiveness.

The Federal Reserve's emergency lending authority, under section 13(3) of the Federal Reserve Act, in the past allowed the Federal Reserve to make loans to individual entities like AIG. While such lending played an important role in ending the recent financial crisis, it also created potential moral hazard. If the Federal Reserve were to retain authority to make emergency loans to individual firms, then large, interconnected firms might increase their risk-taking behavior, since the Federal Reserve would be there to bail them out in a future financial crisis.

By eliminating the ability to lend to individual institutions, and by requiring all emergency lending to be done through widely-available liquidity facilities that will be approved by the Treasury, monitored through periodic reports to Congress and by Comptroller General audits, and backed by collateral sufficient to protect taxpayers from loss, emergency lending by the Federal Reserve will not be a source of moral hazard.

During the recent crisis the Federal Deposit Insurance Corporation (FDIC) used the "systemic risk exception" to its normal bank receivership rules to establish the Temporary Liquidity Guarantee Program (TLGP) on an *ad hoc* basis.

By paying a TLGP insurance fee, federally insured depositories and U.S. bank, financial and thrift holding companies were able to issue unsecured short-term debt with a federal government guarantee.[13] Many firms used this program, and its existence helped them to roll over needed short-term financing after a period in which the outstanding volume of financial commercial paper con-

[11] Testimony of Daniel Tarullo, Federal Reserve Board Governor, to the Banking Committee, July 23, 2009.

[12] Testimony of Eugene Ludwig, former Comptroller of the Currency, to the Banking Committee, September 29, 2009.

[13] The fees charged increase with the maturity of the debt, rising from 12.5 basis points for three-month debt to 100 basis points for debt with maturities of one year or more, with additional charges added under certain conditions. Eligible entities include: (1) FDIC-insured depository institutions; (2) U.S. bank holding companies; (3) U.S. financial holding companies; and (4) U.S. savings and loan holding companies that either engage only in activities that are permissible for financial holding companies under section 4(k) of the Bank Holding Company Act (BHCA) or have an insured depository institution subsidiary that is the subject of an application under section 4(c)(8) of the BHCA regarding activities closely related to banking. See *http://www.fdic.gov/regulations/resources/tlgp/index.html.*

tracted sharply and discount rates spiked upward.[14] At its peak usage level in May 2009 the TLGP insured approximately $345 billion in outstanding debt. As of December 2009 the debt guarantee program had assessed $10.3 billion in guarantee fees.[15]

Under the TLGP, the FDIC also established a program to guarantee non-interest bearing transaction accounts that exceed the deposit insurance limit. Participating insured depositories pay an annualized risk-based assessment ranging from 15 to 25 basis points on transaction account amounts that exceed the current FDIC insurance amount of $250,000.

This Title allows the FDIC to guarantee short-term debt during financial crises, but limits the guarantees to *solvent* banks and bank holding companies, restricts the conditions under which such support may be offered, increases accountability of the guarantee program, and eliminates the possibility that taxpayers will pay for any losses from the program.

Under this Title no guarantee can be offered unless the Board of Governors of the Federal Reserve and the FDIC jointly agree that a liquidity event—essentially a breakdown in the ability of borrowers to access credit markets in a normal fashion—exists. The FDIC may then set up a facility to guarantee debt, following policies and procedures determined by regulation. The regulation is to be written in consultation with the Treasury. The terms and conditions of the guarantees must be approved by the Secretary of the Treasury.

The Secretary will determine a maximum amount of guarantees, and the President will request Congress to allow that amount. If the President does not submit the request, the guarantees will not be made. Congress has 5 days under an expedited procedure to disapprove the request. Fees for the guarantees are set to cover all expected costs. If there are losses, they are recouped from those firms that received guarantees. Firms that default on guarantees will be put into receivership, resolution or bankruptcy. Any FDIC aid to an individual firm under the "systemic risk exception" will henceforth only be possible if the firm has been placed in receivership, and therefore the FDIC will no longer be able to provide "open bank assistance" using this exception.

Hence FDIC debt guarantees will be available to help ease liquidity problems during financial crises, but will not be a source of moral hazard since the FDIC may guarantee only the debt of solvent institutions. Moreover, taxpayers are protected from any loss by the recoupment requirements.

Title XI also makes important changes to Federal Reserve governance. It establishes the position of Vice Chairman for Supervision on the Federal Reserve Board of Governors. The Vice Chairman will have the responsibility to develop policy recommendations on supervision and regulation for the Board, and will report twice each year to Congress. The Federal Reserve is also given formal responsibility to identify, measure, monitor, and mitigate risks to U.S. financial stability. In addition, the Federal Reserve is formally

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[14] For data on outstanding volumes of financial commercial paper and discount rates for AA financial commercial paper *see http://www.federalreserve.gov/releases/cp/*.

[15] For data on outstanding volumes guaranteed *see http://www.fdic.gov/regulations/resources/tlgp/reports.html.*

prohibited from delegating its functions for establishing regulatory or supervisory policy to Federal Reserve banks.

To eliminate potential conflicts of interest at Federal Reserve banks, the Federal Reserve Act is amended to state that no company, or subsidiary or affiliate of a company, that is supervised by the Board of Governors can vote for Federal Reserve Bank directors; and the officers, directors and employees of such companies and their affiliates cannot serve as directors. In addition, to increase the accountability of the Federal Reserve Bank of New York president, who plays a key role in formulating and executing monetary policy, this reserve bank officer will be appointed by the President, by and with the advice and consent of the Senate, rather than by the bank's board of directors.

"THE VOLCKER RULE"

Section 619 of Title VII prohibits or restricts certain types of financial activity—in banks, bank holding companies, other companies that control an insured depository institution, their subsidiaries, or nonbank financial companies supervised by the Board of Governors—that are high-risk or which create significant conflicts of interest between these institutions and their customers.

Banks, bank holding companies, other companies that control an insured depository institution, their subsidiaries, or nonbank financial companies supervised by the Board of Governors will be prohibited from proprietary trading, sponsoring and investing in hedge funds and private equity funds, and from having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser. A nonbank financial institution supervised by the Board of Governors that engages in proprietary trading, or sponsoring or investing in hedge funds and private equity funds will be subject to Board rules imposing capital requirements related to, or quantitative limits on, these activities.[16]

The incentive for firms to engage in these activities is clear: when things go well, high-risk behavior can produce high returns. In good times these profits allow firms to grow rapidly, and encourage additional risk-taking. However, when things do not go well, these same activities can produce outsize losses.

When losses from high-risk activities are significant, they can threaten the safety and soundness of individual firms and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses. In addition, when banks engage in these activities for their own accounts, there is an increased likelihood that they will find that their interests conflict with those of their customers.

The prohibitions in section 619 therefore will reduce potential taxpayer losses at institutions protected by the federal safety net, and reduce threats to financial stability, by lowering their exposure to risk. Conflicts of interest will be reduced, for example, by eliminating the possibility that firms will favor inside funds when placing funds for clients. The prohibitions also will prevent firms pro-

[16] These firms will be supervised by the Board of Governors because their failure could threaten overall financial stability.

tected by the federal safety net, which have a lower cost of funds, from directing those funds to high-risk uses. Moreover, they will restrict high-risk activity in those nonbank financial firms that pose threats to financial stability.

The prohibitions also will reduce the scale, complexity, and interconnectedness of those banks that are now actively engaged in proprietary trading, or have hedge fund or private equity exposure. They will reduce the possibility that banks will be too big or too complex to resolve in an orderly manner should they fail.

In testimony submitted to the Committee, Neal Wolin, Deputy Secretary of the Treasury, stated that "Proprietary trading, by definition, is not done for the benefit of customers or clients. Rather, it is conducted solely for the benefit of the bank itself. It is therefore difficult to justify an arrangement in which the federal safety net redounds to the benefit of such activities." Wolin noted that the role of proprietary trading and ownership of hedge funds, and their associated high risk, contributed to the crisis when banks were forced to bail out those operations. Wolin testified, "Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms 'bailed out' their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most." [17]

Paul Volcker, former Federal Reserve Board Chairman, discussed the benefits to the market from the prohibition and the impact on systemic risk: "Curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services." Volcker added that the proposal was "particularly designed to help deal with the problem of "too big to fail' and the related moral hazard that looms so large as an aftermath of the emergency rescues of financial institutions[.]" [18]

THE BUREAU OF CONSUMER FINANCIAL PROTECTION

The Committee has documented in numerous hearings over the years the failure of the federal banking and other regulators to address significant consumer protection issues detrimental to both consumers and the safety and soundness of the banking system.[19] These failures, which are described in more detail below, led to what has become known as the Great Recession in which millions of Americans have lost jobs; millions of American families have lost trillions of dollars in net worth; millions of Americans have lost their homes; and millions of Americans have lost their retirement, college, and other savings.

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[17] Testimony by Neal Wolin, Deputy Secretary of the Treasury, to the Senate Banking Committee, 2/2/10.

[18] Testimony by Paul Volcker, former Federal Reserve Board Chairman and Chairman of the President's Economic Recovery Advisory Board, to the Senate Banking Committee, 2/2/10.

[19] "*The need could not be clearer. Today's consumer protection regime just experienced massive failure. It could not stem a plague of abusive and unaffordable mortgages and exploitative credit cards despite clear warning signs. It cost millions of responsible consumers their homes, their savings, and their dignity. And it contributed to the near-collapse of our financial system. We did not have just a financial crisis; we had a consumer crisis.*" Testimony of Michael Barr, Assistant Secretary of the Treasury for Financial Institutions, to the Senate Committee on Banking, Housing, and Urban Affairs, July 14, 2009.

Structural Problems with Current Consumer Regulation

The current system of consumer protection suffers from a number of serious structural flaws that undermine its effectiveness, including a lack of focus resulting from conflicting regulatory missions, fragmentation, and regulatory arbitrage.

To begin with, placing consumer protection regulation and enforcement within safety and soundness regulators does not lead to better coordination of the two functions, as some would argue. As has been made amply apparent, when these two functions are put in the same agency, consumer protection fails to get the attention or focus it needs. Protecting consumers is not the banking agencies' priority, nor should it be. The primary mission of these regulators "in law and practice," as Assistant Secretary of the Treasury Michael Barr testified, is to ensure the safe and sound operations of the banks. Because of this, former Director of the Office of Thrift Supervision (OTS) Ellen Seidman testified, "[consumer] compliance has always had a hard time competing with safety and soundness for the attention of regulators. . . ."[20] In fact, as Assistant Secretary Barr pointed out, bank regulators conduct consumer protection supervision with an eye toward bank safety and soundness by, for example, trying to protect the banks from reputation and litigation risks rather than examining how products and services affect consumers. "Managing risks to the bank does not and cannot protect consumers effectively. This approach judges a bank's conduct toward consumers by its effect on the bank, not . . . on consumers."[21]

This may lead, as some witnesses before the Committee testified, to an emphasis by the regulators on the short term profitability of the banks at the expense of consumer protection.[22]

The current system is also too fragmented to be effective. There are seven different federal regulators involved in consumer rule writing or enforcement. Gene Dodaro, Acting Comptroller General, testified that "the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability."[23] This undermines accountability.

This fragmentation led to regulatory arbitrage between federal regulators and the states, while the lack of any effective supervision on nondepositories led to a "race to the bottom" in which the institutions with the least effective consumer regulation and enforcement attracted more business, putting pressure on regulated institutions to lower standards to compete effectively, "and on their regulators to let them."[24]

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[20] Testimony of Ellen Seidman, former Director of the Office of Thrift Supervision, to the Banking Committee, March 2, 2009.

[21] Testimony of Michael Barr, July 14, 2009.

[22] Testimony of Patricia McCoy, George J. and Helen M. England Professor of Law, University of Connecticut to the Banking Committee, hearing on March 3, 2009 and testimony of Travis Plunkett, Legislative Director of the Consumer Federation of America to the Banking Committee, July 14, 2009.

[23] Testimony of Gene Dodaro, Acting Comptroller General of the United States, February 4, 2009.

[24] Testimony of Michael Barr, July 14, 2009.

A More Effective Approach

This legislation creates the Bureau of Consumer Financial Protection (CFPB), a new, streamlined independent consumer entity housed within the Federal Reserve System. The CFPB will be focused on ensuring that consumers get clear and effective disclosures in plain English and in a timely fashion so that they will be empowered to shop for and choose the best consumer financial products and services for them.

The new CFPB will establish a basic, minimum federal level playing field for all banks and, for the first time, nondepository financial companies that sell consumer financial products and services to American families. It will do so without creating an undue burden on banks, credits unions, or nondepository providers of these products and services.

The CFPB will help protect consumers from unfair, deceptive, and abusive acts that so often trap them in unaffordable financial products. The CFPB will stop regulatory arbitrage. It will write rules and enforce those rules consistently, without regard to whether a mortgage, credit card, auto loan, or any other consumer financial product or service is sold by a bank, a credit union, a mortgage broker, an auto dealer, or any other nondepository financial company. This way, a consumer can shop and compare products based on quality, price, and convenience without having to worry about getting trapped by the fine print into an abusive deal.

The legislation ends the fragmentation of the current system by combining the authority of the seven federal agencies involved in consumer financial protection in the CFPB, thereby ensuring accountability.

The CFPB will have enough flexibility to address future problems as they arise. Creating an agency that only had the authority to address the problems of the past, such as mortgages, would be too short-sighted. Experience has shown that consumer protections must adapt to new practices and new industries.

Mortgage Crisis

> The fundamental story of the current turmoil is relatively easy to tell. It began early in this decade with a weakening of underwriting standards for subprime mortgages in the U.S. Subprime, alt-A and other mortgage products [which] were sold to people who could not afford them and in some cases in violation of legal standards.[25]
> —*Eugene Ludwig*

This financial crisis was precipitated by the proliferation of poorly underwritten mortgages with abusive terms, followed by a broad fall in housing prices as those mortgages went into default and led to increasing foreclosures. These subprime and nontraditional mortgages were characterized by relatively low initial interest rates that allowed borrowers to obtain loans for which they might not otherwise qualify.[26] However, after 2 or 3 years, the rates

[25] Testimony of Eugene Ludwig to the Banking Committee, October 16, 2008.

[26] It is important to note that the vast majority of subprime mortgages were used to refinance existing mortgages rather than to purchase a home. According to data collected by the Center for Responsible Lending ("Subprime Lending: A Net Drain on Homeownership," CRL Issue Paper #14, March 27, 2007), 62% of subprime loans made from 1998 through 2006 were refi-

Continued

would jump up significantly—by as much as 30 to 40 percent or more, according to the testimony of Michael Calhoun, President of the Center for Responsible Lending (CRL).[27] The great majority of the payment-option adjustable rate mortgages (option ARMs) resulted in significant negative amortization, so that many borrowers owed more on their mortgages after several years than when the mortgages were initially sold.

According to testimony heard in the Committee in late 2006,[28] and again in early 2007,[29] many of these loans were made with little or no regard for a borrower's understanding of the terms of, or their ability to repay, the loans. At a September 20, 2006 Subcommittee hearing, Subcommittee Chairman Bunning said "it is not clear that borrowers understand [the] risks" associated with these mortgages, a conclusion borne out both by a study by the Federal Reserve Board and the Consumer Federation of America (CFA). As Allen Fishbein, then Director of Housing Policy at the CFA, testified:

> Consumers today face a dizzying array of mortgage products that are marketed and promoted under a range of products names. While the number of products has exploded, there appears to be little understanding by many borrowers about key features in today's mortgages and how to compare or even understand the differences between these products.
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> A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage. . . . all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate [increased] from 6 percent to 8 percent. . . . Younger, poorer, and less formally educated respondents underestimated by as much as 50 percent.[30]

Fishbein also cited a Federal Reserve study of ARM borrowers that found that 35 percent of them did not know the maximum amount their interest rate could increase at one time; 44 percent did not know the maximum rate they could be charged; and 17 per-

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nances; only 9% were for first time home purchase loans (11% in 2006 was the highest figure). In other words, even before the foreclosure crisis hit, subprime loans did not make a substantial contribution to new homeownership. Rather, they put existing homeowners at greatly increased risk of losing their homes. Indeed, according to CRL, as of early 2007, there was a net loss in homeownership of over 900,000 households, a figure that has certainly increased greatly since the CRL paper was written. FDIC Vice Chair Marty Gruenberg made this point in a speech in New York on January 8, 2008, when he said:

> "[i]t has been said that a lot of these homes were bought on a speculative basis and people who did that don't deserve help. That is true of some. But it is important to understand that the majority of subprime mortgages were refinancings of existing homes. In other words, these were homes in which the homeowner was living, with mortgages that the homeowner was paying and could afford. In many cases the homeowner was encouraged or induced to refinance into one of these subprime mortgages with exploding interest rates that the homeowner couldn't afford.

[27] Testimony of Michael Calhoun, President of the Center for Responsible Lending, to the Subcommittee on Housing, Transportation, and Community Development of the Banking Committee, June 26, 2007.

[28] The Housing and Transportation and Economic Policy Subcommittees of the Banking Committee held two hearings on the issues arising from the increase in nontraditional mortgage lending: September 13, 2006 and September 20, 2006.

[29] See Banking Committee Hearings on February 7 and March 22, 2007.

[30] Testimony of Allen Fishbein, Director of Housing Policy at the Consumer Federation of America, to the joint Subcommittees, September 20, 2006. Mr. Fishbein is currently Assistant Director for Policy Analysis, Consumer Education and Research at the Federal Reserve Board.

cent did not know the frequency with which the rate could change.[31]

Finally, Fishbein cited a focus group of exotic mortgage borrowers organized by Public Opinion Strategies. It found that these consumers were "surprised by the magnitude of the payment shock" once rate sheets with the various mortgage option terms were shown to them. Lower-income borrowers, in particular, called the payment increases "shocking." Fishbein explained that these lower-income borrowers "were less informed about the payment increases and debt risks of non-traditional mortgages, with some noting they "wish they had known more.'"[32]

In that same hearing, Senator Sarbanes said that:

> Too often . . . loans have been made without the careful consideration as to the long-term sustainability of the mortgage. Loans are being made without the lender documenting that the borrower will be able to afford the loan after the expected payment shock hits without depending on rising incomes or increased appreciation.

Several months later, as the problem worsened, Chairman Dodd noted in a March 22, 2007 hearing that:

> . . . a sort of frenzy gripped the market over the past several years as many [mortgage] brokers and lenders started selling these complicated mortgages to low-income borrowers, many with less than perfect credit, who *they knew or should have known* . . . would not be able to afford to repay these loans when the higher payments kicked in. (emphasis added).

Underscoring this point, the General Counsel of Countrywide Financial Corporation, one of the biggest subprime lenders in 2007, acknowledged in response to a question from Chairman Dodd that "about 60 percent of the people who do qualify for the hybrid ARMs would not be able to qualify at the fully indexed rate"[33] (that is, at the rate a borrower would have to pay after the loan reset, even assuming interest rates did not rise). Another witness, Jennie Haliburton, an elderly resident of Philadelphia, Pennsylvania who lived on a fixed income of social security benefits, had been sold such a mortgage and was facing a jump in her mortgage payment to 70 percent of her income. The Department of Housing and Urban Development considers payments by consumers of more than 50% of income for shelter to put those consumers at "high risk" of losing their homes.

This testimony clearly demonstrates that the lenders were aware that borrowers would need to refinance their loans or sell their homes when the mortgages reset, thereby generating additional fees for the brokers and lenders. This was, in the words of Martin

[31] Testimony to the joint Subcommittee hearing, September 20, 2006 citing January, 2006 Federal Reserve Study, written by Brian Buck and Karen Pence, "Do Homeowners Know Their House Values and Mortgage Terms?"

[32] Testimony of Allen Fishbein, September 20, 2006.

[33] See Banking Committee hearings on March 22, 2008.

Eakes, Chief Operating Officer of the Self-Help Credit Union, "a devil's choice."[34]

The Committee heard some discussion as to what institutions were most responsible for originating these loans. There is little doubt that nondepository financial companies were among the largest sellers of subprime and exotic mortgages. However, insured depositories and their subsidiaries were heavily involved in these markets. According to data compiled by Federal Reserve Board Economists, 36 percent of all higher-priced loans in 2005 and 31 percent in 2006 were made by insured depositories and their subsidiaries. Those numbers jump to 48 percent and 44 percent when bank affiliates are included.[35] This illustrates that being under the supervision of a federal prudential regulator did not guarantee that mortgage underwriting practices were any stronger, or consumer protections any more robust. As noted, the regulators allowed this deterioration in underwriting standards to take place in part to prevent the institutions they regulate from getting priced out of the market.

Unfortunately, many of these mortgages were packaged by big Wall Street banks into mortgage-backed securities (MBS) and sold in pieces all over the world. Because of the unaffordable and abusive terms of the loans, these mortgages became delinquent at the highest rates since mortgage performance data started being collected over 30 years ago, leading, in turn, to increasing foreclosures, decreasing housing demand, and a widespread decline in housing prices. Once housing prices fell, families who might otherwise have been able to refinance their mortgages were unable to do so because they found themselves "underwater," owing more on their mortgages than the home is worth at that time.

As a result, the MBS into which these now non-performing mortgages were bundled lost significant value, helping lead to the systemic collapse from which we are currently suffering.

Effect on Minorities

> The mortgage lending system is deeply flawed. . . . The crisis is having a disproportionate impact on African American families, Latino families, low income families. And that disproportionate impact is not explained away by factors that would ordinarily justify such a problem.[36]
> —*Wade Henderson*

Regrettably, the Committee heard a lot of testimony outlining how mortgage originators targeted minorities for subprime mortgages even when these borrowers might have qualified for lower cost prime mortgages. In fact, according to a study conducted by the *Wall Street Journal*, as many as 61 percent of those receiving subprime loans "went to people with credit scores high enough to often qualify for conventional loans with far better terms."[37] Under the Home Mortgage Disclosure Act (HMDA), the Federal Reserve

[34] Testimony of Martin Eakes, Chief Operating Officer of the Self-Help Credit Union, to the Committee, February 7, 2007.

[35] Neil Bhutta and Glenn Canner, "Did CRA Cause the Mortgage Market Meltdown," Federal Reserve Bank of Minneapolis, March 9, 2009.

[36] Testimony of Wade Henderson, President and CEO of the Leadership Conference on Civil Rights, to the Subcommittee on Housing, Transportation, and Community Development hearing, June 26, 2007.

[37] "Subprime Debacle Traps Even Very Credit-Worthy, *Wall Street Journal*, December 3, 2007.

collects data on "high cost" mortgage lending, defined as mortgage loans which are 3 points above the Treasury rate. According to HMDA data released in 2007 by the Federal Reserve, 54 percent of African-Americans and 47 percent of Hispanics received high cost mortgages in 2006. Only 18 percent of non-Hispanic whites received high cost mortgages. The Federal Reserve study found that borrower related factors, such as income, accounted for only one sixth of this disparity. CRL did a study of the 2004 HMDA data which controls for other significant risk factors used to determine loan pricing, such as income and credit scores. The CRL study found that African-Americans were more likely to receive higher-rate home-purchase and refinance loans than similarly-situated white borrowers, and that Latino borrowers were more likely to receive higher-rate home purchase loans than similarly-situated non-Latino white borrowers.[38]

Failure of the Safety and Soundness Regulators

> It has become clear that a major cause of the most calamitous worldwide recession since the Great Depression was the simple failure of federal regulators to stop abusive lending, particularly unsustainable home mortgage lending.[39]
>
> —*Travis Plunkett*

Underlying this whole chain of events leading to the financial crisis was the spectacular failure of the prudential regulators to protect average American homeowners from risky, unaffordable, "exploding" adjustable rate mortgages, interest only mortgages, and negative amortization mortgages. These regulators "routinely sacrificed consumer protection for short-term profitability of banks,"[40] undercapitalized mortgage firms and mortgage brokers, and Wall Street investment firms, despite the fact that so many people were raising the alarm about the problems these loans would cause.

In 1994, Congress enacted the "Home Ownership and Equity Protection Act" (HOEPA) which states that:

> the Board, by regulation or order, shall prohibit acts or practices in connection with—
>
> (a) Mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
>
> (b) Refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interests of borrower.

As early as late 2003 and early 2004, Federal Reserve staff began to "'observe deterioration of credit standards'" in the origination of non-traditional mortgages.[41] Yet, the Federal Reserve Board failed to meet its responsibilities under HOEPA, despite persistent calls for action.

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[38] CRL, "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages," May 31, 2006.

[39] Testimony of Travis Plunkett, Legislative Director of the Consumer Federation of America to the Banking Committee, July 14, 2009.

[40] Testimony of Patricia McCoy to the Banking Committee, March 3, 2009.

[41] Banking Committee document, "Mortgage Market Turmoil: A Chronology of Regulatory Neglect" prepared by the staff of the Banking Committee, March 22, 2007.

As Professor McCoy noted in her testimony to the Committee, "federal banking regulators added fuel to the crisis by allowing reckless loans to flourish." Professor McCoy points out that the regulators had "ample authority" to prohibit banks from extending credit without proof of a borrower's ability to pay. Yet, she notes, "they refused to exercise their substantial powers of rule-making, formal enforcement, and sanctions to crack down on the proliferation of poorly underwritten loans until it was too late."[42]

Finally, in July of 2008, long after the marketplace had shut down the availability of subprime and exotic mortgage credit, and much of prime mortgage credit not directly supported by federal intervention, the Federal Reserve Board issued rules that would likely prevent a repeat of the same kinds of problems that led to the current crisis.

Where federal regulators refused to act, the states stepped into the breach. In 1999, North Carolina became the first State to enact a comprehensive anti-predatory law. Other States followed suit as the devastating results of predatory mortgage lending became apparent through increased foreclosures and disinvestment.

Unfortunately, rather than supporting these anti-predatory lending laws, federal regulators preempted them. In 1996, the OTS preempted all State lending laws. The OCC promulgated a rule in 2004 that, likewise, exempted all national banks from State lending laws, including the anti-predatory lending laws. At a hearing on the OCC's preemption rule, Comptroller Hawke acknowledged, in response to questioning from Senator Sarbanes, that one reason Hawke issued the preemption rule was to attract additional charters, which helps to bolster the budget of the OCC.[43]

Two recent studies by the Center for Community Capital at the University of North Carolina document the damage created by this preemption regulation. The two studies found that:

> (1) States with strong anti-predatory lending laws exhibited significantly lower foreclosure risk than other States. A typical State law reduced neighborhood default rates by as much as 18 percent;
>
> (2) Loans made by lenders covered by tougher State laws had fewer risky features and better underwriting practices to ensure that borrowers could repay;
>
> (3) Mortgage defaults increased more significantly among exempt OCC lenders in States with strong anti-predatory lending laws than among lenders that were still subject to tougher State laws. For example, default rates of fixed-rate refinance mortgages made by national banks not subject to State laws were 41 percent more likely to default and purchase-money mortgages made by these banks were 7 percent more likely to default than loans those banks made prior to preemption; and
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> (4) Risky lending by national banks more than doubled in some loan categories (fixed-rate refinances) after preemption than before, 11 percent to 29 percent.[44]

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[42] Testimony to the Banking Committee, March 3, 2009.

[43] Banking Committee hearing, April 7, 2004.

[44] "The APL Effect: The Impacts of State Anti-Predatory Lending Laws on Foreclosures," by Lei Ding, et al; University of North Carolina, March 23, 2010 and "The Preemption Effect: The

In remarkably prescient testimony, Martin Eakes warned in 2004 that the OCC's action on preemption "plants the seeds for long-term trouble in the national banking system." He went on to say:

> Abusive practices may well be profitable in the short term, but are ticking time bombs waiting to explode the safety and soundness of national banks in the years ahead. The OCC has not only done a tremendous disservice to hundreds of thousands of borrowers, but has also sown the seeds for future stress on the banking system.[45]

In sum, the Federal Reserve and other federal regulators failed to use their authority to deal with mortgage and other consumer abuses in a timely way, and the OCC and the OTS actively created an environment where abusive mortgage lending could flourish without State controls.

Other Consumer Financial Products and Services

Though the problems in the mortgage market have received most of the public's attention, consumers have long faced problems with many other consumer financial products and services without adequate federal rules and enforcement. Abusive lending, high and hidden fees, unfair and deceptive practices, confusing disclosures, and other anti-consumer practices have been a widespread feature in commonly available consumer financial products such as credit cards. These problems have been documented in numerous hearings before the Banking Committee and other Congressional Committees over the years.

Credit Cards. For example, credit card companies have long been known to provide extremely confusing disclosures, making it nearly impossible for consumers to understand the terms for which they are signing up. Card companies have engaged in extremely aggressive marketing, such that from 1999 to 2007 creditor marketing and credit extension increased at about two times the rate as credit card debt taken on by consumers.[46]

Moreover, typical credit card companies and banks engaged in a number of abusive pricing practices, including double-cycle billing, universal default, retroactive changes in interest rates, over the limit fees even where the consumer was not notified that a charge put him or her over the allotted credit limit, and arbitrary rate increases.

Despite the growing problems, federal banking regulators did very little. As Adam Levitin, Associate Professor of Law at Georgetown University Law Center explained to the Committee at a February, 2009 hearing,

> The current regulatory regime for credit cards is inadequate and incapable of keeping pace with credit card industry innovation. The agencies with jurisdiction over

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Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis," by Lei Ding et al, March 23, 2010.

[45] Testimony of Martin Eakes to the Banking Committee, April 7, 2004.

[46] Testimony of Travis Plunkett to the Banking Committee, February 12, 2009.

> credit cards lack regulatory motivation and have conflicting missions. . . .[47]

To illustrate this point, research shows that from 1997 to 2007 the OCC took just 9 formal enforcement actions regarding violations of the Truth in Lending Act with regards to credit cards or other consumer lending.[48] In fact, the Comptroller of the Currency wrote a letter objecting to certain parts of the Federal Reserve Board's proposed regulation on credit cards on safety and soundness grounds.[49]

Even after President Obama signed the Credit Card Accountability, Responsibility, and Disclosures Act (CARD Act) into law, credit card companies sought ways to structure products to get around the new rules, highlighting the difficulty of combating new problems with additional laws, while underscoring the importance of creating a dedicated consumer entity that can respond quickly and effectively to these new threats to consumers.

Overdrafts. Similar problems have been revealed by the Committee's examination of overdraft fees.[50] Overdraft coverage for a fee is a form of short term credit that financial institutions extend to consumers to cover overdrafts on check, ACH, debit and AMT transactions. Historically, financial institutions covered overdrafts for a fee on an ad hoc basis. With the growth in specially designed software programs and in consumer use of debit cards, overdraft coverage for a fee has become more prevalent.

A consumer normally qualifies for overdraft coverage if his or her account has been open for a specified period (usually six months), and there are regular deposits into the account. If those criteria are met, most financial institutions automatically enroll consumers in overdraft coverage without the consumer's knowledge or choice. "Consumers do not apply for . . . this credit, do not receive information on the cost to borrow [these funds], are not warned when a transaction is about to initiate an overdraft, and are not given the choice of whether to borrow the funds at an exorbitant price or simply cancel the transaction."[51]

Once overdraft coverage for a fee has been added to an account, some financial institutions do not allow consumers the option of eliminating the coverage, although other more consumer friendly alternatives like overdraft lines of credit or linking checking and savings accounts are available.

Many consumers who are enrolled in these programs without their knowledge find themselves subject to high fees of up to $35 per transaction even if the overdraft is only a few cents. In some cases, consumers have been charged multiple fees in one day without being notified until days later. Most institutions also charge an additional fee for each day the account remains overdrawn. Some financial institutions will even re-arrange the order in which they process purchases, charging for a later, larger purchase first so

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[47] Testimony of Levitin, Associate Professor of Law at Georgetown University Law Center to the Banking Committee, February 12, 2009.

[48] Testimony of Michael Calhoun to the U.S. House of Representatives Committee on Financial Services, September 30, 2009.

[49] Letter from Comptroller of the Currency John Dugan to the Board of Governors of the Federal Reserve System, August 18, 2008.

[50] Banking Committee hearing, November 17, 2009.

[51] Testimony of Jean Ann Fox, Director of Financial Services at Consumer Federation of America to the Banking Committee, November 17, 2009.

that they can charge repeated overdraft coverage fees for earlier, smaller purchases.

The result has been that American consumers paid $24 billion in overdraft fees in 2008[52] and $38.5 billion in overdraft fees in 2009.[53] CRL also found that nearly $1 billion of those fees would come from young adults and that $4.5 billion would come from senior citizens.

In addition, the Federal Deposit Insurance Corporation (FDIC) found that a small percentage (12%) of consumers overdraw their account five times per year or more. For these consumers, overdraft coverage is a form of high cost short term credit similar to a payday loan. For example, a consumer repaying a $20 point of sale debit overdraft in two weeks is effectively paying an APR of 3,520%.[54]

For many years, the Federal Reserve and other regulators have been aware of the abusive nature of overdraft coverage programs. In fact, an Interagency Guidance in 2005 called overdraft coverage programs "abusive and misleading." Nonetheless, the Federal Reserve has only issued modest rule after modest rule to address these programs. Despite years of concerns raised, it was not until November of last year that the Federal Reserve adopted another modest rule on overdraft coverage that would prohibit financial institutions from charging any consumer a fee for overdrafts on ATM and debit card transactions, unless the consumer opts in to the overdraft service for those types of transactions. Much more needs to be done in this area to protect consumers and rein in abusive practices.

Debt Collection. The Committee has similar concerns regarding the record of abusive, deceptive and unfair practices by debt collectors. The Fair Debt Collection Practices Act (FDCPA) was passed by Congress to regulate debt collection activities and behavior, but despite the existence of the act, debt collection abuses proliferate. In the last five years, consumers have filed nearly half a million complaints with the Federal Trade Commission about debt collection practices. These complaints include numerous reports of behavior in violation of the act, including: debt collectors threatening violence, using profane or harassing language, bombarding consumers with continuous calls, telling neighbors or family about what is owed, calling late at night, and falsely threatening arrest, seizure of property or deportation. The FTC receives more complaints from consumers about debt collectors than any other industry. Despite these complaints, in the last five years, the FTC has only filed nine debt collection cases.

In addition to concerns about debt collection tactics, the Committee is concerned that consumers have little ability to dispute the validity of a debt that is being collected in error. The FDCPA provides that, if a consumer disputes a debt, the collector is required to obtain verification of the debt and provide it to the consumer before renewing its collection efforts. The FDCPA does not, however, specify what constitutes "verification of the debt," with the result

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[52] Testimony of Michael Calhoun, November 17, 2009.

[53] Julianne Pepitone, "Bank overdraft fees to total $38.5 billion," *CNNMoney.com, http://money.cnn.com/2009/08/10/news/companies/bank_overdraft_fees_Moebs/index.htm*. August 10, 2009.

[54] *FDIC Study of Bank Overdraft Programs,* November, 2008.

that many collectors currently do little more than confirm that their information accurately reflects what they received from the creditor. The limited information debt collectors obtain in verifying debts is unlikely to dissuade them from continuing their attempts to collect from the wrong consumer or the wrong amount, so that an aggrieved consumer has virtually no protection against erroneous efforts to collect.

Debt collectors who are unsuccessful in collecting on a debt may use attorneys to file frequent lawsuits that they are not prepared to litigate, and which may not be factually valid, with the expectation that a large number of consumers will default or will not be prepared to defend themselves. Abuses in these suits have been documented in numerous press reports[55] and by the FTC as well as by consumer advocates. The FTC found that "the vast majority of debt collection suits filed in recent years has posed considerable challenges to the smooth and efficient operations of the courts."[56] This deluge of debt collection suits means the following abusive debt collection practices can occur: filing collection suits against the wrong people; filing suits past the statute of limitations; collection attorneys not having any proof of the debt sued upon and falsely swearing they do; suing for more than is legally owed; and laundering a time-barred debt with a new judgment. Most of these cases result in default judgment, often with little or no evidence to support the debt, because the debtor is intimidated and does not show up. Once a creditor obtains a judgment, the effects can be sustained and devastating, regardless of whether the consumer actually owed on the underlying debt. Despite the FDCPA, the FTC in February of 2009 issued a report stating that debt collection litigation practices appear to raise substantial consumer protection concerns.

Payday Lending. Payday loans are small, short-term cash advances made at extremely high interest rates. Typically, a borrower writes a personal check for $100–$500, plus a fee, payable to the lender. The loan is secured by the borrower's personal check or some form of electronic access to the borrower's bank account, and the full amount of the loan plus interest must be repaid on the borrower's next payday to keep the personal check required to secure the loan from bouncing.

The average loan amount for a payday loan is $325, and finance charges are generally calculated as a fee per hundred dollars borrowed. This fee is usually $15 to $30 per $100 borrowed. The average interest rate for a payday loan is between 391% and 782% APR for a two-week loan. Payday loans cost consumers over $4.2 billion in fees each year.

Cash-strapped consumers who must borrow money this way are usually in significant debt or living on the financial edge. A loan can become even more expensive for the borrower who does not have the funds to repay the loan at the end of two weeks and obtains a rollover or loan extension. Many borrowers must devote 25 to 50 percent of their take-home income to repay the payday loan, leaving them with inadequate resources to meet their other obligations. This often leads to a succession of new payday loans for that

[55] "Debtors' Hell" 4-Part Series, *Boston Globe*, July 30–August 2, 2006.

[56] "Collecting Consumer Debts: The Challenges Of Change," Federal Trade Commission, February 2009, p. 55.

family.[57] An additional fee is attached each time the loan is extended through a rollover transaction. The high rates make it difficult for many borrowers to repay the loan, thus putting many consumers on a perpetual debt treadmill where they extend the loan several times over. For example, if a payday loan of $100 for 14 days with a fee of $15 were rolled over three times, it would cost the borrower $60 to borrow $100 for 56 days. Loan fees can quickly mount and could eventually become greater than the amount actually borrowed. The typical payday borrower renews his or her loan multiple times before being able to pay the loan in full, and ends up paying $793 for a $325 loan.[58]

If the borrower defaults on the loan, serious financial consequences can occur. Loans secured by personal checks or electronic access to the borrower's bank account can endanger the banking status of borrowers. The lender can deposit the customer's personal check, which would result in additional fees from the bank for insufficient funds if it did not clear the borrower's checking account and could result in the consumer being identified as a writer of bad checks. Requiring consumers to turn over a post-dated check can subject consumers to coercion or harassment by illegal threats or coercive collection practices. For example, consumers have reported being threatened with jail for passing a bad check, even when the law specifically says they cannot be prosecuted if the check bounces.

Auto Dealer Lending. Auto loans constitute the largest category of consumer credit outside of mortgages. Today, there is more outstanding auto debt ($850 billion) than there is credit card debt in this country. Auto dealers finance 79% of the purchases of cars in the United States. Auto dealers actively market and price borrowers' loans. They also routinely mark up loan rates that are higher than the borrower would need to pay to qualify for the credit, and, like mortgage brokers or bankers, the auto dealers collect a significant portion of the excess finance charges that result from that markup, similar to a yield spread premium.[59] In addition, auto dealers often charge origination fees and may use the financing transaction as a way to sell other unrelated products (warranties and credit insurance, for example) to unsuspecting buyers. Unlike a mortgage broker, however, auto dealers are the legal creditors.

As with mortgages, borrowers are simply unaware of the incentives pushing the auto dealers to charge buyers higher interest rates. Auto dealers have a history of abusive and discriminatory lending. In a letter to Chairman Dodd and Ranking Member Shelby, the Leadership Conference on Civil Rights (LCCR) explains that:

> detailed research by academics earlier this decade on millions of auto loans revealed that auto dealers were far more likely to mark up the loan rates of minorities. Class actions revealed discrimination at GM, Toyota, Ford deal-

[57] Leslie Parish and Uriah King, *Phantom Demand,* Center for Responsible Lending, July 9, 2009.

[58] King, Uriah, Parrish, Leslie, and Tanki, Ozlem. "Financial Quicksand." *Center for Responsible Lending*. November 30, 2006.

[59] Raj Date and Brian Reed, *Auto Race to the Bottom; Free Markets and Consumer Protection in Auto Finance*, November 16, 2009.

> erships, among others. As a result, courts ordered most major car finance companies to cap rates . . . though the orders expire soon.[60]

In meetings with Banking Committee staff, the National Automobile Dealers Association (NADA) argued that the current rate cap imposed by the courts mitigate the need for CFPB rulemaking to protect consumers. To the contrary, this history of discriminatin indicates the need for careful oversight into the future, particularly as the court orders expire over the next several years.

As with mortgage bankers and brokers, auto dealers use an "originate to sell" model which results in the car dealers receiving upfront compensation for originating the loans, without regard to the ongoing performance of the loan. And, unlike mortgages, very few people ever refinance car loans, even if they find out that they have been charged above-market rates. As a result, auto dealers have a significant incentive to steer borrowers to the highest rate loans they can, without borrowers ever being aware of the backdoor transaction.

In addition to minorities and lower-income borrowers, military personnel are among those whom are frequently exploited by auto dealers. For that reason, Clifford Stanley, the Under Secretary of Defense for Personnel and Readiness, "welcome[s] and encourage[s] CFP[B] protections" for service members and their families "with regard to unscrupulous automobile sales and financing practices. . . ." Under Secretary Stanley writes that the oversight of auto financing by the CFPB for service members will help reduce concerns they have about their well-being. He goes on to say:

> The Department of Defense fully believes that personal financial readiness of our troops and families equates to mission readiness.[61]

Similarly, The Military Coalition, a consortium of nationally prominent military and veterans organizations representing more than 5.5 million current and former service members and their families supports CFPB regulation of auto dealers with regard to auto lending. In a letter to the Chairman and Ranking Member, the Coalition notes that auto financing is "the most significant financial obligation for the majority of service members." It goes on to say that "including auto dealers financing . . . in the financial reform bill will provide greater protections for our service members and their families" by protecting them from reported abuses such as bait and switch financing, falsification of loan documents, failure to pay off liens, and packing loans with other products.[62]

Access to automobile financing on fair terms is very important to American families, particularly to low-income families. Studies indicate that access to a reliable automobile is an important factor

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[60] Letter to Chairman Dodd and Ranking Member Shelby from the Leadership Conference on Civil Rights, December 3, 2009. The letter explains that "minority car buyers pay significantly higher dealer markups [for auto loans] than non-minority car buyers *with the same credit scores*." (Emphasis in original).

[61] Letter from Under Secretary of Defense to Clifford Stanley to Assistant Secretary of the Treasury, Michael Barr. February 26, 2010.

[62] Letter to Chairman Dodd and Ranking Member Shelby from The Military Coalition, April 15, 2010. The Coalition includes 31 members, including the Veterans of Foreign Wars, the Military Order of the Purple Heart, the National Guard Association of the U.S., the Non Commissioned Officers Association of the U.S.A., the Iraq and Afghanistan Veterans of America, and others.

for finding and keeping jobs, especially as more and more jobs are being created outside of city centers. Writing in *New England Community Developments,* Signe-Mary McKernan and Caroline Ratcliffe of the Urban Institute note that:

> providing low-income families with less burdensome auto-financing alternatives and helping them avoid the subprime loan market can lead to better credit scores and increase the likelihood that low-income families become integrated into the formal financial sector.[63]

However, despite the abuses in this sector, and the urgent need for better consumer protections, the federal government has not done enough to address these issues. "Given the widespread nature of the problem [with auto lending] revealed in the academic studies and private litigation, the current structure has failed to effectively police auto finance."[64] That is one of the reasons, according to the LCCR, the CFPB is needed.

STRENGTHENING AND CONSOLIDATING PRUDENTIAL SUPERVISION

Title III seeks to increase the accountability of the banking regulators by establishing clearer lines of responsibility and to reduce the regulatory arbitrage in the financial regulatory system whereby financial companies "shop" for the most lenient regulators and regulatory framework. "One clear lesson learned from the recent crisis was that competition among different government agencies responsible for regulating similar financial firms led to reduced regulation in important parts of the financial system. The presence of multiple federal supervisors of firms that could easily change their charter led to weaker regulation and became a serious structural problem within our supervisory system."[65]

Need to Consolidate Fragmented Banking Supervision

Title III rationalizes the fragmented structure of banking supervision in the U.S. by abolishing one of the multiple banking regulators, consolidating supervision of state banks in a single federal regulator, and consolidating supervision of smaller bank holding companies (those with assets of less than $50 billion) so that the regulator for the bank or thrift will also regulate the holding company. For the largest bank and thrift holding companies, the Board will be the consolidated holding company supervisor. The Board will thus focus its supervisory responsibilities on the larger, more interconnected bank and thrift holding companies (which will include, but not be limited to, those companies whose failures potentially pose risk to U.S. financial stability) where its experience in capital and global markets can best be applied. By consolidating its supervision over these holding companies, the Board can pursue risks wherever they may emerge within the company (including its subsidiaries) and will ultimately be responsible for the sound operation of the entire organization.

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[63] Signe-Mary McKernan and Caroline Ratcliffe, "Asset Building for Today's Stability and Tomorrow's Security," *New England Community Developments*, Federal Reserve Bank of Boston, 2009, Issue 2.

[64] Letter to Chairman Dodd and Senator Shelby by the LCCR, December 3, 2009.

[65] "Financial Regulatory Reform: A New Foundation", Administration's White Paper, June 2009.

The Committee heard repeated testimony that the U.S. financial regulatory system is more a product of history and responses to various crises, than deliberate design. According to the GAO, it has not kept pace with major developments in the financial marketplace. In testimony before the Committee on September 29, 2009, the GAO testified in favor of decreasing fragmentation in the system (beyond the Administration's proposal to abolish the OTS), reducing the potential for differing regulatory treatment, and improving regulatory independence.[66]

At the same hearing, former Comptroller of the Currency, Eugene Ludwig, testified that, "We must dramatically streamline the current alphabet soup of regulators", citing the needless burden on financial institutions of the duplicative and inefficient system, the fertile ground that multiple regulatory agencies create for regulatory arbitrage, and the serious gaps between regulatory responsibilities.[67]

The Committee heard testimony from Richard Carnell, Fordham Law School professor and former Treasury Assistant Secretary for Financial Institutions, that our current bank regulatory structure is needlessly complex and costly for banks. He maintained that its overlapping jurisdictions and responsibilities undercut regulators' accountability. And, it encourages regulators to compete with each other for "regulatory clientele" thereby creating an incentive for laxity in supervision.[68]

These sentiments were echoed by Martin Baily, senior fellow with the Brookings Institution, and former Chairman of the Council of Economic Advisers, who testified about the need for increased accountability among regulators. In speaking about competition among regulators Baily said, "The serious danger in regulatory competition is that it allows a race to the bottom as financial institutions seek out the most lenient regulator that will let them do the risky things they want to try, betting with other people's money."[69]

The Committee also heard testimony that the number of banking regulators could be reduced by creating a single federal regulator for state chartered banks, in contrast to the current scheme in which the Federal Reserve and the FDIC each supervise certain state banks. According to Comptroller of the Currency, John Dugan, "Today there is virtually no difference in the regulation applicable to state banks at the federal level based on membership in the [Federal Reserve] System and thus no real reason to have two different federal regulators. It would be simpler to have one. Opportunities for regulatory arbitrage—resulting, for example, from differences in the way federal activities restrictions are administered by one or the other regulator—would be reduced. Policy would be streamlined." Dugan went on to state the importance of ensuring the FDIC maintain a window into day-to-day banking supervision, which would be less of a problem for the Board if it maintained holding company supervision.[70]

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[66] Testimony of Richard J. Hillman, Managing Director Financial Markets and Community Investment, GAO, to the Banking Committee, 9/29/09.
[67] Testimony of Eugene Ludwig to the Banking Committee, 9/29/09.
[68] Testimony of Richard Carnell to the Banking Committee, September 29, 2009.
[69] Testimony of Martin Baily to the Banking Committee, September 29, 2009.
[70] Testimony of John Dugan to the Banking Committee, August 4, 2009.

Dugan identified further opportunity for regulatory consolidation. He testified there was little need for separate holding company regulation where the bank is small or where it is the holding company's only, or dominant, asset. "Elimination of a separate holding company regulator thus would eliminate duplication, promote simplicity and accountability, and reduce unnecessary compliance burden for institutions as well. The case is harder and more challenging for the very largest bank holding companies engaged in complex capital market activities, especially where the company is engaged in many, or predominantly, nonbanking activities, such as securities and insurance." In those cases, Dugan recommended maintaining the role of the Board as the holding company supervisor.[71]

In his September 2009 testimony, Baily echoed Dugan's remarks that there was no good case for the Board to continue to supervise smaller bank holding companies. That regulation should be moved to the prudential regulator. Indeed public data from the banking regulators from year end 2009 demonstrate that in almost all instances of banking organizations with less than $50 billion in assets, the vast majority of assets are in the depository institution. According to Federal Reserve Board Governor Daniel Tarullo, "When a bank holding company is essentially a shell, with negligible activities or ownership stakes outside the bank itself, holding company regulation can be less intensive and more modest in scope."[72]

Title III adopts a number of these recommendations for consolidating bank supervision to enhance the accountability of individual regulators, reduce the opportunities for depository institutions to shop for the most lenient regulator, reduce regulatory gaps in supervision, and limit inefficiencies, duplication and needless regulatory burdens on the industry. Title III does so by abolishing the OTS in accordance with the Administration's financial reform proposal.

Abolishing the OTS

The OTS is responsible for regulating state and federal thrifts, as well as their holding companies.[73] The thrift charter suffered disproportionate losses during the financial crisis. According to FDIC data, 95 percent of failed institution assets in 2008 were attributable to thrifts regulated by the OTS. These losses were predominantly attributed to the failures of Washington Mutual and Indy Mac Bank.[74] From the start of 2008 through the present, 73

[71] *Id.*

[72] Testimony of Daniel Tarullo to the Banking Committee, August 4, 2009.

[73] The OTS currently regulates 694 federal thrifts and 63 state thrifts.

[74] In its reports of the Washington Mutual and IndyMac failures, the inspectors general offices of the Treasury and FDIC cited numerous shortcomings with OTS supervision. With over $300 billion in total assets, Washington Mutual was OTS's largest regulated institution and represented as much as 15 percent of OTS's total assessment revenue from 2003 to 2008. The inspectors general found that, despite the multiple findings by OTS examiners of weaknesses at Washington Mutual, the OTS consistently gave the bank a high composite rating (CAMELS—capital, assets, management, earnings, liquidity, and sensitivity to risk) and Washington Mutual was thus considered well-capitalized until its closure. They further concluded that OTS did not adequately ensure that the thrift's management corrected examiner-identified weaknesses, that the agency failed to take formal enforcement action until it was too late, and that the OTS never instituted corrective measures under "prompt corrective action" (PCA) to minimize losses to the Deposit Insurance Fund because the OTS never properly downgraded the bank's CAMELS rat-

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percent of failed institution assets were attributable to thrifts regulated by the OTS, even though the agency supervised only 12 percent of all bank and thrift assets at the beginning of this period.

In its White Paper on reforming the financial regulatory system, the Administration argues that advances in the financial services industry have decreased the need for federal thrifts as a specialized class of depository institutions focused on mortgage lending.[75] Additionally, the White Paper points out that the thrift charter "created opportunities for private sector arbitrage" of the regulatory system and that its focus on residential mortgage lending made it particularly susceptible to the housing downturn.[76] The fragility of the charter is borne out by the statistics, including the fact that total assets of OTS-supervised thrifts declined by 36 percent between 2006 and 2009, compared to an increase of 11 percent in all FDIC-insured banks and thrifts for the same time period.

Thus the bill does not permit the chartering of any new federal thrifts and disbands the OTS. Title III apportions the responsibility to regulate thrifts and thrift holding companies among the FDIC, the OCC and the Federal Reserve, and ensures that all OTS employees are transferred to the FDIC and the OCC.

Consolidating Federal Supervision of State Banks and Smaller Bank Holding Companies

It also consolidates federal supervision for state banks in the FDIC. As of yearend 2009, the FDIC regulated 4,941 state banks ranging in size from less than one billion dollars in assets to more than $100 billion in assets, compared to the 844 banks the Federal Reserve supervised. In addition to the state banks the FDIC supervises, the agency has on-site dedicated examiners at the largest banks. The FDIC also conducts targeted supervisory activities at specific Federal Reserve regulated banks over $10 billion. These institutions present complex risk profiles and activities and operations that include international operations, securitization activities, and trading books with material derivatives exposures. Thus, the FDIC has ample experience in supervising banks of all sizes, including large, complex organizations.

And Title III gives the prudential regulators—the FDIC and the OCC—the responsibility for supervising the holding companies of smaller, less complex organizations where nearly all of the assets in the holding companies are concentrated in the depository institutions these agencies already regulate. The Board, however, will retain its supervisory responsibility for the larger bank holding companies and for the larger thrift holding companies, thus ensuring that the Board continues to have a window into day-to-day supervision.

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ing that would have triggered PCA. Evaluation of Federal Regulatory Oversight of Washington Mutual Bank, Report No. EVAL–10–002, April 2010.

In the case of IndyMac, the Treasury Inspector General found that the OTS did not identify or sufficiently address the core weaknesses that ultimately caused the thrift to fail until it was too late. As in the case of Washington Mutual, the Inspector General found that the OTS gave IndyMac inflated CAMELS ratings, and, that it failed to follow up with bank management to ensure that corrective actions were taken. The Inspector General also found that the OTS waited too long to bring an enforcement action against the bank. Material Loss Review of IndyMac Bank, FSB (OIG–09–032).

[75] "Financial Regulatory Reform: A New Foundation", June 2009.

[76] *Id.* The OTS was also the consolidated supervisor of AIG because AIG was a thrift holding company. To date, AIG's failure has cost the U.S.government over $180 billion.

Focusing the Federal Reserve System on its Core Functions

The crisis exposed the shortcomings of the Federal Reserve System—mainly that it has too many responsibilities to execute well.[77] [78] Currently, the Federal Reserve is responsible for conducting monetary policy, policing the payment system, serving as the lender of last resort, supervising state member banks, regulating all bank holding companies, and writing most of the consumer financial protection rules.

Chairman Dodd and other members of the Committee repeatedly expressed concerns during hearings about the many responsibilities of the Federal Reserve and about the need to preserve the Federal Reserve's primary focus on its core function of monetary policy. The Chairman also expressed concerns that so many diverse functions could ultimately threaten the independence of the Federal Reserve's monetary policy. Chairman Dodd said, "Some have expressed a concern—which I share, by the way—about overextending the Fed when they have not properly managed their existing authority, particularly in the area of protecting consumers."[79] The Chairman also said, "I worry that over the years loading up the Federal Reserve with too many piecemeal responsibilities has left important duties without proper attention and exposed the Fed to dangerous politicization that threatens the very independence of this institution."[80] Ranking Member Shelby stated, "The Federal Reserve already handled monetary policy, bank regulation, holding company regulation, payment systems oversight, international banking regulation, consumer protection, and the lender-of-last-resort function. These responsibilities conflict at times, and some receive more attention than others. I do not believe that we can reasonably expect the Fed or any other agency [to] effectively play so many roles."[81]

In response to a question from Ranking Member Shelby, Former Federal Reserve Chairman Paul Volcker agreed that the Federal Reserve's conduct of monetary policy could be undermined if the Fed assumed additional responsibilities.[82] Chairman Volcker further testified, "You will have a different Federal Reserve if the Federal Reserve is going to do the main regulation or all the regulation from a prudential standpoint. And you'll have to consider whether that's a wise thing to do, given their primary—what's considered now their primary responsibilities for monetary policy. They obviously have important regulatory functions now, and maybe those functions have not been pursued with sufficient avidity all the

[77] The Committee heard testimony about the failures of the Federal Reserve in executing its consumer protection functions, as well as in identifying the risks in bank holding companies. Martin Eakes, CEO of Self-Help and CEO of the Center for Responsible Lending, testified to the Committee in November 2008, "The Board has been derelict in the duty to address predatory lending practices. In spite of the rampant abuses in the subprime market and all the damage imposed on consumers by predatory lending—billions of dollars in lost wealth—the Board has never implemented a single discretionary rule under HOEPA outside of the high cost context. To put it bluntly, the Board has simply not done its job."

[78] Speaking to its failures in identifying risk, Orice Williams, Director of Financial Markets and Community Investment at the Government Accountability Office, testified to the Committee in March 2009, "Although for some period, the Federal Reserve analyzed financial stability issues for systemically important institutions it supervises, it did not assess the risks on an integrated basis or identify many of the issues that just a few months later led to the near failure of some of these institutions and to severe instability in the overall financial system."

[79] Statement of Chairman Chris Dodd, hearing of the Banking Committee, 12/3/09.

[80] Statement of Chairman Chris Dodd, hearing of the Banking Committee, 2/4/09.

[81] Ranking Member Richard Shelby, Banking Committee hearing, 6/18/09.

[82] Banking Committee hearing, "Modernizing The U.S. Financial Regulatory System," 2/4/09.

time. But if you're going to give them the whole responsibility, for which there are arguments, I do think you have to consider whether that's consistent with the degree of independence that they have to focus on monetary policy."[83]

To narrow the focus of the Federal Reserve to its core functions, the bill strips it of its consumer protection functions,[84] and its role in supervising a relatively small number of state banks, as well as smaller bank holding companies. However, the Committee was persuaded that because of the Federal Reserve's expertise and its other unique functions, it should play an expanded role in maintaining financial stability.[85] Thus, Title III assigns the Federal Reserve the responsibility for the supervision of bank and thrift holding companies with assets over $50 billion. (Other aspects of the bill that address financial stability enhance the Federal Reserve's oversight of systemically important payment systems, direct the Federal Reserve to apply heightened prudential standards to large bank holding companies, and give the Federal Reserve supervisory responsibilities over designated nonbank financial companies.) To ensure the Federal Reserve can focus on these and its other essential responsibilities, the bill assigns the regulation of state member banks and smaller bank holding companies to other federal regulators. The bill therefore strikes an important balance in providing the Federal Reserve with enhanced authority to maintain financial stability, while at the same time, reducing its responsibilities for areas that are not central to its mission.

Finally, it should be noted that Title III leaves intact the Federal Reserve's ability to obtain information needed for the conduct of monetary policy. Section 11 of the Federal Reserve Act gives the Board of Governors authority to require any depository institution to provide "such reports of its liabilities and assets as the Board may determine to be necessary or desirable to enable the Board to discharge its responsibility to monitor and control monetary and credit aggregates." This information may be obtained from any bank, savings and loan association, or credit union, and does not depend on the chartering agency or regulator of the depository. In addition, section 21 of the Federal Reserve Act provides that the Board may conduct special examinations of any Federal Reserve member bank. Members include all national banks and state banks that elect to become members of their district Federal Reserve bank. These provisions of the Federal Reserve Act remain unchanged. Therefore the Federal Reserve will retain extensive powers to gather the data it needs to conduct monetary policy, including data from banks that it does not supervise.

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[83] Testimony of Former Federal Reserve Board Chairman Paul Volcker to the Banking Committee, February 9, 2009.

[84] In proposing to take away the Federal Reserve's authority to write and enforce consumer protection rules Secretary Geithner called this authority a "preoccupation and distraction" for the Federal Reserve in testimony to the Banking Committee, June 18, 2009.

Martin Baily, Senior Fellow of Economic Studies at the Brookings Institution, stated in testimony during a hearing in September 2009 that the Federal Reserve Board's added focus on consumer protection took time from properly doing the rest of its job: "I think the thing that the Federal Reserve has done well is monetary policy . . . they certainly haven't done a great job on prudential regulation and I don't see—what is the point of the Chairman of the Federal Reserve sitting around worrying about details of credit card regulation? That is what he is doing right now, and I think that is a mistake and not a good use of his time."

[85] "The Fed has several missions, and monetary policy is the primary one," said Alice Rivlin, a Brookings Institution scholar and former Fed vice chairman. "But they also have a mission to stabilize the banking system, and we're in the process of expanding our view of what the banking system is." Washington Post, 7/17/08.

REGULATION OF OVER-THE-COUNTER DERIVATIVES AND SYSTEMICALLY SIGNIFICANT PAYMENT, CLEARING, AND SETTLEMENT FUNCTIONS

> Making derivatives safer is a very important part of solving too-big-to-fail.[86]—*Chairman Ben Bernanke*

Many factors led to the unraveling of this country's financial sector and the government intervention to correct it, but a major contributor to the financial crisis was the unregulated over-the-counter ("OTC") derivatives market. Derivatives can trade either over-the-counter where contracts are often customized and privately negotiated between counterparties, or through regulated central clearinghouses and exchanges that establish rules for trading contracts among many different counterparties.

Massive growth in bilateral, unregulated derivatives trading: At the time of the crisis in December, 2008, the global over-the-counter derivatives market stood at $592 trillion.[87] The top five derivatives dealers in the United States accounted for 96 percent of outstanding over-the-counter contracts made by the leading bank holding companies, according to the OCC. As such, this market was dominated by the too-big-to-fail financial companies that trade derivatives with financial and non-financial users. The dangers posed by the OTC derivatives market have been known for many years. In 1994, the GAO produced a report, titled, "Financial Derivatives: Actions Needed to Protect the Financial System." At the time of their report, the GAO determined the size of the derivatives market to be $12.1 trillion. Included in GAO's findings in 1994 were concerns about risks to taxpayers arising from the interconnectedness between dealers and end users: "the rapid growth and increasing complexity of derivatives activities increase risks to the financial system, participants, and U.S. taxpayers;" and "relationships between the 15 major U.S. dealers that handle most derivatives activities, end users, and the exchange-traded markets makes the failure of any one of them potentially damaging to the entire financial market."[88] By the time of the 2008 crisis, the derivatives market had grown to be almost fifty times as large from when GAO raised a red flag. Much of this growth has been attributed to the Commodities Futures Modernization Act of 2000 which explicitly exempted OTC derivatives, to a large extent, from regulation by the Commodity Futures Trading Commission ("CFTC") and limited the SEC's authority to regulate certain types of OTC derivatives. By 2008, 59 percent of derivatives were traded over-the-counter, or away from regulated exchanges, compared to 41 percent in 1998.

According to the Obama Administration, "the downside of this lax regulatory regime . . . became disastrously clear during the recent financial crisis . . . many institutions and investors had substantial positions in credit default swaps—particularly tied to asset backed securities . . . excessive risk taking by AIG and certain monoline insurance companies that provided protection against declines in the value of such asset backed securities, as well as poor counterparty credit risk management by many banks, saddled our

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[86] Testimony of Ben Bernanke, Federal Reserve Board Chairman, to the Senate Banking Committee, 12/3/09.

[87] Bank for International Settlements, press release, 5/19/09.

[88] U.S. Government Accountability Office, "Financial Derivatives: Actions Needed to Protect the Financial System," GGD–94–133 May 18, 1994.

financial system with an enormous—and largely unrecognized—level of risk." "[T]he sheer volume of these contracts overwhelmed some firms that had promised to provide payment on the CDS and left institutions with losses that they believed they had been protected against. Lacking authority to regulate the OTC derivatives market, regulators were unable to identify or mitigate the enormous systemic threat that had developed."[89]

OTC contracts can be more flexible than standardized contracts, but they suffer from greater counterparty and operational risks and less transparency. Information on prices and quantities is opaque. This can lead to inefficient pricing and risk assessment for derivatives users and leave regulators ill-informed about risks building up throughout the financial system. Lack of transparency in the massive OTC market intensified systemic fears during the crisis about interrelated derivatives exposures from counterparty risk. These counterparty risk concerns played an important role in freezing up credit markets around the failures of Bear Stearns, AIG, and Lehman Brothers.

Hidden leverage due to under-collateralization: Although over-the-counter derivatives can be used to manage risk and increase liquidity, they also increase leverage in the financial system; traders can take large speculative positions on a relatively small capital base because there are no regulatory requirements for margin or capital. The ability of derivatives to hide leverage was evident in problems faced by financial companies such as Bear Stearns and Lehman as well as non-financial derivatives participants such as the government of Greece—Chairman Gensler recently stated that higher capital requirements for derivatives would have prevented Greece from using currency swaps to hide debt.[90] When users negotiate margin bilaterally, they "will act in their own interest to manage their risk. These actions may not take into account the spillover risk throughout the system."[91] For example, the markets generally considered AIG Financial Products ("AIGFP") an extremely low risk counterparty because its parent company was rated AAA. This high rating allowed AIGFP to hold lower capital/margin against its derivatives portfolio. Had market participants or regulators demanded more capital, the company would have had less incentive to enter into such large positions as the projected return on investment would have been lower. Even if AIGFP had such large positions, the company would have had more funds to apply to the losses. Had information been more readily available to regulators and counterparties about the scope of AIGFP's credit default swap positions, regulators and market participants might have detected the systemic implications of AIGFP's book.

The dangers of under-collateralization were recently identified by the International Monetary Fund ("IMF") and the Wall Street Journal:

> The main risk posed by this gigantic pool is the hidden leverage. Put simply, a bank may have a large derivatives position but avoid posting cash upfront with its trading partner as others do.

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[89] Obama Administration white paper, *Financial Regulatory Reform: A New Foundation,* June 2009.

[90] Associated Press, *U.S. Warns EU Derivatives Ban Won't Work,* 3/16/10.

[91] Acharya, et al., *The Ultimate Financial Innovation,* 2008.

> This "under-collateralization" makes the system prone to runs because, when instability arrives, all banks rush to collect what they are owed on derivatives—and try to delay paying out what they themselves owe. Witness the Lehman Brothers collapse. And the numbers aren't small.
>
> On Tuesday, the International Monetary Fund released a paper estimating that five large U.S. derivatives dealers were potentially under-collateralized by between $500 billion and $275 billion as of September 2009. The IMF gets to that range using firms' net derivatives liabilities, a figure showing how much banks owe on derivatives trades adjusted for netting and collateral posting.
>
> Putting nearly all derivatives through clearinghouses, with tough margin rules, could do away with most of the under-collateralization. The IMF says getting there could be very costly for the banks. But consider it a bill they should have paid years ago.[92]

Counterparty credit exposure in the derivatives market was largely seen as a source of systemic risk during the failures of both Bear Stearns and Lehman Brothers, and would have brought down AIG but for a massive collateral payment made with taxpayer money. It created the dangerous interconnections that spread and amplified risk across the entire financial system. More collateral in the system, through margin requirements, will help protect taxpayers and the economy from bailing out companies' risky derivatives positions in the future. In testimony before the Senate Banking Committee, Federal Reserve Chairman Bernanke described margin requirements for derivatives users as "an appropriate cost of protecting against counterparty risk."[93]

Need to reduce systemic risk build-up and risk transmission in the derivatives market: Chairman Gensler of the Commodity Futures Trading Commission described the flaws of bilaterally-negotiated margin as follows: "Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system."[94] "One of the lessons that emerged from this recent crisis was that institutions were not just 'too big to fail,' but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled."[95]

In July of 2008, during a hearing on derivatives regulation before the Senate Banking Committee, Patrick Parkinson, deputy director of the Division of Research and Statistics for the Board of Governors of the Federal Reserve System, testified to the danger present in the OTC derivatives market: "weaknesses in the infrastructure for the credit derivatives markets and other OTC derivatives markets have created operational risks that could undermine

[92] Wall Street Journal, 4/13/10.
[93] Chairman Bernanke, Senate Banking Committee testimony, 12/3/09.
[94] Chairman Gensler, Senate Agriculture Committee testimony, 11/18/09.
[95] Chairman Gensler, Senate Banking Committee testimony, 6/22/09.

the effectiveness of counterparty risk-management practices."[96] In June of 2009, A. Patricia White, the associate director of the Division of Research and Statistics for the Board of Governors of the Federal Reserve System, testified about unregulated derivatives' ability to spread harm through the system and the need to combat such risk. Ms. White said, "OTC derivatives appear to have amplified or transmitted shocks. An important objective of regulatory initiatives related to OTC derivatives is to ensure that improvements to the infrastructure supporting these products reduce the likelihood of such transmissions and make the financial system as a whole more resilient to future shocks. Centralized clearing of standardized OTC products is a key component of efforts to mitigate such systemic risk."[97] While the systemic risk presented by the unregulated OTC derivatives market has long been known, it was realized in 2008 with devastating consequences. Now it must be addressed to restore stability and confidence in the financial system.

Creating a Safer Derivatives Market to Protect Taxpayers Against Future Bailouts

As a key element of reducing systemic risk and protecting taxpayers in the future, protections must include comprehensive regulation and rules for how the OTC derivatives market operates. Increasing the use of central clearinghouses, exchanges, appropriate margining, capital requirements, and reporting will provide safeguards for American taxpayers and the financial system as a whole.

Under Title VII, for the first time, over-the-counter derivatives will be regulated by the SEC and the CFTC, more transactions will be required to clear through central clearing houses and trade on exchanges, un-cleared swaps will be subject to margin requirements, swap dealers and major swap participants will be subject to capital requirements, and all trades will be reported so that regulators can monitor risks in this vast, complex market. Under Title VIII, the Federal Reserve will be granted the authority to regulate and examine systemically important payment, clearing, and settlement functions. The overall result would be reduced costs and risks to taxpayers, end users, and the system as a whole. The language in these titles is based on proposals drafted by the Obama Administration and includes all of the key regulatory features for derivatives market reform that have been endorsed by the G20: more central clearing, exchange trading, capital, margin, and transparency.

> G20 Steering Group Letter, 3/31/10: "Standardized over-the-counter derivatives contracts should be traded on exchanges or electronic platforms, where appropriate, cleared through central clearing counterparties by 2012 at the latest, and reported to trade repositories."[98]
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> G20 Leaders' Statement, The Pittsburgh Summit, 9/25/09: "Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on ex-

[96] Testimony before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs, 7/9/08.
[97] Testimony before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs, 6/22/09.
[98] G20 Steering Group Letter, 3/31/10.

> changes or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."[99]

The combination of these new regulatory tools will provide market participants and investors with more confidence during times of crisis, taxpayers with protection against the need to pay for mistakes made by companies, derivatives users with more price transparency and liquidity, and regulators with more information about the risks in the system.

Central clearing, margin, and capital requirements as a systemic risk management tool: "The main tool for regulating contagion and systemic risk is liquidity reserves (margin)."[100] In the OTC market, margin requirements are set bilaterally and do not take account of the counterparty risk that each trade imposes on the rest of the system, thereby allowing systemically important exposures to build up without sufficient capital to mitigate associated risks. The problem of under-collateralization is especially apparent in bank transactions with non-financial firms and regulators should address this problem through the new margin requirements for uncleared derivatives established in the legislation. According to the Comptroller of the Currency, "Banks held collateral against 64 percent of total net current credit exposure ("NCCE") at the end of the third quarter. Bank credit exposures to banks/securities firms and hedge funds are very well secured. Banks hold collateral against 90 percent of their exposure to banks and securities firms, and 219 percent of their exposure to hedge funds. The high coverage of hedge fund exposures occurs because banks take 'initial margin' on transactions with hedge funds, in addition to fully securing any current credit exposure. Coverage of corporate, monoline and sovereign exposures is much less."[101]

With appropriate collateral and margin requirements, a central clearing organization can substantially reduce counterparty risk and provide an organized mechanism for clearing transactions. For uncleared swaps, regulators should establish margin requirements. In addition, regulators should also impose capital requirements on swap dealers and major swap participants. While large losses are to be expected in derivatives trading, if those positions are fully margined there will be no loss to counterparties and the overall financial system and none of the uncertainty about potential exposures that contributed to the panic in 2008.

Exchange trading as a price transparency mechanism: "While central clearing would mitigate counterparty risk, central clearing alone is not enough. Exchange trading is also essential in order to

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[99] G20 Leaders' Statement, The Pittsburgh Summit, 9/25/09, *http://www.pittsburghsummit.gov/mediacenter/129639.htm.*

[100] Rama Conti, Columbia University, Credit Derivatives: Systemic Risk and Policy Options, 2009.

[101] Comptroller of the Currency, *Quarterly Report on Bank Trading and Derivatives Activities,* 12/18/09.

provide price discovery, transparency, and meaningful regulatory oversight of trading and intermediaries," said Former CFTC Chairman Brooksley Born.[102] Exchange trading can provide pre- and post-trade transparency for end users, market participants, and regulators. When swaps are executed on the basis of robust price information, rather than privately quoted, the cost of those transactions can be reduced over time. "The relative opaqueness of the OTC market implies that bid/ask spreads are in many cases not being set as competitively as they would be on exchanges. This entails a loss in market efficiency," wrote Stanford University Professor Darrel Duffie.[103] Trading more derivatives on regulated exchanges should be encouraged because it will result in more price transparency, efficiency in execution, and liquidity. In order to allow the OTC market to adapt to more exchange-trading, the legislation provides for "alternative swap execution facilities" ("ASEF") to fulfill the exchange-trading mandate. The absence of an exchange trading mandate provides "supra-normal returns paid to the dealers in the closed OTC derivatives market [and] are effectively a tax on other market participants, especially investors who trade on open, public exchanges," according to International Risk Analytics co-founder Christopher Whalen.[104] Resistance to price transparency in the financial markets has been overcome in the past, as noted by Duffie: "About 6 years ago, a post-trade reporting system known as TRACE was forced by U.S. regulation into the OTC markets for corporate and municipal bonds, which operate in a manner that is otherwise similar to the OTC derivatives markets. Dealers resisted the introduction of TRACE, claiming that more price transparency would reduce the incentives of dealers to make markets and in the end reduce market liquidity. So far, empirical evidence appearing in the academic literature has not given much support to these claims."[105]

Allow for some customized, bilateral contracts: Some parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible. Also, OTC (contracts not cleared centrally) should still be subject to reporting, capital, and margin requirements so that regulators have the tools to monitor and discourage potentially risky activities, except in very narrow circumstances. These exceptions should be crafted very narrowly with an understanding that every company, regardless of the type of business they are engaged in, has a strong commercial incentive to evade regulatory requirements. "Every firm has reasons why its contracts are 'exceptional' and should trade privately; in reality, most derivatives contracts are standardized—or standardizable—and could trade on exchanges," said Joe Dear, Chief Investment Officer of the California Public Employees' Retirement System.[106]

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[102] Former CFTC Chairman Brooksley Born, Joint Economic Committee testimony, 12/1/09.

[103] Stanford University Professor Darrel Duffie, *The Road Ahead for the Fed,* 2009.

[104] International Risk Analytics co-founder Christopher Whalen, Senate Banking Committee testimony, 6/22/09.

[105] Stanford University Professor Darrel Duffie, *Pew Research,* 2009.

[106] Chief Investment Officer of the California Public Employees' Retirement System Joe Dear, National Press Club speech, 11/3/09.

Therefore, the legislation permits regulators to exempt contracts from the clearing and exchange trading requirement based on these narrow criteria: one counterparty is not a swap/security-based swap dealer or major swap/security-based swap participant and does not meet the eligibility requirements of a clearinghouse. If no clearinghouse, board of trade, exchange, or alternative swap execution facility accepts the contract for clearing or trading, then the contract must be exempt from the clearing and exchange trading requirements. The regulators may also exempt swaps from the margin requirement for uncleared swaps under the following narrow criteria: one counterparty is not a swap/security-based swap dealer or major swap/security-based swap participant, using the swap as part of an effective hedge under generally accepted accounting principles, and predominantly engaged in activities that are not financial in nature. Regulators must notify the Financial Stability Oversight Council before issuing any permissive exemptions.

In providing exemptions, regulators should minimize making distinctions between the types of firms involved in the market or the types of products the firms are engaged in and instead evaluate the nature of the firm's derivatives activity: "[T]wo complementary regulatory regimes must be implemented: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves—including regulated exchanges, electronic trading systems and clearing houses . . . These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved," testified Chairman Gensler.[107] To achieve the objectives of regulatory reform in the OTC market,"it is critical that similar products and activities be subject to similar regulations and oversight."[108] In determining whether to bring non-swap dealers into the regulatory framework, regulators should focus on counterparty credit exposure. It was counterparty credit risk that played a critical role in exacerbating the 2008 crisis. Regulators would measure credit exposure by evaluating the value of collateral held against such exposure. According to the Office of the Comptroller of the Currency, "the first step to measuring credit exposure in derivative contracts involves identifying those contracts where a bank would lose value if the counterparty to a contract defaulted today . . . A more risk sensitive measure of credit exposure would also consider the value of collateral held against counterparty exposures." [109]

INVESTOR PROTECTION

Title IX addresses a number of securities issues, including provisions that respond to significant aspects of the financial crisis caused by poor securitization practices (Subtitle D); erroneous credit ratings (Subtitle C); ineffective SEC regulation of Madoff Securities, Lehman Brothers and other firms (Subtitle F); and executive compensation practices that promoted excessive risk-taking (Subtitle E). In connection with the crisis, concerns have also been raised that investors need more protection; shareholders need a

[107] Chairman Gensler, Senate Banking Committee testimony, 6/22/09.

[108] Obama Administration white paper, *Financial Regulatory Reform: A New Foundation,* June 2009.

[109] Comptroller of the Currency, *Quarterly Report on Bank Trading and Derivatives Activities, 12/18/09.*

greater voice in corporate governance; the SEC needs more authority; the SEC should be self-funded; and the municipal securities markets need improved regulation, which are addressed here as well.

Significant aspects of the financial crisis involved securities. Serious and far reaching problems were caused by poor and risky securitization practices; erroneous credit ratings; ineffective SEC regulation of investment banks such as Lehman Brothers and broker dealers such as Madoff; and excessive compensation incentives that promoted excessive risk taking. During the crisis, it became apparent that investors needed better protection, shareholders needed more voice in corporate governance, the municipal securities markets needed improved regulation, and the SEC needs assistance. Title IX addresses these and other investor protection and related securities issues.

Credit ratings that vastly understated the risks of complex mortgage-backed securities encouraged the build-up of excessive leverage and credit risk throughout the financial system in the years before the crisis. With the onset of the crisis, the ratings of many mortgage-backed bonds were sharply downgraded, fuelling widespread uncertainty about asset values and amplifying problems in residential mortgage markets into a global financial panic. The rating agencies' errors can be attributed to overreliance on mathematical risk models based on inadequate data and to conflicts of interest in the process of rating complex structured securities, where the rating agencies actually advised the issuers on how to obtain AAA ratings, without which the securities could not have been sold.

This legislation will improve the regulation and performance of credit rating agencies by enhancing SEC oversight authority and requiring more robust internal supervision of the ratings process. In addition, rating agencies will be required to disclose more data about assumptions and methodologies underlying ratings, in order to permit investors to better understand credit ratings and their limitations. Due diligence investigations into the facts underlying ratings will be encouraged. Rating agencies will be held accountable for failures to produce ratings with integrity, both by allowing the SEC to suspend rating agencies that consistently fail to produce accurate ratings and by lowering the pleading standard for private lawsuits alleging that a rating agency knowingly or recklessly failed to conduct a reasonable investigation of the factual elements of the rated security, or failed to obtain reasonable verification of such factual elements from independent sources that it considered to be competent. Finally, the legislation requires financial regulators to review and remove unnecessary references to credit ratings in their regulations.

Excesses and abuses in the securitization process played a major role in the crisis. Under the "originate to distribute" model, loans were made expressly to be sold into securitization pools, which meant that the lenders did not expect to bear the credit risk of borrower default. This led to significant deterioration in credit and loan underwriting standards, particularly in residential mortgages. Moreover, investors in asset-backed securities could not assess the risks of the underlying assets, particularly when those assets were resecuritized into complex instruments like collateralized debt obligations. With the onset of the crisis, there was widespread uncer-

tainty regarding the true financial condition of holders of asset-backed securities, freezing interbank lending and constricting the general flow of credit. Complexity and opacity in securitization markets prolonged and deepened the crisis, and have made recovery efforts much more difficult.

This title requires securitizers to retain an economic interest in a material portion of the credit risk for any asset that securitizers transfer, sell, or convey to a third party. This "skin in the game" requirement will create incentives that encourage sound lending practices, restore investor confidence, and permit securitization markets to resume their important role as sources of credit for households and businesses.

Congress is empowering shareholders in a public company to have a greater voice on executive compensation and to have more fairness in compensation affairs. Under the new legislation, each publicly traded company would give its shareholders the right to cast advisory votes on whether they approve of its executive compensation. The board committee that sets compensation policy would consist only of directors who are independent. The company would tell shareholders about the relationship between the executive compensation it paid and its financial performance. The company would be required to have a policy to recover money that it erroneously paid to executives based on financials that later had to be restated due to an accounting error.

Management nominees for directors of public companies could generally serve on the board only if they won a majority of the votes in an uncontested election. Also, the S.E.C. would have the authority to allow shareholders to have more power in governing the public companies in which they own stock. If the S.E.C. gives shareholders proxy access, a shareholder who has owned an amount of stock for a period of time, as specified by the S.E.C., could choose a candidate to nominate for election to the board of directors on the company's proxy.

Investors would have new sources of assistance. The new Office of Investor Advocate housed within the SEC would help retail investors with problems they have with the SEC or self-regulatory organizations. Securities broker-dealers, such as Bernard L. Madoff Investment Securities, would have to use auditors that are subject to the inspections and discipline by a rigorous regulator, the Public Company Accounting Oversight Board, which would better protect investor accounts. Larger investors would have to post margin collateral based on the net positions in their securities and futures portfolio. An Investment Advisory Committee is created in the law to give advice to the SEC from its members, which would include representatives of mutual fund, stock and bond investors, senior citizens, State securities regulators, and others. The law increases the amount of money available to the Securities Investor Protection Corporation to pay off valid claims of customers of defunct broker-dealers.

The SEC would get more power, assistance and money at its disposal to be an effective securities markets regulator. The SEC would have new authority to impose limitation on mandatory arbitration; to bar someone who violated the securities laws while working for one type of registered securities firm, such as a broker-dealer, from working for other types of securities firms, such as in-

vestment advisers; to require that securities firms give new disclosures to investors before they buy investment products. The SEC would have more help in identifying securities law violations through a new, robust whistleblower program designed to motivate people who know of securities law violations to tell the SEC. It also expands existing whistleblower law. In light of recent failures of the SEC, the GAO will also provide assistance through studies and recommendations to improve the agency's internal supervisory controls, management and financial controls. The SEC has asked to be unfettered by the Congressional appropriation process and the new law would allow the agency to be self-funded.

A major lesson from the crisis is the importance of transparency in financial markets. The $3 trillion municipal securities market is subject to less supervision than corporate securities markets, and market participants generally have less information upon which to base investment decisions. During the crisis, a number of municipalities suffered losses from complex derivatives products that were marketed by unregulated financial intermediaries. This title requires a range of municipal financial advisors to register with the SEC and comply with regulations issued by the Municipal Securities Rulemaking Board (MSRB). The composition of the MSRB will be changed so that representatives of the public—including investors and municipalities—make up a majority of the board. In addition, the title establishes an Office of Municipal Securities within the SEC and contains a number of studies on ways to improve disclosure, accounting standards, and transparency in the municipal bond market.

REGULATION OF PRIVATE FUNDS

Title IV requires advisers to large hedge funds to register with the Securities and Exchange Commission, in order to close a significant gap in financial regulation. Because hedge funds are currently unregulated, no precise data regarding the size and scope of hedge fund activities are available, but the common estimate is that the funds had at least $2 trillion in capital before the crisis. Their impact on the financial system can be magnified by extensive use of leverage—their trades can move markets. While hedge funds are generally not thought to have caused the current financial crisis, information regarding their size, strategies, and positions could be crucial to regulatory attempts to deal with a future crisis. The case of Long-Term Capital Management, a hedge fund that was rescued through Federal Reserve intervention in 1998 because of concerns that it was "too-interconnected-to-fail," shows that the activities of even a single hedge fund may have systemic consequences.

Hedge fund registration was part of the Treasury's Department's regulatory reform proposal, and has been endorsed by many witnesses before the Committee, including Mr. James Chanos, Chairman of the Coalition of Private Investment Companies, who testified that "private funds (or their advisers) should be required to register with the SEC. . . . Registration will bring with it the ability of the SEC to conduct examinations and bring administrative proceedings against registered advisers, funds, and their personnel. The SEC also will have the ability to bring civil enforcement ac-

tions and to levy fines and penalties for violations."[110] Other supporters of the title include a range of industry groups, institutional investors, the Group of Thirty, the G–20, and the Investors' Working Group.

In addition to SEC registration, this title requires private funds—hedge funds with more than $100 million in assets under management—to disclose information regarding their investment positions and strategies. The required disclosures include information on fund size, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies, types of assets held, and any other information that the SEC, in consultation with the Financial Stability Oversight Council, determines is necessary and appropriate to protect investors or assess systemic risk. The Council will have access to this information to monitor potential systemic risk, while the SEC will use it to protect investors and market integrity.

III. BACKGROUND AND NEED FOR LEGISLATION

The statistics alone reveal the terrible toll the financial crisis exacted on the U.S. economy. From the start of the crisis through March 2010, more than 8 million jobs were lost.[111] Unemployment in the United States reached 10.1% in October 2009, the highest rate of unemployment since 1983, and as of March 2010 was holding at 9.7%; prior to the economic collapse, in October 2008, the unemployment rate was just 6.6%.[112] American household wealth fell by more than $13 trillion from the peak value of American wealth in 2007 to the height of the crisis at the end of 2008. Even after several months of recovery, household wealth is still down $11 trillion, or almost 17%, from its 2007 peak.[113] Home prices have dropped 30.2% from their 2006 peak,[114] and retirement assets dropped by more than 20%. Real Gross Domestic Product in the United States in the fourth quarter of 2008, and the first and second quarters of 2009 decreased by an annual rate of about 5.4%, 6.4%, and 0.7%, respectively, from the previous periods, and Real GDP through 2009 had not reached the levels seen prior to the economic collapse.[115] More than 7 million homes in America have entered foreclosure since the beginning of 2007.[116]

Behind the statistics are hardworking men and women whose lives have been shattered, small businesses that have been shuttered, retirement funds that have evaporated, and families who have lost their homes. While some of the most prominent American financial institutions have been destroyed or badly weakened, it is the millions of American families, who did nothing wrong, who have suffered the most. Indeed, the financial crisis has torn at the very fiber of our middle class.

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[110] Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, to the Senate Banking Committee, 7/15/09.

[111] Bureau of Labor Statistics, database of seasonally adjusted total nonfarm payroll, *www.bls.gov*.

[112] Bureau of Labor Statistics, database of seasonally adjusted unemployment rate, 16 years and older, *www.bls.gov*.

[113] The Federal Reserve, Flow of Funds report, 3/11/10, *www.federalreserve.gov*.

[114] S&P/Case-Shiller Home Prices Indices, 20-City Composite, press release, 3/30/10, *www.standardandpoors.com*.

[115] Bureau of Economic Analysis, Gross Domestic Product: Fourth Quarter 2009 press release, 3/26/10, *www.bea.gov*.

[116] Reuters News, January 29, 2008; January 15, 2009; January 14, 2010; March 11, 2010.

This devastation was made possible by a long-standing failure of our regulatory structure to keep pace with the changing financial system and prevent the sort of dangerous risk-taking that led us to this point, propelled by greed, excess, and irresponsibility. The United States' financial regulatory structure, constructed in a piecemeal fashion over many decades, remains hopelessly inadequate to handle the complexities of modern finance. In January 2009, the GAO added the U.S. financial regulatory system to its list of high-risk areas of government operations because of its fragmented and outdated structure.[117]

Rather than taking measures to strengthen the financial services sector, some of our regulators actively embraced deregulation, pushed for lower capital standards, ignored calls for greater consumer protections and allowed the companies they supervised to use complex financial instruments to manage risk that neither they nor the companies really understood. Moreover, many actors in the financial system—the "shadow" banking system—have escaped any form of meaningful regulation. As former Comptroller of the Currency Eugene Ludwig testified, "The paradigm of the last decade has been the conviction that un- or under-regulated financial services sectors would produce more wealth, net-net. If the system got sick, the thinking went, it could be made well through massive injections of liquidity. This paradigm has not merely shifted—it has imploded." [118]

The financial crisis can trace its origins to a downturn in the housing market that in turn exposed a raft of unsound lending practices. These practices ultimately led to the failure of a number of companies heavily involved in making or investing in subprime loans. On April 2, 2007, New Century Financial Corporation, a leading subprime mortgage lender, filed for Chapter 11 bankruptcy. Quickly, the first signs of trouble in the housing market came to Wall Street. In June of 2007, Bear Stearns suspended redemptions from one of its funds and in July of 2007, Bear Stearns liquidated two of its hedge funds that were heavily invested in mortgage-backed securities. On August 6, a large retail mortgage lender, American Home Mortgage Investment Corporation, filed for Chapter 11 bankruptcy. In December of 2007, the Federal Reserve, after announcing several cuts to interest rates of both the federal funds rate and the primary credit rate over the previous months, announced the creation of a Term Auction Facility to address pressures in the short-term funding markets. In March of 2008, the Federal Reserve announced an additional short-term lending facility, the Term Securities Lending Facility to promote liquidity in the financial markets.[119]

On March 14, 2008, the first major shock wave spread across Wall Street when the Federal Reserve announced the bailout of Bear Stearns through an arrangement with JPMorgan Chase. Bear Stearns, whose assets were concentrated in mortgage-backed securities, faced a major liquidity crisis as it failed to find buyers for its now-toxic assets. Just days later, on March 16, JPMorgan Chase

[117] GAO, High Risk Series: An Update, GAO–09–271 (Washington, D.C.: Jan. 2009).

[118] Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, 10/16/08.

[119] Federal Reserve Bank of St. Louis, "The Financial Crisis—A Timeline of Events and Policy Actions."

agreed to buy all of Bear Stearns with assistance from the Federal Reserve.[120]

In the months that followed the crisis grew more severe. On July 11, 2008, the OTS closed IndyMac BankFSB, a large thrift saddled with nonperforming mortgages. IndyMac had relied on an "originate-to-distribute" model of mortgage lending,[121] under which it originated loans or brought them from others, and then packaged them together in securities and sold them on the secondary market to banks, thrifts, or Wall Street investment banks.[122] By securitizing and selling its loans, IndyMac could shift the risk of borrower defaults onto others. This business model led to significant deterioration in its credit and loan underwriting standards. Accordingly, , when housing prices declined and the secondary market collapsed IndyMac was left with a large number of nonperforming mortgages in its portfolio which was the primary cause of its failure.[123]

Later in July 2008, regulators and lawmakers made several moves to stabilize government-sponsored entities Fannie Mae and Freddie Mac; the Federal Reserve authorized emergency lending by the Federal Reserve Bank of New York (FRBNY) and; the Securities and Exchange Commission temporarily prohibited naked short-selling in securities; President Bush signed into law the Housing and Economic Recovery Act of 2008 which allowed the Treasury Department to purchase GSE obligations and created a new regulatory regime for the entities—the Federal Housing Finance Agency (FHFA). Ultimately, on September 7, FHFA placed both Fannie Mae and Freddie Mac into government conservatorship.[124]

September 15, 2008 saw two more icons of Wall Street collapse and ushered in a period of extraordinary government intervention to prevent a complete financial meltdown, the depths of which, according to Federal Reserve Board Chairman Ben Bernanke, "could have rivaled or surpassed the Great Depression."[125] Bank of America announced its plan to purchase Merrill Lynch, and Lehman Brothers filed for bankruptcy, unable to find a buyer. The following day, the Federal Reserve authorized the FRBNY to provide the

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[120] Ibid.

[121] In an "originate-to-distribute" model, for the most part, the originator of mortgages sells the mortgages to a person who packages the loans into securities and sells the securities to investors. By selling the mortgages, the originator thus gets more funds to make more loans. However, the ability to sell the mortgages without retaining any risk, also frees up the originator to make risky loans, even those without regard to the borrower's ability to repay. In the years leading up to the crisis, the originator was not penalized for failing to ensure that the borrower was actually qualified for the loan, and the buyer of the securitized debt had little detailed information about the underlying quality of the loans.

[122] Material Loss Review of IndyMac Bank, FSB (OIG–09–032); Office of Inspector General, U.S. Department of Treasury.

[123] "The primary causes of IndyMac's failure were largely associated with its business strategy of originating and securitizing Alt-A loans on a large scale. This strategy resulted in rapid growth and a high concentration of risky assets." *Id.* "IndyMac's aggressive growth strategy, use of Alt-A and other nontraditional loan products, insufficient underwriting, credit concentrations in residential real estate in the California and Florida markets, and heavy reliance on costly funds borrowed from the Federal Home Loan Bank (FHLB) and from brokered deposits, led to its demise when the mortgage market declined in 2007. IndyMac often made loans without verification of the borrower's income or assets, and to borrowers with poor credit histories. Appraisals obtained by IndyMac on underlying collateral were often questionable as well. As an Alt-A lender, IndyMac's business model was to offer loan products to fit the borrower's needs, using an extensive array of risky option-adjustable-rate-mortgages (option ARMs), subprime loans, 80/20 loans, and other nontraditional products. Ultimately, loans were made to many borrowers who simply could not afford to make their payments." *Id.*

[124] Federal Reserve Bank of St. Louis, "The Financial Crisis—A Timeline of Events and Policy Actions."

[125] Speech to the 43rd Annual Alexander Hamilton Awards Dinner, Center for the Study of the Presidency and Congress, Washington, D.C., 4/8/10.

American International Group with up to $85 billion of emergency lending (the FRBNY was authorized to lend an additional $37.8 billion to AIG on October 6 and later the Treasury Department would purchase $40 billion of AIG preferred shares through the TARP program). On September 17, the SEC announced a ban on short-selling of all stocks of financial sector companies. On September 21, the Federal Reserve accepted applications from investment banking companies Goldman Sachs and Morgan Stanley to become bank holding companies, allowing them access to the federal safety net. From September 12 to October 10, the Dow Jones Industrial Average dropped 26%. Major bank failures continued, with the OTS closing Washington Mutual on September 25, and facilitating its acquisition by JPMorgan Chase. Wachovia bank also faced collapse, forcing it to find a buyer; ultimately Wells Fargo purchased the bank on October 12.[126]

While Wall Street was reeling, lawmakers worked to craft an emergency measure to stabilize the markets and halt the momentum of the crisis. On September 20, Treasury Secretary Henry Paulson delivered to Capitol Hill his proposal for the Emergency Economic Stabilization Act. Nine days later, the House of Representatives voted down a modified version of the Treasury Department proposal. On that day, the Dow Jones Industrial Average fell by more than 750 points.[127] The Senate later acted to pass a further modified measure including comprehensive oversight, help for homeowners, and corporate governance requirements not included in the Treasury Department proposal. The bill was signed into law by President Bush on October 3, 2008, establishing the $700 billion Troubled Asset Relief Program (TARP).

As a result of the crisis, in addition to the losses of homes, family savings, and jobs, the government became a reluctant, but major shareholder of private banks, automobile companies, and other giants of the economy. The TARP program was enacted to provide the government with a critical tool needed to wrest the economy from a free-fall. But with the passage of TARP, the Congress granted the Treasury Department extraordinary powers and a staggering sum of taxpayer money to address a crisis that was brought on by the failures of the very banks that benefited from the program and by the government regulators that failed at their jobs. While this extent of government intervention was necessary to avert a complete collapse of the U.S. economy, our nation should never again be put in the position of having to bail out big companies.

The consequences of the crisis could not be more evident, from the failures on Wall Street to the devastation on Main Street and across the globe. Its myriad causes however, are buried in a patchwork of problems touching on almost every aspect of the financial services sector. Throughout the course of its work over the past 40 months, the Committee probed and evaluated the causes of the economic downfall in order to develop a legislative response that prevents a recurrence of the same problems and that creates a new regulatory framework that can respond to the challenges of a 21st century marketplace.

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[126] Federal Reserve Bank of St. Louis, "The Financial Crisis—A Timeline of Events and Policy Actions."

[127] Dow Jones Indexes, Index Data, *www.djaverages.com.*

Causes of the Financial Crisis

The crisis was first triggered by the downturn in the national housing market, leading to an overall housing slump. This slump brought into focus the prevalence of unsound lending practices, including predatory lending tactics, most often in the subprime market. Many of these practices, and the products that ultimately spread the risks associated with these practices, existed in what came to be known as the shadow banking system, a structure that eluded regulation and oversight despite its prevalence in the financial marketplace.

Though the market for subprime mortgages was less than 1% of global financial assets, the faults in the system allowed the turmoil in the housing market to spill over into other sectors. Faults in the system included a securitization process that fueled excessive risk taking by permitting mortgage originators to quickly sell the unsuitable loans they made, and thereby transfer the risks to someone else; credit rating agencies that gave inflated ratings to securities backed by risky mortgage loans; and the use of unregulated derivatives products based on these faulty loans that only served to spread and magnify the risk. The system operated on a wholesale misunderstanding of, or complete disregard for the risks inherent in the underlying assets and the complex instruments they were backing. Explaining the rise in complex financial products and their danger to the financial system, Eugene Ludwig testified to the Committee, "Technology, plus globalization, plus finance has created something quite new, often called 'financial technology.' Its emergence is a bit like the discovery of fire—productive and transforming when used with care, but enormously destructive when mishandled."[128]

Gaps in the regulatory structure allowed these risks and products to flourish outside the view of those responsible for overseeing the financial system. Many major market participants, such as AIG, were not subject to meaningful oversight by federal regulators. Additionally, no financial regulator was responsible for assessing the impact the failure of a single firm might have on the state of the financial system. Indeed, as the crisis grew more severe, the interconnected relationships among financial companies increased the pressure on those already struggling to survive, which only served to accelerate the downfall of some firms. For example, as AIG's position worsened, it was required to post more collateral to its counterparties and to increase its capital holdings as required by regulators.

Fueling the loss of confidence in the system was the failure of regulators and market participants to fully understand the extent of the obligations of these teetering firms, thus making an orderly shutdown of these companies nearly impossible. When Lehman Brothers declared bankruptcy, the markets panicked and the crisis escalated. With no other means to resolve large, complex and interconnected financial firms, the government was left with few options other than to provide massive assistance to prop up failing companies in an effort to prevent the crisis from spiraling into a great depression.

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[128] Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, 10/16/08.

Despite initial efforts of the government, credit markets froze and the U.S problem spread across the globe. The crisis on Wall Street soon spilled over onto Main Street, touching the lives of most Americans and devastating many.

IV. HISTORY OF THE LEGISLATION

From the beginning of the 110th Congress, the work of the Senate Committee on Banking, Housing and Urban Affairs focused on the problems in the housing market that started with the spread of predatory lending and culminated in the turmoil in the credit markets that led to the economic crisis of 2008 and 2009. This work led to the drafting and committee passage of the Restoring American Financial Stability Act in March 2010.

The Committee's first official examination of the housing crisis began with a hearing in February 2007, titled "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures" which featured testimony from representatives of the mortgage industry, consumer advocates, and victims of predatory lending. The next month, the Committee followed up with a hearing to explore problems in the mortgage market—"Mortgage Market Turmoil: Causes and Consequences." The hearing featured testimony from federal and state banking regulators as well as representatives from industry and consumers.

As the crisis evolved and leading up to Committee passage of RAFSA, the Committee held nearly 80 hearings to both examine the causes of the housing and economic crisis and assess how best to stabilize the nation's financial services industry and capital markets, while lessening the impact of the crisis on Main Street Americans. In the immediate aftermath of the collapse of Bear Stearns, the Committee held 8 hearings on the "Turmoil in the U.S. Credit Markets" and the foreclosure crisis. Upon the collapse of Lehman Brothers, the Committee held another series of hearings on the economic turmoil, including on the Bush Administration's proposed legislation that eventually became the "Emergency Economic Stabilization Act of 2008." The Committee has held a series of oversight hearings on the implementation of that Act since its passage as well as on other extraordinary measures the financial regulatory agencies have taken, including the Federal Reserve, to stabilize the economy.

Beginning in February 2009, the Committee began its first of more than 50 hearings to assess the types of reforms needed to protect the economy from another devastating financial crisis. The Committee held comprehensive hearings on how to end the abuses and loopholes that led the country into the current crisis. Hearings explored all specific elements of the financial reform legislation, as well as specific regulatory failures that contributed to the crisis.

With an eye toward drafting comprehensive legislation, the Committee held hearings on prudential bank supervision, systemic risk, ending taxpayer bailouts of companies perceived to be "too big to fail," consumer protection, derivatives regulation, investor protection, private investment pools, insurance regulation and government-sponsored entities. Throughout its examinations, the Committee took testimony from regulators, policy experts, industry representatives, and consumer advocates.

In looking at the consequences of the crisis, the Committee examined how the crisis affected sectors all across the financial services industry and the Main Street economy. Areas covered, aside from the overall state of the banking, housing and securities industries, included the impact on community banks and credit unions, manufacturing, international aspects of regulation, consumers, and the effect on homeownership.

To learn from the mistakes of the past, the Committee thoroughly examined factors that led to the crisis. These hearings began with investigations into the problems associated with subprime and predatory lending, and continued with hearings including the failure of AIG, investment fraud including the Bernard Madoff and Allen Stanford cases, the actions of credit ratings agencies, failures of regulators, problems of risk management oversight, and the role of securitization in the financial crisis.

In the spring of 2009, the Obama Administration released a set of its proposals for financial regulatory reform. On June 18, 2009, the Committee held a hearing, "The Administration's Proposal to Modernize the Financial Regulatory System," to examine the President's ideas for reforms, including testimony from Treasury Secretary Timothy Geithner. This hearing was followed by two hearings on additional proposals from the Administration in the start of 2010, titled "Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies" and "Implications of the 'Volcker Rules' for Financial Stability." These hearings included testimony from Deputy Secretary Neal S. Wolin and Presidential Economic Recovery Advisory Board Chairman and former Federal Reserve Board Chairman Paul Volcker.

On November 10, 2009, Banking Committee Chairman Christopher Dodd introduced to his colleagues a discussion draft of financial reform legislation, based on the Committee's extensive hearing record, numerous briefings and meetings, as well as the Administration's proposal. Introducing the draft, Chairman Dodd said:

> It is the job of this Congress to restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them. . . . The financial crisis exposed a financial regulatory structure that was the product of historic accident, created piece by piece over decades with little thought given to how it would function as a whole, and unable to prevent threats to our economic security. . . . I will not stand for attempts to protect a broken status quo, particularly when those attempts are made by some of the same special interests who caused this mess in the first place.

The Committee convened on November 19, 2009, to begin consideration of the Restoring American Financial Stability Act of 2009. The Committee met only to receive opening statements from members. Based on the opening statements, the Chairman decided to postpone further consideration of the legislation, pending the outcome of various bipartisan working groups the Chairman assembled to consider significant aspects of the legislation.

On March 16, 2010, following more than 80 hearings with testimony from hundreds of experts and months of negotiations with both Republicans and Democrats on the Banking Committee, Chairman Dodd unveiled the financial reform proposal that he would introduce to the Committee. One week later, on March 22, the Committee met and passed the bill by a vote of 13 to 10, as amended with a single manager's amendment. No additional amendments were offered.

V. SECTION-BY-SECTION ANALYSIS

Title I—Financial Stability

Section 101. Short title

The title may be cited as the "Financial Stability Act of 2010."

Section 102. Definitions

This section defines various terms used in the title, including "bank holding company," "member agency," "nonbank financial company," "Office of Financial Research," and "significant nonbank financial company." "Nonbank financial companies" are defined as companies substantially engaged in activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956), excluding bank holding companies and their subsidiaries. "Nonbank financial companies supervised by the Board of Governors" refer to those nonbank financial companies that the Financial Stability Oversight Council ("Council") has determined shall be supervised by the Board of Governors of the Federal Reserve System ("Board of Governors") under section 113 and subject to prudential standards authorized under this title.

This section requires the Board of Governors to establish by rulemaking the criteria for determining whether a company is substantially engaged in financial activities to qualify as a nonbank financial company. It is intended that commercial companies, such as manufacturers, retailers, and others, would not be considered to be nonbank financial companies generally, and this provision is intended to provide certainty by mandating the establishment of the criteria through the public notice and comment process required for rulemaking.

This section provides that the Board of Governors will define the term "significant bank holding company" and "significant nonbank financial company" through rulemaking. It is not intended that securities or futures exchanges regulated by the SEC and the CFTC that act as administrators of marketplaces be considered a "significant nonbank financial company," which term is used in this title with respect to counterparty exposure, to the extent the exchanges do not act as a counterparty (and thus do not create credit exposures).

This section also clarifies that with respect to foreign nonbank financial companies, references to "company" and "subsidiary" include only the United States activities and subsidiaries of such foreign companies.

Subtitle A—Financial Stability Oversight Council

Section 111. Financial Stability Oversight Council established

This section establishes the Council, consisting of the following voting members: (1) the Secretary of the Treasury, who will serve as the Chairperson ("Chairperson") of the Council, (2) the Chairman of the Board of Governors ("Board of Governors") of the Federal Reserve System, (3) the Comptroller of the Currency, (4) the Director of the Bureau of Consumer Financial Protection, (5) Director of the Federal Housing Finance Agency, (6) the Chairman of the Securities and Exchange Commission, (7) the Chairperson of the Federal Deposit Insurance Corporation ("FDIC"), (8) the Chairperson of the Commodity Futures Trading Commission, and (9) an independent member (appointed by the President, with the advice and consent of the Senate) having insurance expertise.

The Director of the Office of Financial Research (which is established under subtitle B) will serve in an advisory capacity as a nonvoting member. The Council will meet at the call of the Chairperson or majority of the members then serving, but not less frequently than quarterly. Any employee of the Federal government may be detailed to the Council, and any department or agency of the United States may provide the Council such support services the Council may determine advisable.

Section 112. Council authority

This section enumerates the purposes of the Council, which include: (1) identifying risks to the financial stability of the United States that could arise from the material financial distress or failure of large, interconnected bank holding companies or nonbank financial companies; (2) promoting market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure; and (3) responding to emerging threats to the stability of the United States financial markets.

The duties of the Council include: (1) collecting information from member agencies and other regulatory agencies, and, if necessary to assess risks to the United States financial system, directing the Office of Financial Research to collect information from bank holding companies and nonbank financial companies; (2) providing direction to, and requesting data and analyses from, the Office of Financial Research to support the work of the Council; (3) monitoring the financial services marketplace to identify threats to U.S. financial stability; (4) facilitating information sharing among the member agencies; (5) recommending to member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies; (6) identifying gaps in regulation that could pose risks to U.S. financial stability; (7) requiring supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the U.S. in the event of their material financial distress or failure; (8) making recommendations to the Board of Governors concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, inter-

connected bank holding companies supervised by the Board of Governors; (9) identifying systemically important financial market utilities and payments, clearing, and settlement system activities and subjecting them to prudential standards established by the Board of Governors; (10) making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets; (11) providing a forum for discussion and analysis of emerging market developments and financial regulatory issues, and for resolution of jurisdictional disputes among member agencies; and (12) reporting to and testifying before Congress.

The section also authorizes the Council to request and receive data from the Office of Financial Research and member agencies to carry out the provisions of this title. The Council, acting through the Office of Financial Research, may also require the submission of reports from financial companies to help assess whether a financial company, activity, or market poses a threat to U.S. financial stability. Before requiring such reports, the Council, acting through the Office of Financial Research, shall coordinate with the appropriate member agency (including the Office of National Insurance established in the Treasury Department under Title V of this Act) or primary financial regulatory agency and shall rely, whenever possible, on information already available from these agencies. In the case of a foreign nonbank financial company or a foreign-based bank holding company, it is intended that the Council, acting through the Office of Financial Research, consult to the extent appropriate with the applicable foreign regulator for the company.

Section 113. Authority to require supervision and regulation of certain nonbank financial companies

This section authorizes the Council, by a vote of not fewer than ⅔ of members then serving, including an affirmative vote by the Chairperson, to determine that a nonbank financial company will be supervised by the Board of Governors and subject to heightened prudential standards, if the Council determines that material financial distress at such company would pose a threat to the financial stability of the United States. Each determination will be based on a consideration of enumerated factors by the Council, including, among others: the degree of leverage (a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage); amount and nature of financial assets; amount and types of liabilities (which could be different types of liabilities based on, for example, their maturity, volatility, or stability), including degree of reliance on short-term funding; extent and type of off-balance-sheet exposures; extent to which assets are managed rather than owned and to which ownership of assets under management is diffuse; the operation of, or ownership interest in, any clearing, settlement, or payment business of the company; and any other risk-related factors that the Council deems appropriate. Size alone should not be dispositive in the Council's determination; in its consideration of the enumerated factors, the Council should also take into account other indicia of the overall

risk posed to U.S. financial stability, including the extent of the nonbank financial company's interconnections with other significant financial companies and the complexity of the nonbank financial company. It is not intended that a Council determination be based on the exchange functions of securities or futures exchanges regulated by the SEC and the CFTC, to the extent that as part of these functions the exchanges act as administrators of marketplaces and not as counterparties. Further, it is not intended that the activities of securities and futures exchanges overseen by the SEC and the CFTC that consist of, or occur prior to, trade execution be considered a "clearing, settlement or payment business," provided that such activities do not include functioning as a counterparty.

The Council will provide written notice to each nonbank financial company of its proposed determination and the company would have the opportunity for a hearing before the Council to contest the proposed determination. The Council will consult with the primary federal regulatory agency of each nonbank financial company or subsidiary of the company before making any final determination. The section provides for judicial review of the final determination of the Council. In case of a foreign nonbank financial company, it is intended that the Council consult to the extent appropriate with the applicable foreign regulator for the company.

Section 114. Registration of nonbank financial companies supervised by the Board of Governors

This section directs a nonbank financial company to register with the Board of Governors if a final determination is made by the Council under section 113 that such company is to be supervised by the Board of Governors.

Section 115. Enhanced supervision and prudential standards for nonbank financial companies supervised by the Board of Governors and certain bank holding companies

This section authorizes the Council to make recommendations to the Board of Governors concerning the establishment and refinement of prudential standards and reporting and disclosure requirements for nonbank financial companies supervised by the Board of Governors pursuant to a determination under section 113 and large, interconnected bank holding companies. Such standards and requirements must be more stringent than those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States, and they must increase in stringency as appropriate in relation to certain characteristics of the company, including its size and complexity. The Council may only recommend standards for bank holding companies with total consolidated assets of $50 billion or more, and the Council may recommend an asset threshold greater than $50 billion for the applicability of any particular standard. The prudential standards may include risk-based capital requirements, leverage limits, liquidity requirements, a contingent capital requirement, resolution plan and credit exposure report requirements, concentration limits, enhanced public disclosures, and overall risk management requirements.

The section enumerates the factors that the Council shall consider in making its recommendation, which include those factors considered in determining whether a nonbank financial company should be subject to supervision and prudential standards by the Board of Governors under section 113, among them the amounts and types of assets and liabilities, degree of leverage, and extent of off-balance sheet exposures. In making its recommendation, it is intended that the Council take into account the nature of the business of different types of nonbank financial companies as well as any existing regulatory regime applicable to different types of nonbank financial companies; the Committee recognizes that not all standards and requirements may be applicable universally. With respect to the contingent capital requirement, the Council shall conduct a study of the feasibility, benefits, costs, and structure of such a requirement and report to Congress not later than two years after the date of enactment of this Act.

Section 116. Reports

Under this section, the Council, acting through the Office of Financial Research, may require reports from nonbank financial companies supervised by the Board of Governors pursuant to a section 113 determination and bank holding companies with total consolidated assets of $50 billion or more and their subsidiaries, but must use existing reports to the fullest extent possible.

Section 117. Treatment of certain companies that cease to be bank holding companies

This section is intended to ensure that a bank holding company that could pose a risk to U.S. financial stability if it experienced material financial distress would remain supervised by the Board of Governors and subject to the prudential standards authorized under this title even if it sells or closes its bank. The section applies to any entity or a successor entity that (1) was a bank holding company having total consolidated assets equal to or greater than $50 billion as of January 1, 2010, and (2) received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program. If such entity ceases to be a bank holding company at any time after January 1, 2010, then the entity will be treated as a nonbank financial company supervised by the Board of Governors as if the Council had made a determination under section 113. The entity may request a hearing and appeal to the Council its treatment as a nonbank financial company supervised by the Board of Governors.

Section 118. Council funding

Any expenses of the Council will be treated as expenses of, and paid by, the Office of Financial Research. (The Council will have only one member for which it incurs salary and benefit expenses, the independent member having insurance expertise. All other members of the Council, and any employees detailed to the Council, will be paid by their respective agencies or departments.)

Section 119. Resolution of supervisory jurisdictional disputes among member agencies

This section authorizes a dispute resolution function for the Council. The Council shall resolve disputes among member agencies about the respective jurisdiction over a particular financial company, activity, or product if the agencies cannot resolve the dispute without the Council's intervention. The section prescribes the procedures for dispute resolution and makes the Council's written decision binding on the member agencies that are parties to the dispute.

Section 120. Additional standards applicable to activities or practices for financial stability purposes

This section authorizes the Council to issue recommendations to the primary financial regulatory agencies to apply new or heightened prudential standards and safeguards, including those enumerated in section 115, for a financial activity or practice conducted by bank holding companies or nonbank financial companies under the agencies' jurisdiction. The Council would make such recommendation if it determines that the conduct of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies or U.S. financial markets. The section requires the Council to consult with the primary financial regulatory agencies, provide notice and opportunity for comment on any proposed recommendations, and consider the effect of any recommendation on costs to long-term economic growth. The Council may recommend specific actions to apply to the conduct of a financial activity or practice, including limits on scope or additional capital and risk management requirements.

The Council may inform the primary financial regulatory agency of any Council determination that a bank holding company or nonbank financial company, activity, or practice no longer requires any heightened standards implemented under this title. The primary financial regulatory agency may determine whether to keep such standards in effect, and shall promulgate regulations to establish a procedure by which entities under its jurisdiction may appeal the determination of the primary financial regulatory agency.

Section 121. Mitigation of risks to financial stability

This section is intended to provide additional authority for regulators to address grave threats to U.S. financial stability if the prudential standards established under this title would not otherwise do so. The section authorizes the Board of Governors, if it determines that a nonbank financial company supervised by the Board of Governors pursuant to a determination under section 113 or a bank holding company with total consolidated assets of $50 billion or more poses a grave threat to the financial stability of the United States, to require such company to comply with conditions on the conduct of certain activities, terminate certain activities, or, if the Board of Governors determines that such action is inadequate to mitigate a threat to the financial stability of the United States, sell or transfer assets to unaffiliated entities, with an affirmative vote of 2/3 of the Council members then serving and after notice and opportunity for hearing. The Board of Governors and the Council will

take into consideration the factors set forth in section 113(a) and (b) in any determination or decision under this section.

Subtitle B—Office of Financial Research

Section 151. Definitions

Section 152. Office of Financial Research established

This section establishes within the Treasury Department the Office of Financial Research, ("Office") headed by a Director appointed by the President and confirmed by the Senate. The Director shall serve for a term of 6 years. This section provides the Director with certain authorities to manage the Office and also authorizes a fellowship program to be established.

Section 153. Purpose and duties of the Office

The purpose of the Office is to support the Council in fulfilling the purposes and duties of the Council and to support member agencies of the Council by (1) collecting data on behalf of the Council and providing such data to the Council and member agencies; (2) standardizing the types and formats of data reported and collected; (3) performing applied research and essential long-term research; (4) developing tools for risk measurement and monitoring; (5) performing other related services; (6) making the results of the activities of the Office available to financial regulatory agencies, and (7) assisting member agencies in determining the types and formats of data where member agencies are authorized by this Act to collect data. This section provides the Office with certain administrative authorities and rulemaking authority regarding data collection and standardization, requires the Director to testify annually before Congress, and authorizes the Director to provide additional reports to Congress. Testimony provided by the Director is not subject to review or approval by any other Federal agency or officer.

Section 154. Organizational structure; responsibilities of primary programmatic units

This section establishes within the Office, to carry out the programmatic responsibilities of the Office, the Data Center and the Research and Analysis Center. The Data Center shall, on behalf of the Council, collect, validate, and maintain all data necessary to carry out the duties of the Data Center. The data assembled shall be obtained from member agencies of the Council, commercial data providers, publicly available data sources, and financial entities. The Data Center shall prepare and publish a financial company reference database, financial instrument reference database, and formats and standards for Office data, but shall not publish any confidential data. The Research and Analysis Center shall, on behalf of the Council, develop and maintain independent analytical capabilities and computing resources to (1) develop and maintain metrics and reporting systems for risks to the financial stability of the United States, (2) monitor, investigate, and report on changes in system-wide risk levels and patterns to the Council and Congress, (3) conduct, coordinate, and sponsor research to support and improve regulation of financial entities and markets, (4) evaluate and report on stress tests or other stability-related evaluations of

financial entities overseen by the member agencies, (5) maintain expertise in such areas as may be necessary to support specific requests for advice and assistance from financial regulators, (6) investigate disruptions and failures in the financial markets, report findings, and make recommendations to the Council based on those findings, (7) conduct studies and provide advice on the impact of policies related to systemic risk, and (8) promote best practices for financial risk management. Not later than 2 years after the date of enactment of this Act, and not later than 120 days after the end of each fiscal year thereafter, the Office shall submit a report to Congress that assesses the state of the United States financial system, including an analysis of any threats to the financial stability of the United States, the status of the efforts of the Office in meeting the mission of the Office, and key findings from the research and analysis of the financial system by the Office.

Section 155. Funding

This section provides authority to fund the Office through assessments on nonbank financial companies supervised by the Board of Governors pursuant to a determination under section 113 and bank holding companies with total consolidated assets of $50 billion or more. The Board of Governors shall provide interim funding during the 2-year period following the date of enactment of this Act, and subsequent to the 2-year period the Secretary of Treasury shall establish by regulation, with the approval of the Council, an assessment schedule applicable to such companies that takes into account differences among such companies based on considerations for establishing the prudential standards for such companies under section 115.

Section 156. Transition oversight

The purpose of this section is to ensure that the Office has an orderly and organized startup, attracts and retains a qualified workforce, and establishes comprehensive employee training and benefits programs. The Office shall submit an annual report to the Senate Banking Committee and the House Financial Services Committee that includes a training and workforce development plan, workplace flexibilities plan, and recruitment and retention plan. The reporting requirement shall terminate 5 years after the date of enactment of the Act. Nothing in this section shall be construed to affect a collective bargaining agreement or the rights of employees under chapter 71 of title 5, United States Code.

Subtitle C—Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies

Section 161. Reports by and examination of nonbank financial companies by the Board of Governors

The Board of Governors may require reports from nonbank financial companies supervised by the Board of Governors pursuant to a determination under section 113 and any subsidiaries of such companies, and may examine them to determine the nature of the operations and financial condition of the company and its subsidiaries; the financial, operational, and other risks within the company that may pose a threat to the safety and soundness of the

company or the stability of the U.S. financial system; the systems for monitoring and controlling such risks; and compliance with the requirements of this subtitle.

To the fullest extent possible, the Board of Governors shall rely on reports and information that such companies and their subsidiaries have provided to other Federal and State regulatory agencies, and on reports of examination of functionally regulated subsidiaries made by their primary regulators (or in case of foreign nonbank financial companies, reports provided to home country supervisor to the extent appropriate).

Section 162. Enforcement

Nonbank financial companies supervised by the Board of Governors will be subject to the enforcement provisions under section 8 of the Federal Deposit Insurance Act.

If the Board of Governors determines that a depository institution or functionally regulated subsidiary does not comply with the regulations of the Board of Governors or otherwise poses a threat to the financial stability of the U.S., the Board of Governors may recommend in writing to the primary financial regulatory agency for the subsidiary that the agency initiate a supervisory action or an enforcement proceeding. If the agency does not initiate an action within 60 days, the Board of Governors may take the recommended supervisory or enforcement action.

Section 163. Acquisitions

A nonbank financial company supervised by the Board of Governors pursuant to a determination under section 113 shall be treated as a bank holding company for purposes of section 3 of the Bank Holding Company Act which governs bank acquisitions. A nonbank financial company supervised by the Board of Governors or a bank holding company with total consolidated assets of $50 billion or more shall not acquire direct or indirect ownership or control of any voting shares of a company engaged in nonbanking activities having total consolidated assets of $10 billion or more without providing advanced written notice to the Board of Governors.

In addition to other criteria under the Bank Holding Company Act for reviewing acquisitions, the Board of Governors shall consider the extent to which a proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability of the global or U.S. economy.

Section 164. Prohibition against management interlocks between certain financial holding companies

A nonbank financial company supervised by the Board of Governors pursuant to a determination under section 113 shall be treated as a bank holding company for purposes of the Depository Institutions Management Interlocks Act. It is not intended that a registered investment company sponsored by a nonbank financial company be deemed unaffiliated with its sponsor for the purpose of this section.

Section 165. Enhanced supervision and prudential standards for nonbank financial companies supervised by the Board of Governors and certain bank holding companies

This section directs the Board of Governors to establish prudential standards and reporting and disclosure requirements for nonbank financial companies supervised by the Board of Governors pursuant to a determination under section 113 and large, interconnected bank holding companies with total consolidated assets of $50 billion or more. The standards and requirements shall be more stringent than those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States, and increase in stringency as appropriate in relation to certain characteristics of the company, including its size and complexity. The Board of Governors may adopt an asset threshold greater than $50 billion for the applicability of any particular standard. The prudential standards will include risk-based capital requirements, leverage limits, liquidity requirements, a contingent capital requirement, resolution plan and credit exposure report requirements, concentration limits, enhanced public disclosures, and overall risk management requirements. The section enumerates the factors that the Board of Governors shall consider in setting the standards, which include those factors considered in determining whether a nonbank financial company should be subject to supervision and prudential standards by the Board of Governors under section 113, among them the amounts and types of assets and liabilities, degree of leverage, and extent of off-balance sheet exposures. It requires that each nonbank financial company supervised by the Board of Governors as well as bank holding company with total consolidated assets of $10 billion or more that is a publicly traded company to establish a risk committee to be responsible for oversight of enterprise-wide risk management practices of the company.

With respect to the resolution plan requirement authorized in this section, if the Board of Governors and the FDIC jointly determine that the resolution plan of a company is not credible and would not facilitate an orderly resolution under the bankruptcy code, such company would have to resubmit resolution plans to correct deficiencies. Failure to resubmit a plan correcting deficiencies within a certain timeframe would result in the imposition of more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company. If, two years after the imposition of these requirements or restrictions, the company still has not resubmitted a plan that corrects the deficiencies, the Board of Governors and the FDIC, in consultation with the Council, may direct the company to divest certain assets or operations in order to facilitate an orderly resolution under the bankruptcy code in the event of failure.

Section 166. Early remediation requirements

The Board of Governors, in consultation with the Council and the FDIC, shall by regulation establish requirements to provide for early remediation of financial distress of a nonbank financial company supervised by the Board of Governors pursuant to a determination under section 113 or a large, interconnected bank holding company with total consolidated assets of $50 billion or more. This

provision does not authorize the provision of any financial assistance from the Federal government. Instead, the purpose of this provision is to establish a series of specific remedial actions to be taken by such company if it is experiencing financial distress, in order to minimize the probability that the company will become insolvent and the potential harm of such insolvency to the financial stability of the United States. It is intended that the requirements established under this section take into account the structure and operations of, and any existing regulatory regime applicable to, different types of nonbank financial companies, including whether certain structures impose legal or structural limits on the ability of the nonbank financial company to hold capital.

Section 167. Affiliation

Nothing in this subtitle shall be construed to require a nonbank financial company supervised by the Board of Governors pursuant to a determination under section 113 or a company that controls such nonbank financial company to conform it's activities to the requirements of section 4 of the Bank Holding Company Act. If such company engages in activities that are not financial in nature, the Board of Governors may require such company to establish and conduct its financial activities in an intermediate holding company.

Section 168. Regulations

Except as otherwise specified in this subtitle, the Board of Governors shall issue final regulations to implement this subtitle no later than 18 months after the transfer date.

Section 169. Avoiding duplication

The Board of Governors shall take any action it deems appropriate to avoid imposing requirements that are duplicative of applicable requirements under other provisions of law.

Section 170. Safe harbor

The Board of Governors shall promulgate regulations on behalf of, and in consultation with, the Council setting forth the criteria for exempting certain types or classes of nonbank financial companies from supervision by the Board of Governors pursuant to a determination under section 113. It is intended that such regulations take into account potential duplication between the requirements under this title and Title VIII of this Act for financial market utilities. The Board of Governors, in consultation with the Council, shall review such regulations no less frequently than every 5 years, and based upon the review, the Board of Governors may update such regulations, and such updates will not take effect until 2 years after publication in final form. The Chairpersons of the Board of Governors and the Council shall submit a joint report to the Senate Banking Committee and the House Financial Services Committee not later than 30 days after issuing the regulations or updates, and such report shall include at a minimum the rationale for exemption and empirical evidence to support the criteria for exemption.

Title II—Orderly Liquidation Authority

Section 201. Definitions

This section defines various terms used in this title. Financial companies are defined as (1) bank holding companies, (2) nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (Board of Governors) pursuant to a determination under section 113 of this Act, (3) other companies predominantly engaged in activities that the Board of Governors has determined are financial in nature, or incidental to activities that are financial in nature, for purposes of section 4(k) of the Bank Holding Company Act of 1956, and (4) subsidiaries of any of the companies included in (1), (2), and (3) other than an insured depository institution or insurance company (but it is not intended that an investment company required to be registered under the Investment Company Act of 1940 would be deemed to be a subsidiary of a company included in (1) (2), and (3) by reason of the provision by such company of services to the investment company, unless such company (including through all of its affiliates) owns 25 percent or more of the shares of the investment company). An "insurance company" is any entity that is engaged in the business of insurance, subject to regulation by a State insurance regulator, and covered by a State law that is designed to specifically deal with the rehabilitation, liquidation, or insolvency of an insurance company. A mutual insurance holding company organized and operating under State insurance laws may be considered an insurance company for the purpose of this title. A "covered financial company" is a financial company for which a determination has been made to use the orderly liquidation authority under section 203.A "covered broker or dealer" is a covered financial company that is a broker dealer registered with the Securities and Exchange Commission ("SEC") under section 15(b) of the Securities Exchange Act of 1934 and is a member of Securities Investor Protection Corporation ("SIPC").

Section 202. Orderly Liquidation Authority Panel

This section establishes an Orderly Liquidation Authority Panel ("Panel") composed of 3 judges from the United States Bankruptcy Court for the District of Delaware. Subsequent to a determination by the Secretary of the Treasury ("Secretary") under section 203, the Secretary, upon notice to the Federal Deposit Insurance Corporation ("FDIC") and the covered financial company, shall petition the Panel for an order authorizing the Secretary to appoint the FDIC as receiver. The Panel, after notice to the covered financial company and a hearing in which the covered financial company may oppose the petition, shall determine within 24 hours of receipt of the petition whether the determination of the Secretary is supported by substantial evidence. If the Panel determines that the determination of the Secretary (1) is supported by substantial evidence, the Panel shall issue an order immediately authorizing the Secretary to appoint the Corporation as receiver of the covered financial company, and (2) is not supported by substantial evidence, the Panel shall immediately provide the Secretary with a written statement of its reasons and afford the Secretary with an opportunity to amend and refile the petition with the Panel. The decision

of the Panel may be appealed to the United States Court of Appeals not later than 30 days after the date on which the decision of the Panel is rendered, and the decision of the Court of Appeals may be appealed to the Supreme Court not later than 30 days after the date of the final decision of the Court of Appeals.

This section also requires the following studies: a study each by the Administrative Office of the United States Courts and the Comptroller General of the United States regarding the bankruptcy and orderly liquidation process for financial companies under the Bankruptcy Code, and a study by the Comptroller General of the United States regarding international coordination relating to the orderly liquidation of financial companies under the Bankruptcy Code.

Section 203. Systemic risk determination

This section establishes the process for triggering the use of the orderly liquidation authority. The process includes several steps intended to make the use of this authority very rare. There is a strong presumption that the Bankruptcy Code will continue to apply to most failing financial companies (other than insured depository institutions and insurance companies which have their own separate resolution processes), including large financial companies.

To trigger the orderly liquidation authority, the Board of Governors and the Board of Directors of the FDIC must each, by a two-thirds vote of its members then serving, provide a written recommendation to the Secretary that includes: (1) an evaluation of whether a financial company is in default or in danger of default; (2) a description of the effects that the failure of the financial company would have on financial stability in the United States; and (3) a recommendation regarding the nature and extent of actions that should be taken under this title. (The Secretary may request the Board of Governors and the FDIC to consider making the recommendation, or the Board of Governors and the FDIC may make the recommendation on their own initiative.)

In the case of a covered broker or dealer, or in which the largest U.S. subsidiary of a covered financial company is a covered broker or dealer, the SEC and the Board of Governors must each, by a two-thirds vote of its members then serving, provide a written recommendation to the Secretary as described above. (The Secretary of the Treasury may request the Board of Governors and the SEC to consider making the recommendation, or the Board of Governors and the SEC may make the recommendation on their own initiative.)

Upon receiving such recommendations, the Secretary (in consultation with the President) may make a written determination that: (1) the financial company is in default or in danger of default; (2) the failure of the financial company and its resolution under otherwise applicable law would have serious adverse effects on U.S. financial stability; (3) no viable private sector alternative is available to prevent default; (4) any effect on the claims or interests of creditors, counterparties, and shareholders as a result of actions taken under this title has been taken into account; (5) any action under section 204 would avoid or mitigate such adverse effects; and (6) a Federal regulatory agency has ordered the financial company

to convert all of its convertible debt instruments that are subject to the regulatory order. The Secretary would take into consideration the effectiveness of the action in mitigating adverse effects on the financial system, any cost to the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the covered financial company.

The Secretary shall provide written notice of the determination to Congress within 24 hours. The FDIC shall submit a report to Congress within 60 days of its appointment as receiver on the covered financial company and update the information contained in the report at least quarterly. The Government Accountability Office will review and report on the Secretary's determination.

The FDIC shall establish policies and procedures acceptable to the Secretary governing the use of funds available to the FDIC to carry out this title.

If an insurance company that is a covered financial company or subsidiary or affiliate of a covered financial company, its liquidation or rehabilitation shall be conducted as provided under state law. The FDIC shall have backup authority to file appropriate judicial action in state court to place such a company into liquidation under state law if the state regulator fails to act within 60 days.

Section 204. Orderly liquidation

This section provides a strong presumption that, in the exercise of orderly liquidation authority: (1) creditors and shareholders will bear losses, (2) management responsible for the company's financial condition are not retained, and (3) the FDIC and other agencies (where applicable) take steps to ensure that management and other parties responsible for the failed company's financial condition bear losses through actions for damages, restitution, and compensation clawbacks. The section provides that the FDIC act as receiver of the covered financial company upon appointment of the Corporation under section 202. The FDIC, as receiver, must consult with primary financial regulatory agencies of: (1) the covered financial company and its covered subsidiaries to ensure an orderly liquidation; and (2) any subsidiaries that are not covered subsidiaries to coordinate the appropriate treatment of any such solvent subsidiaries and the separate resolution of any such insolvent subsidiaries under other governmental authority, as appropriate. The FDIC shall consult with the SEC and the SIPC in the case of a covered financial company that is a broker dealer and member of SIPC. The FDIC may consult with or acquire the services of outside experts to assist in the orderly liquidation process.

The FDIC may make funds available to the receivership for the orderly liquidation of the covered financial company subject to the mandatory terms and conditions set forth in section 206 and the orderly liquidation plan described in section 210(n)(14).

Section 205. Orderly liquidation of covered brokers and dealers

This section authorizes the application of orderly liquidation authority, if necessary, to a SIPC-member broker or dealer while generally preserving SIPC's powers and duties under the Securities Investor Protection Act of 1970 ("SIPA") with respect to the liquidation of such entity. The section provides that the FDIC shall appoint SIPC, without any need for court approval, to act as trustee

for liquidation under the SIPA of a covered broker or dealer. The subsection prescribes the powers, duties, and limitation of powers of SIPC as trustee. Except as otherwise provide in this title, no court may take any action, including an action pursuant to the SIPA or the Bankruptcy Code, to restrain or affect the powers or functions of the FDIC as receiver of the covered broker or dealer.

Section 206. Mandatory terms and conditions for all orderly liquidation actions

The FDIC shall take action under this title only if it determines that such actions are necessary for financial stability and not for the purpose of preserving the covered financial company. The FDIC must also ensure that shareholders would not receive any payment until after all other claims are fully paid, that unsecured creditors bear losses in accordance with the claims priority provisions in section 210, and that management responsible for the company's failure is removed (if it has not already been removed at the time of the FDIC's appointment as receiver).

Section 207. Directors not liable for acquiescing in appointment of receiver

This section exempts the board of directors of a covered financial company from liability to the company's shareholders or creditors for acquiescing or consenting in good faith to appointment of a receiver under section 202.

Section 208. Dismissal and exclusion of other actions

This section provides that the appointment of the FDIC as receiver under section 202 for a covered financial company or the appointment of SIPC as trustee for a covered broker or dealer under section 205 shall result in the dismissal of any existing bankruptcy or insolvency case or proceeding and prevent the commencement of any such case or proceeding while the orderly liquidation is pending.

Section 209. Rulemaking; non-conflicting law

This section requires the FDIC, in consultation with the Council, to prescribe such rules or regulations as considered necessary or appropriate to implement this title. To the extent possible, the FDIC shall seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company.

Section 210. Powers and duties of the corporation

Subsection (a). Powers and authorities

This subsection defines the powers and authorities of the FDIC as receiver of a covered financial company, including its powers and duties: (1) to succeed to the rights, title, powers, and privileges of the covered financial company and its stockholders, members, officers, and directors; (2) to operate the company with all the powers of shareholders, members, directors, and officers; (3) to liquidate the company through sale of assets or transfer of assets to a bridge financial company established under subsection (h); (4) to merge the company with another company or transferring assets or liabil-

ities; (5) to pay valid obligations that come due, to the extent that funds are available; (6) to exercise subpoena powers; (7) to utilize private sector services to manage and dispose of assets; (8) to terminate rights and claims of stockholders and creditors (except for the right to payment of claims consistent with the priority of claims provision under this section); and (9) to determine and pay claims. The subsection also prescribes the FDIC's authorities to avoid fraudulent or preferential transfers of interests of the covered financial company.

Subsection (b). Priority of expenses and unsecured claims

This section defines the priority of expenses and unsecured claims against the covered financial company or the FDIC as receiver for such company. All claimants of a covered financial company that are similarly situated in the expenses and claims priority shall be treated in a similar manner except in cases where the FDIC determines that doing otherwise would maximize the value of the company's assets or maximize the present value of the proceeds (or minimize the amount of any loss) from disposing of the assets of the company. Creditors who receive more than they would otherwise receive if all similarly situated creditors were treated in a similar manner would be subject to a substantially higher assessment rate under subsection (o)(1)(E)(ii). All claimants that are similarly situated in the expenses and claims priority shall not receive less than the maximum liability amount defined in subsection (d). The section also defines the priority of expenses and unsecured claims in those cases where the FDIC is appointed receiver for a covered broker or dealer.

Subsection (c). Provisions relating to contracts entered into before appointment of receiver

This subsection authorizes the FDIC to repudiate and enforce contracts and handle the financial company's qualified financial contracts (including derivatives). A counterparty to a qualified financial contract would be stayed from terminating, liquidating, or netting the contract (solely by reason of the appointment of a receiver) until 5:00 PM on the fifth business day after the date that the FDIC was appointed receiver. (The length of the stay differs from that authorized under the Federal Deposit Insurance Act with respect to an insured depository institution. Under the Federal Deposit Insurance Act, the stay would last until 5:00 PM one business day following the date that the FDIC was appointed receiver.)

Subsection (d). Valuation of claims in default

This subsection establishes the FDIC's maximum liability for claims against the covered financial company (or FDIC as receiver) as the amount that the claimant would have received if the FDIC had not been appointed receiver with respect to the covered financial company and the company was liquidated under chapter 7 of the U.S. Bankruptcy Code or any State insolvency law. The subsection also authorizes the FDIC, as receiver and with the Secretary's approval, to make additional payments to claimants only if the FDIC determines this to be necessary to minimize losses to the FDIC as receiver from the orderly liquidation of the covered financial company. Creditors who receive such additional payments

would be subject to a substantially higher assessment rate under subsection (o)(1)(E)(ii).

Subsection (e). Limitation on court action

This subsection precludes a court from taking action to restrain or affect the powers or functions of the FDIC when it is exercising its powers as receiver, except as otherwise provided in the title.

Subsection (f). Liability of directors and officers

This subsection provides that FDIC may take actions to hold directors and officers of a covered financial company personally liable for monetary damages with respect to gross negligence.

Subsection (g). Damages

This subsection provides that recoverable damages in claims brought against directors, officers, or employees of a covered financial company for improper investment or use of company assets include principal losses and appropriate interest.

Subsection (h). Bridge financial companies

This subsection authorizes the FDIC, as receiver, to establish one or more bridge financial companies. Such bridge financial companies may assume liabilities and purchase assets of the covered financial company, and perform other temporary functions that the FDIC may prescribe.

Subsection (i). Sharing records

This subsection requires other Federal regulators to make available to the FDIC all records relating to the covered financial company.

Subsection (j). Expedited procedures for certain claims

This subsection expedites federal courts' consideration of cases brought by the FDIC against a covered financial company's directors, officers, employees, or agents.

Subsection (k). Foreign investigations

This subsection authorizes the FDIC, as receiver, to request assistance from, and provide assistance to, any foreign financial authority.

Subsection (l). Prohibition on entering secrecy agreements and protective orders

This subsection prohibits the FDIC from entering into any agreement that prohibits it from disclosing the terms of any settlement of any action brought by the FDIC as receiver of a covered financial company.

Subsection (m). Liquidation of certain covered financial companies or bridge financial companies

This subsection provides that the FDIC, as receiver, in liquidating any covered financial company or bridge financial company that is either (1) a stockbroker that is not a member of SIPC, or (2) a commodity broker, will apply the applicable liquidation provisions of the bankruptcy code pertaining to "stockbrokers" and "com-

modity brokers" (as such terms are defined in subchapters III and IV, respectively, of chapter 7 of chapter 7 of the U.S. Bankruptcy Code).

Subsection (n). Orderly Liquidation Fund

This subsection creates the Orderly Liquidation Fund ("Fund') in the Treasury Department that will be available to the FDIC to carry out the authorities in this title. The sole purpose of the Fund is to allow the FDIC to carry out the orderly liquidation of a covered financial company as authorized by this title; the Fund may not be used for any other purpose. The FDIC shall manage the Fund consistent with the policies and procedures acceptable to the Secretary of Treasury that are established under section 203(d), and invest amounts held in the Fund that are not required to meet the FDIC's current needs in obligations of the United States.

The target size of the Fund shall be $50 billion, adjusted on a periodic basis for inflation. The FDIC shall impose assessments as provided in subsection (o) to capitalize the Fund and reach the target size during an "initial capitalization period" of not less than 5 years or greater than 10 years from the date of enactment. (The FDIC, with the approval of the Secretary of the Treasury, may extend the initial capitalization period if the Fund incurs a loss from the failure of a covered financial company before the initial capitalization period expires.) Except as provided in subsection (o), FDIC shall suspend assessments when the initial capitalization period expires. The intention of this subsection and subsection (o) is to require large financial firms, rather than taxpayers, to serve as the first source of liquidity in winding down the failed financial company.

The FDIC may issue obligations to the Secretary of the Treasury. FDIC may not issue or incur any obligation that would result in total obligations outstanding that exceed the sum of (1) the amount of cash and cash equivalents held in the Fund, and (2) the amount that is equal to 90 percent of the fair value of assets from each covered financial company that are available to repay the FDIC (the "maximum obligation limitation"). It is intended that the determination of the amount available to the FDIC under (2) above be limited to what the assets of the covered financial company, calculated on a consolidated basis, can support. The FDIC and the Secretary shall jointly prescribe rules, in consultation with the Council, governing the calculation of the maximum obligation limitation.

The FDIC may issue obligations only after the cash and cash equivalents of the Fund have been drawn down to facilitate the orderly liquidation of a covered financial company.

Amounts in the Fund shall be available to the FDIC with regard to a covered financial company for which the FDIC has been appointed receiver after the FDIC has developed an orderly liquidation plan acceptable to the Secretary of the Treasury. The FDIC may amend an approved plan at any time, with the concurrence of the Secretary.

Subsection (o). Risk-based assessments

This subsection requires the FDIC to charge risk-based assessments to eligible financial companies during the initial capitaliza-

tion period until the FDIC determines that the Fund has reached the target size. Eligible financial companies include bank holding companies with total consolidated assets equal to or greater than $50 billion and nonbank financial companies supervised by the Board of Governors pursuant to a determination under section 113 of Title I.

The FDIC must charge additional risk-based assessments if: (1) the Fund falls below the target size after the initial capitalization period in order to restore the Fund to the target size over a period determined by the FDIC; (2) the FDIC is appointed receiver for a covered financial company and the Fund incurs a loss during the initial capitalization period; or (3) such assessments are necessary to pay in full obligations issued to the Secretary of the Treasury within 60 months of their issuance (unless the FDIC requests, and the Secretary approves, an extension in order to avoid as serious adverse effect on the U.S. financial system). If required, any such additional risk-based assessments shall be imposed on (1) eligible financial companies and financial companies with total assets equal to or greater than $50 billion that are not eligible financial companies, and (2) any financial company, at a substantially higher rate than would otherwise be assessed, that benefitted from the orderly liquidation under this title by receiving payments or credit pursuant to subsections (b)(4), (d)(4), and (h)(5). The subsection outlines the risk factors that the FDIC shall consider in imposing risk-based assessments to capitalize the Fund as well as any additional assessments that may be required.

The FDIC shall prescribe regulations to carry out this subsection in consultation with the Secretary and the Council, and such regulations shall take into account the differences in risks posed by different financial companies, the differences in the liability structure of financial companies, and the different bases for other assessments that such financial companies may be required to pay, to ensure that assessed financial companies are treated equitably and that assessments under this subsection reflect such differences. It is intended that the risk-based assessments may vary among different types or classes of financial companies in accordance with the risks posed to the financial stability of the United States. For instance, certain types of financial companies such as insurance companies and other financial companies that may present lower risk to U.S. financial stability (as indicated, for example, by higher capital, lower leverage, or similar measures of risk as appropriate depending on the nature of the business of the financial companies) relative to other types of financial companies should be assessed at a lower rate. Furthermore, the FDIC should consider the impact of potential assessment on the ability of certain tax-exempt entities to carry out their legally required charitable and educational missions, such as the ability of not-for-profit fraternal benefit societies to carry out their state and federally required missions to serve their members and communities.

Subsection (p). Unenforceability of certain agreements

This subsection prohibits enforceability of any term contained in any existing or future standstill, confidentiality, or other agreement that affects or restricts the ability of a person to acquire, that prohibits a person from offering to acquire, or that prohibits a per-

son from using previously disclosed information in connection with an offer to acquire, all or part of a covered financial company.

Subsection (q). Other exemptions

This subsection provides certain exemptions to the FDIC from taxes and levies when acting as a receiver for a covered financial company.

Subsection (r). Certain sales of assets prohibited

This subsection requires the FDIC to prescribe regulations prohibiting the sale of assets of a covered financial company to certain persons found to have been engaged in fraudulent activity or participated in transactions causing substantial losses to a covered financial company or who are convicted debtors.

Section 211. Miscellaneous provisions

This section makes a conforming change relating to concealment of assets from the FDIC acting as receiver for a covered financial company, and makes a conforming change to the netting provisions contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 by expanding the exceptions to include section 210(c) of this Act and section 1367 of HERA (12 U.S.C. 4617(d)).

Title III—Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

Section 301. Short title and purposes

The short title is "Enhancing Financial Institution Safety and Soundness Act of 2010." Among the purposes of the title are to provide for the safe and sound operation of the banking system; to preserve and protect the dual banking system of federal and state chartered depository institutions; and to streamline and rationalize the supervision of depository institutions and their holding companies.

Section 302. Definitions

Defines the term "transferred employee" to refer to those employees who are transferred from the Office of Thrift Supervision ("OTS") to the Office of the Comptroller of the Currency ("OCC") or the Federal Deposit Insurance Corporation ("FDIC").

Subtitle A—Transfer of Powers and Duties

Section 311. Transfer date

The "transfer date" is the date that is 1 year after the date of enactment or another date not later than 18 months if so designated by the Secretary of the Treasury. The transfer date is the date upon which various functions are transferred from the OTS to the Federal Reserve Board ("Board"), the OCC, and the FDIC. Additionally, certain functions of the Board are transferred to the OCC and FDIC. The transfer of personnel, property and funding are also keyed to the transfer date.

Section 312. Powers and duties transferred

This section transfers all functions of the OTS to the Board, the OCC, and the FDIC. It also transfers from the Board to the OCC and the FDIC, supervisory authority over the holding companies of smaller banks. And, it transfers from the Board to the FDIC, the supervision of insured state member banks.

As a result of these various transfers, the Board will regulate the larger, more complex bank and thrift holding companies—i.e., those with total consolidated assets of $50 billion or more. The OCC will retain its authority over all national banks regardless of their size and will also supervise federal thrifts. The OCC will become a holding company regulator for the smaller bank and thrift holding companies (under $50 billion) where the majority of depository institution assets are in national banks or federal thrifts. The FDIC will regulate all insured state banks regardless of their size—including those that are members of the Federal Reserve System—and all state savings associations. The FDIC will also supervise the smaller holding companies (under $50 billion) where the majority of depository institution assets are in insured state banks or state thrifts.

The Board will retain its authority to issue rules under the Bank Holding Company Act and will also have the authority to issue rules under the Home Owners Loan Act with respect to savings and loan holding companies. When issuing rules under these acts that apply to bank and thrift holding companies with less than $50 billion in assets, the Board must consult with the OCC and the FDIC. The OCC and FDIC will jointly write the rules that apply to thrifts.

This section amends the definition of "appropriate federal banking agency" in section 3(q) of the Federal Deposit Insurance Act which indicates the allocation of regulatory responsibility among the federal banking agencies by type of company—such as a national bank, a state member bank, a federal savings association. The definition is amended to reflect the new responsibilities of the Board, FDIC, and OCC. In addition to the description above, the Board will maintain its supervision of uninsured state member banks and various foreign bank-related entities.

This section also requires the OCC, Board and FDIC to issue a joint regulation specifying how the $50 billion will be calculated and at what frequency to determine the appropriate holding company regulator. In terms of the frequency of the assessment, it can be no less than 2 years, unless with respect to a particular institution there is a transaction outside the ordinary course of business, such as a merger or acquisition. In issuing the regulations, the agencies are directed to avoid disruptive transfers of regulatory authority.

Section 313. Abolishment

This section abolishes the OTS.

Section 314. Amendments to the revised statutes

This section clarifies the mission and authorities of the OCC.

Section 315. Federal information policy

This section clarifies that the OCC is an independent agency for purposes of Federal information policy.

Section 316. Savings provisions

This section preserves the existing rights, duties and obligations of the OTS, the Board, and the Federal Reserve banks that existed on the day before the transfer date. This section also preserves existing law suits by or against the OTS, the Board, and the Federal Reserve banks, but states that as of the transfer date, law suits against the OTS in connection with functions transferred to the OCC, the FDIC, or Board, are transferred to these agencies as appropriate. In addition, as of the transfer date, law suits against the Board or a Federal Reserve bank in connection with functions transferred to the OCC or the FDIC are transferred to these agencies as appropriate.

This section also continues all of the existing orders, regulations, determinations, agreements, procedures, interpretations and advisory materials of the OTS and those of the Board that relate to the Board's functions that have been transferred.

Section 317. References in Federal law to Federal banking agencies

This section provides that references in Federal law to the OTS with respect to functions that are transferred shall be deemed references to the OCC, FDIC, or Board, as appropriate. In addition, references in Federal law to the Board and the Federal Reserve banks with respect to their functions that are transferred shall be deemed references to the OCC or the FDIC, as appropriate.

Section 318. Funding

This section allows the Comptroller to collect an assessment, fee, or other charge from any entity the OCC supervises as necessary to carry out its responsibilities including with respect to holding companies, federal thrifts, and nonbank affiliates (that are not functionally regulated) that engage in bank permissible activities. The OCC's supervision of these nonbank affiliates is provided under a new section 6 of the Bank Holding Company Act of 1956 which is added in Title VI of this Act. In establishing the amount of an assessment, fee, or other charge collected from an entity, the OCC may take into account the funds transferred to the OCC (under a new arrangement with the FDIC), the nature and scope of the activities of the entity, the amount and types of assets held by the entity, the financial and managerial condition of the entity, and any other factor that the OCC deems appropriate.

This section also authorizes the FDIC to charge for its supervision of nonbank affiliates under new section 6 of the Bank Holding Company Act.

This section requires the OCC to submit to the FDIC a proposal to promote parity in the examination fees state and federal depository institutions having total consolidated assets of less than $50,000,000,000 pay for their supervision.

Currently, the FDIC and the Board do not charge state banks for their federal supervision. (These agencies share examination responsibilities with the states, and thus lower the costs to the states of supervising these entities. While the states charge for super-

vision, the FDIC and Board do not.) The FDIC pays for supervision of state banks from the Deposit Insurance Fund (DIF). Both state and federal depository institutions pay insurance premiums into the DIF. Thus, national banks and federal thrifts help defray the costs associated with the FDIC's supervision of state nonmember banks. This subsidy will only grow when the FDIC assumes the supervision of all state banks and state thrifts, as well as most of their holding companies, if the FDIC continues to rely on the DIF to fund supervision.

The funding disparity can also exacerbate regulatory arbitrage according to testimony the Committee received. The OCC must assess its banks for examination fees whereas the FDIC and the Board have other means to fund their supervision of state banks. [footnote to Ludwig's testimony, September 29, 2009] Thus promoting parity in examination fees should reduce the arbitrage in the system and the subsidy for federal supervision of state banks by national banks and federal thrifts.

Under this section, the OCC's proposal will recommend a transfer from the FDIC to the OCC of a percentage of the amount that the OCC estimates is necessary or appropriate to carry out its supervisory responsibilities of federal depository institutions having total consolidated assets of less than $50,000,000,000. The FDIC is directed to assist the OCC in collecting data relative to the supervision of State depository institutions to develop the proposal.

Not later than 60 days after receipt of the proposal, the FDIC Board must vote on the proposal and promptly implement a plan to periodically transfer to the OCC a percentage of the amount that the OCC estimates is necessary or appropriate to carry out the its supervisory responsibilities for national banks and federal thrifts having total consolidated assets of less than $50,000,000,000, as approved by the FDIC Board. Not later than 30 days after the FDIC Board's vote, the FDIC must submit to the Senate Banking Committee and House Financial Services Committee a report describing the OCC's proposal and the decision resulting from the FDIC Board's vote. If, by 2 years after the date of enactment of this Act, the FDIC Board has failed to approve a plan, the Financial Stability Oversight Council shall approve a plan using the dispute resolution procedures under section 119.

The section also requires the Board to collect assessments, fees, and charges from (1) bank holding companies and savings and loan holding companies that have total consolidated assets equal to or greater than $50 billion, and (2) all nonbank financial companies supervised by the Board under section 113 of this Act, that are equal to the total expenses incurred by the Board to carry out its responsibilities with respect to such companies. Charging holding companies for the Board's supervision will result in savings by the taxpayer.

Section 319. Contracting and leasing authority

This section clarifies the contracting and leasing authorities of the Office of the Comptroller of the Currency.

Subtitle B—Transitional Provisions

Section 321. Interim use of funds, personnel, and property

This section provides for the orderly transfer of functions (1) from the OTS to the OCC, FDIC and the Board; and (2) from the Board to the OCC and FDIC, with specific reference to funds, personnel and property.

Section 322. Transfer of employees

This section states that all employees of the OTS are transferred to OCC or the FDIC. The OTS, OCC and FDIC must jointly identify the employees necessary to carry out the duties transferred from the OTS to the OCC and the FDIC. The Board, OCC and FDIC must jointly identify the employees necessary to carry out the duties transferred from the Board (including the Federal Reserve banks) to the OCC or the FDIC.

Under this section, relevant employees are transferred within 90 days of the transfer date. The section also describes the extent to which employees' status, tenure, pay, retirement and health care benefits are protected, and describes employee protections from involuntary separation and reassignments outside locality pay area. It also provides that not later than 2 years from the transfer date, the OCC and FDIC must each place the transferred employees into the established pay and classification systems of the OCC and FDIC. In addition, this section provides that the OCC and FDIC may not take any action that would unfairly disadvantage a transferred employee relative to other OCC and FDIC employees on the basis of their prior employment by the OTS.

Section 323. Property transferred

This section provides that property of the OTS is transferred to the OCC and FDIC. The OCC, FDIC and Board, will jointly determine which property of the Board should be transferred and to which of the agencies.

Section 324. Funds transferred

This section provides that except to the extent necessary to dispose of the affairs of the OTS, all funds available to the OTS are transferred to the OCC, FDIC, or Board, in a manner commensurate with the functions that are transferred to these agencies.

Section 325. Disposition of affairs

This section describes the authority of the Director of the OTS and the Chairman of the Board during the 90 day period beginning on the transfer date, to manage employees and property that have not yet been transferred, and to take actions necessary to wind up matters relating to any function transferred to another agency.

Section 326. Continuation of services

This section states that any agency, department or instrumentality of the U.S. that was providing support services to the OTS or the Board, in connection with functions transferred to another agency, shall continue to provide such services until the transfer of functions is complete, and consult with the OCC, FDIC, or Board,

as appropriate, to coordinate and facilitate a prompt and orderly transition.

Subtitle C—Federal Deposit Insurance Corporation

Section 331. Deposit insurance reform

This section amends the Federal Deposit Insurance Act to repeal the provision that states no institution may be denied the lowest-risk category solely because of its size. This section also directs the FDIC, unless it makes a written determination discussed below, to amend its regulations to define the term "assessment base" of an insured depository institution for purposes of deposit insurance assessments as the average total assets of the insured depository institution during the assessment period, minus the sum of (1) the average tangible equity of the insured depository institution during the assessment period and (2) the average long-term unsecured debt of the insured depository institution during the assessment period.

If, not later than 1 year after the date of enactment of this Act, the FDIC submits to the Senate Banking Committee and House Financial Services Committee, in writing, a finding that such an amendment to its regulations regarding the definition of the term "assessment base" would reduce the effectiveness of the FDIC's risk-based assessment system or increase the risk of loss to the Deposit Insurance Fund, the FDIC may retain the definition of the term "assessment base", as in effect on the day before the date of enactment of this Act, or establish, by rule, a definition of the term "assessment base" that the FDIC deems appropriate.

There is concern that the new assessment base will create an additional burden on insured depository institutions that support asset growth through increased reliance on Federal Home Loan Bank advances. Based on its current risk-based assessment rate regulations, the FDIC imposes an upward adjustment on an institution's deposit insurance assessment rate if the institution has secured liabilities, including Federal Home Loan Bank advances, in excess of a certain threshold. This section would now direct the FDIC to include assets funded by secured liabilities (including Federal Home Loan Bank advances) in an institution's assessment base. Therefore, the Committee recommends that the FDIC also review and adjust its risk-based assessment rate regulations, if warranted, to ensure that the assessment appropriately reflects the risk posed by an insured depository institution as a result of the changes to the assessment base.

Section 332. Management of the Federal Deposit Insurance Corporation

This section replaces the position of the OTS on the FDIC Board of Directors with the Director of the Consumer Financial Protection Bureau.

Subtitle D—Termination of Federal Thrift Charter

Section 341. Termination of federal savings associations

This section provides that upon the date of enactment of this Act, neither the Director of the OTS nor the OCC may issue a charter for a federal savings association.[129]

While this provision would not allow the establishment of any new federal thrifts, it does not affect the state thrift charter. Nor does it impose any new limits on existing federal thrifts or their owners. It would not require the divestiture of any thrift and it protects the status of existing unitary thrift holding companies.

Section 342. Branching

This section states that a savings association that becomes a bank may continue to operate its branches.

Title IV—Private Fund Investment Advisers Registration Act of 2010

Section 401. Short title

Section 401 provides the title of the Act as the "Private Fund Investment Advisers Registration Act of 2010".

Section 402. Definitions

Section 402 defines the terms "private fund" and "foreign private adviser." "Private funds" are issuers that would be regulated investment companies, but for sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (which provide exemptions for issuers with fewer than 100 shareholders or where all shareholders are qualified purchasers).

"Foreign private advisers" are those that have no place of business in the United States; do not hold themselves out generally to the public in the United States as investment advisers; and have fewer than 15 U.S. clients with less than $25 million in assets under management.

Section 403. Elimination of private adviser exemption; limited exemption for foreign private advisers; limited intrastate exemption

Section 403 would require advisers to large hedge funds to register with the SEC, making them subject to record keeping, examination, and disclosure requirements. The rationale for the provision is that the unregulated status of large hedge funds constitutes

[129] "Congress created the federal thrift charter in the Home Owners' Loan Act of 1933 in response to the extensive failures of state-chartered thrifts and the collapse of the broader financial system during the Great Depression. The rationale for federal thrifts as a specialized class of depository institutions focused on residential mortgage lending made sense at the time but the case for such specialized institutions has weakened considerably in recent years. Moreover, over the past few decades, the powers of thrifts and banks have substantially converged.

As securitization markets for residential mortgages have grown, commercial banks have increased their appetite for mortgage lending, and the Federal Home Loan Bank System has expanded its membership base. Accordingly, the need for a special class of mortgage-focused depository institutions has fallen. Moreover, the fragility of thrifts has become readily apparent during the financial crisis. In part because thrifts are required by law to focus more of their lending on residential mortgages, thrifts were more vulnerable to the housing downturn that the United States has been experiencing since 2007. The availability of the federal thrift charter has created opportunities for private sector arbitrage of our financial regulatory system." "Financial Regulatory Reform: A New Foundation," Administration's White Paper, introduced June 17, 2009.

a serious regulatory gap. No precise data regarding the size and scope of hedge fund activities are available, but the common estimate is that the funds had about $2 trillion under management before the crisis, and that amount may be magnified by leverage. They are significant participants in many financial markets; their trades and strategies can affect prices. While hedge funds are generally not thought to have caused the current financial crisis, information regarding their size, strategies, and positions could be crucial to regulatory attempts to deal with a future crisis. The case of Long-Term Capital Management, a hedge fund that was rescued through Federal Reserve intervention in 1998 because of concerns that it was "too-interconnected-to-fail," indicates that the activities of even a single hedge fund may have systemic consequences.

Section 403 was included in the Treasury's Department's regulatory reform proposal for hedge funds.[130] Former SEC Chairman Arthur Levitt wrote in testimony for the Senate Banking Committee that he would "recommend placing hedge funds under SEC regulation in the context of their role as money managers and investment advisers."[131] Advocates such as the AFL–CIO[132], CalPERS,[133] and the Investment Adviser Association[134] also support placing hedge funds under SEC regulation via the Investment Advisers Act of 1940. Expert panels such as the Group of Thirty,[135] the G–20,[136] the Investor's Working Group,[137] and the Congressional Oversight Panel[138] also support this provision, as do industry groups such as the Alternative Investment Management Association,[139] the Private Equity Council,[140] and the Coalition of Private Investment Companies (CPIC). Mr. James Chanos, Chairman of the CPIC, testified before the Committee that "private funds (or their advisers) should be required to register with the SEC. . . . Registration will bring with it the ability of the SEC to conduct examinations and bring administrative proceedings against registered advisers, funds, and their personnel. The SEC also will have the ability to bring civil enforcement actions and to levy fines and pen-

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[130] *FACT SHEET: Administration's Regulatory Reform Agenda Moves Forward; Legislation for the Registration of Hedge Funds Delivered to Capitol Hill,* U.S. Department of the Treasury, Press Release, July 15, 2009, www.financialstability.gov.

[131] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.9 (2009) (Testimony of Mr. Arthur Levitt).

[132] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Damon Silvers).

[133] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Joseph Dear).

[134] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. David Tittsworth).

[135] *Financial Reform: A Framework for Financial Stability,* Group of Thirty, January 15, 2009.

[136] *Enhancing Sound Regulation and Strengthening Transparency,* G20 Working Group 1, March 25, 2009.

[137] *U.S. Financial Regulatory Reform: An Investor's Perspective,* Investor's Working Group, July 2009.

[138] *Special Report on Regulatory Reform,* Congressional Oversight Panel, January 2009.

[139] Alternative Investment Management Association (January 23, 2009) "AIMA Supports US Regulatory Reform Proposals", Press Release, www.aima.org.

[140] *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Testimony before the U.S. House Committee on Financial Services,* 111th Congress, 1st session (2009) (Testimony of Mr. Douglas Lowenstein).

alties for violations."[141] Former SEC Chief Accountant Lynn Turner also supported this provision in testimony.[142]

A significant number of hedge funds are already registered with the SEC, on a voluntary basis. Hedge Fund Research reports that nearly 55 percent of the hedge fund firms located in the United States are currently registered with the SEC, and that SEC-registered hedge fund firms manage nearly 71 percent of all US-based hedge fund capital.

Section 403 eliminates the exemption in section 203(b)(3) of the Investment Advisers Act of 1940 for advisers with fewer than 15 clients. Under current law, a hedge fund is counted as a single client, allowing hedge fund advisers to escape the obligation to register with the SEC. The Section adds an exemption for foreign private advisers, as defined in this Act. The Section adds a limited intrastate exemption, and an exemption for Small Business Investment Companies licensed by (or in the process of obtaining a license from) the Small Business Administration.

Section 404. Collection of systemic risk data; reports; examinations; disclosures

Section 404 authorizes the SEC to require advisers to private funds to file specific reports, which the SEC shall share with the Financial Stability Oversight Council. The filings shall describe the amount of assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies, types of assets held, and other information that the SEC, in consultation with the Council, determines is necessary and appropriate to protect investors or assess systemic risk. Reporting requirements may be tailored to the type or size of the private fund. Frequency of reporting is at the SEC's discretion.

Paul Schott Stevens, President of the Investment Company Institute, testified before the Committee that "the Capital Markets Regulator should require nonpublic reporting of information, such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants."[143] Richard Ketchum, Chairman of FINRA, said "The absence of transparency about hedge funds and their investment positions is a concern."[144] Hedge fund industry groups also support this provision, including

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[141] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.17 (2009) (Testimony of Mr. James Chanos).

[142] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Lynn Turner).

[143] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.12 (2009) (Testimony of Mr. Paul Schott Stevens).

[144] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.5 (2009) (Testimony of Mr. Richard Ketchum).

the Managed Funds Association,[145] the Coalition of Private Investment Companies,[146] and the Private Equity Council.[147]

Section 404 requires the SEC to make available to the Financial Stability Oversight Council any private fund records it receives that the Council considers necessary to assess the systemic risk posed by a private fund. These records must be kept confidential: the Council must observe the same standards of confidentiality that apply to the SEC. Private fund records, including those containing proprietary information, are not subject to disclosure pursuant to the Freedom of Information Act.

This section also directs the SEC to report annually to Congress on how it has used information collected from private funds to monitor markets for the protection of investors and market integrity.

Section 405. Disclosure provision eliminated

Section 405 authorizes the SEC to require investment advisers to disclose the identity, investments, or affairs of any client, if necessary to assess potential systemic risk.

Section 406. Clarification of rulemaking authority

Section 406 clarifies the SEC's authority to define technical, trade, and other terms used in the title, except that the SEC may not define "client" to mean investors in a fund, rather than the fund itself, for purposes of Section 206 (1) and (2) of the Advisers Act, which governs fraud. The clarification avoids potential conflicts between the fiduciary duty an adviser owes to a private fund and to the individual investors in the fund (if those investors are defined as clients of the adviser). Actions in the best interest of the fund may not always be in the best interests of each individual investor. The section also directs the SEC and CFTC to jointly promulgate rules regarding the form and content of reporting by firms that are registered with both agencies.

Section 407. Exemptions of venture capital fund advisers

The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone. Terry McGuire, Chairman of the National Venture Capital Association, wrote in congressional testimony that "venture capital did not contribute to the implosion that occurred in the financial system in

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[145] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Mr. Richard Baker).

[146] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session (2009) (Testimony of Mr. James Chanos).

[147] *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session (2009) (Testimony of Mr. Douglas Lowenstein).

the last year, nor does it pose a future systemic risk to our world financial markets or retail investors."[148] Section 407 directs the SEC to define "venture capital fund" and provides that no investment adviser shall become subject to registration requirements for providing investment advice to a venture capital fund.

Section 408. Exemption of and record keeping by private equity fund advisers

The Committee believes that private equity funds characterized by long-term equity investments in operating businesses do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Private equity investments are characterized by long-term commitments of equity capital—investors generally do not have redemption rights that could force the funds into disorderly liquidations of their positions. Private equity funds use limited or no leverage at the fund level, which means that their activities do not pose risks to the wider markets through credit or counterparty relationships. Accordingly, Section 408 directs the SEC to define "private equity fund" and provides an exemption from registration for advisers to private equity funds.

Informed observers believe that in some cases the line between hedge funds and private equity may not be clear, and that the activities of the two types of funds may overlap. We expect the SEC to define the term "private equity fund" in a way to exclude firms that call themselves "private equity" but engage in activities that either raise significant potential systemic risk concerns or are more characteristic of traditional hedge funds. The section requires advisers to private equity funds to maintain such records, and provide to the SEC such annual or other reports, as the SEC determines necessary and appropriate in the public interest and for the protection of investors.

Section 409. Family offices

Family offices provide investment advice in the course of managing the investments and financial affairs of one or more generations of a single family. Since the enactment of the Investment Advisers Act of 1940, the SEC has issued orders to family offices declaring that those family offices are not investment advisers within the intent of the Act (and thus not subject to the registration and other requirements of the Act). The Committee believes that family offices are not investment advisers intended to be subject to registration under the Advisers Act. The Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved. Accordingly, Section 409 directs the SEC to define "family office" and excludes family offices from the definition of investment adviser Section 202(a)(11) of the Advisers Act.

Section 409 directs the SEC to adopt rules of general applicability defining "family offices" for purposes of the exemption. The rules shall provide for an exemption that is consistent with the

[148] *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, p.15 (2009) (Testimony of Mr. Terry McGuire).

SEC's previous exemptive policy and that takes into account the range of organizational and employment structures employed by family offices. The Committee recognizes that many family offices have become professional in nature and may have officers, directors, and employees who are not family members, and who may be employed by the family office itself or by an affiliated entity. Such persons (and other persons who may provide services to the family office) may co-invest with family members, enabling them to share in the profits of investments they oversee, and better aligning the interests of such persons with those of the family members served by the family office. The Committee expects that such arrangements would not automatically exclude a family office from the definition.

Section 410. State and federal responsibilities; asset threshold for federal registration of investment advisers

Section 410 increases the asset threshold above which investment advisers must register with the SEC from $25,000,000 to $100,000,000. States will have responsibility for regulating advisers with less than $100,000,000 in assets under management. The Committee expects that the SEC, by concentrating its examination and enforcement resources on the largest investment advisers, will improve its record in uncovering major cases of investment fraud, and that the States will provide more effective surveillance of smaller funds. In a letter to Chairman Dodd and Ranking Member Shelby, the North American Securities Administrators Association stated that "State securities regulators are ready to accept the increased responsibility for the oversight of investment advisers with up to $100 million in assets under management. The state system of investment adviser regulation has worked well with the $25 million threshold since it was mandated in 1996 and states have developed an effective regulatory structure and enhanced technology to oversee investment advisers. . . . An increase in the threshold would allow the SEC to focus on larger investment advisers while the smaller advisers would continue to be subject to strong state regulation and oversight." [149]

In a letter to Senate Banking Committee staff in October 2009, Professor Mercer Bullard stated, "I support the $100 million threshold. This merely restores the distribution of advisers between the SEC and states that existed at the time they were split by [the National Securities Markets Improvement Act]."

Section 411. Custody of client assets

Section 411 requires registered investment advisers to comply with SEC rules for the safeguarding of client assets and to use independent public accountants to verify assets. The SEC has recently adopted new rules imposing heightened standards for custody of client assets. Mr. James Chanos, Chairman of the Coalition of Private Investment Companies, wrote in testimony for the Committee that "Any new private fund legislation should include provisions to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, and

[149] North American Securities Administrators Association, letter to Chairman Dodd and Ranking Member Shelby, November 17, 2009.

by requiring investment funds to be audited by independent public accounting firms that are overseen by the PCAOB."[150]

Professor John Coffee wrote in testimony for the Senate Banking Committee that "the custodian requirement largely removes the ability of an investment adviser to pay the proceeds invested by new investors to old investors. The custodian will take the instructions to buy or sell securities, but not to remit the proceeds of sales to the adviser or to others (except in return for share redemptions by investors). At a stroke, this requirement eliminates the ability of the manager to recycle' funds from new to old investors."[151] SEC Inspector General H. David Kotz also supports this provision.[152]

Section 412. Adjusting the accredited investor standard for inflation

Accredited investor status, defined in SEC regulations under the Securities Act of 1933, is required to invest in hedge funds and other private securities offerings. Accredited investors are presumed to be sophisticated, and not in need of the investor protections afforded by the registration and disclosure requirements that apply to public offerings. For individuals, the accredited investor thresholds are dollar amounts for annual income ($200,000 or $300,000 for an individual and spouse) and net worth ($1 million, which may include the value of a person's primary residence). These amounts have not been adjusted since 1982; some observers believe that because of inflation and real estate price appreciation many individuals who now meet the accredited investor standard may lack the degree of financial expertise that was implied by the thresholds when they were established nearly three decades ago. The North American Securities Administrators Association wrote in a 2007 comment letter to the SEC that "NASAA has long advocated for adjusting the definition of accredited investor' in light of inflation and has expressed concern at the length of time the thresholds contained in the definition have not been adjusted . . . [I]nflation has seriously eroded the efficacy of the existing thresholds in the definition of accredited investor' since their adoption in 1982. NASAA further supports an inflation adjustment every five years."[153]

Section 412 requires the SEC to increase the dollar thresholds for accredited investor status, to take into account price inflation since the current figures were established. The Section also directs the SEC to adjust those figures at least every five years to reflect the percentage increase in the cost of living. This provision is intended to increase investor protection by limiting participation in private securities offerings to investors who are capable of evaluating the risks of such offerings.

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[150] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p. 18 (2009) (Testimony of Mr. James Chanos).

[151] *Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, pp. 8,10 (2009) (Testimony of Professor John Coffee).

[152] SEC Inspector General H. David Kotz, letter to Senator Dodd, October 29, 2009.

[153] North American Securities Administrators Association, comment letter in response to SEC proposed rule *Revisions of Limited Offering Exemptions in Regulation D, Release No. 33 8828; IC–27922; File No. S7–18–07*, October 26, 2007.

Section 413. GAO study and report on accredited investors

Section 413 directs the GAO to submit a report on the appropriate criteria for accredited investor status and eligibility to invest in private funds. The goal of the exemptions for accredited investors is to identify a category of investors who have sufficient knowledge and expertise to fend for themselves in making investment decisions. Currently, this category is identified by salary or wealth. However, we recognize that these are imperfect standards. For example, a person's wealth may include a valuable primary residence but little liquid cash, or a wealthy person may be a widow or widower with a large inheritance, but little investment expertise. Accordingly, we ask the GAO to determine whether other measures would be more appropriate.

Section 414. GAO study on self-regulatory organization for private funds

Section 414 directs the GAO to study the feasibility of creating a self-regulatory organization to oversee private funds—which can include hedge funds, private equity funds, and venture capital funds.

Section 415. Commission study and report on short selling

Section 415 directs the Office of Risk, Strategy, and Financial Innovation of the SEC to conduct a study on the current state of short selling, the impact of recent SEC rules, the recent incidence of failures to deliver, the practice of delivering shares sold short on the fourth day following the trade, and consideration of real time reporting of short positions.

Section 416. Transition period

Section 416 provides that the title becomes effective one year after the date of enactment of this Act, but advisers to private funds may voluntarily register with the SEC during that 1-year period.

Title V—Insurance

Subtitle A—Office of National Insurance

Section 501. Short title

Section 502. Establishment of Office of National Insurance

This section establishes the Office of National Insurance ("Office") within the Department of the Treasury. The Office, to be headed by a career Senior Executive Service Director appointed by the Secretary of the Treasury ("Secretary"), will have the authority to: (1) monitor all aspects of the insurance industry; (2) recommend to the Financial Stability Oversight Council ("Council") that the Council designate an insurer, including its affiliates, as an entity subject to regulation by the Board of Governors as a nonbank financial company as defined in Title I of the Restoring American Financial Stability Act; (3) assist the Secretary in administering the Terrorism Risk Insurance Program; (4) coordinate Federal efforts and establish Federal policy on prudential aspects of international insurance matters; (5) determine whether State insurance meas-

ures are preempted by International Insurance Agreements on Prudential Measures; and (6) consult with the States regarding insurance matters of national importance and prudential insurance matters of international importance. The authority of the Office extends to all lines of insurance except health insurance and crop insurance.

In carrying out its functions, the Office may collect data and information on the insurance industry and insurers, as well as issue reports. It may require an insurer or an affiliate to submit data or information reasonably required to carry out functions of the Office, although the Office may establish an exception to data submission requirements for insurers meeting a minimum size threshold. Before collecting any data or information directly from an insurer, the Office must first coordinate with each relevant State insurance regulator (or other relevant Federal or State regulatory agency, in the case of an affiliate) to determine whether the information is available from such State insurance regulator or other regulatory agency. The Office will have power to require by subpoena that an insurer produce the data or information requested, but only upon a written finding by the Director that the data or information is required to carry out its functions and that it has coordinated with relevant regulator or agency as required. The subpoena authority is intended to be an option of last resort that would very rarely be used, since it is expected that the relevant regulator or agency and the insurers would cooperate with reasonable requests for data or information by the Office. Any non-publicly available data and information submitted to the Office will be subject to confidentiality provisions: privileges are not waived; any requirements regarding privacy or confidentiality will continue to apply; and information contained in examination reports will be considered subject to the applicable exemption under the Freedom of Information Act for this type of information.

The Director will determine whether a State insurance measure is preempted because it: (a) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to an International Insurance Agreement on Prudential Measures than a United States insurer domiciled, licensed, or otherwise admitted in that State and (b) is inconsistent with an International Insurance Agreement on Prudential Measures. However, the savings clause provides that nothing in this section preempts any State insurance measure that governs any insurer's rates, premiums, underwriting or sales practices, State coverage requirements for insurance, application of State antitrust laws to the business of insurance, or any State insurance measure governing the capital or solvency of an insurer (except to the extent such measure results in less favorable treatment of a non-United States insurer than a United States insurer). The savings clause is intended to shield these important State consumer protection measures from preemption.

An "International Insurance Agreement on Prudential Measures" is defined as a written bilateral or multilateral agreement entered into between the United States and a foreign government, authority, or regulatory entity regarding prudential measures applicable to the business of insurance or reinsurance. Before making a determination of inconsistency, the Director will notify and consult with

the appropriate State, publish a notice in the Federal Register, and give interested parties the opportunity to submit comments. Upon making the determination, the Director will notify the appropriate State and Congress, and establish a reasonable period of time before the preemption will become effective. At the conclusion of that period, if the basis for the determination still exists, the Director will publish a notice in the Federal Register that the preemption has become effective and notify the appropriate State.

The Director will consult with State insurance regulators, to the extent the Director determines appropriate, in carrying out the functions of the Office. The Director may also consult on insurance matters with Indian Tribes (as defined in Section 4(e) of the Indian Self-Determination and Education Assistance Act, as amended (25 U.S.C. 450b(e))) regarding insurance entities wholly owned by Indian Tribes. Nothing in this section will be construed to give the Office or the Treasury Department general supervisory or regulatory authority over the business of insurance.

The Director must submit a report to the President and to Congress by September 30th of each year on the insurance industry and any actions taken by the Office regarding preemption of inconsistent State insurance measures.

The Director must also conduct a study and submit a report to Congress within 18 months of the enactment of this section on how to modernize and improve the system of insurance regulation in the United States. The study and report must be guided by the following six considerations: (1) systemic risk regulation with respect to insurance; (2) capital standards and the relationship between capital allocation and liabilities; (3) consumer protection for insurance products and practices; (4) degree of national uniformity of state insurance regulation; (5) regulation of insurance companies and affiliates on a consolidated basis; and (6) international coordination of insurance regulation. The study and report must also examine additional factors as set forth in this section.

This section also authorizes the Secretary of the Treasury to negotiate and enter into International Insurance Agreements on Prudential Measures on behalf of the United States. However, nothing in this section will be construed to affect the development and coordination of the United States international trade policy or the administration of the United States trade agreements program. The Secretary will consult with the United States Trade Representative on the negotiation of International Insurance Agreements on Prudential Measures, including prior to initiating and concluding any such agreements.

Subtitle B—State-Based Insurance Reform

Section 511. Short title

This subtitle may be cited as the "Nonadmitted and Reinsurance Reform Act of 2009".

Section 512. Effective date

Part I—Nonadmitted Insurance

Sec. 521. Reporting, payment, and allocation of premium taxes

Gives the home State of the insured (policyholder) sole regulatory authority over the collection and allocation of premium tax obligations related to nonadmitted insurance (also known as surplus lines insurance). States are authorized to enter into a compact or other agreement to establish uniform allocation and remittance procedures. Insured's home State may require surplus lines brokers and insureds to file tax allocation reports detailing portion of premiums attributable to properties, risks, or exposures located in each state.

Sec. 522. Regulation of nonadmitted insurance by insured's home state

Unless otherwise provided, insured's home State has sole regulatory authority over nonadmitted insurance, including broker licensing.

Sec. 523. Participation in national producer database

State may not collect fees relating to licensing of nonadmitted brokers unless the State participates in the national insurance producer database of the National Association of Insurance Commissioners (NAIC) within 2 years of enactment of this subtitle.

Sec. 524. Uniform standards for surplus lines eligibility

Streamlines eligibility requirements for nonadmitted insurance providers with the eligibility requirements set forth in the NAIC's Nonadmitted Insurance Model Act.

Sec. 525. Streamlined application for commercial purchasers

Allows exempt commercial purchasers, as defined in section 527, easier access to the non-admitted marketplace by waiving certain requirements.

Sec. 526. GAO study of nonadmitted insurance market

The Comptroller General shall conduct a study of the nonadmitted insurance market to determine the effect of the enactment of this part on the size and market share of the nonadmitted market. The Comptroller General shall consult with the NAIC and produce this report within 30 months after the effective date.

Sec. 527. Definitions

Among others, defines Exempt Commercial Purchasers and details the qualifications necessary to qualify as such for the purposes of section 525.

Part II—Reinsurance

Sec. 531. Regulation of credit for reinsurance and reinsurance agreements

Prohibits non-domiciliary States from denying credit for reinsurance if the State of domicile of a ceding insurer is an NAIC-accredited State or has solvency requirements substantially similar to

those required for NAIC accreditation. Prohibits non-domiciliary States from restricting or eliminating the rights of reinsurers to resolve disputes pursuant to contractual arbitration clauses, prohibits non-domiciliary States from ignoring or eliminating contractual agreements on choice of law determinations, and prohibits non-domiciliary States from enforcing reinsurance contracts on terms different from those set forth in the reinsurance contract.

Sec. 532. Solvency regulation

State of domicile of the reinsurer is solely responsible for regulating the financial solvency of the reinsurer. Non-domiciliary States may not require reinsurer to provide any additional financial information other than the information required by State of domicile. Non-domiciliary States are required to be provided with copies of the financial information that is required to be filed with the State of domicile.

Sec. 533. Definitions

Among others, defines a reinsurer and clarifies how an insurer could be determined as a reinsurer under the laws of the state of domicile.

Part III—Rule of Construction

Sec. 541. Rule of construction

Clarifies that this subtitle will not modify, impair, or supersede the application of antitrust laws, confirms that any potential conflict between this subtitle and the antitrust laws will be resolved in favor of the operation of the antitrust laws.

Sec. 542. Severability

States that if any section, subsection, or application of this subtitle is held to be unconstitutional, the remainder of the subtitle shall not be affected.

Title VI—Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2009

Section 601. Short title

The short title of this section is the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010."

Section 602. Definitions

This section defines the term "commercial firm" as any entity that derives not less than 15 percent of the consolidated annual gross revenues of the entity, including all affiliates of the entity, from engaging in activities that are not financial in nature or incidental to activities that are financial in nature, as provided in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).

Section 603. Moratorium and study on treatment of credit card banks, industrial loan companies, trust banks and certain other companies as bank holding companies under the Bank Holding Company Act

This section imposes a three-year moratorium on the ability of the Federal Deposit Insurance Corporation to approve a new application for deposit insurance for an industrial loan company, credit card bank, or trust bank that is owned or controlled by a commercial firm. During this period, the appropriate Federal banking agency may not approve a change in control of an industrial bank, a credit card bank, or a trust bank if the change in control would result in direct or indirect control of the industrial bank, credit card bank, or trust bank by a commercial firm, unless the bank is in danger of default, or unless the change in control results from the merger or whole acquisition of a commercial firm that directly or indirectly controls the industrial bank, credit card bank, or trust bank in a bona fide merger with or acquisition by another commercial firm.

In addition, this section provides that within 18 months of enactment of this Act, the Comptroller General must submit a report to Congress analyzing whether it is necessary to eliminate the exceptions in the Bank Holding Company Act of 1956 (BHCA) for credit card banks, industrial loan companies, trust banks, thrifts, and certain other companies, in order to strengthen the safety and soundness of these institutions or the stability of the financial system.

The Treasury Department's legislative proposal for financial reform includes a provision that would have eliminated the exceptions in the BHCA for credit card banks, industrial loan companies, trust banks and certain other limited purpose banks.[154] Under this proposal, firms owning such companies, including commercial firms, would have been subject to regulation as bank holding companies. As a consequence, these firms would have been required to divest of certain financial businesses in accordance with BHCA activity limitations, and would have been subject to new capital requirements. The Committee is seeking additional information through the GAO to determine whether this new supervisory regime should be applied to firms that own credit card banks, industrial loan companies, trust banks, or other limited purpose banks.

Section 604. Reports and examinations of bank holding companies; regulation of functionally regulated subsidiaries

This section removes limitations on the ability of the appropriate Federal banking agency (AFBA) for a bank or savings and loan holding company to obtain reports from, examine, and regulate all subsidiaries of the holding company. The Committee agrees with testimony provided by Governor Daniel K. Tarullo, on behalf of the Board of Governors of the Federal Reserve System (Federal Reserve) "that to be fully effective, consolidated supervisors need the information and ability to identify and address risk throughout an

[154] *FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD; Legislation for Strengthening Investor Protection Delivered to Capitol Hill*, U.S. Department of the Treasury, Press Release, July 10, 2009, www.financialstability.gov.

organization."[155] For this reason, this section removes the so-called Fed-lite provisions of the Gramm-Leach-Bliley Act that placed limitations on the ability of the Federal Reserve to examine, obtain reports from, or take actions to identify or address risks with respect to subsidiaries of a bank holding company that are supervised by other agencies. However, this section also requires the AFBA for the holding company to coordinate with other Federal and state regulators of subsidiaries of the holding company, to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information.

While the Committee supports consolidated regulation, it also supports coordinated regulation. Accordingly, section 604(b) requires the AFBA for a bank holding company to give prior notice to, and to consult with, the primary regulator of a subsidiary before commencing an examination of that subsidiary. The section contains an identical requirement with respect to the examination by the AFBA for a savings and loan holding company of a subsidiary of a savings and loan holding company. Other provisions in section 604 specifically require the holding company regulator to rely "to the fullest extent possible" on reports and supervisory information that are available from sources other than the subsidiary itself, including information that is "otherwise available" from other Federal or State regulators of the subsidiary. These provisions effectively require that the holding company regulator provide notice to and consult with the primary regulator, *e.g.*, the appropriate Federal banking agency for a depository institution, to identify the information it wants and ascertain whether that information already is available from the primary regulator. In addition, section 604 specifically requires the AFBA for the holding company to coordinate with other Federal and state regulators of subsidiaries of the holding company, "to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information."

This section also requires the AFBA for the holding company to consider risks to the stability of the United States banking or financial system when reviewing bank holding company proposals to engage in mergers, acquisitions, or nonbank activities or financial holding company proposals to engage in activities that are financial in nature. A financial holding company also may not engage in certain activities that are financial in nature without the approval of the AFBA for the holding company if they involve the acquisition of assets that exceed $25 billion.

In addition, the section amends the Home Owners' Loan Act to clarify the authority of the AFBA of a savings and loan holding company to examine and require reports from the savings and loan holding company and all of its subsidiaries. It also directs the AFBA to coordinate its supervisory activities with other Federal and state regulators of the holding company subsidiaries.

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[155] *Strengthening and Streamlining Prudential Bank Supervision—Part I: Testimony of Daniel K. Tarullo, Member Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 2nd session, p.13 (August 4, 2009).

Section 605. Assuring consistent oversight of permissible activities of depository institution subsidiaries of holding companies

This section requires the "lead Federal banking agency" for each depository institution holding company to examine the bank permissible activities of each non-depository institution subsidiary (other than a functionally regulated subsidiary) of the depository institution holding company to determine whether the activities present safety and soundness risks to any depository institution subsidiary of the holding company. For purposes of this section, "lead Federal banking agency" is defined as (1) the Office of the Comptroller of the Currency for holding companies with Federally-chartered depository institution subsidiaries, or where total consolidated assets in its Federally-chartered depository institution subsidiaries exceed those in its State-chartered depository institution subsidiaries or (2) the Federal Deposit Insurance Corporation for holding companies with state-chartered depository institution subsidiaries, or where total consolidated assets in its state-chartered depository institution subsidiaries exceed those in its Federally-chartered depository institution subsidiaries. The "lead Federal banking agency" can recommend that the Federal Reserve take enforcement action against a non-depository subsidiary where the Board is the holding company regulator. If the Federal Reserve does not take enforcement action within 60-days of receiving the recommendation, the "lead Federal banking agency" may take enforcement action against the non-depository institution.

This provision addresses the problem of the uneven supervisory standards under today's regulatory regime, applicable to depository and non-depository subsidiaries holding companies, highlighted by John C. Dugan, Comptroller of the Currency, in his testimony before the Committee. Changes made by this section are consistent with the recommendation of Comptroller Dugan that where subsidiaries are engaged in the same business as is conducted, or could be conducted, by an affiliated bank mortgage or other consumer lending, for example the prudential supervisor already has the resources and expertise needed to examine the activity. Affiliated companies would then be made subject to the same standards and examined with the same frequency as the affiliated bank. This approach also would ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.[156]

Section 606. Requirements for financial holding companies to remain well capitalized and well managed

This section amends the BHCA to require all financial holding companies engaging in expanded financial activities to remain well capitalized and well managed.

Section 607. Standards for interstate acquisitions and mergers

This section raises the capital and management standards for bank holding companies engaging in interstate bank acquisitions by requiring them to be well capitalized and well managed. In ad-

[156] *Strengthening and Streamlining Prudential Bank Supervision—Part I: Testimony of John C. Dugan, Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 2nd session, p.17 (August 4, 2009).

dition, interstate mergers of banks will only be permitted if the resulting bank is well capitalized and well managed.

Section 608. Enhancing existing restrictions on bank transactions with affiliates

This section amends section 23A of the Federal Reserve Act by, among other things, defining an investment fund, for which a member bank is an investment adviser, as an affiliate of the member bank.

It also adds credit exposure from a securities borrowing or lending transaction or derivative transaction to the list of inter-affiliate "covered transactions" in section 23A. The Federal Reserve is provided the discretion to define "credit exposure." In addition, the Federal Reserve may issue regulations or interpretations with respect to the manner in which a netting agreement may be taken into account in determining the amount of a covered transaction between a member bank or a subsidiary and an affiliate, including the extent to which netting agreements between a member bank or a subsidiary and an affiliate may be taken into account in determining whether a covered transaction is fully secured for purposes of subsection (d)(4) of section 23A.

This provision represents a second attempt by Congress to address the credit exposure to banks from affiliate derivative transactions. Section 121 of the Gramm-Leach-Bliley Act provided that "not later than 18 months after November 12, 1999, the Federal Reserve shall adopt final rules under this section [23A of the Federal Reserve Act] to address as covered transactions credit exposure arising out of derivative transactions between member banks and their affiliates."[157] In 2002, the Federal Reserve announced that it "expects to issue, in the near future, a proposed rule that would invite public comment on how to treat as covered transactions under section 23A certain derivative transactions that are the functional equivalent of a loan by a member bank to an affiliate or the functional equivalent of an asset purchase by a member bank from an affiliate."[158] However, the proposed rule was not issued.

The bank regulatory framework must address bank credit exposure to affiliates from derivative transactions to limit a bank's exposure to loss in the event of the failure of an affiliate. Over the last two years, the Committee has heard testimony regarding the damage to the U.S. economy caused by derivatives. Inter-affiliate derivative transactions are a major source of intra-firm complexity among the largest depository institutions. Moreover, tight limits on traditional credit exposures of banks to affiliates, such as loans, and no limits on nontraditional credit exposures of banks to affiliates, such as derivatives, have created a perverse incentive for banks to engage with their affiliates in these more complex, volatile and opaque transaction forms.

Placing limits on derivative transactions will result in greater transparency and disclosure of derivative transactions between banks and their affiliates, a reduction in the volume of internal

[157] Pub. L. 106–102, Title I, section 121(b), 113 Stat. 1378 (November 12, 1999).
[158] 69 Fed Reg. 239 (December 12, 2002).

risk-shifting transactions, and in the simplification of the internal structures of our major financial firms.

Section 609. Eliminating exceptions for transactions with financial subsidiaries

This section amends section 23A of the Federal Reserve Act by eliminating the special treatment for transactions with financial subsidiaries.

Section 610. Lending limits applicable to credit exposure on derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions

This section tightens national bank lending limits by treating credit exposures on derivatives, repurchase agreements, and reverse repurchase agreements as extensions of credit for the purposes of national bank lending limits. Accordingly, banks must take into account these exposures for purposes of the affiliate transaction limitations described in section 608, the insider transaction limits described in section 614, but also for purposes of lending limits that apply to non-affiliated third parties.

Section 611. Application of national bank lending limits to insured state banks

This section requires all insured depository institutions to comply with national bank lending limits. This legislation applies national bank lending limits to insured state banks for several reasons. First, lending limits restrict the percentage of a bank's capital that can be loaned to a single borrower and are one of the core safety and soundness laws applicable to bank operations. In almost all similar areas involving safety and soundness (capital adequacy, affiliate transaction limits, limits on loans to executive officers, and limits on loans to insiders) there is a uniform Federal standard that applies to all insured depository institutions. It is the view of the Committee that, as a matter of good public policy, banks should be subject to a uniform Federal standard with respect to lending limits, and should not compete on the basis of differences in safety and soundness regulation. A second reason relates to section 610 of the legislation that requires exposure from derivatives transactions to be included in Federal lending limits. State bank lending limits typically do not address derivatives. This section addresses the Committee's concern that if uniform restrictions in this area do not apply across the banking sector, risky derivative activities could migrate to state banks, or national banks may seek state charters to escape from regulation in this area. This section includes a 2-year transition period to ensure that state banks have adequate time to implement these new limits.

Section 612. Restriction on conversions of troubled banks and savings associations

This section prohibits conversions from a national bank charter to a state bank or savings association charter or vice versa during any time in which a bank or savings association is subject to a cease and desist order, other formal enforcement action, or memorandum of understanding. It also prohibits the conversion of a fed-

eral savings association to a national or state bank or state savings association under these circumstances.

As Governor Daniel K. Tarullo noted in his testimony to the Committee, on behalf of the Federal Reserve, "while institutions may engage in charter conversions for a variety of sound business reasons, conversions that are motivated by a hope of escaping current or prospective supervisory actions by the institution's existing supervisor undermine the efficacy of the prudential supervisory framework."[159] The Federal Financial Institutions Examination Council (FFIEC) recently issued a Statement on Regulatory Conversions declaring that supervisors will only consider applications undertaken for legitimate reasons and will not entertain regulatory conversion applications that undermine the supervisory process.[160] This section codifies this important principle.

Section 613. De novo branching into states

This section expands the ability of a national bank or state bank to establish a de novo branch in another state. In the age of Internet transactions, such branching restrictions are anachronistic and ineffectual.

Section 614. Lending limits to insiders

This section expands the type of transactions subject to insider lending limits to include derivatives transactions, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions. This section is consistent with this legislation's expansion of affiliate transaction limits in section 608, and lending limits applicable to non-affiliated third parties in section 610, and to include such exposures.

Section 615. Limitations on purchases of assets from insiders

This section prohibits insured depository institutions from entering into asset purchase or sales transactions with its executive officers, directors, or principal shareholders or a related interest unless the transaction is on market terms and, if the transaction represents more than ten percent of the capital and surplus of the institution, has been approved in advance by a majority of the disinterested members of the board.

This section replaces and expands a similar provision in section 22(d) of the Federal Reserve Act (12 U.S.C. 375) that simply restricts purchases and sales transactions between a member bank and its directors.

Section 616. Rules regarding capital levels of holding companies

This section clarifies that the Federal Reserve may adopt rules governing the capital levels of bank and savings and loan holding companies. According to testimony provided to the Committee by John C. Dugan, Comptroller of the Currency, under the current regulatory system, "thrift holding companies, unlike bank holding companies, are not subject to consolidated regulation for example,

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[159] *Strengthening and Streamlining Prudential Bank Supervision—Part I: Testimony of Daniel K. Tarullo, Member Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 2nd session, p. 13 (August 4, 2009).

[160] Federal Financial Institutions Examination Council (2009), "FFIEC Issues Statement on Regulatory Conversions, press release, July 1, www.ffiec.gov/press/pr070109.htm.

no consolidated capital requirements apply at the holding company level. This difference between bank and thrift holding company regulation created arbitrage opportunities for companies that were able to take on greater risk under a less rigorous regulatory regime."[161] This section provides the Federal Reserve with the same authority to prescribe capital standards for savings and loan holding companies that it currently has for bank holding companies. It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies.

This section also directs the AFBA for a bank or savings and loan holding company to require the company to serve as a source of financial strength for any insured depository institution that the company owns or controls. If an insured depository institution is not the subsidiary of a bank or savings and loan holding company, the AFBA for the insured depository institution must require any company that owns or controls the insured depository institution to serve as a source of financial strength for the institution. The AFBA for such an insured depository institution may, from time to time, require the company, or a company that directly or indirectly controls the depository to submit a report, under oath, for the purposes of assessing the ability of the company to comply with the source of strength requirement, and for purposes of enforcing the company's compliance with the source of strength requirement. It is the intent of the Committee that such companies will be permitted to provide financial reporting to the AFBA utilizing the accounting method they currently employ in reporting their financial information. More specifically, nothing in this provision is intended to mandate that insurance companies otherwise subject to alternative regulatory accounting practices and procedures use GAAP reporting.

Section 617. Elimination of elective investment bank holding company framework

This section eliminates the elective Investment Bank Holding Company Framework in the Securities Exchange Act of 1934. This repeals the current supervised investment bank holding company program under which the Securities and Exchange Commission may supervise a non-bank securities firm that is required by a foreign regulator to be subject to consolidated supervision by a U.S. regulator and replaces this program with the supervisory regime described in section 618.

Section 618. Securities holding companies

This section permits a securities holding company, not otherwise regulated by an AFBA, that is required by a foreign regulator to be subject to comprehensive consolidated supervision to register with the Federal Reserve to become a "supervised securities hold-

[161] *Strengthening and Streamlining Prudential Bank Supervision—Part I: Testimony of John C. Dugan, Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 2nd session, p.7 (August 4, 2009).

ing company." To qualify, a securities holding company must own or control one or more brokers or dealers registered with the Securities and Exchange Commission, and cannot be a nonbank financial company supervised by the Board, an affiliate of an insured bank or savings association, a foreign bank, or subject to comprehensive consolidated supervision by a foreign regulator. This section describes the manner in which the Board must supervise and regulate "supervised securities holding companies," including through issuance of regulations that prescribe capital adequacy and other risk management standards to protect the safety and soundness of the company and to address risks posed to financial stability by such companies.

Section 619. Restrictions on capital market activity by banks and bank holding companies

The intent of this section is to prohibit or restrict certain types of financial activity—in banks, bank holding companies, other companies that control an insured depository institution, their subsidiaries, or nonbank financial companies supervised by the Board of Governors—that are high-risk or which create significant conflicts of interest between these institutions and their customers. The prohibitions and restrictions are intended to limit threats to the safety and soundness of the institutions, to limit threats to financial stability, and eliminate any economic subsidy to high-risk activities that is provided by access to lower-cost capital because of participation in the regulatory safety net.

Subject to recommendations and modifications by the Financial Stability Oversight Council, an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act, and any subsidiary of such institution or company, will be prohibited from proprietary trading, sponsoring and investing in hedge funds and private equity funds, and from having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser. A nonbank financial institution supervised by the Board of Governors that engages in proprietary trading, or sponsoring or investing in hedge funds and private equity funds will be subject to Board rules imposing capital requirements relate to, or quantitative limits on, these activities. These prohibitions and restrictions will be subject to certain exemptions.

The Council recommendations and modifications will be included in a study to assess the extent to which the prohibitions, limitations and requirements of section 619 will promote several goals, including: the safety and soundness of depositories and their affiliates; protecting taxpayers from loss; limiting the inappropriate transfer of economic subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal government to unregulated entities; reducing inappropriate conflicts of interest between depositories and their affiliates, or financial companies supervised by the Board of Governors, and their customers; affecting the cost of credit or other financial services, limiting undue risk or loss in financial institutions; and appropriately accommodating the business of insurance within insurance companies subject to State insurance company investment laws.

The Council study is included to assure that the prohibitions included in section 619 work effectively. It is not the intent of the section to interfere inadvertently with longstanding, traditional banking activities that do not produce high levels of risk or significant conflicts of interest. For that reason the Council is given some latitude to make needed modifications to definitions and provisions in order to prevent undesired outcomes. However, it is intended that the Council will determine how to effectively implement the prohibitions and restrictions of the section, and not to weaken them.

The Council will have six months to write the study, and the appropriate Federal bank agencies will have nine months in which to issue regulations that reflect the recommendations of the Council.

Paul Volcker, chairman of the President's Economic Recovery Advisory Board and former chairman of Board of Governors of the Federal Reserve, has strongly advocated that beneficiaries of the federal financial safety net be prohibited from engaging in high-risk activities. In the statement he submitted to the Senate Committee on Banking, Housing and Urban Affairs on February 2, Mr. Volcker argued that there is no public policy rationale for subsidizing high risk activities:

> The basic point is that there has been, and remains, a strong public interest in providing a "safety net"—in particular, deposit insurance and the provision of liquidity in emergencies—for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.

He also went on to note that these high-risk activities produce unacceptable conflicts of interest in insured and regulated institutions:

> . . . I want to note the strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity. That is especially evident for banks conducting substantial investment management activities, in which they are acting explicitly or implicitly in a fiduciary capacity. When the bank itself is a "customer", i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. "Inside" hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same "inside" funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades.

At the same hearing Deputy Treasury Secretary Neal Wolin emphasized the volatility and riskiness of the activities that are prohibited under section 619. In his statement he noted that:

> Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms "bailed out" their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised.

Section 620. Concentration limits on large financial firms

Subject to recommendations from the Financial Stability Oversight Council, a financial company may not merge or consolidate with, acquire all or substantially all of the assets of, or otherwise acquire control of, another company, if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction.

The Council recommendations will be included in a study of the extent to which the concentration limit under section 620 would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of United States financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States. The intent is to have the Council determine how to effectively implement the concentration limit, and not whether to do so.

The Council will have six months to write the study, and the Board of Governors of the Federal Reserve will have nine months in which to issue regulations that reflect the recommendations and modifications of the Council.

Title VII—Over-the-Counter Derivatives Markets Act of 2009

Section 701. Short title

Section 701. Findings and purposes

This section describes the findings and purposes of the Over-the-Counter Derivatives Markets Act of 2009. In order to mitigate costs and risks to taxpayers and the financial system, this Act establishes regulations for the over-the-counter derivatives market including requirements for clearing, exchange trading, capital, margin, and reporting.

Subtitle A—Regulation of Swap Markets

Section 711. Definitions

This section adds new definitions to the Commodity Exchange Act and directs the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") to jointly adopt uniform interpretations. The defined terms include

"swap," "swap dealer," "swap repository," and "major swap participant."

This section also establishes guidelines for joint CFTC and SEC rulemaking authority under this Act. This section requires that rules and regulations prescribed jointly under this Act by the CFTC and SEC shall be uniform and shall treat functionally or economically equivalent products similarly. This section authorizes the CFTC and SEC to prescribe rules defining "swap" and "security-based swap" to prevent evasions of this Act. This section also requires the CFTC and SEC to prescribe joint rules in a timely manner and authorizes the Financial Stability Oversight Council to resolve disputes if the CFTC and SEC fail to jointly prescribe rules.

Section 712. Jurisdiction

This section removes limitations on the CFTC's jurisdiction with respect to certain derivatives transactions, including swap transactions between "eligible contract participants."

Section 713. Clearing

Subsection (a). Clearing requirement

This subsection requires clearing of all swaps that are accepted for clearing by a registered derivatives clearing organization unless one of the parties to the swap qualifies for an exemption. This subsection requires cleared swaps that are accepted for trading to be executed on a designated contract market or on a registered alternative swap execution facility. The CFTC may exempt a party to a swap from the clearing and exchange trading requirement if one of the counterparties to the swap is not a swap dealer or major swap participant and does not meet the eligibility requirements of any derivatives clearing organization that clears the swap. The CFTC must consult the Financial Stability Oversight Council before issuing an exemption. Requires a party to a swap to submit the swap for clearing if a counterparty requests that such swap be cleared and the swap is accepted for clearing by a registered derivatives clearing organization.

This subsection requires derivatives clearing organizations to seek approval from the CFTC prior to clearing any group or category of swaps and directs the CFTC and SEC to jointly adopt rules to further identify any group or category of swaps acceptable for clearing based on specified criteria; authorizes the CFTC and SEC jointly to prescribe rules or issue interpretations as necessary to prevent evasions of section 2(j) of the Commodity Exchange Act; and requires parties who enter into non-cleared swaps to report such transactions to a swap repository or the CFTC.

Subsection (b). Derivatives clearing organizations

This subsection requires derivatives clearing organizations that clear swaps to register with the CFTC, and directs the CFTC and SEC (in consultation with the appropriate federal banking agencies) to jointly adopt uniform rules governing entities registered as derivatives clearing organizations for swaps under this subsection and entities registered as clearing agencies for security-based swaps under the Securities Exchange Act of 1934 ("Exchange Act"). This subsection also permits dual registration of a derivatives

clearing organization with the CFTC and SEC or appropriate banking agency, authorizes the CFTC to exempt from registration under this subsection a derivatives clearing organization that is subject to comparable, comprehensive supervision and regulation on a consolidated basis by another regulator, and provides transition for existing clearing agencies. This subsection specifies core regulatory principles for derivatives clearing organizations, including standards for minimum financial resources, participant and product eligibility, risk management, settlement procedures, safety of member or participant funds and assets, rules and procedures for defaults, rule enforcement, system safeguards, reporting, recordkeeping, disclosure, information sharing, antitrust considerations, governance arrangements, conflict of interest mitigation, board composition, and legal risk. This subsection also requires a derivatives clearing organization to provide the CFTC with all information necessary for the CFTC to perform its responsibilities.

Subsection (c). Legal certainty for identified banking products

This subsection clarifies that the Federal banking agencies, rather than the CFTC or SEC, retain regulatory authority with respect to identified banking products, unless a Federal banking agency, in consultation with the CFTC and SEC, determines that a product has been structured as an identified banking product for the purpose of evading the provisions of the Commodity Exchange Act, Securities Act of 1933, or Exchange Act.

Section 714. Public reporting of aggregate swap data

This section directs the CFTC (or a derivatives clearing organization or swap repository designated by the CFTC) to make available to the public, in a manner that does not disclose the business transactions or market positions of any person, aggregate data on swap trading volumes and positions.

Section 715. Swap repositories

This section describes the duties of a swap repository as accepting, maintaining, and making available swap data as prescribed by the CFTC; makes registration with the CFTC voluntary for swap repositories; and subjects registered swap repositories to CFTC inspection and examination. This section also directs the CFTC and SEC to jointly adopt uniform rules governing entities that register with the CFTC as swap repositories and entities that register with the SEC as security-based swap repositories, and authorizes the CFTC to exempt from registration any swap repository subject to comparable, comprehensive supervision or regulation by another regulator.

Section 716. Reporting and recordkeeping

This section requires reporting and recordkeeping by any person who enters into a swap that is not cleared through a registered derivatives clearing organization or reported to a swap repository.

Section 717. Registration and regulation of swap dealers and major swap participants

This section requires swap dealers and major swap participants to register with the CFTC, directs the CFTC and SEC to jointly

adopt rules to mitigate conflicts, and directs the CFTC and SEC to jointly prescribe uniform rules for entities that register with the CFTC as swap dealers or major swap participants and entities that register with the SEC as security-based swap dealers or major security-based swap participants. This section also requires a registered swap dealer or major swap participant to (1) meet such minimum capital and margin requirements as the primary financial regulatory agency (for banks) or CFTC and SEC (for nonbanks) shall jointly prescribe; (2) meet reporting and recordkeeping requirements; (3) conform with business conduct standards; (4) conform with documentation and back office standards; and (5) comply with requirements relating to position limits, disclosure, conflicts of interest, and antitrust considerations. The Commission may exempt swap dealers and major swap participants from the margin requirement according to certain criteria and pursuant to consultation with the Financial Stability Oversight Council. If a party requests margin for an exempt swap, the exemption shall not apply. Regulators may permit the use of non-cash collateral to meet margin requirements.

Section 718. Segregation of assets held as collateral in swap transactions

For cleared swaps, this section requires that swap dealers, futures commission merchants, and derivatives clearing organizations segregate funds held to margin, guarantee, or secure the obligations of a counterparty under a cleared swap in a manner that protects their property. In addition, counterparties to an un-cleared swap will be able to request that any margin posted in the transaction be held by an independent third party custodian. Assets must be segregated on a non-discriminatory basis and may not be re-hypothecated.

Section 719. Conflicts of interest

This section also directs the CFTC to require futures commission merchants and introducing brokers to implement conflict-of-interest systems and procedures relating to research activities and trading.

Section 720. Alternative swap execution facilities

This section defines alternative swap execution facility and requires a facility for the trading of swaps to register with the CFTC as an alternative swap execution facility ("ASEF"), subject to certain criteria relating to deterrence of abuses, trading procedures, and financial integrity of transactions. This section also establishes core regulatory principles for ASEFs relating to enforcement, anti-manipulation, monitoring, information collection and disclosure, position limits, emergency powers, recordkeeping and reporting, antitrust considerations, and conflicts of interest. This section directs the CFTC and SEC to jointly prescribe rules governing the regulation of alternative swap execution facilities, and authorizes the CFTC to exempt from registration under this section an alternative swap execution facility that is subject to comparable, comprehensive supervision and regulation by another regulator.

Section 721. Derivatives transaction execution facilities and exempt boards of trade

This section repeals the existing provisions of the Commodity Exchange Act relating to derivatives transaction execution facilities and exempt boards of trade.

Section 722. Designated contract markets

This section requires a board of trade, in order to maintain designation as a contract market, to demonstrate that it provides a competitive, open, and efficient market for trading; has adequate financial, operational, and managerial resources; and has established robust system safeguards to help ensure resiliency.

Section 723. Margin

This section authorizes the CFTC to set margin levels for registered entities.

Section 724. Position limits

This section authorizes the CFTC to establish aggregate position limits across commodity contracts listed by designated contract markets, commodity contracts traded on a foreign board of trade that provides participants located in the United States with direct access to its electronic trading and order matching system, and swap contracts that perform or affect a significant price discovery function with respect to regulated markets.

Section 725. Enhanced authority over registered entities

This section enhances the CFTC's authority to establish mechanisms for complying with regulatory principles and to review and approve new contracts and rules for registered entities.

Section 726. Foreign boards of trade

This section authorizes the CFTC to adopt rules and regulations requiring registration by, and prescribing registration requirements and procedures for, a foreign board of trade that provides members or other participants located in the United States direct access to the foreign board of trade's electronic trading and order matching system. This section also prohibits foreign boards of trade from providing members or other participants located in the United States with direct access to the electronic trading and order matching systems of the foreign board of trade with respect to a contract that settles against the price of a contract listed for trading on a CFTC-registered entity unless the foreign board of trade meets, in the CFTC's determination, certain standards of comparability to the requirements applicable to U.S. boards of trade. This section also provides legal certainty for certain contracts traded on or through a foreign board of trade.

Section 727. Legal certainty for swaps

This section clarifies that no hybrid instrument sold to any investor and no transaction between eligible contract participants shall be void based solely on the failure of the instrument or transaction to comply with statutory or regulatory terms, conditions, or definitions.

Section 728. FDICIA amendments

Makes conforming amendments to the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") to reflect that the definition of "over-the-counter derivative instrument" under FDICIA no longer includes swaps or security-based swaps.

Section 729. Primary enforcement authority

This section clarifies that the CFTC shall have primary enforcement authority for all provisions of Subtitle A of this Act, other than new Section 4s(e) of the Commodity Exchange Act (as added by Section 717 of this Act, relating to capital and margin requirements for swap dealers and major swap participants), for which the primary financial regulatory agency shall have exclusive enforcement authority with respect to banks and branches or agencies of foreign banks that are swap dealers or major swap participants. This section also provides the primary financial regulatory agency with backstop enforcement authority with respect to the non-prudential requirements of the new Section 4s of the Commodity Exchange Act (relating to registration and regulation of swap dealers and major swap participants) if the CFTC does not initiate an enforcement proceeding within 90 days of a written recommendation by the primary financial regulatory agency.

Section 730. Enforcement

This section clarifies the enforcement authority of the CFTC with respect to swaps and swap repositories, and of the primary financial regulatory agency with respect to swaps, swap dealers, major swap participants, swap repositories, alternative swap execution facilities, and derivatives clearing organizations.

Section 731. Retail commodity transactions

This section clarifies CFTC jurisdiction with respect to certain retail commodity transactions.

Section 732. Large swap trader reporting

This section requires reporting and recordkeeping with respect to large swap positions in the regulated markets.

Section 733. Other authority

This section clarifies that this title, unless otherwise provided by its terms, does not divest any appropriate federal banking agency, the CFTC, the SEC, or other federal or state agency of any authority derived from any other applicable law.

Section 734. Antitrust

This section clarifies that nothing in this title shall be construed to modify, impair, or supersede antitrust law.

Subtitle B—Regulation of Security-Based Swap Markets

Section 751. Definitions under the Securities Exchange Act of 1934

This section adds new definitions to the Securities Exchange Act of 1934 and directs the CFTC and SEC to jointly adopt uniform interpretations. The defined terms include "security-based swap," "se-

curity-based swap dealer," "security-based swap repository," "mixed swap," and "major security-based swap participant."

This section also establishes guidelines for joint CFTC and SEC rulemaking authority under this Act. This section requires that rules and regulations prescribed jointly under this Act by the CFTC and SEC shall be uniform and shall treat functionally or economically equivalent products similarly. This section authorizes the CFTC and SEC to prescribe rules defining "swap" and "security-based swap" to prevent evasions of this Act. This section also requires the CFTC and SEC to prescribe joint rules in a timely manner and authorizes the Financial Stability Oversight Council to resolve disputes if the CFTC and SEC fail to jointly prescribe rules.

Section 752. Repeal of prohibition on regulation of security-based swaps

This section repeals provisions enacted as part of the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act that prohibit the SEC from regulating security-based swaps.

Section 753. Amendments to the Securities Exchange Act of 1934

Subsection (a). Clearing for security-based swaps

This subsection requires clearing of all security-based swaps that are accepted for clearing by a registered clearing agency unless one of the parties to the swap qualifies for an exemption. This subsection requires cleared security-based swaps that are accepted for trading to be executed on a registered national securities exchange or on a registered alternative swap execution facility. The SEC may exempt a security-based swap from the clearing and exchange trading requirement if one of the counterparties to the swap is not a security-based swap dealer or major swap participant and does not meet the eligibility requirements of any clearing agency that clears the swap. The SEC must consult the Financial Stability Oversight Council before issuing an exemption. Requires a party to a security-based swap to submit the swap for clearing if a counterparty requests that the swap be cleared and the swap is accepted for clearing by a registered clearing agency.

This subsection requires clearing agencies to seek approval from the SEC prior to clearing any group or category of security-based swaps and directs the CFTC and SEC to jointly adopt rules to further identify any group or category of security-based swaps acceptable for clearing based on specified criteria; authorizes the CFTC and SEC jointly to prescribe rules or issue interpretations as necessary to prevent evasions of section 3A of the Exchange Act; requires parties who enter into non-cleared swaps to report such transactions to a swap repository or the CFTC; and directs the SEC and CFTC to jointly adopt uniform rules governing entities registered with the CFTC as derivatives clearing organizations for swaps and with the SEC as clearing agencies for security-based swaps.

Subsection (b). Alternative swap execution facilities

This subsection defines alternative swap execution facility and requires facilities for the trading of security-based swaps to register with the SEC as ASEFs, subject to certain criteria relating to de-

terrence of abuses, trading procedures, and financial integrity of transactions. This subsection also establishes core regulatory principles for ASEFs relating to enforcement, anti-manipulation, monitoring, information collection and disclosure, position limits, emergency powers, recordkeeping and reporting, antitrust considerations, and conflicts of interest. This subsection directs the SEC and CFTC to jointly prescribe rules governing the regulation of alternative swap execution facilities, and authorizes the SEC to exempt from registration under this subsection an alternative swap execution facility that is subject to comparable, comprehensive supervision and regulation by another regulator.

Subsection (c). Trading in security-based swap agreements

This subsection prohibits parties who are not eligible contract participants (as defined in the Commodity Exchange Act) from effecting security-based swap transactions off of a registered national securities exchange.

Subsection (d). Registration and regulation of swap dealers and major swap participants

This subsection requires security-based swap dealers and major security-based swap participants to register with the SEC, and directs the SEC and CFTC to jointly prescribe uniform rules for entities that register with the SEC as security-based swap dealers or major security-based swap participants and entities that register with the CFTC as swap dealers or major swap participants. This subsection also requires security-based swap dealers and major security-based swap participants to (1) meet such minimum capital and margin requirements as the primary financial regulatory agency (for banks) or CFTC and SEC (for nonbanks) shall jointly prescribe; (2) meet reporting and recordkeeping requirements; (3) conform with business conduct standards; (4) conform with documentation and back office standards; and (5) comply with requirements relating to position limits, disclosure, conflicts of interest, and antitrust considerations. The Commission may exempt security-based swap dealers and major swap participants from the margin requirement according to certain criteria and pursuant consultation with the Financial Stability Oversight Council. If a party requests margin for an exempt swap, the exemption shall not apply. Regulators may permit the use of non-cash collateral to meet margin requirements.

Subsection (e). Additions of security-based swaps to certain enforcement provisions

This subsection adds security-based swaps to the Exchange Act's list of financial instruments that a person may not use to manipulate security prices.

Subsection (f). Rulemaking authority to prevent fraud, manipulation, and deceptive conduct in security-based swaps

This subsection prohibits fraudulent, manipulative, and deceptive acts involving security-based swaps and security-based swap agreements, and directs the SEC to prescribe rules and regulations to define and prevent such conduct.

Subsection (g). Position limits and position accountability for security-based swaps and large trader reporting

As a means to prevent fraud and manipulation, this subsection authorizes the SEC to (1) establish limits on the aggregate number or amount of positions that any person or persons may hold across security-based swaps that perform or affect a significant price discovery function with respect to regulated markets; (2) exempt from such limits any person, class of persons, transaction, or class of transactions; and (3) direct a self-regulatory organization to adopt rules relating to position limits for security-based swaps. This subsection also requires reporting and recordkeeping with respect to large security-based swap positions in regulated markets.

Subsection (h). Public reporting and repositories for security-based swap agreements

This subsection requires the SEC or its designee to make available to the public, in a manner that does not disclose the business transactions and market positions of any person, aggregate data on security-based swap trading volumes and positions. This subsection also describes the duties of a security-based swap repository as accepting and maintaining security-based swap data as prescribed by the SEC, makes SEC registration for security-based swap repositories voluntary, and subjects registered security-based swap repositories to SEC inspection and examination. This subsection directs the SEC and CFTC to jointly adopt uniform rules governing entities that register with the SEC as security-based swap repositories and entities that register with the CFTC as swap repositories and authorizes the SEC to exempt from registration any security-based swap repository subject to comparable, comprehensive supervision or regulation by another regulator.

Section 754. Segregation of assets held as collateral in security-based swap transactions

For cleared swaps, this section requires that security-based swap dealers or clearing agencies segregate funds held to margin, guarantee, or secure the obligations of a counterparty in a manner that protects their property. In addition, counterparties to an un-cleared swap will be able to request that any margin posted in the transaction be held by an independent third party custodian. Assets must be segregated on a non-discriminatory bases and may not be re-hypothecated.

Section 755. Reporting and recordkeeping

This section requires reporting and recordkeeping by any person who enters into a security-based swap that is not cleared with a registered clearing agency or reported to a security-based swap repository. This section also includes security-based swaps within the scope of certain reporting requirements under Sections 13 and 16 of the Exchange Act.

Section 756. State gaming and bucket shop laws

This section clarifies the applicability of certain state laws to security-based swaps.

Section 757. Amendments to the Securities Act of 1933; treatment of security-based swaps

This section amends the Securities Act of 1933 to include security-based swaps within the definition of "security." This section also amends Section 5 of the Securities Act of 1933 to prohibit offers to sell or purchase a security-based swap without an effective registration statement to any person other than an eligible contract participant (as defined in the Commodity Exchange Act).

Section 758. Other authority

This section clarifies that this title, unless otherwise provided by its terms, does not divest any appropriate federal banking agency, the SEC, the CFTC, or other federal or state agency of any authority derived from any other applicable law.

Section 758. Jurisdiction

This section clarifies that the SEC shall not have authority to grant exemptions from the provisions of this Act, except as expressly authorized by this Act; provides the SEC with express authorization to use any authority granted under subsection (a) to exempt any person or transaction from any provision of this title that applies to such person or transaction solely because a security-based swap is a security under section 3(a).

Subtitle C—Other Provisions

Section 761. International harmonization

This section requires regulators to consult and coordinate with international authorities on the establishment of consistent standards for the regulation of swaps and security-based swaps.

Section 762. Interagency cooperation

This section establishes a SEC–CFTC Joint Advisory Committee to monitor and develop solutions emerging in the swaps and security-based swaps markets, a SEC–CFTC Joint Enforcement Task Force to improve market oversight, a SEC–CFTC–Federal Reserve Trading and Markets Fellowship Program to provide cross-training among agency staff about the interaction between financial markets activity and the real economy, SEC–CFTC cross-agency enforcement training and education, and detailing of staff between the SEC and CFTC.

Section 763. Study and report on implementation

This section requires the GAO to conduct on study on the implementation of this Act within one year of the date of enactment.

Section 764. Recommendations for changes to insolvency laws

This section requires the SEC, CFTC, and FIRA to make recommendations to Congress within 180 days of enactment regarding Federal insolvency laws and their impact on various swaps and security-based swaps activity.

Section 765. Effective date

This section specifies that this title shall become effective 180 days after the date of enactment.

Title VIII—Payment, Clearing, and Settlement Supervision Act of 2009

Section 801. Short title

Section 802. Findings and purposes

This section describes the findings and purposes of the Payment, Clearing, and Settlement Supervision Act of 2009. In order to mitigate systemic risk in the financial system and promote financial stability, this Act provides the Financial Stability Oversight Council a role in identifying systemically important financial market utilities and the Board of Governors of the Federal Reserve System ("Board") with an enhanced role in supervising risk management standards for systemically important financial market utilities and for systemically important payment, clearing, and settlement activities conducted by financial institutions.

Section 803. Definitions

Section 804. Designation of systemic importance

This section authorizes the Financial Stability Oversight Council to designate financial market utilities or payment, clearing, or settlement activities as systemically important, and establishes procedures and criteria for making and rescinding such a designation. Criteria for designation and rescission of designation include the aggregate monetary value of transactions processed and the effect that a failure of a financial market utility or payment, clearing, or settlement activity would have on counterparties and the financial system.

Section 805. Standards for systemically important financial market utilities and payment, clearing, or settlement activities

This section authorizes the Board, in consultation with the Financial Stability Oversight Council and the appropriate supervisory agencies, to prescribe risk management standards governing the operations of designated financial market utilities and the conduct of designated payment, clearing, and settlement activities by financial institutions. This section also establishes the objectives, principles, and scope of such standards.

Section 806. Operations of designated financial market utilities

This section authorizes a Federal Reserve bank to establish and maintain an account for a designated financial market utility and allows the Board to modify or provide an exemption from reserve requirements that would otherwise be applicable to the designated financial market utility. This section requires a designated financial market utility to provide advance notice of and obtain approval of material changes to its rules, procedures, or operations.

Section 807. Examination and enforcement actions against designated financial market utilities

This section requires the supervisory agency to conduct safety and soundness examinations of a designated financial market utility at least annually and authorizes the supervisory agency to take enforcement actions against the utility. This section also allows the Board to participate in examinations by, and make recommenda-

tions to, other supervisors and designates the Board as the supervisory agency for designated financial market utilities that do not otherwise have a supervisory agency. The Board is also authorized to take enforcement actions against a designated financial market utility if there is an imminent risk of substantial harm to financial institutions or the broader financial system.

Section 808. Examination and enforcement actions against financial institutions engaged in designated activities

This section authorizes the primary financial regulatory agency to examine a financial institution engaged in designated payment, clearing, or settlement activities and to enforce the provisions of this Act and the rules prescribed by the Board against such an institution. This section also requires the Board to collaborate with the primary financial regulatory agency to ensure consistent application of the Board's rules. The Board is granted back-up authority to conduct examinations and take enforcement actions if it has reasonable cause to believe a violation of its rules or of this Act has occurred.

Section 809. Requests for information, reports, or records

This section authorizes the Financial Stability Oversight Council to collect information from financial market utilities and financial institutions engaged in payment, clearing, or settlement activities in order to assess systemic importance. Upon a designation by the Financial Stability Oversight Council, the Board may require submission of reports or data by systemically important financial market utilities or financial institutions engaged in activities designated to be systemically important. This section also facilitates sharing of relevant information and coordination among financial regulators, with protections for confidential information.

Section 810. Rulemaking

This section authorizes the Board and the Financial Stability Oversight Council to prescribe such rules and issue such orders as may be necessary to administer and carry out the purposes of this title and prevent evasions thereof.

Section 811. Other authority

This section clarifies that this Act, unless otherwise provided by its terms, does not divest any appropriate financial regulatory agency, supervisory agency, or other Federal or State agency of any authority derived from any other applicable law.

Section 812. Effective date

This section specifies that this Act shall be effective as of the date of enactment.

Title IX—Investor Protections

Subtitle A

Section 911. Investor Advisory Committee established

Section 911 establishes within the SEC the Investor Advisory Committee to assist the SEC by advising and consulting on regu-

latory priorities; issues relating to securities, trading, fee structures and the effectiveness of disclosures; investor protection; and initiatives to promote investor confidence. The Committee shall be composed of the Investor Advocate, a representative of state securities commissions because of the important work that States have performed in protecting investors, a representative of the interests of senior citizens who are sometimes targeted for securities frauds, and between 12 and 22 members who represent the interests of individual investors, institutional investors, and pension fund investors.

The Committee shall elect from among themselves a Chairman, Vice Chairman, Secretary, and Assistant Secretary, each of whom shall serve a 3 year term. The Committee shall meet at least twice per year. The SEC shall provide the Committee with the staff necessary to fulfill its mission. The SEC must publicly respond to Committee findings and recommendations by assessing them and disclosing any action the SEC intends to take. It is expected that the responses will be made shortly after the Committee acts.

In June of 2009, the SEC formed an Investor Advisory Committee. This legislation gives the Investor Advisory Committee a statutory foundation and sets congressional prerogatives for the Committee's composition and function.

The proposal for this Committee was included in the Treasury Department legislative proposal for financial reform.[162] AARP supports the statutory establishment of this Committee. On November 19, 2009, the AARP wrote in a letter to Senators Dodd and Shelby, "AARP also supports additional powers granted to the SEC to strengthen its work on behalf of investors, including explicit authority to establish an Investor Advisory Committee."[163]

Section 912. Clarification of authority of the commission to engage in consumer testing

Section 912 clarifies the SEC's authority to gather information from and communicate with investors and engage in such temporary programs as the SEC determines are in the public interest for the purpose of evaluating any rule or program of the SEC.

In the past, the SEC has carried out consumer testing programs, but there have been questions of the legality of this practice. This legislative language gives clear authority to the SEC for these activities.

This proposal is included in the Treasury Department's legislative language for financial reform[164]. The AARP told the Committee that it "supports the explicit authority granted to the SEC to test rules or programs by gathering information and communicating with investors and other members of the public. This type of testing has the very real potential to improve the clarity and usefulness of the disclosures that our securities regulatory scheme relies upon."[165] Mr. James Hamilton, Principal Analyst, CCH Fed-

[162] *FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD; Legislation for Strengthening Investor Protection Delivered to Capitol Hill,* U.S. Department of the Treasury, Press Release, July 10, 2009, www.financialstability.gov.

[163] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

[164] *FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD; Legislation for Strengthening Investor Protection Delivered to Capitol Hill,* U.S. Department of the Treasury, Press Release, July 10, 2009, www.financialstability.gov.

[165] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

eral Securities Law Reporter has said "The SEC can better evaluate the effectiveness of investor disclosures if it can meaningfully engage in consumer testing of those disclosures. The SEC should be better enabled to engage in field testing, consumer outreach and testing of disclosures to individual investors, including by providing budgetary support for those activities." [166]

Section 913. Study and rulemaking regarding obligations of brokers, dealers, and investment advisers

Section 913 was authored by Senators Johnson and Crapo. It directs the SEC to conduct a study of the effectiveness of existing legal or regulatory standards of care for brokers, dealers, and investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the SEC and FINRA, and whether there are legal or regulatory gaps or overlap in legal or regulatory standards in the protection of retail customers. The section also requires the SEC to issue a report within one year that considers public input. If this study identifies any gaps or overlap in the legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, and investment advisers, the SEC shall commence a rulemaking within two years to address such regulatory gaps and overlap that can be addressed by rule, using its existing authority under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.

Section 914. Creation of Office of the Investor Advocate

Section 914 was authored by Senator Akaka. Section 914 creates the Office of the Investor Advocate within the Securities and Exchange Commission (SEC). The Committee believes it is necessary to create an office of the Investor Advocate within the SEC to strengthen the institution and ensure that the interests of retail investors are better represented. The Investor Advocate is tasked with assisting retail investors to resolve significant problems with the SEC or the self-regulatory organizations (SROs). The Investor Advocate's mission includes identifying areas where investors would benefit from changes in SEC or SRO policies and problems that investors have with financial service providers and investment products. The Investor Advocate will recommend policy changes to the SEC and Congress in the interests of investors. The Taxpayer Advocate within the Internal Revenue Service has contributed significantly to the improvement of policies that have benefitted taxpayers. A similar office in the SEC has a tremendous potential to similarly benefit retail investors. The Investor Advocate, with its independent reporting lines, would help to ensure that the interests of retail investors are built into rulemaking proposals from the outset and that agency priorities reflect the issues that confront average investors. The Investor Advocate will increase transparency and accountability at the SEC and be equipped to act in response to feedback from investors and potentially avoid situations such as the mishandling of tips that could have exposed Ponzi schemes much earlier. The Investor Advocate, and staff of the Office of the

[166] *Obama Reform Proposal Would Enhance SEC Investor Protection Role,* Jim Hamilton's World of Securities Regulation, jimhamiltonblog.blogspot.com, June 17, 2009.

Investor Advocate, shall maintain the same level of confidentiality for any document or information made available under this section as is required of any member, officer, or employee of the SEC. In this regard, the Investor Advocate and staff in the Office of the Investor Advocate are subject to the same statutory and regulatory restrictions on, and applicable penalties for, the unauthorized disclosure or use of any nonpublic information that apply to any member, officer, or employee of the SEC.

Section 915. Streamlining of filing procedures for self-regulatory organizations

Section 915 requires the SEC to approve a proposed SRO rule or institute a proceeding to consider whether the rule should be disapproved within 45 days. The SEC can extend this period by 45 days if appropriate. If the SEC does not approve the rule within this period then it must provide a hearing within 180 days of the rule proposal publication. The SEC must approve or disapprove the rule during this same period, or it can extend this period by 60 days if necessary. If the SEC does not follow these time restrictions, the rule is deemed to have been approved. The SEC has 7 days after the receipt of the proposal to notify the SRO if the proposed rule change does not comply with the rules of the SEC relating to the required form of a proposed rule change.

The Committee recognizes that in the modern securities markets it is important that the SEC operate efficiently and responsively. The Committee has heard concerns about current SEC processes for action on rule changes by exchanges and other self-regulatory organizations.

The Committee expects that the changes will encourage the SEC to employ a more transparent and rapid process for consideration of rule changes.

Nothing in the Section diminishes the SEC's authority to reject an improperly filed rule, disapprove a rule that is not consistent with the Exchange Act, or diminishes the applicable public notice and comment period.

Nasdaq OMX, NYSE Euronext, International Securities Exchange and Chicago Board Options Exchange have written jointly by letter dated November 24, 2009 in strong support of this provision because "it would streamline the Securities and Exchange Commission's (SEC) process for making a determination on an exchange rule proposal." They explained, "As Self Regulatory Organizations (SROs), we are subject to the regulatory authority of the SEC, which includes the requirement that we submit all proposed rule changes to the SEC for approval. Although the SEC has made progress in increasing the number of rule proposals that may be submitted for immediate effectiveness, the process that rule proposals that are not subject to immediate effectiveness must undergo remains a point of frustration for SROs. The current process enables the SEC to use internal interpretations to avoid what should be reasonable timelines to move rule filings toward a determination of approval or denial. This process not only delays transparency and public input, it provides a significant competitive advantage to our less regulated competitors, which do not have to seek regulatory approval before changing their rules."

Section 916. Study regarding financial literacy among investors

Section 916 was authored by Senator Akaka. This Section directs the SEC to study and issue a report on the existing level of financial literacy among retail investors. The SEC will have to develop an investor financial literacy strategy. The strategy is intended to bring about positive behavioral change in investors. The study will identify: (1) the existing level of financial literacy among retail investors; (2) methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services; (3) the most useful and understandable relevant information that retail investors need to make informed financial decisions; (4) methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products; (5) the most effective existing private and public efforts to educate investors; and (6) in consultation with the Financial Literacy and Education Commission, a strategy to increase the financial literacy of investors in order to bring about a positive change in investor behavior.

The AARP also supported the study of financial literacy in a letter to Senators Dodd and Shelby.[167]

Section 917. Study regarding mutual fund advertising

Section 917 directs the GAO to conduct a study and issue a report on mutual fund advertising to examine: (1) existing and proposed regulatory requirements for open-end investment company advertisements; (2) current marketing practices for the sale of open-end investment company shares, including the use of past performance data, funds that have merged, and incubator funds; (3) the impact of such advertising on consumers; and (4) recommendations to improve investor protections in mutual fund advertising and additional information necessary to ensure that investors can make informed financial decisions when purchasing shares.

Section 918. Clarification of commission authority to require investor disclosures before purchase of investment products and services

Section 918 was authored by Senator Akaka. Section 918 clarifies the SEC's authority to require investor disclosures before the purchase of investment company shares. This section will give the SEC the authority to require broker-dealers to disclose to clients their compensation for sales of open- and closed-end mutual funds. The Committee believes that investors must be provided with relevant, meaningful, and timely disclosures about financial products and services from which they can make better informed investment decisions. The Committee encourages the SEC to use the consumer testing authorized under Section 912 and the study on financial literacy under Section 916 to inform its scope of disclosures.

Mr. James Hamilton, Principal Analyst, CCH Federal Securities Law Reporter, said "legislation should authorize the SEC to require that certain disclosures (including a summary prospectus) be provided to investors at or before the point of sale, if the SEC finds that such disclosures would improve investor understanding of the

[167] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

particular financial products, and their costs and risks. Currently, most prospectuses (including the mutual fund summary prospectus) are delivered with the confirmation of sale, after the sale has taken place. Without slowing the pace of transactions in modem capital markets, the SEC should require that adequate information is given to investor to make informed investment decisions."[168]

Mr. Travis Plunkett, Legislative Director of the Consumer Federation of America, also supports this provision. In testimony for the House Financial Services Committee, he wrote "we also strongly support requiring pre-sale disclosure to assist mutual fund investors to make more informed investment decisions. While mutual funds are subject to more robust disclosure requirements than many competing investment products and services, the disclosures typically do not arrive until three days after the sale. This makes them essentially useless in helping investors to assess the risks and costs of the fund, as well as the uses for which it may be most appropriate."[169] AARP also supports this provision.[170] The Committee encourages that Securities and Exchange Commission to use the consumer testing authorized under Section 912 and the study on financial literacy under Section 916 to inform its scope of disclosures.

Section 919. Study on conflicts of interest

Section 919 directs the GAO to conduct a study and make recommendations regarding potential conflicts of interest between securities underwriting and securities analysis functions within firms. In this study, the GAO will consider potential harm to investors of these conflicts, the nature and benefit of the undertakings to which the firms agreed as part of the Global Settlement, whether any of these undertakings should be codified, and whether to recommend regulatory or legislative measures to mitigate harm to investors caused by these conflicts of interest. The GAO will consult with the SEC, FINRA, investor advocates, retail investors, institutional investors, academics, and State securities officials in performing this study. This issue has been a subject of public concern for many years. On March 15, 2010, the U.S. District Court in New York rejected a proposal by the SEC and 12 securities firms to change the legal settlement put in place with the Global Research Analyst Settlements to end abuses on Wall Street that would have allowed employees in investment-banking and research departments at Wall Street firms to "communicate with each other . . . outside of the presence" of lawyers or compliance-department officials responsible for policing employee conduct—an activity strictly prohibited by the settlement. The 2003 Global Settlement resolved a major securities scandal, in which 10 of the largest securities firms and two individual analysts were charged with issuing misleading or fraudulent analyst recommendations and fines of $1.4 billion were assessed.

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[168] *Obama Administration Would Enhance SEC's Investor Protection Role*, Mr. James Hamilton, *CCH Financial Crisis Newsletter*, June 18, 2009, *www.financialcrisisupdate.com.*

[169] *Community and Consumer Advocates' Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, p.24 (2009) (Testimony of Mr. Travis Plunkett).

[170] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

Title V of the Sarbanes-Oxley Act of 2002 (P.L. 107–204) addressed aspects of this issue by amending the Securities Exchange Act of 1934 to require the SEC, or upon the authorization and direction of the SEC, a registered securities association or national securities exchange, to adopt rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances.

Section 919A. Study on improved access to information on investment advisers and broker-dealers

Senator Brown (OH) authored Section 919A. This Section directs the SEC to study and make recommendations on ways to improve the access of investors to registration information about registered and previously registered investment advisers, associated persons of investment advisers, brokers and dealers and their associated persons on the existing Central Registration Depository and Investment Adviser Registration Depository systems, as well as identify additional information that should be made publicly available.

Section 919B. Study on financial planners and the use of financial designations

Senator Kohl authored Section 919B. This Section directs the GAO to conduct a study to evaluate and make recommendations on the effectiveness of State and Federal regulations to protect consumers from misleading financial advisor designations; current State and Federal oversight structure and regulations for financial planners; and legal or regulatory gaps in the regulation of financial planners and other individuals who provide or offer to provide financial planning services to consumers.

Senator Kohl has said that "Financial planners provide advice on a wide range of issues, including home ownership, saving for college and selecting appropriate investment products. Because this advice will have a lasting impact on the financial health of the consumer, it is important that the service provider meets certain standards. Currently, different states' laws govern financial planners, with no standard code of conduct, training requirements or conflict of interest disclosure requirements. Additionally, there is little accountability for financial planners that take advantage of consumers. Both consumers and financial planners will benefit from standardizing rules and increased oversight at the federal level."[171] Marilyn Mohrman-Gillis, Managing Director, Public Policy, Certified Financial Planner Board of Standards, Inc. said "we recognize that the study is certainly a first step in Congress recognizing the need for reform."

Subtitle B

Section 921. Authority to issue rules to restrict mandatory predispute arbitration

Section 921 gives the SEC the authority to conduct a rulemaking to prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or

[171] Senator Kohl, letter to Senator Dodd, February 22, 2010.

municipal securities dealer to arbitrate any dispute between them. This provision was included in the Treasury Department's legislative proposal.[172]

There have been concerns over the past several years that mandatory pre-dispute arbitration is unfair to the investors. In a letter to Chairman Dodd and Ranking Member Shelby, AARP expressed support for this provision. In listing some of the problems with mandatory pre-dispute arbitration, the letter identified "high upfront costs; limited access to documents and other key information; limited knowledge upon which to base the choice of arbitrator; the absence of a requirement that arbitrators follow the law or issue written decisions; and extremely limited grounds for appeal."[173]

The North American Securities Administrators Association also supports this provision, stating in testimony that a "major step toward improving the integrity of the arbitration system is the removal of the mandatory industry arbitrator. This mandatory industry arbitrator, with their industry ties, automatically puts the investor at an unfair disadvantage."[174] The Consumer Federation of America,[175] AARP,[176] and the Public Investors Arbitration Bar Association support this approach.[177]

Section 922. Whistleblower protection

The Whistleblower Program, established and administered by the Securities and Exchange Commission, is intended to provide monetary rewards to those who contribute "original information" that lead to recoveries of monetary sanctions of $1,000,000 or more in criminal and civil proceedings. The genesis of the program is found in President Obama's June 2009 financial regulatory reform proposal.[178] A similar provision was included in the House of Representatives financial reform bill (H.R. 4173).

The Whistleblower Program aims to motivate those with inside knowledge to come forward and assist the Government to identify and prosecute persons who have violated securities laws and recover money for victims of financial fraud. In a testimony for the Senate Banking Committee, Certified Fraud Examiner and Madoff whistleblower Harry Markopolos testified in support of creating a strong Whistleblower Program. He cited statistics showing the efficiency of Whistleblower Programs: "whistleblower tips detected 54.1% of uncovered fraud schemes in public companies. External auditors, and the SEC exam teams would certainly be considered external auditors, detected a mere 4.1% of uncovered fraud schemes. Whistleblower tips were 13 times more effective than external audits, hence my recommendation to the SEC to encourage

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[172] *FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD; Legislation for Strengthening Investor Protection Delivered to Capitol Hill,* U.S. Department of the Treasury, Press Release, July 10, 2009, *www.financialstability.gov*.

[173] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

[174] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.18 (2009) (Testimony of Mr. Fred Joseph).

[175] Consumer Federation of America (November 10, 2009), "CFA Applauds Introduction of Senator Dodd's Financial Reform Package," Press release, *www.consumerfed.org*.

[176] AARP, letter to Senators Dodd and Shelby, November 19, 2009.

[177] The following article references the Public Investors Arbitration Bar Association's support for this provision: "*Death Knell For Mandatory Arbitration,*" Helen Kearney, *On Wall Street*, August 1, 2009.

[178] *Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward; Legislation for Strengthening Investor Protection Delivered to Capitol Hill,* U.S. Department of the Treasury, Press Release, July 10, 2009. Available at *http://www.financialstability.gov*.

the submission of whistleblower tips." [179] In his letter to Senator Dodd, SEC Inspector General David Kotz also recommended a similar Whistleblower Program.[180]

Recognizing that whistleblowers often face the difficult choice between telling the truth and the risk of committing "career suicide", the program provides for amply rewarding whistleblower(s), with between 10% and 30% of any monetary sanctions that are collected based on the "original information" offered by the whistleblower. The program is modeled after a successful IRS Whistleblower Program enacted into law in 2006. The reformed IRS program, which, too, has a similar minimum-maximum award levels and an appeals process,[181] is credited to have reinvigorated the earlier, largely ineffective, IRS Whistleblower Program. The Committee feels the critical component of the Whistleblower Program is the minimum payout that any individual could look towards in determining whether to take the enormous risk of blowing the whistle in calling attention to fraud.

We also note a recent report of the current SEC insider-trading Whistleblower Program by the Office of Inspector General of SEC. Since the inception of the program in 1989, there have been a total of only seven payouts to five whistleblowers for a meager total of $159,537.[182] In the report, the Inspector General recommends several important guidelines that any current or future SEC Whistleblower Programs should follow, including: development of specific criteria for bounty awards (including a provision to award whistleblowers that partly rely upon public information), development of tips and complaints tracking systems, incorporating best practices from DOJ and IRS's Whistleblower Programs, and establishment of a timeframe for the new policies.

"Original information" is defined as information that is derived from the independent analysis or knowledge of the whistleblower, and is not derived from an allegation in court or government reports, and is not exclusively from news media. In circumstances when bits and pieces of the whistleblower's information were known to the media prior to the emergence of the whistleblower, and that for the purposes of the SEC enforcement [183] the critical components of the information was supplied by the whistleblower, the intent of the Committee is to require the SEC to reward such person(s) in accordance with the degree of assistance that was provided. The rewards are to be from the Investor Protection Fund, which receives funds from sanctions collected based on civil enforcement and from other funds within SEC that are otherwise not distributed to investors (i.e., unused disgorgement funds). Whenever a whistleblower or whistleblowers tip leads the SEC to collect sanctions and penalties that are determined to be distributed to the victims of the fraud, the intent of the Committee is to reward

[179] "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs", 111th Congress, 1st session, p.33 (2009) (Testimony of Mr. Harry Markopolos).

[180] Inspector General H. David Kotz, letter to Senator Dodd, October 29, 2009.

[181] Like the IRS program, the new SEC Whistleblower Program provides for an appeals process, the appropriate court of appeals will review the determination made by the Commission in accordance with section 706 of title 5 of U.S. Code (i.e., abuse of discretion).

[182] "Assessment of the SEC's Bounty Program", Office of Inspector General, U.S. Securities and Exchange Commission, Report No. 474. March 29, 2010.

[183] Same would apply to cases when SEC forwards criminal cases to DOJ that lead to penalties and sanctions.

the whistleblower prior or at the same time as paying such victims, recognizing that were it not for the whistleblower's actions, there would have been no discovery of the harm to the investors and no collection of any sanctions for their benefit.

The SEC has discretion in determining the amount and whether or not a whistleblower is eligible to be awarded. In cases when whistleblowers feel that the SEC had abused its discretion in determining the amount of the award, they have the right to appeal, within 30 days of the decision to a court of appeals. The court is to review the determination in accordance with section 706 of title 5 of U.S. Code. The Committee feels that this review process will significantly contribute to make the program reliable for persons who are contemplating whether or not to blow the whistle on fraud. It will add to the notion of enforceable payout. The Committee, having heard from several parties involved in whistleblower related cases, has determined that enforceability and relatively predictable level of payout will go a long way to motivate potential whistleblowers to come forward and help the Government identify and prosecute fraudsters. Whistleblowers who are employees of an appropriate regulatory agency, DOJ, SROs, PCAOB, accountants in certain circumstances, or a law enforcement organization are generally not eligible for an award. Also not eligible are whistleblowers who are convicted of a criminal violation related to the case at hand.

The Committee intends for this program to be used actively with ample rewards to promote the integrity of the financial markets.

The program also requires the SEC to annually report back to Congress, among other things, with details regarding the number and types of awards granted. It also provides for various protections for whistleblowers, specifically barring employers to discharge, demote, suspend, threaten, harass directly or indirectly, or in any other manner discriminate. The provision also makes it unlawful to knowingly and willfully make any false, fictitious or fraudulent statement or representation, or use any false writing or document knowing the writing or document contains any false, fictitious, or fraudulent statement or entry. Following the enactment of the Act, the SEC will have 270 days to issue final regulations implementing the provisions of the Act.

Section 923. Conforming amendments for whistleblower protection

Section 923. contains conforming amendments for whistleblower protection.

Section 924. Implementation and transition provisions for whistleblower protection

Section 924 contains implementation and transition provisions for whistleblower provisions. The section directs the SEC to issue final regulations implementing the provisions of section 21F of the Securities Exchange Act of 1934 within 270 days within enactment of the Act.

Section 925. Collateral bars

Section 925 gives the SEC the authority to bar individuals from being associated with various registered securities market participants after violating the law while associated in only one area.

This provision is included in the Treasury Department's legislative proposal.[184] The Committee finds that this provision is necessary because, under current rules, individuals could be barred from one registered entity for violations, such as fraud, but then work in another industry where they could prey upon other investors.

Section 926. Authority of state regulators over regulation D offerings

Section 926 restores certain authority of States over Regulation D offerings. This provision will give the States the authority over certain securities sales that are not subject to the '33 Act requirements due to their size and scope, as determined by the SEC.

The North American Securities Administrators Association described why this provision is needed: "These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no regulatory scrutiny even where the promoters or broker-dealers have a criminal or disciplinary history. As a result, Rule 506 offerings have become the favorite vehicle under Regulation D, and many of them are fraudulent. Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all 'covered' securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors."[185] In light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)4(D) of the Securities Act of 1933."[186]

The Committee also heard from interested parties stating that the SEC is adequately capable of reviewing these filings, however we note, in the words of Jennifer Johnson, that "the SEC simply does not have the resources, even if it had the will, to police smaller private placements. State regulators, on the other hand, as "local cops on the beat," are well positioned to fill this regulatory gap. While states currently have enforcement powers under NSMIA . . . they may not become aware of serious problems involving Rule 506 offerings until after injured investors contact them. While states may be able to prosecute the perpetrators of fraud, they cannot prophylactically protect future victims."[187]

The Committee is concerned to protect investors who, under current regulatory scheme and practice, lack regulatory protections. There is a particular concern to protect investors from recidivist perpetrators of securities fraud. This Section does not resolve other current issues involving the SEC's administration of Regulation D, several of which are highlighted in the SEC Office of Inspector General audit report on "Regulation D Exemption Process," March 31, 2009 (e.g., the SEC "should develop a process to assess and better ensure issuers' compliance with Regulation D and take appro-

[184] *FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD; Legislation for Strengthening Investor Protection Delivered to Capitol Hill*, U.S. Department of the Treasury, Press Release, July 10, 2009, *www.financialstability.gov*.

[185] North American Securities Administrators Association, Inc., letter to Chairman Dodd and Ranking Member Shelby, November 17, 2009.

[186] *Pro-Investor Legislative Agenda for the 111th Congress*, North American Securities Administrators Association, January, 2009, *www.nasaa.org*.

[187] Johnson, Jennifer, 2010. "Private Placements: A regulatory Black Hole". Delaware Journal of Corporate Law. Vol. 34, p. 195.

priate action when . . . [it] finds companies have materially misused the Regulation D exemptions").

Section 927. Equal treatment of self-regulatory organization rules

Section 927 provides equal treatment for the rules of all SROs under Section 29(a), which voids any condition, stipulation, or provision binding any person to waive compliance with any provision of the Exchange Act, any rule or regulation thereunder, or any rule of an exchange.

Section 928. Clarification that Section 205 of the Investment Advisers Act of 1940 does not apply to state-registered advisers

Section 928 clarifies that Sec. 205 of the Advisers Act (performance fees and advisory contracts) does not apply to state-registered investment advisors. This is a clarification from the National Securities Markets Improvement Act that these restrictions on investment adviser contracts do not apply to state-registered advisers.

Section 929. Unlawful margin lending

Under previous law, it was unlawful for any member of a national securities exchange or any broker or dealer to provide margin lending to or for any customer on any non-exempt security unless the loan met margin regulations provided for in Chapter 2B of Title 15 of the U.S. Code and was properly collateralized. Section 929 provides that either of these two infractions is unlawful by itself.

Section 929A. Protection for employees of subsidiaries and affiliates of publicly traded companies

Amends Section 806 of the Sarbanes-Oxley Act of 2002 to make clear that subsidiaries and affiliates of issuers may not retaliate against whistleblowers, eliminating a defense often raised by issuers in actions brought by whistleblowers. Section 806 of the Sarbanes-Oxley Act creates protections for whistleblowers who report securities fraud and other violations. The language of the statute may be read as providing a remedy only for retaliation by the issuer, and not by subsidiaries of an issuer. This clarification would eliminate a defense now raised in a substantial number of actions brought by whistleblowers under the statute.

Section 929B. Fair Fund amendments

Amends Section 308 of the Sarbanes-Oxley Act of 2002 to permit the SEC use penalties obtained from a defendant for the benefit of victims even if the SEC does not obtain disgorgement from the defendant (e.g., because defendant did not benefit from its securities law violation that nonetheless harmed investors). Under the Fair Fund provisions of the Sarbanes-Oxley Act, the SEC must obtain disgorgement from a defendant before the SEC can use penalties obtained from the defendant in a Fair Fund for the benefit of victims of the defendant's violation of the securities laws, or a rule or regulation thereunder. This section would revise the Fair Fund provisions to permit the SEC to use penalties obtained from a defendant for the benefit of victims even if the SEC does not obtain an order requiring the defendant to pay disgorgement. 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, for example, the defendant did not benefit from the violation.

Section 929C. Increasing the borrowing limit on treasury loans

Section 929C updates Securities Investor Protection Act, including borrowing of funds, distinction between securities and cash insurance, portfolio margin, and liquidation. This line of credit has not been increased since SIPA was enacted in 1970. SEC staff believes an increase is necessary to provide the Securities Investor Protection Corporation (SIPC) with sufficient resources in the event of the failure of a large broker-dealer. This line of credit is used in the event that SIPC asks for a loan from the SEC and the SEC determines that such a loan is necessary "for the protection of customers of brokers or dealers and the maintenance of confidence in the United States securities markets." SEC staff also support eliminating the distinction in the statute between claims for cash and claims for securities. Section 21 of the Glass-Steagall Act, 12 USC 378, prevents broker-dealers (and any entity other than a bank) from accepting deposits. Staff believes that the distinction between claims for cash and claims for securities has become blurred in recent years and that the distinction can be confusing to customers.

Subtitle C

Section 931. Findings

This section contains Congressional findings that credit ratings are systemically important; relied upon by individual and institutional investors and regulators; and central to capital formation, investor confidence and economic efficiency. Credit rating agencies play a gatekeeper role in financial markets that justifies the same level of oversight and accountability that applies to securities analysts, auditors, and investment banks. Inaccurate ratings, generated in part by conflicts of interest in the process of rating structured financial products, contributed to the mismanagement of risk by large financial institutions and investors, which set the stage for global financial panic.

Section 932. Enhanced regulation, accountability, and transparency of nationally recognized statistical ratings organizations

This section provides for enhanced regulation of nationally recognized statistical ratings organizations (NRSROs), greater accountability on the part of NRSROs that fail to produce accurate ratings, and more disclosure to permit investors to better understand credit ratings and their limitations. The section builds upon the principles of the Credit Rating Agency Reform Act of 2006, which introduced the NRSRO designation and sought to improve ratings performance through a combination of regulatory oversight and competition.

Enhanced Regulation

Paragraph (1) of Section 932 provides that each NRSRO shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the SEC may pre-

scribe, by rule. This provision also calls for an annual report containing an assessment of the effectiveness and a CEO attestation on the internal controls. In support of this provision, Ms. Rita Bolger, Senior Vice President and Associate General Counsel of Standard & Poor's, wrote in testimony for the Senate Banking Committee that "a regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and refrain from second-guessing rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard risk in influencing a rating outcome."[188]

Section 932 also gives the SEC the authority to fine an NRSRO for violations of law or regulation. Under previous law, the SEC could not fine NRSROs, but could only censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any NRSRO. Under this provision the SEC retains these abilities. Lynn Turner, former Chief Accountant of the SEC, supports this provision. He wrote in testimony for the Senate Banking Committee that "the SEC should be given the authority to fine the agencies or their employees who fail to adequately protect investors."[189]

Section 932 attempts to eliminate the effect of the inherent conflict of interest in the issuer-pays model of the credit rating industry. Under this model, issuers of debt have the incentive to use the rating agency that provides the highest rating. A conflict of interest thus arises because rating agencies want to provide the highest rating to keep the issuer's business and are less willing to publish a lower rating. The section addresses this conflict by directing the SEC to write rules preventing sales and marketing considerations from influencing the production of ratings. Violation of these rules will lead to suspension or revocation of NRSRO status if the violation affects a rating.

Section 932 addresses the role of the NRSRO compliance officer, a position created by the Credit Rating Agency Reform Act of 2006. The section prohibits NRSRO compliance officers from participating in production of ratings, the development of ratings methodologies, or the setting of compensation for NRSRO employees. The section allows the SEC to provide exemptions for small NRSROs if the SEC finds that compliance would impose an unreasonable burden.

Section 932 also directs NRSRO compliance officers to establish procedures for the receipt, retention, and treatment of complaints about the rating agency or its ratings. Finally, the section directs the compliance officer to submit to the NRSRO an annual report on its compliance with the securities laws, and its related policies and procedures. The NRSRO must submit this report to the SEC.

Paragraph 6 of Section 932 establishes the Office of Credit Ratings within the SEC. The Office shall administer the rules of the

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[188] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p. 11 (2009) (Testimony of Ms. Rita Bolger).

[189] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p. 11 (2009) (Testimony of Mr. Lynn Turner).

SEC with respect to NRSROs to protect investors and the public interest, to promote accuracy in credit ratings, and to prevent conflicts of interest from unduly influencing credit ratings. The Director of the Office will report to the Chairman of the SEC. The Office will be adequately staffed to fulfill its statutory role and will include persons with knowledge of and expertise in corporate, municipal, and structured debt.

The Committee believes that the unique nature of NRSRO oversight warrants an independent office within the SEC. The fact that there will be a dedicated Office within the SEC to focus on NRSROs should improve the quality and efficiency of the regulation. Many advocated for a separate Office within the SEC to carry out the regulation of NRSROs because of the NRSRO's unique and distinct role from the other entities overseen by the SEC. Mr. Deven Sharma, President of Standard & Poor's, supports "creating a dedicated office within the SEC to oversee NRSROs." [190]

The Office of Credit Ratings shall conduct annual examinations of each NRSRO. Each examination will include a review of the policies, procedures, and rating methodologies of the NRSRO and whether the NRSRO follows these; the management of conflicts of interest by the NRSRO; the implementation of ethics policies; the internal supervisory controls of the NRSRO; the governance of the NRSRO; the activities of the NRSRO compliance officer; the processing of complaints by the NRSRO; and the policies of the NRSRO governing the post-employment activities of former staff.

The SEC will make public, in an easily understandable format, an annual report summarizing the essential findings of all NRSRO examinations that year. The report shall include the responses of NRSROs to material regulatory deficiencies identified by the SEC and to recommendations made by the SEC.

Many interested parties believe that, given the rating agencies' important role in the financial markets, it is appropriate and desirable for the SEC to examine them as they would other securities firms. Mr. Lynn Turner, former Chief Accountant of the SEC wrote in congressional testimony that "the SEC has insufficient authority over the credit ratings agencies despite the roles those firms played in Enron and now the sub-prime crisis. This deficiency needs to be remedied by giving the SEC the authority to inspect credit ratings, just as Congress gave the PCAOB the ability to inspect independent audits." [191] Ms. Barbara Roper, Director of Investor Protection at the Consumer Federation of America, wrote in testimony that "the agency should have authority to examine individual ratings engagements to determine not only that analysts are following company practices and procedures but that those practices and procedures are adequate to develop an accurate rating. Congress would need to ensure that any such oversight function was adequately funded and staffed." [192] Standard & Poor's President Deven Sharma wrote in testimony that S&P supports "empowering the

[190] *Reforming Credit Rating Agencies: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, p.12 (2009) (Testimony of Mr. Deven Sharma).

[191] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p. 11 (2009) (Testimony of Mr. Lynn Turner).

[192] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.9 (2009) (Testimony of Ms. Barbara Roper).

SEC to conduct frequent reviews of NRSROs to ensure that NRSROs follow their internal controls and policies for determining ratings and managing conflicts of interest." [193]

Accountability

Paragraph (2) of Section 932 provides that the SEC may temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class or subclass of securities, if the SEC finds, on the record after notice and opportunity for hearing, that NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity. In determining whether an NRSRO lacks such resources, the SEC shall consider an NRSRO's failure to consistently produce accurate ratings over a sustained period of time.

Subsection (q) of Paragraph 6 of Section 932 directs the SEC to require that each NRSRO publicly disclose information on the initial credit ratings published by the NRSRO for each type of obligor, security, and money market instrument and any subsequent changes to such credit ratings. The purpose of this disclosure is to allow users of credit ratings to compare the performance and accuracy of ratings issued by different NRSROs. Disclosures would be clear and informative for investors with varying levels of financial sophistication.

This provision seeks to address the lack of market competition in the credit rating industry by allowing investors to compare NRSRO performance. Industry analysts often identify the lack of competition as one reason why the industry performed poorly in rating securities, such as mortgage-backed securities, and thus contributed to the economic crisis of 2008. To portray the concentrated market for credit ratings, Sean Egan, Managing Director of Egan-Jones Ratings Co., noted that S&P and Moody's control over 90% of the revenues in the ratings industry.[194] This provision will make rating performance public—the goal is to foster market competition by forcing ratings firms to compete on the basis of their rating accuracy. In support of this proposal, Mr. George Miller, Executive Director of the American Securitization Forum, wrote in congressional testimony "we support the publication in a format reasonably accessible to investors of a record of all ratings actions for securitization instruments for which ratings are published. We believe that publication of these data will enable investors and other market participants to evaluate and compare the performance, stability and quality of ratings judgments over time." [195] Ms. Rita Bolger, on behalf of Standard & Poor's, an NRSRO, supports this performance disclosure. She wrote in congressional testimony that a way to promote sound rating oversight would be to "require registered rating agencies to publicly issue performance measurement

[193] *Reforming Credit Rating Agencies: Testimony before the U.S. House Committee on Financial Services*, 111th Congress, 1st session, p.12 (2009) (Testimony of Mr. Deven Sharma).

[194] *Examining the Role of Credit Rating Agencies in the Capital Markets: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 109th Congress, 2nd session, p.1 (2005) (Testimony of Mr. Sean Egan).

[195] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.25 (2009) (Testimony of Mr. George Miller).

statistics over the short, medium, and long term, and across asset classes and geographies." [196]

Finally, this subsection makes accommodation for subscriber-pay NRSROs, by mandating that the disclosure be appropriate to the business model of an NRSRO. For these NRSROs, the publication of rating performance would likely be unsustainable because they rely on credit rating users to pay them for ratings.

During the markup of this legislation, the Committee adopted an amendment proposed by Senator Bennet that would require that at least one-half the members of NRSRO boards be independent directors. Independent directors are defined as those who do not accept consulting, advisory, or other fees from the NRSRO; are not associated with the NRSRO or an affiliate; and do not participate in any deliberation involving a rating in which the independent director has a financial interest. The NRSRO board must be responsible for establishing, maintaining, and enforcing policies and procedures for determining credit ratings; preventing conflicts of interests; the internal control systems; and compensation practices. The provision authorizes the SEC to grant an exemption from independence rules for small NRSROs where compliance would present an unreasonable burden, provided that the responsibilities of the board are delegated to a committee including at least one user of NRSRO ratings.

Disclosure

Subsection (r) of Paragraph 6 of Section 932 directs the SEC to prescribe rules to require each NRSRO to ensure that credit ratings are determined using procedures and methodologies that are approved by the board of directors or senior credit officer. The SEC's rules must require that material changes to ratings procedures and methodologies be applied consistently and publicly disclosed. Such changes must be applied to all credit ratings to which they apply within a reasonable time period, to be determined by the SEC.

The rules will also require each NRSRO to notify users of credit ratings when a material change is made to a procedure or methodology, and when a significant error is identified in a procedure or methodology that may result in credit rating actions. Ms. Rita Bolger, Senior Vice President and Associate General Counsel of Standard & Poor's, wrote in testimony for the Senate Banking Committee that "with greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions." [197]

Subsection (s) of Paragraph 6 of Section 932 directs the SEC to require NRSROs, by rule, to publish a form with each rating that discloses qualitative and quantitative information that is intended to enable investors and users of credit ratings to better understand the main principles and assumptions that underlie the rating. The disclosures shall be easy to use, directly comparable across dif-

[196] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.9 (2009) (Testimony of Ms. Rita Bolger).

[197] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.9 (2009) (Testimony of Ms. Rita Bolger).

ferent classes of securities, and may be provided in either paper or electronic form, as the SEC may, by rule, determine.

The qualitative content of the form shall include the credit ratings produced; the main assumptions and principles used in constructing procedures and methodologies (including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across obligors used in rating structured products); the potential limitations of the credit ratings and the types of risks excluded from the credit ratings that the NRSRO does not comment on; information on the uncertainty of the credit rating including information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; a statement on the reliability and limitations of the data relied upon and any other data accessibility limitations; and whether and to what extent third party due diligence services have been used by the NRSRO, including a description of the information that such third party reviewed in conducting due diligence services and a description of the findings or conclusions of such third party.

The form shall include an overall assessment of the quality of information available and considered in producing a rating in relation to the quality of information available to the NRSRO in rating similar issuances; information relating to conflicts of interest of the nationally recognized statistical rating organization; and such additional information as the SEC may require.

The quantitative content will include an explanation or measure of the potential volatility of the credit rating (including any factors that might lead to a change in the credit ratings), information on the sensitivity of the rating to assumptions made by the NRSRO, and the extent of the change that a user can expect under different market conditions. In addition, the disclosures will include information on the historical performance of the rating and the expected probability of default and the expected loss in the event of default.

These substantial disclosures will give investors and other market participants far more information about the credit risk of a debt issue and the reliability of ratings. Dr. William Irving, Portfolio Manager at Fidelity Investments, wrote in congressional testimony that the Committee should "facilitate greater transparency of the methodology and assumptions used by the rating agencies to determine credit ratings. In particular, there should be public disclosure of the main assumptions behind rating methodologies and models. Furthermore, when those models change or errors are discovered, the market should be notified."[198] Mr. George Miller, Executive Director of the American Securitization Forum, added that he "strongly supports enhanced disclosure of securitization ratings methods and processes, including information relating to the use of ratings models and key assumptions utilized by those models."[199] The Council of Institutional Investors wrote in a letter to Senator Dodd that it supports these reforms designed to "improve the transparency of rating methodologies and assumptions and make

[198] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.12 (2009) (Testimony of Dr. William Irving).

[199] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.25 (2009) (Testimony of Mr. George Miller).

rating agencies truly accountable to the investors that depend on them."[200]

Another disclosure that the NRSROs will have to make regards due diligence services. Subsection (s) provides the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter of an asset-backed security shall be made public, in a format to be determined by the SEC. The disclosures shall be in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party. Many analysts point to the decline of due diligence as a factor that contributed to the poor performance of asset-backed securities during the crisis. Professor John Coffee described the effect of poor due diligence in the credit rating industry in testimony for the Senate Banking Committee: "Unlike other gatekeepers, the credit rating agencies do not perform due diligence or make its performance a precondition of their ratings. In contrast, accountants are, quite literally, bean counters who do conduct audits. But the credit rating agencies do not make any significant effort to verify the facts on which their models rely (as they freely conceded to this Committee in earlier testimony here). Rather, they simply accept the representations and data provided them by issuers, loan originators and underwriters. The problem this presents is obvious and fundamental: no model, however well designed, can outperform its information inputs—Garbage, In; Garbage Out. . . . Ultimately, unless the users of credit ratings believe that ratings are based on the real facts and not just a hypothetical set of facts, the credibility of ratings, particularly in the field of structured finance, will remain tarnished, and private housing finance in the U.S. will remain starved and underfunded because it will be denied access to the broader capital markets."[201] Ms. Barbara Roper, Director of Investor Protection at the Consumer Federation of America, also believes that this provision is important. She wrote in congressional testimony that new legislation should address "lack of due diligence regarding information on which ratings are based."[202]

Section 933. State of mind in private actions

Section 933 was introduced by Senator Reed. It provides that the enforcement and penalty provisions applicable to statements made by a credit rating agency shall apply in the same manner and to the same extent as to statements made by a registered public accounting firm or a securities analyst, and such statements shall not be deemed forward looking statements. In actions for money damages brought against a credit rating agency or a controlling person, it shall be sufficient for pleading any required state of mind in relation to such action, that the complaint state facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the factual elements of the rated security, or failed to obtain reasonable

[200] Mr. Jeff Mahoney, Council of Institutional Investors, letter to Senator Dodd, p. 3, November 18, 2009.

[201] *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, pp.1–2 (2009) (Testimony of Professor John Coffee).

[202] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.8 (2009) (Testimony of Ms. Barbara Roper).

verification of such factual elements from independent sources that it considered to be competent.

Section 933 specifies that, for purposes of passing the pleading test of the Private Securities Litigation Reform Act, plaintiffs need not plead that the CRA "knowingly or recklessly" engaged in a deceptive misrepresentation or omission in communicating with investors, but instead requires only that they plead that the CRA "knowingly or recklessly failed . . . to conduct a reasonable investigation . . . with respect to . . . factual elements . . . or to obtain reasonable verification of such . . . elements . . ."

The Section permits plaintiffs to more easily pass the motion to dismiss stage of litigation. It does not change the ultimate standard used by a fact-finder in determining whether the basic elements of 10b–5 have been met.

Columbia University Law Professor John C. Coffee testified before the Committee that this provision "struck a very sensible compromise in my judgment. It created a standard of liability for the rating agencies, but one with which they easily could comply (if they tried)." He opined that this "language does not truly expose rating agencies to any serious risk of liability—at least if they either conduct a reasonable investigation themselves or obtain verification from others (such as a due diligence firm) that they reasonably believed to be competent and independent . . . so that a rating agency would be fully protected when it received such a certification from an independent due diligence firm that covered the basic factual elements in its model."

Professor Coffee further testified, "The case for this limited litigation threat is that it is unsafe and unsound to let rating agencies remain willfully ignorant. Over the last decade, they have essentially been issuing hypothetical ratings in structured finance transactions based on hypothetical assumed facts provided them by issuers and underwriters. Such conduct is inherently reckless; the damage that it caused is self-evident, and the proposed language would end this state of affairs (without creating anything approaching liability for negligence)."[203]

Section 934. Referring tips to law enforcement or regulatory authorities

Section 934 provides that each NRSRO will refer to the appropriate law enforcement or regulatory authorities any information that the NRSRO receives and finds credible that alleges that an issuer of securities rated by the NRSRO has committed or is committing a violation of law that has not been adjudicated by a Federal or State court. This is in effect a mandatory whistle-blowing provision, and exceptions could be created to cover circumstances when the compliance officer concluded that the information was false or unreliable. This provision requires the NRSRO to determine whether it feels the information is credible, but does not require the NRSRO to undertake extensive fact finding or analysis or to determine whether a violation of law has occurred.

[203] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Professor John Coffee).

Section 935. Consideration of information from sources other than the issuer in rating decisions

Section 935 provides that NRSROs must consider information about an issuer that the NRSRO has, or receives from a source other than the issuer, that the NRSRO finds credible and potentially significant to a rating decision. The Section does not require an NRSRO to initiate a search for such information. The information is expected to be evaluated on its own merits as to whether it indeed should affect the rating. The Committee believes that if the NRSRO possesses credible information that is significant to a rating decision about an issuer, it should consider it even if it has not undertaken to independently verify information it has received from an issuer.

NRSROs use data received from issuers in formulating a rating and may not undertake to verify it. For example, one NRSRO states:

> While [the NRSRO] has obtained information from sources it believes to be reliable, [the NRSRO] does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.
>
> This type of disclosure and policy may create the appearance that the NRSRO could receive credible, material information about the creditworthiness of an issuer from an outside source but choose not to consider it in formulating a rating. Such information could come from a highly credible press report, information from a knowledgeable industry insider, views from a former employee or other source.
>
> Mr. James Gellert, Chairman of Rapid Ratings International, Inc., wrote in congressional testimony that "we believe that, if a rating agency's business model is to provide qualitative assessments of an entity or pool of assets collateralizing a structured product, it should take into account all data it can reasonably attain and qualify as being reliable."[204]

Section 936. Qualification standards for credit rating analysts

Section 936 directs the SEC to issue rules reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings meets standards of training, experience, and competence necessary to produce accurate ratings; and is tested for knowledge of the credit rating process.

Following the devastating impact on investors, the economy, and families that erroneous ratings had during the credit crisis, the Committee feels there is need to improve the analysis underlying credit ratings. This requirement is intended to improve the quality of ratings by increasing the skills of those who formulate them. This section would require credit rating analysts to meet high professional standards for their industry, just as investment advisers, registered representatives, and auditors do for theirs.

Mr. Mark Froeba testified before the Committee about concerns that "Every rating agency employs 'rating analysts' but there are

[204] *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p.18 (2009) (Testimony of Mr. James Gellert).

no independent standards governing this 'profession': there are no minimum educational requirements, there is no common code of ethical conduct, and there is no continuing education obligation. Even where each agency has its own standards for these things, the standards differ widely from agency to agency. One agency may assign a senior analyst with a PhD in statistics to rate a complex transaction; another might assign a junior analyst with a BA in international relations to the same transaction. The staffing decision might appear to investors as yet another tool to manipulate the rating outcome."[205]

Section 937. Timing of regulations

Section 937 directs the SEC to issue final regulations within 1 year of the date of enactment of the Act.

Section 938. Universal ratings symbols

Section 938 was introduced by Senator Menendez. It requires NRSROs to clearly define any symbols used to denote a credit rating, and apply any such symbols in a consistent manner to all types of securities and money market instruments to which they are applied. The Committee believes that an NRSRO's credit rating symbol should have the same meaning about creditworthiness when it is applied to any issuer—the same symbol should not have different meaning depending on the issuer. This Section does not dictate the meaning of any credit rating—whether it refers to an issuer's likelihood of default, ability to pay on time, or other factors. Also, this Section does not prevent an NRSRO from using distinct sets of symbols to denote credit ratings for different types of securities.

Some observers have expressed concerns that some rating agencies apply stricter standards to municipal debt than to corporate debt. Consumer Federation of America and Americans for Financial Reform stated, "Most municipal bonds are rated on a different, more conservative rating scale than corporate bonds. This dual system employed by the largest rating agencies ends up costing state and local governments and their taxpayers over a billion dollars a year, a cost these governments can ill afford. Bond issuers, be they corporate bond issuers or municipal bond issuers, should be rated on the same standard—the likelihood of default."[206] They recommended that the legislation require each NRSRO to: (1) establish, maintain and enforce written policies and procedures designed to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of such securities and instruments, (2) define clearly any credit rating symbols used by the organization, and (3) apply such credit rating symbols in a consistent manner for all types of securities and money market instruments."[207] The National Association of State Treasurers stated that "Bond ratings have a direct impact on the interest rates at which governments can issue their bonds to finance the construction of critically-need infrastructure, and the rat-

[205] *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Mark Froeba).

[206] Consumer Federation of America, Letter to Senators Dodd and Shelby, November 24, 2009.

[207] Letter to Chairman Dodd and Ranking Member Shelby, November 24, 2009.

ings given to these bonds by the major credit ratings agencies play a large role in determining the cost that taxpayers assume when their governments invest in infrastructure . . . We believe that ratings applied to municipal bonds should indicate the same risk as the identical rating applied to a corporate bond, while also recognizing the need for relative ratings among municipal issuers. We further believe that ratings should measure the ability of an issuer to meet its obligation to investors as promised in the bond documents, such obligation primarily being to pay its debt service on time and in full."[208]

Section 939. Government Accountability Office study and federal agency review of required uses of nationally recognized statistical rating organization ratings

Section 939 directs the GAO to study the scope of Federal and State laws and regulations with respect to the regulation of securities markets, banking, insurance, and other areas that require the use of ratings issued by NRSROs. Consulting with a range of regulators and market participants, GAO shall evaluate the necessity of such rating requirements and the potential impact on markets and investors of removing them. Within 2 years of the date of enactment of this Act, the GAO shall report to Congress with recommendations on which ratings requirements, if any, could be removed with minimal disruption to the markets and whether the financial markets and investors would benefit from the rescission of the ratings requirements identified by the study.

Within one year of the completion of GAO's report, the SEC and other financial regulators shall review rating requirements in their regulations, and shall remove such rating requirements, unless they determine that there is no reasonable alternative standard of creditworthiness to replace a credit rating, and that removing the rating requirement would be inconsistent with the purposes of the statute that authorized the regulation and not in the public interest.

Currently, there are numerous instances in government rules and regulations that require the use of NRSRO ratings. This gives the ratings a tacit government sanction. Many observers have recommended to the Senate Banking Committee to enact policy to remove these references to ratings. Professor Lawrence White advised "Eliminate regulatory reliance on ratings—eliminate the force of law that has been accorded to these third-party judgments. The institutional participants in the bond markets could then more readily (with appropriate oversight by financial regulators) make use of a wider set of providers of information, and the bond information market would be opened to new ideas and new entry in a way that has not been possible for over 70 years."

One concern is that the reliance on ratings has become so prevalent that the abrupt removal of ratings could cause unintended consequences and negative effects in the market. Therefore, the Committee provides for a GAO study of the reliance on ratings. Supporting the caution behind this approach, Mr. George Miller, Executive Director of the American Securitization Forum, wrote in congressional testimony "ASF believes that credit ratings are an im-

[208] Letter dated November 17, 2009.

portant part of existing regulatory regimes, and that steps aimed at reducing or eliminating the use of ratings in regulation should be considered carefully, to avoid undue disruption to market function and efficiency." The Investor's Working Group[209] and Mr. Andrew Davidson[210] also support the ultimate goal of reducing the reliance on ratings. The studies would identify those requirements for NRSRO ratings for which there is a necessity and those requirements which could be removed with minimal disruption to the markets over a sufficiently long time period to fully explore possible unintended consequences, alternative measures of creditworthiness and other factors which can ultimately lead to strengthening the financial markets.

Section 939A. Securities and Exchange Commission study on strengthening credit rating agency independence

Section 939A directs the SEC to conduct a study of the independence of NRSROs, evaluate the management of conflicts of interest by NRSROs, and evaluate the potential impact of rules prohibiting an NRSRO that provided a rating to an issuer from providing other services to the issuer. The Committee intends this study to include an identification of the types and scope of services provided by NRSROs and which of these services raises a potential for raising a conflict that could change a rating and to cover other relevant issues identified by GAO.

Section 939B. Government Accountability Office study on alternative business models

Section 939B directs the GAO to conduct a study on alternative means of compensating NRSROs in order to create incentives for NRSROs to provide more accurate ratings and any statutory changes that would be required to facilitate these changes. The GAO will submit this report, with recommendations, within one year of passage of the Act. The predominant NRSRO business model involves the issuer paying for the rating, while a small number of NRSROs rely on subscription fees from users. The Committee asks the GAO to analyze which model is likely to produce the most accurate ratings.

The Committee recognizes that conflicts of interest exist for NRSROs and is interested in an analysis of how and whether they are effectively managed so that they do not unfairly influence ratings decisions. The study should include any recommendations for legislative, regulatory or voluntary industry action. Mr. Stephen Joynt, President and CEO of Fitch, testified "The majority of Fitch's revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market—and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the qual-

[209] *U.S. Financial Regulatory Reform: An Investor's Perspective*, Investor's Working Group, July 2009.

[210] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session (2009) (Testimony of Mr. Andrew Davidson).

ity of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the "issuer pays" model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight."

Mark Froeba, Principal at PF2 Securities Evaluations, Inc. and former Senior Vice President at Moody's, testified that "there are those who believe that real rating agency reform requires a return to an investor-pay model. But there may be a third way, a business model that preserves the issuer-pay "delivery system" (the issuer still gets the bill for the rating) but incorporates the incentives of the investor-pay model. . . . These and other reforms are necessary not only to restore investor confidence in ratings but also to prevent future ratings-related financial crises."[211]

Section 939C. Government Accountability Office study on the creation of an independent professional analysts organization

Section 939C directs the GAO to conduct a study on the feasibility and merits of creating an independent professional organization for NRSRO rating analysts that would establish independent standards for governing the rating analyst profession, establishing a code of ethical conduct, and overseeing the rating analyst profession. The GAO shall submit a report to the relevant congressional committees within one year of passage of the Act. In the aftermath of the devastating financial crisis caused in part by poor credit ratings, the Committee is interested in exploring means to increase the skills of the professionals who produce credit ratings. This Section directs the GAO to explore the potential impact of an independent professional analysts organization. Mark Froeba, Principal at PF2 Securities Evaluations, Inc. and former Senior Vice President at Moody's, testified that he recommended the creation of "an independent professional organization for rating analysts. Every rating agency employs 'rating analysts' but there are no independent standards governing this 'profession': there are no minimum educational requirements, there is no common code of ethical conduct, and there is no continuing education obligation. Even where each agency has its own standards for these things, the standards differ widely from agency to agency. One agency may assign a senior analyst with a PhD in statistics to rate a complex transaction; another might assign a junior analyst with a BA in international relations to the same transaction . . . Creating one independent professional organization to which rating analysts from all rating agencies must belong will ensure uniform standards especially ethical standards—across all the rating agencies. It would also provide a forum external to the agencies where rating analysts might bring confidential complaints about ethical concerns. An independent organization could track and report the nature and number of these complaints and alert regulators if there are patterns in the complaints, problems at particular agencies, and even whether there are problems with particular managers at

[211] *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.18 (2009) (Testimony of Mr. Mark Froeba).

one rating agency. Finally, such an organization should have the power to discipline analysts for unethical behavior."[212]

Subtitle D

Section 941. Regulation of credit risk retention

This section requires securitizers, defined as those who issue, organize, or initiate asset-backed securities, to retain an economic interest in a material portion of the credit risk for any asset that securitizers transfer, sell, or convey to a third party. The provision intends to create incentives that will prevent a recurrence of the excesses and abuses that preceded the crisis, restore investor confidence in asset-backed finance, and permit securitization markets to resume their important role as sources of credit for households and businesses.

The Committee's investigation into the causes of the financial crisis identified abuses of the securitization process as a major contributing factor. Two problems emerged in the crisis. First, under the "originate to distribute" model, loans were made expressly to be sold into securitization pools, which meant that the lenders did not expect to bear the credit risk of borrower default. This led to significant deterioration in credit and loan underwriting standards, particularly in residential mortgages. According to the testimony of Dr. William Irving, Portfolio Manager of Fidelity Investments:

> Without a doubt, securitization played a role in this crisis. Most importantly, the "originate-to-distribute" model of credit provision seemed to spiral out of control. Under this model, intermediaries found a way to lend money profitably without worrying if the loans were paid back. The loan originator, the warehouse facilitator, the security designer, the credit rater, and the marketing and product-placement professionals all received a fee for their part in helping to create and distribute the securities. These fees were generally linked to the size of the transaction and most of them were paid up front. So long as there were willing buyers, this situation created enormous incentive to originate mortgage loans solely for the purpose of realizing that up-front intermediation profit.[213]

Second, it proved impossible for investors in asset-backed securities to assess the risks of the underlying assets, particularly when those assets were resecuritized into complex instruments like collateralized debt obligations (CDOs) and CDO-squared. With the onset of the crisis, there was widespread uncertainty regarding the true financial condition of holders of asset-backed securities, freezing interbank lending and constricting the general flow of credit. Complexity and opacity in securitization markets created the conditions that allowed the financial shock from the subprime mortgage sector to spread into a global financial crisis, as Professor Patricia A. McCoy testified before the Committee:

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[212] *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.18 (2009) (Testimony of Mr. Mark Froeba).

[213] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Dr. William Irving).

> General investor panic is [another] reason for contagion. Even in transactions involving no nonprime collateral, concerns about the nonprime crisis had a ripple effect, making it hard for companies and cities across-the-board to secure financing. Banks did not want to lend to other banks out of fear that undisclosed nonprime losses might be lurking on their books. Investors did not want to buy other types of securitized bonds, such as those backed by student loans or car loans, because they lost faith in ratings and could not assess the quality of the underlying collateral.[214]

Section 941 directs the Federal banking agencies and the SEC to jointly prescribe regulations to require any securitizer to retain a material portion of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. When securitizers retain a material amount of risk, they have "skin in the game," aligning their economic interests with those of investors in asset-backed securities. Securitizers who retain risk have a strong incentive to monitor the quality of the assets they purchase from originators, package into securities, and sell.

The regulations will prohibit securitizers from hedging or otherwise transferring the credit risk they are required to retain. The prohibition does not extend to hedging risks other than credit risk (such as interest rate risk) associated with the retained assets or position. Originators (defined as persons who through the extension of credit or otherwise create financial assets that collateralize an asset-backed security, and sell assets to a securitizer) will come under increasing market discipline because securitizers who retain risk will be unwilling to purchase poor-quality assets. Thus, the bill does not require that the regulations impose risk retention obligations on originators. Risk retention may be divided between securitizers and originators only if the regulators consider that assets being securitized do not have characteristics of low credit risk, that conditions in securitization markets are creating incentives for imprudent origination, and that allocating part of the risk retention obligation to originators would not prevent consumers and businesses from obtaining credit on reasonable terms.

There is broad support for risk retention by securitizers. The provision was included in the Treasury Department's 2009 legislative proposal.[215] Mr. George Miller, Executive Director of the American Securitization Forum, testified before the Committee that "we support the concept of requiring retention of a meaningful economic interest in securitized loans as a means of creating a better alignment of incentives among transaction participants."[216] The Group of Thirty recommended risk retention as part of broad financial reform:

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[214] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Patricia A. McCoy).

[215] *Title IX—Additional Improvements to Financial Markets Regulation Subtitle D*, U.S. Department of the Treasury, 2009, www.financialstability.gov.

[216] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.19 (2009) (Testimony of Mr. George Miller).

> The healthy redevelopment of securitized credit markets requires a restoration of market confidence in the adequacy and sustainability of credit underwriting standards. To help achieve this, regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.[217]

The Consumer Federation of America[218], CalPERS[219], and the Investor's Working Group[220] also support this provision.

The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes. Witnesses before the Committee and a number of market participants have indicated that a "one size fits all" approach to risk retention may adversely affect certain securitization markets. For example, Mr. J. Christopher Hoeffel of the Commercial Mortgage Securities Association testified that "[P]olicymakers must ensure that any regulatory reforms are tailored to address the specific needs of each securitization asset class. Again, CMSA does not oppose these [risk retention] measures *per se*, but emphasizes that they should be tailored to reflect key differences between the different asset-backed securities markets."[221] Accordingly, the bill requires that the initial joint rulemaking include separate components addressing individual asset classes—home mortgages, commercial mortgages, commercial loans, auto loans, and any other asset class that the regulators deem appropriate. The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required.

In addition, the risk retention rules may provide a total or partial exemption for any securitization, as may be appropriate in the public interest and for the protection of investors. The Committee expects that asset-backed securities backed by the full faith and credit of the United States, or where the underlying assets were guaranteed by an agency of the United States, would qualify for such an exemption.

The section provides a baseline risk retention amount of 5 percent of the credit risk in any securitized asset. The figure may be set higher at the regulators' discretion, or it may be reduced below 5 percent when the assets securitized meet standards of low credit risk to be established by rule for the various asset classes. The Committee believes that regulators should have flexibility in setting risk retention levels, to encourage recovery of securitization

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[217] *Financial Reform: A Framework for Financial Stability*, Group of Thirty, p. 49, January 15, 2009.

[218] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session (2009) (Testimony of Ms. Barbara Roper).

[219] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Mr. Joseph Dear).

[220] *U.S. Financial Regulatory Reform: An Investor's Perspective*, Investor's Working Group, July 2009.

[221] [*Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Mr. J. Christopher Hoeffel).]

markets and to accommodate future market developments and innovations, but that in all cases the amount of risk retained should be material, in order to create meaningful incentives for sound and sustainable securitization practices.

The section also authorizes regulators to make exemptions, exceptions, or adjustments to the risk retention rules, provided that any such exemptions, exceptions, or adjustments help ensure high underwriting standards, encourage appropriate risk management practices, improve access to credit on reasonable terms, or are otherwise in the public interest.

Section 942. Disclosures and reporting for asset-backed securities

Section 942 seeks to improve transparency in asset-backed securities. It directs the SEC to adopt regulations requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security. These disclosures shall be in a format that facilitates comparison of such data across securities in similar types of asset classes. Issuers of asset-backed securities shall disclose asset-level or loan-level data necessary for investors to independently perform due diligence. This data would include data having unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention by the originator or the securitizer of such assets. The Committee does not expect that disclosure of data about individual borrowers would be required in cases such as securitizations of credit card or automobile loans or leases, where asset pools typically include many thousands of credit agreements, where individual loan data would not be useful to investors, and where disclosure might raise privacy concerns.

Mr. George Miller, Executive Director of the American Securitization Forum, wrote in testimony for the Committee that "ASF supports increased transparency and standardization in the securitization markets, and related improvements to the securitization market infrastructure. . . . ASF believes that every mortgage loan should be assigned a unique identification number at origination, which would facilitate the identification and tracking of individual loans as they are sold or financed in the secondary market, including via RMBS securitization."[222] The Investor's Working Group wrote in a report that "the SEC should develop a regulatory regime for such asset-backed securities that would require issuers to make prospectuses available for potential investors in advance of their purchasing decisions. These prospectuses should disclose important information about the securities, including the terms of the offering, information about the sponsor, the issuer and the trust, and details about the collateral supporting the securities. Such new rules would give investors critical information they need to perform due diligence on offerings prior to investing. It would also create better opportunities for due diligence by the underwriters of such securities, thus adding additional levels of oversight of the quality

[222] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.18 (2009) (Testimony of Mr. George Miller).

and appropriateness of structured offerings."[223] Professor Patricia McCoy wrote in testimony "the SEC should require securitizers to provide investors with all of the loan-level data they need to assess the risks involved. . . . In addition, the SEC should require securitizers and servicers to provide loan-level information on a monthly basis on the performance of each loan and the incidence of loan modifications and recourse."[224] CalPERS[225], Mr. Andrew Davidson[226], and Dr. William Irving[227] also supported enhanced disclosure in testimony before the Committee.

Section 943. Representations and warranties in asset-backed offerings

This section directs the SEC to prescribe regulations on the use of representations and warranties in the market for asset-backed securities that require each NRSRO to include in any report accompanying a credit rating a description of the representations, warranties, and enforcement mechanisms available to investors and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities. The SEC will also prescribe rules to 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.

This provision was included in the Treasury Department's legislative proposal.[228] Moody's Investor Services described the use of representations and warranties and pointed out weaknesses in their current usage:

> [T]he seller or originator in structured securities makes representations and warranties regarding the characteristics of the loans they sell into securitizations. In light of recent events, typical representations and warranties should be strengthened. In addition to other matters, the seller could provide representations and warranties to investors as to the quality and accuracy of all information presented to investors, rating agencies and other market participants. The value of representations and warranties is diminished when made by entities that are not financially strong, as such entities may be less able to fulfill their obligation to repurchase loans that breach the representations and warranties.[229]

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[223] *U.S. Financial Regulatory Reform: An Investor's Perspective*, Investor's Working Group, p.14, July 2009.

[224] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.13 (2009) (Testimony of Professor Patricia McCoy).

[225] *Regulating Hedge Funds and Other Private Investment Pools: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session (2009) (Testimony of Mr. Joseph Dear).

[226] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session (2009) (Testimony of Mr. Andrew Davidson).

[227] *Securitization of Assets: Problems and Solutions: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p. (2009) (Testimony of Dr. William Irving).

[228] *Title IX—Additional Improvements to Financial Markets Regulation Subtitle D*, U.S. Department of the Treasury, 2009, www.financialstability.gov.

[229] *Moody's Proposes Enhancements to Non-Prime RMBS Securitization*, Moody's, Special Report, p.2, September 25, 2007.

The Committee believes that enhanced disclosure will allow investors to better evaluate representations and warranties and create incentives for issuers to insist that originators back up their representations and warranties with real financial resources.

Section 944. Exempted transactions under the Securities Act of 1933

Section 944 removes the Securities Act of 1933 exemption of transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure.

Section 945. Due diligence analysis and disclosure in asset-backed securities issues

Section 945 directs the SEC to issue rules that require any issuer of an asset-backed security to perform a due diligence analysis of the assets underlying the asset-backed security; and to disclose the nature of this analysis. Professor John Coffee, in congressional testimony, called for action to "re-introduce due diligence into the securities offering process." [230]

Subtitle E

Section 951. Shareholder vote on executive compensation disclosures

Section 951 provides that any proxy or consent or authorization for an annual or other meeting of the shareholders will include a separate resolution subject to shareholder advisory vote to approve the compensation of executives. The Committee believes that shareholders, as the owners of the corporation, have a right to express their opinion collectively on the appropriateness of executive pay. The vote must be tabulated and reported, but the result is not binding on the board or management.

In crafting this Section, there was consideration of alternative time intervals, such as votes every three years, and of whether votes after the first year should be triggered only by a failure to receive a minimum percentage of votes in support of the compensation plan. This provision would not preclude an issuer from seeking more specific shareholder opinion through separate votes on cash compensation, golden parachute policy, severance or other aspects of compensation.

A "say on pay" proposal was included in the Treasury Department's legislative proposal. The economic crisis revealed instances in which corporate executives received very high compensation despite the very poor performance by their firms. For example, Mr. Charles O. Prince III, the former chief executive of Citigroup, "collected $110 million while presiding over the evaporation of roughly $64 billion in market value. He left Citigroup in November with an exit package worth $68 million, including $29.5 million in accumulated stock, a $1.7 million pension, an office and assistant, and a car and a driver. Citigroup's board also awarded him a cash bonus for 2007 worth about $10 million, largely based on his performance in 2006 when the bank's results were better. Citigroup has an-

[230] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, p.53 (2009) (Testimony of Professor John Coffee).

nounced write-offs worth roughly $20 billion and its share has plummeted over 60 percent from last year's high."[231]

Ms. Ann Yerger, representing the Council of Institutional Investors, wrote in congressional testimony for the Committee that "the Council believes an annual, advisory shareowner vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members. They might also induce compensation committees to be more careful about doling out rich rewards, to avoid the embarrassment of shareowner rejection at the ballot box. In addition, compensation committees looking to actively rein in executive compensation could use the results of advisory shareowner votes to stand up to excessively demanding officers or compensation consultants."[232]

The UK has implemented "say on pay" policy. Professor John Coates in testimony for the Senate Banking Committee stated that the UK's experience has been positive; "different researchers have conducted several investigations of this kind . . . These findings suggest that say-on-pay legislation would have a positive impact on corporate governance in the U.S. While the two legal contexts are not identical, there is no evidence in the existing literature to suggest that the differences would turn what would be a good idea in the UK into a bad one in the U.S."

Other observers who support "say on pay" include the Consumer Federation of America, AFSCME, and the Investor's Working Group.

Section 952. Compensation committee independence

Section 952 directs the SEC to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with independent compensation committee standards. In determining whether a director is independent, the national securities exchanges should consider the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the board of directors; and whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. Any compensation counsel or adviser shall be independent.

The issuer's proxy or consent materials must disclose whether the compensation committee has used the advice of a compensation consultant and whether the committee has raised any conflict of interest. However, the provision does not require the use of compensation consultants. The Section also directs the SEC to conduct a study of the use of compensation consultants and their impact.

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[231] "Chiefs' Pay Under Fire At Capitol," The New York Times, March 8, 2008.

[232] *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Testimony before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress, 1st session, (2009) (Testimony of Ms. Ann Yerger).

The Treasury Department's legislative proposal included an independent compensation committee.

The Council of Institutional Investors wrote in a letter to Senator Dodd "Compensation committees and their external consultants play a key role in the pay-setting process. Conflicts of interest contribute to a ratcheting up effect for executive pay, however, and should thus be minimized and disclosed. Reforms included in the discussion draft would help ensure that compensation committees are free of conflicts and receive unbiased advice."

Section 953. Executive compensation disclosures

Section 953 directs the SEC to require each issuer to disclose in the annual proxy statement of the issuer a clear description of any compensation required to be disclosed under the SEC executive compensation forms and information that shows the relationship between executive compensation and the financial performance of the issuers, taking into account the change in the value of the shares, dividends and distributions. It has become apparent that a significant concern of shareholders is the relationship between executive pay and the company's financial performance for the benefit of shareholders. Shareholders are keenly interested when executive compensation is increasing sharply at the same time as financial performance is falling.

The Committee believes that these disclosures will add to corporate responsibility as firms will have to more clearly disclose and explain executive pay. Ms. Ann Yerger wrote in congressional testimony on behalf of the Council of Institutional Investors "of primary concern to the Council is full and clear disclosure of executive pay. As U.S. Supreme Court Justice Louis Brandeis noted, 'sunlight is the best disinfectant.' Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting."

This disclosure about the relationship between executive compensation and the financial performance of the issuer may include a clear graphic comparison of the amount of executive compensation and the financial performance of the issuer or return to investors and may take many forms. For example, a graph could have a horizontal axis of a number of years and a vertical axis with two scales, one for executive compensation and a second for financial performance of the issuer for each year.

Section 954. Recovery of erroneously awarded compensation

Section 954 requires public companies to have a policy to recover money that they erroneously paid in incentive compensation to executives as a result of material noncompliance with accounting rules. This is money that the executive would not have received if the accounting was done properly and was not entitled to. This provision creates Section 10D of the Securities Exchange Act of 1934, which requires the SEC to direct the national securities exchanges and national securities associations to prohibit the listing of issuers who do not develop and implement a policy providing that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance, the issuer will recover

from any current or former executive officer of the issuer any compensation in excess of what would have been paid to the executive officer had correct accounting procedures been followed. This policy is required to apply to executive officers, a very limited number of employees, and is not required to apply to other employees. It does not require adjudication of misconduct in connection with the problematic accounting that required restatement.

The Committee believes it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously. This proposal will clarify that all issuers must have a policy in place to recover compensation based on inaccurate accounting so that shareholders do not have to embark on costly legal expenses to recoup their losses or so that executives must return monies that should belong to the shareholders. The Investor's Working Group wrote "federal clawback provisions on unearned executive pay should be strengthened."[233]

Section 955. Disclosure regarding employee and director hedging

Section 955 directs the SEC to require each issuer to disclose in the annual proxy statement whether the employees or members of the board of the issuer are permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted to employees by the issuer as part of an employee compensation. This will allow shareholders to know if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform. Dr. Carr Bettis has written that derivatives instruments "provide a mechanism that insiders can use to trade on inside information prior to adverse corporate events without the level of transparency typically associated with open market sales."[234]

Section 956. Excessive compensation by holding companies of depository institutions

Section 956 amends Section 5 of the Bank Holding Company Act of 1956 to establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or could lead to material financial loss to the bank holding company. This applies regulatory authority currently applicable to banks to their holding companies.

Section 957. Voting by brokers

Section 957 amends the Securities Exchange Act of 1934 so that brokers who are not beneficial owners of a security cannot vote through company proxies unless the beneficial owner has instructed the broker to do so. The final vote tallies should reflect the wishes of the beneficial owners of the stock and not be affected by the wishes of the broker that holds the shares.

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[233] *U.S. Financial Regulatory Reform: An Investor's Perspective*, Investor's Working Group, July 2009.

[234] See Bettis, Bizjak and Kalpathy, "Insiders' Use of Hedging Instruments: An Empirical Examination," March 2009.

Subtitle F

Section 961. Report and certification of internal supervisory controls

Section 961 directs the SEC to submit a report on SEC's conduct of examinations of registered entities, enforcement investigations, and review of corporate financial securities filings to the House Financial Services and Senate Banking Committees. Each report should contain an assessment of the SEC's internal supervisory controls and examination staff procedures; a certification of adequate supervisory controls by the Directors of the Divisions of Enforcement, Division of Corporation Finance, and Office of Compliance Inspection and Examinations; and a review by the U.S. Comptroller General attesting to the adequacy and effectiveness of the internal supervisory control structure and procedures.

The purpose of this Section is to promote complete and consistent performance of SEC staff examinations, investigations and reviews, and appropriate supervision of these activities, through internal supervisory controls. There have been numerous examples where securities misconduct has flourished and investors have been harmed due to failure to follow reasonable procedures. For example, the Inspector General found that the Enforcement Office of the Chief Accountant received numerous complaints alleging financial fraud committed by a public company over 2½ years which were "not reviewed, analyzed or investigated" because "the referral procedures for monitoring the progress of referrals of complaints . . . were not followed in the 2005–2007 time period. For example, regular meetings to decide the disposition of referrals were being held." (SEC Office of Inspector General Report of Investigation, "Failure to Timely Investigate Allegations of Financial Fraud," February 26, 2010).

The massive fraud perpetrated by Bernard L. Madoff through a Ponzi scheme cost investors a tremendous amount of money and went undetected through failures in SEC exams and investigations. This illustrates the need for such internal supervisory controls. The failure of the SEC (or of FINRA) to identify the fraud before Mr. Madoff confessed to his sons and to law enforcement seriously damaged investor confidence in the effectiveness and competence of regulators. The Inspector General of the SEC, Mr. David Kotz, testified before the Committee about his study of the SEC's failure to find the Madoff fraud. The study found "that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent returns." [IG Report pages 20–21]

Inspector General Kotz's comprehensive study found that on several occasions during more than a decade, the SEC failed to perform what appear to be rudimentary procedures that could or would have uncovered the Ponzi scheme. The Inspector General reported that the "complaints all contained specific information and could not have been fully and adequately resolved without thoroughly examining and investigating Madoff for operating a Ponzi scheme." [Page 22]. For example, the Inspector General retained an expert to assist in the investigation and was told that "the most critical step in examining or investigating a potential Ponzi scheme is to verify the subject's trading through an independent third party." The OIG investigation "found the SEC conducted two investigations and three examinations . . . based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff's trading through an independent third-party." The OIG found that the examinations were "too narrowly focused." The OIG found that "the examination teams . . . caught Madoff in contradictions and inconsistencies. However they either disregarded these concerns or simply asked Madoff about them. Even when Madoff's answers were seemingly implausible, the SEC examiners accepted them at face value." [page 23]

"In the first of the two OCIE examinations, the examiners drafted a letter to the National Association of Securities Dealers . . . seeking independent trade data, but they never sent the letter, claiming that it would have been too time-consuming to review the data they would have obtained. The OIG's expert opined that had the letter to the NASD been sent, the data would have provided the information necessary to reveal the Ponzi scheme. In the second examination, the OCIE Assistant Director sent a document request to a financial institution that Madoff claimed he used to clear his trades, requesting trading done by or on behalf of particular Madoff feeder funds during a specific time period, and received a response that there was no transaction activity in Madoff's account for that period. However, the Assistant Director did not determine that the response required any follow-up . . . Both examinations concluded with numerous unresolved questions and without any significant attempt to examine the possibility that Madoff was misrepresenting his trading and operating a Ponzi scheme." [page 24]

The "Enforcement staff almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on inconsistencies. . . . When Madoff provided evasive or contradictory answers to important questions in testimony, they simply accepted as plausible his explanations . . . They reached out to the NASD and asked for information on whether Madoff had options positions on a certain date, but when they received a report that there were in fact no options positions on that date, they did not take further steps. An Enforcement staff attorney made several attempts to obtain documentation from European counterparties (another independent third-party) and although a letter was drafted, the Enforcement staff decided not to send it. Had any of these efforts been fully executed, they would have led to Madoff's Ponzi scheme being uncovered."

In addition, the incidents of courts overturning SEC rulemakings in recent years calls into question whether the process by which the SEC is promulgating final rules should be reexamined and refined. The SEC's process for reaching settlement recommendations may need to be reexamined also, in light of the recent decision of the Federal District Court in New York that rejected as inadequate a proposed $33 million settlement involving charges of securities fraud against Bank of America which it said "does not comport with the most elementary notions of justice and morality . . . [and] suggests a rather cynical relationship between the parties: the SEC gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile merger; the Bank's management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all of this is done at the expense, not only of the shareholders, but also of the truth."[235] Internationally renowned Columbia University Professor John C. Coffee has expressed concerns about what he has seen as "dysfunction in SEC enforcement practices."[236] Recently, the SEC Office of Inspector General Report of Investigation published a report, "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme" which found that over eight years an SEC office "dutifully conducted examinations of Stanford in 1997, 1998, 2002 and 2004, concluding in each case that Stanford's CDs were likely a Ponzi scheme or a similar fraudulent scheme. . . . [while the] Examination group made multiple effort after each examination to convince . . . [Enforcement] to open and conduct an investigation of Stanford, no meaningful effort was made by Enforcement to investigate the potential fraud or to bring an actions to attempt to stop it until late 2005.

Section 962. Triennial report on personnel management

Section 962 directs the GAO to submit a triennial report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on personnel management by the SEC. In the wake of the financial crisis, it is clear that the SEC, along with other federal regulators, did not perform its duties as intended. The study would review several areas that have been implicated, including supervision, competence, communication, turnover, and other areas, with recommendations for improvements. Within 90 days the SEC will submit a report to these congressional Committees describing what actions it has taken in response to the GAO report.

The SEC has been receiving increased amounts of funds and is expected to continue to do so. It is critical that these funds be used efficiently and not wasted. These studies will promote the effective use of resources.

Mr. Damon Silvers, Associate General Counsel of the AFL-CIO, wrote in congressional testimony that "The Commission should look at more intensive recruiting efforts aimed at more experienced

[235] The case is Securities and Exchange Commission v. Bank of America Corp., 09–cv–06829, U.S. District Court, Southern District of New York (Manhattan).

[236] The End of Phony Deterrence? 'SEC v. Bank of America', John C. Coffee, Jr., *New York Law Journal,* September 17, 2009.

private sector lawyers who may be looking for public service opportunities."[237]

The Investor's Working Group wrote in their regulatory reform report "Regulators should acquire deeper knowledge and expertise. The speed with which financial products and services have proliferated and grown more complex has outpaced regulators' ability to monitor the financial waterfront. Staffing levels failed to keep pace with the growing work load, and many agencies lack staff with the necessary expertise to grapple with emerging issues. Political appointees and senior civil service staff should have a wide range of financial backgrounds. Compensation should be sufficient to attract top-notch talent. In addition, continuing education and training should be dramatically expanded and officially mandated to help regulators keep pace with innovation."[238]

The reports should address key management issues. Renowned Columbia University Law School Professor John C. Coffee said an important "issue is how to change the SEC's culture."[239] Senator Merkley at the Madoff IG hearing asked about SEC employees involved, "Was there a general culture of a lack of curiosity, a lack of wanting to inconvenience big players . . . What are the managerial issues?"[240] Information in the SEC Inspector General's report on the Madoff investigation raises concerns about whether some employees who had been promoted to serve as mid-level supervisors had the necessary judgment, commitment or temperament to be effective supervisors. This suggests questions about the appropriateness of how employees are promoted to supervisory positions. One indication of a supervisor's ineffectiveness may be high turnover among subordinates. Related to this issue, the Committee notes that the Division of Enforcement will eliminate the position of branch chief. The stated purpose "is to streamline our management structure . . . by redeploying our branch chiefs . . . to the heart-and-soul function of the SEC—conducting investigations. This flattening of our management structure will increase the resources dedicated to our investigative efforts, and will operate as a check on the extra process, duplication, unnecessary internal review and the inevitable drag on decision-making that happens in any overly-managed organization." The Committee sees this as a positive step, which suggests the question of whether there are excessive numbers of low- or mid-level managers in other divisions and similar steps should be taken to improve the effectiveness and better use the resources of those divisions.

Members of the Committee noted that it was some SEC employees' apparent incompetence that allowed the Madoff fraud to continue for so long—a case of incompetence and not lack of resources or legal authority. For example, Senator Menendez said that "the SEC staff was, from everything I've read of your report, grossly un-

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[237] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, pp. 5–6 (2009) (Testimony of Mr. Damon A. Silvers).

[238] *U.S. Financial Regulatory Reform: An Investor's Perspective,* Investor's Working Group, p. 10, July 2009.

[239] *The End of Phony Deterrence? 'SEC* v. *Bank of America*', John C. Coffee, Jr., *New York Law Journal,* September 17, 2009.

[240] "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs", 111th Congress, 1st session, p. 33 (2009) (Statement of Senator Jeff Merkley).

trained, uncoordinated and lazy in their investigations." He asked "who's held accountable for these grossly incompetent performances?"[241] This raises a concern to review SEC response to employees who fail to perform their duties. The IG report also identifies a concern that SEC-regulated entities have on many occasions brought informally to the attention of the Committee in other contexts, that different offices within the Commission do not communicate effectively or, at times, willingly, with each other to share expertise. Former SEC Chairman William Donaldson embarked upon a project to "tear down the silos" and promote more communication. Some regulated entities have informally complained to the Committee that the SEC inspectors arrive on their premises with a limited knowledge of the business they are about to inspect, and ask the employees of the regulated entity to teach them how their businesses operate. It would be appropriate for formal reviews of the efficiency of communication between units of the Commission.

Since the concerns identified here, and related ones, have faced the Commission for many years, the Committee feels it is important to have periodic studies by and recommendations from the GAO with the goal of sustaining improvements at the Commission.

Section 963. Annual financial controls audit

Section 963 directs the SEC to submit an annual report to Congress that describes the responsibility of the management of the SEC for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and contains an assessment of the effectiveness of the internal control structure and procedures for financial reporting of the SEC during that fiscal year. This is intended to improve the quality of the SEC's internal financial control structure.

The SEC administers the requirements under Section 404 of the Sarbanes-Oxley Act of 2002 that public companies report on the effectiveness of their internal control structure and procedures for financial reporting. Public companies need effective internal controls in order to produce accurate financial reports, confidently plan their financial activities, and inspire the confidence of investors in the integrity of public companies and in the securities markets.

As the Federal regulator of compliance with these requirements, it is appropriate for the SEC itself to be an example and have an effective internal financial control structure and for that to be attested to. Unfortunately, the SEC has been found to have material weaknesses in its own internal financial controls.

The GAO has reviewed the SEC's internal financial controls since 2004. In many of these reviews, the GAO has found that the SEC has material weaknesses and needs improvement in their internal control structure. GAO stated in November of 2009 that "in GAO's opinion, SEC did not have effective internal control over financial reporting as of September 30, 2009. . . . During this year's audit, we identified six significant deficiencies that collectively represent a material weakness in SEC's internal control over financial reporting. The significant deficiencies involve SEC's internal con-

[241] "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs", 111th Congress, 1st session, p. 33 (2009) (Statement of Senator Robert Menendez).

trol over (1) information security, (2) financial reporting process, (3) fund balance with Treasury, (4) registrant deposits, (5) budgetary resources, and (6) risk assessment and monitoring processes. These internal control weaknesses give rise to significant management challenges that have reduced assurance that data processed by SEC's information systems are reliable and appropriately protected; impaired management's ability to prepare its financial statements without extensive compensating manual procedures; and resulted in unsupported entries and errors in the general ledger."[242] Similarly, the GAO has found that the SEC did not have effective internal controls over financial reporting as of September 30, 2004, 2005, and 2007. In light of these persistent shortcomings and the importance of the SEC, an annual review is appropriate and beneficial.

Section 964. Report on oversight of national securities associations

Section 964 provides that, once every three years, the GAO shall study and submit a report to Congress on the SEC's oversight of national securities associations (NSA). The report is intended to promote regular and effective oversight by the SEC of the NSA and to inform the Congress in its oversight role of the Nation's securities markets. Such oversight is important to assist and promote the NSA's performance of its mission and fair dealing with investors and members and to evaluate any public concerns that arise.

It is the Committee's intent that the SEC should oversee specifically several important functions which have been discussed in connection with the current market situation. These matters include an evaluation of governance, including the identification and management of conflicts of interest, such as those existing when an executive of a broker-dealer sits on an NSA board and the NSA enforces its rules on such firms; examinations, including the evaluation of the expertise of staff; executive compensation practices; the extent of cooperation with and responsiveness in providing assistance to State securities administrators; funding; arbitration services, which may include enforcement of discovery rules and fairness of selection process for arbitrators on the panel, and NSA review of member advertising.

Former SEC Chief Accountant Lynn Turner testified on March 10, 2009 that:

> FINRA has been a useful participant in the capital markets. It has provided resources that otherwise would not have been available to regulate and police the markets. Yet serious questions have arisen that need to be considered when improving the effectiveness and efficiency of regulation.
>
> Currently the Board of FINRA includes representatives from those who are being regulated. This is an inherent conflict and raises the question of whose interest the Board of FINRA serves. To address this concern, consideration should be given to establishing an independent board, much like what Congress did when it established the Public Company Accounting Oversight Board.

[242] *Securities and Exchange Commission's Financial Statements for Fiscal Years 2009 and 2008,* GAO, "Highlights," November 2009.

In addition, the arbitration system at FINRA has been shown to favor the industry, much to the detriment of investors. While arbitration in some instances can be a benefit, in others it has been shown to be costly, time consuming, and biased to those who are constantly involved with it. Accordingly, FINRA's system of arbitration should be made optional, and investors given the opportunity to pursue their case in a court of law if they so desire to do so.

Finally careful consideration should be given to whether or not FINRA should be given expanded powers over investment advisors as well as broker dealers. FINRA's drop in fines and penalties in recent years, and lack of transparency in their annual report to the public, raises questions about its effectiveness as an enforcement agency and regulator. And with broker dealers involved in providing investment advice, it is important that all who do so are governed by the same set of regulations, ensuring adequate protection for the investing public.

The Committee has received letters from groups that have raised numerous concerns about the performance of FINRA, expressing concern that they "have failed to prevent virtually all of the major securities scandals since the 1980s," their compensation packages for the organization's senior executives are "outrageous" for their large size, they failed to warn the public about auction rate securities and other reasons. The Committee believes it is necessary for the GAO to conduct a study and issue a report on the SEC oversight of national securities associations at least every three years given their important role in the market and the concerns which have arisen or persisted for many years.

Section 965. Compliance examiners

Section 965 directs the SEC Divisions of Trading and Markets and of Investment Management each to have a staff of examiners to perform compliance inspections and examinations of entities under their jurisdictions and report to the Director of the Division. This is intended to improve the effectiveness of the SEC. This will provide each Division internally with experts in inspections and in the regulations of that Division, who are closely acquainted with and have access to the staff who write and interpret those regulations.

The Inspector General's report on the Madoff investigation and the testimony of Mr. Harry Markopolos, for example, were critical of the competence and training of the examiners, including their unwillingness to ask for information or expertise from someone in another SEC division. Mr. David G. Tittsworth, Executive Director of the Investment Adviser Association, wrote in testimony for the Senate Banking Committee that "the SEC can and should improve its inspection program."[243] Informal information presented to the Committee from regulated entities has indicated that the Office of Compliance Inspection and Examinations sometimes sends staff on

[243] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. David Tittsworth).

examinations who have lacked requisite expertise to examine complex registered financial or securities firms. As a result, the quality of the exams appears to have suffered, the staff may have taken undue amounts of time to perform inspections because they relied excessively on the employees of the firms being examined to teach them about the business, and the reputation of the agency has suffered.

Section 966. Suggestion program for employees of the commission

Section 966 directs the SEC Inspector General to establish a hotline for SEC employees to submit suggestions for improvements in the efficiency, effectiveness, productivity and use of resources of the SEC, as well as allegations of waste, abuse, misconduct or mismanagement within the SEC. The Inspector General shall maintain as confidential the identity of a person who provides information unless he or she requests otherwise in writing and any specific information at the person's request. The Inspector General will report to Congress annually on the nature, number and potential benefits of the suggestions of any suggestions; the nature, number and seriousness of any allegations; the Inspector General's recommendations and actions taken in response to the allegations; and actions the SEC has taken in response to the suggestions and allegations.

The SEC would benefit by having more meritorious suggestions from its employees on how to improve efficiency and productivity. This is particularly important when the SEC will be receiving larger budgets and after a period of increased public concerns about the agency's ineffective use of resources raised in Madoff, restacking, and in other situations. It is not clear that the current system for attracting suggestions to improve productivity has been producing a robust crop of meritorious suggestions.

The Committee expects that there will be review and appropriate action on meritorious suggestions. The Inspector General may recognize an employee who makes a suggestion that would or does increase efficiency, effectiveness or productivity at the SEC or reduces waste, abuse, misconduct or mismanagement. The costs of this Suggestion Program shall be funded by the SEC Investor Protection Fund. Nothing in this section limits other statutory authorities of the Inspector General.

This Program is placed within the Office of the Inspector General, which has a tradition of analyzing agency activity to prevent abuse and promote effective operations. The IG already has a formal system in place for receiving employee complaints which can be adapted to receive suggestions. Further, the Office of Inspector General has a reputation for keeping employee confidences and is not in the normal chain of command in the SEC, so that employees may feel more confident that they can offer suggestions confidentially and without the risk of retaliation by a supervisor. The Inspector General is sufficiently independent from the daily SEC staff interactions for employees to trust his impartiality in deciding rewards. The Office of IG will have few potential conflicts of interest in reviewing suggestions compared to other SEC offices. The Committee observes that the SEC already has the authority to run a suggestion program and has discretion to make cash awards, so it would not need legislative authority to do so.

The Committee has considered whether a Suggestion Program must offer monetary rewards that are sufficiently large to motivate employees to make meritorious and valuable suggestions, and to overcome fears of offending or annoying a supervisor or of retribution. The Committee hopes that the Suggestion Program would motivate employees to produce meaningful suggestions for the benefit of the SEC.

Subtitle G

Section 971. Election of directors by majority vote in uncontested elections

Section 971 provides that if a majority of a public company's shares are voted against or withheld from a nominee for director who runs uncontested, or without an opponent, he or she should be required to resign, unless the board unanimously finds it is in the best interest of the shareholders for him or her to serve and publishes its reasoning. It does this by requiring the SEC to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer who has on their board members that did not receive a majority vote in uncontested board elections, subject to an exception if the directors unanimously voted that it is in the best interests of the shareholders that the director serve.

The Committee believes that in the uncommon circumstance where a majority of shareholders voting in an uncontested election prefer that a nominee not serve on the board, it is fair and appropriate for their wishes to be honored. Currently, an uncontested nominee who receives even one vote would be elected as a director of many companies.

The Committee has received many views on this matter. Former SEC Chief Accountant Lynn Turner testified that Congress should "[r]equire majority voting for directors and those who can't get a majority of the votes of investors they are to represent should be required to step down."[244] Ms. Barbara Roper, Director of Investor Protection of the Consumer Federation of America also testified in favor of requiring "mandatory majority voting for directors."[245] The Council of Institutional Investors, a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion, favors majority voting stating: "Currently, the accountability of directors at most US companies is severely weakened by the fact that shareowners do not have a meaningful vote in director elections. Under most state laws, including Delaware, the default standard for uncontested elections is a plurality vote, which means that a director is elected even if a majority of the shares are withheld from the nominee. The Council has long believed that a plurality standard for the uncontested election of directors is inherently unfair and undemocratic and should be replaced by a majority vote standard. In recent years, many companies, including more than two-thirds of the S&P 500 have agreed

[244] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Lynn Turner).

[245] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Ms. Barbara Roper).

with the Council and have voluntarily adopted majority voting standards. At most public companies, however, plurality voting still remains the rule. For example, nearly three-quarters of the companies in the Russell 3000 continue to use a straight plurality voting standard for director elections. The benefits of moving to a majority voting standard are many: it would democratize the corporate electoral process; put real voting power in the hands of investors; and make boards more representative of shareowners. Simply stated, Section 971, if enacted, would eliminate a fundamental flaw in the US governance model."[246]

The Committee has also heard from those who are concerned and believe that some directors who fail to receive the vote of a majority of shareholders should nonetheless serve on the board. Such an individual might be, for example, the board's only financial expert or a person with unique expertise.

The Committee has taken this type of concern into account. The legislation would allow a director who received less than a majority of votes to serve on the board if the remaining board members unanimously vote at a board meeting that it is in the best interests of the issuer and its shareholders not to accept the resignation. When the issuer publishes this decision, it should include a specific discussion of the board's analysis in reaching that conclusion. Such publication may be made in a filing made with the SEC.

Section 972. Proxy access

Section 972 was introduced by Senator Schumer. It gives the SEC the authority to require issuers to allow shareholders to put Board nominees on the company proxy. It does not require the SEC to engage in rulemaking. The authority gives the SEC wide latitude in setting the terms of such proxy access.

The Committee intentionally did not specify that shareholders must have held a certain number of shares or have held shares for a particular period of time to be eligible to use the proxy. If the SEC proposes rules, interested persons can offer their views on the appropriateness of proposed regulatory terms in the public comment process.

The Committee feels that it is proper for shareholders, as the owners of the corporation, to have the right to nominate candidates for the Board using the issuer's proxy under limited circumstances.

Former SEC Chairman Richard Breeden testified before the Committee in favor of one form of proxy access and recommended to "Allow the five (or ten) largest shareholders of any public company who have owned shares for more than one year to nominate up to three directors for inclusion on any public company's proxy statement. Overly entrenched boards have widely failed to protect shareholder interests for the simple reason that they sometimes think more about their own tenure than the interests of the people they are supposed to be protecting . . . This provision would give 'proxy access' to shareholder candidates without the cost and distraction of hostile proxy contests. At the same time, any such nomination would require support from a majority of shares held by the largest holders, thereby protecting against narrow special interest campaigns. This reform would make it easier for the largest

[246] Letter to Chairman Dodd, March 19, 2010.

shareowners to get boards to deal with excessive risks, poor performance, excessive compensation and other issues that impair shareholder interests." Ms. Barbara Roper, Director of Investor Protection of Consumer Federation of America, testified before the Committee and recommended "improved proxy access for shareholders." Mr. Jeff Mahoney, General Counsel of the Council of Institutional Investors, wrote in a letter to Chairman Dodd that "the only way that shareowners can present alternative director candidates at a U.S. public company is by waging a full-blown election contest. For most investors, that is onerous and prohibitively expensive. A measured right for investors to place their nominees for directors on the company's proxy card would overcome these obstacles, invigorating board elections and making directors more responsive, thoughtful and vigilant." Former SEC Chief Accountant Lynn Turner testified before the Committee that "Congress should move to adopt legislation that would: . . . Give investors who own the company, the same equal access to the proxy as management currently has." A coalition of state public officials in charge of public investments, AFSCME, CalPERS, and the Investor's Working Group also support proxy access.

Section 973. Disclosures regarding Chairman and CEO structures

Section 973 directs the SEC to issue rules that require an issuer to disclose the reasons that it has chosen the same person or elected to have different people serve in the offices of Chairman of the Board of Directors and Chief Executive Officer of the issuer.

The Committee has received strong views on the merits of one or the other model and on whether to prohibit a public company from having the same individual serve as Chairman and as CEO. For example, Mr. Joseph Dear, Chief Investment Officer of the California Public Employees' Retirement System, on behalf of the Council of Institutional Investors, wrote in testimony for the Senate Banking Committee that "Boards of directors should be encouraged to separate the role of chair and CEO, or explain why they have adopted another method to assure independent leadership of the board."

The Committee feels this is an important matter, and recognizes that different public companies may have good reasons for having the same person as CEO and Chairman or different persons in these two positions. Accordingly, the legislation asks public companies to disclose to shareholders the reasons why it has chosen its governance method. The legislation does not endorse or prohibit either method.

Subtitle H

Section 975. Regulation of municipal securities and changes to the board of the MSRB

Section 975 strengthens oversight of municipal securities and broadens current municipal securities market protections to cover previously unregulated market participants and previously unregulated financial transactions with states, counties, cities and other municipal entities. This section establishes municipal advisors as a new category of SEC registrant. Such municipal advisors provide advice to municipal entities on the issuance of municipal securities,

the use of municipal derivatives, and investment advice relating to bond proceeds.

Mr. Timothy Ryan, President and CEO of SIFMA, in testimony before the Committee, said: "we feel it is important to level the regulatory playing field by increasing the Municipal Securities Rulemaking Board's authority to encompass the regulation of financial advisors, investment brokers and other intermediaries in the municipal market to create a comprehensive regulatory framework that prohibits fraudulent and manipulative practices; requires fair treatment of investors, state and local government issuers of municipal bonds and other market participants; ensures rigorous standards of professional qualifications; and promotes market efficiencies."[247] Mr. Ronald A. Stack, Chair of the Municipal Securities Rulemaking Board (MSRB), wrote in testimony for the Senate Banking Committee:

> Investors in the municipal securities market would be best served by subjecting unregulated market professionals to a comprehensive body of rules that (i) prohibit fraudulent and manipulative practices, (ii) require the fair treatment of investors, issuers, and other market participants, (iii) mandate full transparency, (iv) restrict real and perceived conflicts of interests, (v) ensure rigorous standards of professional qualifications, and (vi) promote market efficiencies.[248]

The U.S. Council of Mayors[249] also testified in support of this policy.

The SEC recently proposed new rules under the Investment Advisers Act of 1940 relating to the provision by registered investment advisers of investment advisory services to municipal entities in which, among other things, the SEC proposed prohibiting investment advisers from making payments to unrelated persons for solicitation of municipal entities for investment advisory services on behalf of investment advisers. Rather than effectively prohibiting such third-party solicitation for investment advisory services, this section would provide that activities of a municipal advisor, broker, dealer or municipal securities dealer to solicit a municipal entity to engage an unrelated investment adviser to provide investment advisory services to a municipal entity or to engage to undertake underwriting, financial advisory or other activities for a municipal entity in connection with the issuance of municipal securities, would be subject to regulation by the MSRB. These activities of municipal advisors are currently unregulated in most respects and would become subject to regulation by the MSRB to the same extent as would such activities undertaken by brokers, dealers and municipal securities dealers with respect to their transactions in municipal securities. Thus, the MSRB would be authorized to establish qualification requirements, continuing education and operational stand-

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[247] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, pp. 9–10 (2009) (Testimony of Mr. Timothy Ryan).

[248] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p. 25 (2009) (Testimony of Mr. Ronald A. Stack).

[249] *Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance: Testimony before the U.S. House Committee on Financial Services,* 111th Congress, 1st session (2009) (Testimony of The Honorable Thomas C. Leppert).

ards, and fair practice, disclosure, conflict of interest and other rules with respect to municipal advisors in the same manner as for brokers, dealers and municipal securities dealers.

Section 975 authorizes the MSRB to make rules regulating municipal advisors, including financial advisors, brokers of guaranteed investment contracts and other investments, swap and other municipal derivatives advisors, and certain third party solicitors of municipal entities. The Committee believes that giving MSRB rulemaking authority in this area is an efficient use of regulatory resources, particularly since the SEC currently has very few staff with expertise in municipal securities. Not only does the MSRB have greater resources in terms of personnel and experience in the municipal market. The Board has an existing, comprehensive set of rules on key issues such as pay-to-play and fair dealing. Therefore, the Committee is of the view that consistency would be important to ensure common standards. As a baseline for rulemaking with respect to municipal advisors, the MSRB has an extensive understanding of the municipal securities market and has put in place a mature body of comprehensive regulation that (i) prohibits fraudulent and manipulative practices, (ii) requires the fair treatment of investors, issuers and other market participants, (iii) mandates full transparency, (iv) restricts real and perceived conflicts of interests, including prohibiting pay-to-play practices, (v) ensures rigorous standards of professional qualifications, and (vi) promotes market efficiencies. The rules for municipal advisory activities would apply equally to broker-dealers acting as financial advisors and to non-affiliated financial advisors. The Committee also notes that the MSRB has made important contributions to the transparency of the municipal market with its EMMA online reporting system.

The SEC has general oversight authority over the MSRB, and would enforce the municipal advisor rules issued pursuant to this section. The MSRB's rulemaking process, including a public comment process and SEC approval of all new rules, provides another layer of protection regarding the appropriateness of rules written by the MSRB. The section creates an expanded role for the MSRB in supporting SEC examinations and enforcement; gives the MSRB a share of fines collected by the SEC and FINRA; and gives the MSRB authority to be an information repository for the systemic risk regulator.

This section also modifies the composition of the MSRB, in light of the expansion of the Board's jurisdiction and to avoid conflicts of interest. Under current law, 10 of the 15 board members represent the securities dealers and underwriters that are regulated by the MSRB. With the expansion of the MSRB's jurisdiction to include municipal advisors, it is appropriate to provide for majority public representation. The section provides that the MSRB shall include 8 individuals who are not associated with broker-dealers, municipal advisors, or municipal securities dealers, and 7 individuals who are associated with broker-dealers, municipal advisors, or municipal securities dealers. The 8 public members will include at least one investor representative, one representative of municipalities, and a member of the public with knowledge or experience in the municipal securities field. As reconstituted under this Section, the MSRB would not be dominated by members having exclusive legal obligations to investors, given the requirement for majority

public membership as well as required representation of regulated municipal advisors. Further, the section would establish an explicit MSRB statutory mandate to protect municipal entities, as well as investors.

The Section also provides that the MSRB, in conjunction with or on behalf of other Federal financial regulators or self-regulatory organizations, may establish information systems and assess reasonable fees to support those information systems.

Section 976. Government Accountability Office study of increased disclosure to investors

Section 976 directs the GAO to conduct a study and review of the disclosure required to be made by issuers of municipal securities and report on the findings. The GAO will describe the size of the municipal securities markets and the issuers and investors; compare the disclosure regimes applicable to issuers of municipal versus corporate bonds; evaluate the costs and benefits to issuers of municipal securities of requiring additional financial disclosures to investors; and make recommendations relating to the repeal of the Tower Amendment, which bars the MSRB and the SEC from imposing disclosure requirements on municipal issuers.

The Committee believes that to improve investor protection there is merit in considering the revocation of the Tower Amendment, but that this move is significant and deserves a deliberate study before action is taken. In support of repealing the Tower Amendment, former SEC Chief Accountant Lynn Turner wrote in testimony for the Senate Banking Committee "there is a gap in regulation of the municipal securities market as a result of what is known as the Tower Amendment. Recent SEC enforcement actions such as with the City of San Diego, the problems in the auction rate securities, and the lurking problems with pension obligation bonds, all cry out for greater regulation and transparency in these markets. As a result, these token regulated markets now amount to trillions of dollars and significant risks. Accordingly, as former Chairman Cox recommended, I believe Section 15B(d)—Issuance of Municipal Securities—of the Securities Act of 1934 should be deleted."[250] The Investment Company Institute,[251] Municipal Market Advisers,[252] and former SEC Chairman Arthur Levitt[253] support increased disclosure by municipalities.

Section 977. Government Accountability Office study on the municipal securities markets

Section 977 directs the GAO to conduct a study and issue a report on the municipal securities markets, to include an analysis of the mechanisms for trading, reporting, and settling transactions;

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[250] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session, p. 11 (2009) (Testimony of Mr. Lynn Turner).

[251] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Paul Schott Stevens).

[252] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Thomas G. Doe).

[253] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Arthur Levitt).

the needs of the markets and investors and the impact of recent innovations; potential uses of derivatives in the municipal markets; and recommendations to improve the transparency, efficiency, fairness, and liquidity of the municipal securities market. The GAO shall submit its report to the Committee on Banking, Housing, and Urban Affairs of the Senate, the Financial Services Committee of the House of Representatives, with a copy to the Special Committee on Aging of the Senate, within 180 days of the enactment of this Act.

Section 978. Study of funding for Government Accounting Standards Board

Section 978 requires the SEC to study the funding of the Government Accounting Standards Board (GASB). GASB establishes accounting principles that are used by many states and local governments. As a result, GASB plays an important role in the municipal securities market by providing the foundation for financial reporting that investors rely on to make investment decisions. GASB is currently funded by voluntary contributions from states, local governments, and the financial community, and through the sale of its publications, to meet its annual budget of less than $8 million.

The Committee is concerned that such voluntary funding arrangements can cause undue uncertainty and potentially lead to the compromise of the GASB standard setting process. The Banking Committee faced and solved a similar problem in 2002, when the Financial Accounting Standards Board, which had been relying on voluntary contributions and materials sales, was given a secure funding mechanism through Section 109 of the Sarbanes-Oxley Act.

The municipal securities market is an important component of the Nation's capital markets, as it finances infrastructure and other government needs, while at the same time providing generally low-risk investment opportunities to Americans. There are over 50,000 issuers of municipal securities, with more than $2.8 trillion of United States municipal securities outstanding. In 2008, over $450 billion of new municipal securities were issued and nearly $5 trillion in municipal securities were traded.

In this regard, the Committee is concerned that the current funding mechanism may not ensure that GASB can produce high-quality, unbiased, and transparent governmental accounting and financial reporting standards.

This section requires the SEC to conduct a study that evaluates: the role and importance of GASB in the municipal securities markets; the manner in which GASB is funded and how such manner of funding affects the financial information available to securities investors; the advisability of changes to the manner in which GASB is funded; and whether legislative changes to the manner in which GASB is funded are necessary for the benefit of investors and in the public interest. In conducting the study, the SEC shall consult with State and local government officers.

In considering the "advisability" of changes to the funding, the Committee expects the SEC to evaluate alternative methods, including methods that would provide GASB with certainty about its income to meet its budget. In addition, the SEC may consider whether it would be feasible or efficient for a private entity, such as a self-regulatory organization, to assess a fee from its members

that underwrite municipal securities offerings or whether it would be appropriate to assess fees on secondary market transactions. The SEC is required to submit the study to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives within 270 days of the date of enactment.

Section 979. Commission Office of Municipal Securities

Section 979 establishes an Office of Municipal Securities in the SEC to administer the Commission's rules with respect to municipal securities dealers, advisors, investors, and issuers. The Director of the Office shall report to the Chairman of the Commission. The Office shall coordinate with the MSRB for rulemaking and enforcement actions, and shall have sufficient staff to carry out the requirements of this section, including individuals with knowledge and expertise in municipal finance. The Committee is concerned that the SEC has reduced the number of staff in its municipal securities office over the past few decades, and expects that the creation of the Office will allow the SEC to devote increased supervisory attention to the municipal market.

Subtitle I

Section 981. Authority to share certain information with foreign authorities

Section 102(a) of the Sarbanes-Oxley Act of 2002 ("the Act") makes it unlawful for any public accounting firm to prepare or issue, or participate in the preparation or issuance, of any audit reports with respect to any issuer without being registered with the Public Company Accounting Oversight Board ("PCAOB"). As of January 1, 2010, 2,349 firms were registered with the PCAOB, including 936 firms in 88 non-U.S. jurisdictions. Many of those non-U.S. firms regularly provide audit reports for issuers and are therefore inspected by the PCAOB on a regular basis. As of March 31, 2010, the Board has conducted 226 non-U.S. inspections located in 33 jurisdictions.

In conducting inspections abroad, the Board has sought to coordinate and cooperate with local authorities. The Board has said that its cooperative efforts have been impeded by the Board's inability to share with its non-U.S. counterparts confidential information related to the Board's oversight activities. The list of authorities that may receive such information is limited to the SEC, the Attorney General of the United States, appropriate federal functional regulators, state attorneys general in connection with criminal investigations, and appropriate state regulatory agencies (such as state boards of accountancy). These provisions, therefore, limit the PCAOB's ability to share such information with other regulators, including non-U.S. regulators.

A significant number of non-U.S. audit regulators have cited this limitation as a reason for not cooperating with PCAOB inspections and discouraging or prohibiting PCAOB-registered firms in their jurisdictions from cooperating. For example, the EU Directive on statutory audits permits cooperation only if reciprocal working relationships have been established between the member state's audit regulator and the PCAOB. The European Commission has as-

serted that these working relationships require that the PCAOB and the EU member state's auditor regulator be able to engage in a mutual exchange of inspection related information including audit working papers.

Section 981 will allow the PCAOB to share confidential inspection and investigative information with foreign audit oversight authorities under specified circumstances. The sharing may occur if (1) the PCAOB makes a finding that it is necessary to accomplish the purposes of the Act of to protect investors in U.S. issuers; (2) the foreign authority has: provided the assurances of confidentiality requested by the PCAOB, described its information systems and controls; described its jurisdiction's laws and regulations that are relevant to information access and (3) the PCAOB determines it is appropriate to share such information. The information about information controls and relevant law is to assist the PCAOB in making an independent determination that the foreign authority has the capability and authority to keep the information confidential in its jurisdiction. The PCAOB may rely on additional information in making the determination that the information will be kept confidential and used no more extensively than the same manner that the U.S. and State entities identified in Section 105(b)(5)(B) of the Act may use the information, which is an important consideration of determining the appropriateness of such sharing.

Thus, the bill requires the Board to consider whether applicable foreign laws and the respective foreign auditor oversight authority offer protections comparable to those provided under the Act. This would require the PCAOB to consider not only the foreign auditor oversight authority's willingness to maintain the confidentiality of the information, but also its ability to do so, both as a matter of the law in its jurisdiction and as a matter of the security of its information technology systems. The Committee believes that the Board could accept an assurance of confidentiality as adequate even in circumstances where the foreign auditor oversight authority could disclose the information to relevant law enforcement or regulatory authorities in its jurisdiction, so long as any such authorities are also committed and able to comply with confidentiality limitations comparable to those that apply to the U.S. and state entities with which the Board shares information under Section 105(b)(5)(B) of the Act.

The Chairman of the PCAOB has written to the Chairman and Ranking Member asking for legislation "to allow the PCAOB to share with a foreign audit oversight authority, upon receiving appropriate assurances of confidentiality, the inspection and investigative information related to the public accounting firms within that authority's jurisdiction . . . [in order to] facilitate the Board's and foreign authorities' efforts to fulfill their inspection mandates. This recommendation enjoys widespread investor and profession support."[254]

Section 982. Oversight of brokers and dealers

Section 982 provides the Public Company Accounting Oversight Board ("PCAOB") with the authority to write professional standards related to audits of SEC-registered brokers and dealers, to in-

[254] Letter from the Honorable Mark W. Olson, July 7, 2009.

spect those audits, and, when appropriate, to investigate and bring disciplinary proceedings related to those audits. This Section provides the PCAOB with authority over audits of registered brokers and dealers that is generally comparable to its existing authority over audits of issuers. This authority permits it to write standards for, inspect, investigate, and bring disciplinary actions arising out of, any audit of a registered broker or dealer. It enables the PCAOB to use its inspection and disciplinary processes to identify auditors that lack expertise or fail to exercise care in broker and dealer audits, identify and address deficiencies in their practices, and, where appropriate, suspend or bar them from conducting such audits.

Currently, every SEC-registered broker and dealer is required by section 17(e)(1)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(e)(1)(A)) to file with the SEC a balance sheet and income statement certified by a public accounting firm that is registered with the PCAOB. However, the PCAOB's authority to write professional standards, inspect audits, investigate audit deficiencies, and bring disciplinary proceedings for audit deficiencies extends to audits of "issuers," as defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(7)). Therefore, the PCAOB does not have the authority to regulate and inspect audits of brokers and dealers unless a broker or dealer is an issuer (which is typically not the case) or its financial statements are part of the consolidated financial statements of an issuer.

Under the current situation, where auditors of brokers and dealers register with the PCAOB but their audits of brokers and dealers are not subject to the PCAOB's standard setting, inspection and disciplinary authority, investors may expect that PCAOB-registered auditors of brokers and dealers are subject to inspections and oversight when, in fact, the PCAOB has no authority to govern the conduct or monitor the quality of their audit work.

In a July 7, 2009 letter to Chairman Dodd and Ranking Member Shelby, Chairman Mark Olson of the PCAOB recommended that Congress consider amending the Sarbanes-Oxley Act to grant the PCAOB authority to inspect audits of brokers and dealers and to take action where deficiencies occur. The Securities Investor Protection Corporation has supported granting the PCAOB full oversight of audits of brokers and dealers, and feels that the PCAOB's new oversight authority should apply to audits of all registered brokers and dealers and not only those that perform a clearing function or carry customer accounts.

The Section requires the PCAOB to allocate, assess and collect its support fees among brokers and dealers as well as issuers. The Committee expects that the PCAOB will reasonably estimate the amounts required to fund the portions of its programs devoted to the oversight of audits of brokers and dealers, as contrasted to the oversight of audits of issuers, in deciding the total amounts to be allocated to, assessed, and collected from all brokers and dealers. The Committee notes that the implementation of a program for PCAOB inspections of auditors of brokers and dealers is not intended to and should not affect the PCAOB's program for the inspections of auditors of issuers. Cost accounting for each program is not required.

An example of the type of harm that might be avoided in the future by extending PCAOB authority is the investor reliance on the fraudulent audit of the broker-dealer Bernard L. Madoff Investment Securities LLC by Friehling & Horowitz, a firm that was not registered with the PCAOB.

Columbia University Law Professor John C. Coffee testified before the Banking Committee on March 10, 2009: "From this perspective focused on prevention, rather than detection, the most obvious lesson is that the SEC's recent strong tilt towards deregulation contributed to, and enabled, the Madoff fraud in two important respects. First, Bernard L. Madoff Investment Securities LLC ("BMIS") was audited by a fly-by-night auditing firm with only one active accountant who had neither registered with the Public Company Accounting Oversight Board ("PCAOB") nor even participated in New York State's peer review program for auditors."

Professor Coffee noted that the Sarbanes-Oxley Act "required broker-dealers to use a PCAOB-registered auditor. Nonetheless, until the Madoff scandal exploded, the SEC repeatedly exempted privately held broker-dealers from the obligation to use such a PCAOB-registered auditor and permitted any accountant to suffice. Others also exploited this exemption. For example, in the Bayou Hedge Fund fraud, which was the last major Ponzi scheme before Madoff, the promoters simply invented a fictitious auditing firm and forged certifications in its name. Had auditors been required to have been registered with PCAOB, this would not have been feasible because careful investors would have been able to detect that the fictitious firm was not registered . . . At the end of 2008, the SEC quietly closed the barn door by failing to renew this exemption—but only after $50 billion worth of horses had been stolen."

Section 983. Portfolio margining

Section 983 amends the Securities Investor Protection Act of 1970 ("SIPA"), which protects customers from certain losses caused by the insolvency of their broker-dealer. Under SIPA, claims of customers take priority over claims of general unsecured creditors with respect to customer property held by an insolvent broker-dealer. Under current law, the protections of SIPA do not extend to futures contracts other than security futures. As a result, customers currently are effectively precluded from including securities and related futures in a single securities account.

The Section will enable customers to benefit from hedging activities by facilitating the inclusion of both securities and related futures products in a single "portfolio margining account" provided for under rules of self-regulatory organizations approved by the Securities and Exchange Commission (the "SEC"). A portfolio margining account can be margined based upon the net risk of the positions in the account.

Section 983 is consistent with a recommendation of the SEC and CFTC in their Joint Report on Harmonization of Regulation released on October 16, 2009. The agencies recommended giving customers the choice of whether to put related futures in a securities account or their related securities derivatives in a futures account. Customer choice is facilitated by extending SIPC insurance to futures in a securities portfolio margining account. The Section is also supported by each of the U.S. exchanges that trade options.

Section 983 amends the definitions of "customer," "customer property," and "net equity" in Section 16 of SIPA to provide that the owner of a portfolio margining account would be given the priority of a customer under SIPA with respect to any futures contracts or options on futures contracts permitted under SEC-approved rules to be carried in the account. Similarly, the customer's "net equity" in the account would include such futures and options on futures, and they would be treated along with cash and securities in the account as securities customer property. The definition of "net equity" is further amended to clarify that a customer's claim for either a commodity futures contract or a security futures contract will be treated as a claim for cash rather than as a claim for a security. The Section also amends the definition of "gross revenues from the securities business" to specifically include revenues earned by a broker or dealer in connection with transactions in portfolio margining accounts carried as securities accounts.

Section 984. Loan or borrowing of securities

During the period preceding the crisis, a number of financial institutions used securities lending programs as a basis for leveraged and risky trading activities. This Section directs the SEC to write rules that are designed to increase the transparency of information available to brokers, dealers, and investors with respect to loaned or borrowed securities within two years of the date of enactment of this Act. The Section also makes it unlawful for any person to effect, accept, or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules as the SEC may prescribe. The SEC is encouraged to act in a shorter period of time if necessary in the public interest.

Section 985. Technical corrections to federal securities laws

Section 986. Conforming amendments relating to the repeal of the Public Utility Holding Company Act of 1935

Section 987. Amendment to definition of material loss and nonmaterial losses to the Deposit Insurance Fund for purposes of Inspector General reviews

Section 987 amends the definition of material loss and adds "nonmaterial losses" definition to the Deposit Insurance Fund for purposes of Inspector General Reviews. The Inspectors General (IG) of Federal Banking Regulators are required to conduct a Material Loss Review for each depository institutions that fails and costs the Deposit Insurance Fund $25 million and more. The Senate Banking Committee has heard from the IGs that due to the rise in bank failures they are severely strained by the amount of Material Loss Reviews they must produce. In their communications to the Banking Committee the IGs from Federal Reserve, Treasury and FDIC have claimed to have hired more personnel to reduce the backlog accumulated during the financial crisis; however, the number of bank failures has also been more than they've expected, and such, the volume of workload has remained strenuously high. Because of this, and the understanding that most of the bank failures seemed have occurred due to similar reasons (exposure to failing mortgages) the Committee is proposing an increase in the dollar amount that the Deposit Insurance Fund must lose to trigger a

Material Loss Review. The change will follow this schedule: it will rise from the current $25,000,000 to $100,000,000 for the period of September 30, 2009 to December 31, 2010 and cascade down to $75,000,000 for the period of January 1, 2011 to December 31, 2011, and rest on $50,000,000 for January 1, 2012 and after. In bank failures that do not meet the materiality threshold (and thus are "nonmaterial losses" to the Deposit Insurance Fund), the IGs could still conduct a Material Loss Review if, based on their preliminary assessment, such a report would be helpful.

For every 6 month period after March 31, 2010, the IGs must prepare and submit a written report to the appropriate Federal banking agency and to Congress on whether any losses deemed to be nonmaterial exhibit unusual circumstances and deserve an in-depth review of the loss.

Section 988. Amendment to definition of material loss and nonmaterial losses to the National Credit Union Share Insurance Fund for purposes of Inspector General reviews

Section 988 does for credit unions what Section 987 does for other insured depository institutions. The Section defines a material loss for the National Credit Union Share Insurance Fund for purposes of Inspectors General reviews. If the Fund incurs a material loss with respect to an insured credit union, the Inspector General of the NCUA Board will submit to the Board a written report reviewing the supervision of the credit union by the Administration. For the purposes of this provision, a material loss is defined as an amount exceeding the sum of $25,000,000 or an amount equal to 10 percent of the total assets of the credit union on the date on which the Board initiated assistance. The GAO, under its discretion, could review each of these reports and recommend improvements to the supervision of insured credit unions.

For every 6 months period after March 31, 2010, the Board IG must prepare and submit a written report to the appropriate Federal banking agency and to Congress on whether any losses deemed to be nonmaterial exhibit unusual circumstances and deserve an in-depth review of the loss.

Section 989. Government Accountability Office study on proprietary trading

Section 989A was authored by Senator Merkley. Section 989 directs the GAO to conduct a study on proprietary trading by financial institutions and the implication of this practice on systemic risk. This will include an evaluation of whether proprietary trading presents a material systemic risk to the stability of the United States financial system; whether proprietary trading presents material risks to the safety and soundness of the covered entities that engage in such activities; whether proprietary trading presents material conflicts of interest between covered entities that engage in proprietary trading and the clients of the institutions who use the firm to execute trades or who rely on the firm to manage assets; whether adequate disclosure regarding the risks and conflicts of proprietary trading is provided to the depositors, trading and asset management clients, and investors of covered entities that engage in proprietary trading; and whether the banking, securities, and commodities regulators of institutions that engage in proprietary

trading have in place adequate systems and controls to monitor and contain any risks and conflicts of interest related to proprietary trading. The GAO will submit a report to Congress on the results of this study within 15 months of passage of the Act.

Section 989A. Senior investor protection

Section 989A was authored by Senator Kohl. Section 989A defines the terms "misleading designation", "financial product", "misleading or fraudulent marketing" and "senior" for the purposes of protecting senior citizens from investment frauds. The Section directs the Office of Financial Literacy within Bureau of Consumer Financial Protection to establish a program to provide grants of up to $500,000 per fiscal year to individual States to investigate and prosecute misleading and fraudulent marketing practices or to develop educational materials and training to reduce misleading and fraudulent marketing of financial products toward seniors. States may use the grants for staff, technology, equipment, training and educational materials. To receive these grants, states must adopt rules on the appropriate use of designations in the offer or sale of securities or investment advice; on fiduciary or suitability requirements in the sale of securities; on the use of designations in the sale of insurance products; and on insurer conduct related to the sale of annuity products. This Section authorizes $8 million to be appropriated for these purposes for fiscal years 2010 through 2014.

This section is intended to protect seniors from less than scrupulous financial advisors who prey on the elderly by touting misleading or fraudulent "senior designations." Often these deceptive designations can be obtained online and require little or no training to acquire. The new grant program will provide needed resources to state fraud enforcement agencies fighting fraud. The grant application process will incentivize states to crack down against the misleading use of senior designations by encouraging them to adopt the North American Securities Administrators Association (NASAA)'s and the National Association of Insurance Commission's (NAIC) newly developed model rules on the use of senior designations for the sale of securities and insurance products. The grant also calls for improved suitability standards for the sales of annuity products, with provisions that are likely to be reflected in the new suitability standards that are being developed by the NAIC. This section has been endorsed by organizations such as the AARP, North American Securities Administrators Association (NASAA), National Organization for Competency Assurance (NOCA), The American College, Financial Planners Association, Fund Democracy, Consumer Federation of America, Alliance for Retired Americans, National Association of Personal Financial Advisors (NAPFA), Older Women's League (OWL) and Financial Certified Planners Board of Standards (CFP Board).

Section 989B. Changes in appointment of certain Inspectors General

Senator Menendez authored this Section, which provides for presidential appointment of the Inspectors General of the Federal Reserve Board of Governors, the CFTC, the NCUA, the PBGC, the SEC, and the Bureau of Consumer Financial Protection with Senate approval. The provision is intended to increase the stature of

the Inspectors General within their agencies. This Section strengthens also the subpoena authority.

Subtitle J

Section 991. Securities and Exchange Commission self-funding

Section 991 provides for the SEC to become a self-funded organization. Each year the SEC will submit a budget request to Congress and the Treasury. The Treasury will deposit this money into an account for use by the SEC. The SEC will set its fees and assessments at a level meant to fully repay Treasury. If the SEC does not recoup sufficient funds, then the SEC is not obligated to fully repay Treasury. Any collections in excess of 25% of the next year's budget request must be paid to Treasury.

The Council of Institutional Investors,[255] former SEC Chief Accountant Mr. Lynn Turner,[256] the Investment Adviser Association,[257] and the Investor's Working Group[258] support this policy.

Title X—Bureau of Consumer Financial Protection

Section 1001. Short title

Section 1001 establishes the name of this title to be the Consumer Financial Protection Act of 2010.

Section 1002. Definitions

Section 1002 provides the definitions for key terms in Title X.

Paragraph 1 defines the term "affiliate."

Paragraph 2 explains that "Bureau" means the Bureau of Consumer Financial Protection.

Paragraph 3 defines the term "business of insurance."

Paragraph 4 defines the term "consumer."

Paragraph 5 makes clear that financial products or services defined in the Act that are offered or provided for use by consumers primarily for personal, family, or household purposes are considered to be "consumer financial products or services" for purposes of this Act. The definition of "consumer financial product or service" in this paragraph is a subset of the defined term "financial product or serve" in paragraph 13, and includes all activities that are part of the broader definition, which excludes the "business of insurance" under paragraph 13(B). In addition, other key financial activities that are central to consumers are also included in this definition. These include, among others listed, the servicing of mortgage loans and debt collection services where the financial service being provided is the result of a contract between the lender and the servicer or debt collector. For example, mortgage servicers typically provide services to the owners of the mortgages. Nonetheless, this service is included in the definition of "consumer financial

[255] Mr. Jeff Mahoney, Council of Institutional Investors, letter to Senator Dodd, p.3, November 18, 2009.

[256] *Enhancing Investor Protection and the Regulation of Securities Markets—Part I: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. Lynn Turner).

[257] *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Congress, 1st session (2009) (Testimony of Mr. David Tittsworth).

[258] *U.S. Financial Regulatory Reform: An Investor's Perspective,* Investor's Working Group, July 2009.

product or service" because of its obvious impact on consumers. A number of other financial activities of a similar nature are included in this definition.

The Committee intends, however, that a financial institution's exercise of bona fide trust or fiduciary powers would not be subject to the jurisdiction of the Bureau. In addition, financial products and services delivered for establishing a trust, or to a trust itself, would not be for use by a consumer primarily for personal, family, or household purposes.

Paragraph 6 defines "covered person" as any person engaged in offering or providing a consumer financial product or service and an affiliate of such a person that provides a material service in connection with the provision of such consumer financial product or service is subject to the regulatory authority of and, in some cases, to examinations by, the CFPB under this title.

Paragraph 7 defines the term "credit."

Paragraph 8 defines "deposit-taking activity."

Paragraph 9 defines the term "designated transfer date."

Paragraph 10 defines the term "Director."

Paragraph 11 defines the term "enumerated consumer laws."

Paragraph 12 defines the term "Federal consumer financial law."

Paragraph 13 defines the term "financial product or service" and is modeled on the activities that are permissible for a bank or a bank holding company, such as under section 4(k) of the Bank Holding Company Act and implementing regulations. However, it is more narrowly drawn in this Act in that the list does not include insurance or securities activities. The paragraph describes the activities, products, and services that are defined as a "financial product or service" in the context of this legislation. The legislation does not intend to capture as "covered persons" companies that engage in financial data processing activities, as defined in paragraph 13, where the company acts as a mere conduit for such data, provides services to a person that enables that person to establish and maintain a web site simply as a conduit, or merchants that provide for electronic payments for the sale of their nonfinancial goods or services.

Paragraph 14 defines the term "foreign exchange."

Paragraph 15 defines the term "insured credit union."

Paragraph 16 defines the term "payment instrument."

Paragraph 17 defines the term "person."

Paragraph 18 defines the term "person regulated by the Commodity Futures Trading Commission."

Paragraph 19 defines the term "person regulated by the Commission."

Paragraph 20 defines the term "person regulated by a State insurance regulator."

Paragraph 21 defines the term "person that performs income tax preparation activities for consumers."

Paragraph 22 defines the term "prudential regulator."

Paragraph 23 defines the term "related person."

Paragraph 24 defines the term "service provider" and is designed to create authority that is generally comparable to the authority that federal banking regulators have under the Bank Service Company Act. It is included in this Act in order to ensure that material outsourced services by a covered person in connection with the of-

fering or provision of a consumer financial product or service are subject to the regulation and supervision of the CFPB for the activities that could be done directly by the covered person. Without such authority, covered persons could remove many important functions that bear directly on consumers from the CFPB's oversight simply by contracting those functions out to service providers, thereby escaping the jurisdiction of the CFPB and leading to significant regulatory arbitrage. Companies that merely provide general support or ministerial services to a broad range of businesses, or space for advertising either in print or in an electronic medium, are not intended to be defined as service providers for the purposes of this Act.

Paragraph 25 defines the term "State."

Paragraph 26 defines the term "stored value."

Paragraph 27 defines the term "transmitting or exchanging money." This paragraph is not intended to capture a mere conduit, such as a telecommunications company that provides a network over which a money service business sends funds. The paragraph is intended to cover the companies that are receiving currency directly from a consumer, not as a consequence of receiving it from the money service business for further transmission to a recipient.

Subtitle A—Bureau of Consumer Financial Protection.

Section 1011. Establishment of the Bureau

This section creates the Bureau of Consumer Financial Protection (the Bureau) in the Federal Reserve System; it establishes the Bureau's authority to regulate the offering and provision of consumer financial products and services. This section also establishes the positions of the Director and Deputy Director of the Bureau. The Director is appointed by the President and confirmed by the Senate for a 5–year term and subject to removal for cause.

Section 1012. Executive and administrative powers

Section 1012 authorizes the Bureau to establish general policies with respect to all executive and administrative functions of the Bureau. It provides that the Director may delegate to any authorized employee, representative, or agent any power vested in the Bureau. The section makes clear that the Bureau is to operate without any interference by the Board of Governors of the Federal Reserve including with regards to rule writing, issuance of orders, examinations, enforcement actions, and appointment or removal of employees of the Bureau. These provisions are modeled on similar statutes governing the Office of the Comptroller of the Currency and the Office of Thrift Supervision, which are located within the Department of Treasury.

This section also establishes that, like other federal financial services regulators, any Bureau testimony, legislative recommendations, or comments on legislation are not subject to review or approval by other agencies. The Bureau must make clear that any such communications do not reflect the views of the President or Board of Governors.

Section 1013. Administration

This section authorizes the Director to appoint and employ officials and professional staff, and to establish in the Bureau functional units for research, community affairs, and consumer complaints. The Committee expects these functions to ensure that the Bureau has a robust knowledge of the markets for consumer financial products and services in order to meet its purposes and objectives in as efficient and effective manner as possible. The Committee also expects the Bureau to work with other federal agencies, such as the Federal Trade Commission (FTC), to make use of the FTC's existing consumer complaints collection infrastructure where efficient and advantageous in facilitating complaint monitoring, response, and referrals. Section 1013 also establishes within the Bureau an Office of Fair Lending and Equal Opportunity and an Office of Financial Literacy. Evidence of discriminatory pricing in the provision of auto loans, certain terms of mortgage loans, and other products indicate the importance of tracking this information. Likewise, a more effective effort to improve financial literacy should play a crucial role in improving consumer protection.

Section 1014. Consumer Advisory Board

Section 1014 requires the Director to create a Consumer Advisory Board and to consult with it on matters pertaining to the Bureau's functions and authorities. This panel is modeled on the Consumer Advisory Council of the Federal Reserve Board and is intended to bring a broad spectrum of perspectives together to advise the Director. This provision requires the Director to appoint 6 members to the Consumer Advisory Board who have been recommended by the Federal Reserve Bank Presidents. The provision requires that members are appointed without regard to party affiliation, just like the members of the advisory committees to the Federal Reserve, the SEC, the FDIC, the FDA, and many other federal advisory committees. This is important because, as the GAO found in 2004, when a federal advisory committee is viewed as politicized, the value of its work can be jeopardized.

Section 1015. Coordination

This section requires the Bureau to coordinate with the SEC and CFTC and Federal agencies and State regulators to promote consistent regulatory treatment of consumer financial and investment products and services.

Section 1016. Appearances before and reports to Congress

This section requires the Director to appear before Congress at semi-annual hearings and, concurrently, to prepare and submit a report to the President and Congress concerning the Bureau's budget and regulation, supervision, and enforcement activities. This provision is modeled on the semi-annual monetary report and testimony requirement imposed on the Federal Reserve. The Committee expects that this requirement will ensure the ongoing accountability of the Bureau to the Committee and the Congress.

Section 1017. Funding; penalties and fines

Section 1017 requires the Federal Reserve Board to transfer the amount determined by the Director to to be reasonably necessary

for the Bureau's annual budget, not to exceed a specified percentage of the total operating expenses of the Federal Reserve System as reported in the 2009 Annual Report of the Board of Governors. The Bureau's funding is capped at 12 percent for fiscal year 2013 and each year thereafter, except that the cap is to be adjusted for inflation, and will be subject to annual audits and reports to Congress by the GAO. This funding is needed to perform the following key functions: examinations and enforcement over larger banks, mortgage market companies, and other large covered nondepository companies; registration and reporting by nondepository companies that are subject to the Bureau's examination authority; analytical support, monitoring and research, industry guidance and rulemaking; operation of a nationwide consumer complaint center; and consumer financial education. The mortgage market consists of more than 25,000 lenders, servicers, brokers, and loan modification firms that would be subject to Bureau supervision and enforcement. The Treasury estimates that there are more than 75,000 nonbank, non-mortgage firms offering or providing consumer financial products or services, of which the agency would supervise a percentage. In order to conduct thorough supervision of these firms comparable to bank consumer compliance supervision will require an adequate budget.

The Committee finds that the assurance of adequate funding, independent of the Congressional appropriations process, is absolutely essential to the independent operations of any financial regulator. This was a hard learned lesson from the difficulties faced by the Office of Federal Housing Enterprise Oversight (OFHEO), which was subject to repeated Congressional pressure because it was forced to go through the annual appropriations process. It is widely acknowledged that this helped limit OFHEO's effectiveness. For that reason, ensuring that OFHEO's successor agency—the Federal Housing Finance Agency—would not be subject to appropriations was a high priority for the Committee and the Congress in the Housing and Economic Recovery Act of 2008. The budget established in this Act will ensure that the Bureau has the funds to perform its mission. By comparison with other financial regulatory bodies, the CFPB budget is modest, as the chart below illustrates.

This section also establishes within the Federal Reserve Board a special fund for receipts which can be invested under certain guidelines and which are to be used to pay for Bureau expenses. Finally, section 1017 creates a victims' relief fund for civil penalties obtained by the Bureau.

Section 1018. Effective date

This section provides that this subtitle shall become effective on the date of enactment of this Act.

Subtitle B—General Powers of the Bureau

Section 1021. Purpose, objectives, and functions

This section mandates that the purpose of the Bureau is to implement and enforce, where applicable, Federal consumer financial laws to ensure that markets for consumer financial products and services are fair, transparent and competitive.

The Bureau is authorized to act to ensure that consumers are provided with accurate, timely, and understandable information in order to make effective decisions about financial transactions; to protect consumers from unfair, deceptive, or abusive acts and practices and from discrimination; to reduce unwarranted regulatory burdens; to ensure that Federal consumer financial law is enforced consistently in order to promote fair competition; and to ensure that markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

This section further establishes the Bureau's functions with regard to regulation, supervision and enforcement, including: conducting financial education programs; collecting, investigating and responding to consumer complaints; collecting and publishing information relevant to the functioning of markets for consumer financial products and services; supervising covered persons for compliance with Federal consumer financial law, and taking appropriate enforcement action; issuing rules, orders and guidance; and performing other necessary support activities to facilitate the Bureau's functions.

Section 1022. Rulemaking authorities

This section authorizes the Bureau to administer, enforce and implement the provisions of Federal consumer financial law and, more specifically, authorizes the Bureau to prescribe rules and issue orders and guidance as may be necessary to carry out the purposes, and prevent evasions of, those laws. Under this section, the Bureau must, when prescribing rules, consider potential benefits and costs to consumers and covered persons, and consult with prudential regulators regarding consistency with safety and soundness considerations and other objectives of such agencies. This consultation would have to take place prior to the Bureau proposing a rule as well as during the public comment process. If during such consultation process a prudential regulator provides the Bureau with a written objection to the proposed rule, the Bureau is required to include in the adopting release a description of the objection and the basis for the Bureau's decision regarding such objection. The Bureau is authorized under this section to exempt classes of covered persons, service providers, or consumer financial products or services, from provisions of this title.

This section requires the Bureau to monitor for risks to consumers in the offering or provision of consumer financial products or services. In monitoring for risks, the Bureau is authorized to consider factors including likely risks and costs to consumers associated with buying or using a type of consumer financial product or service, the extent to which the law is likely to adequately protect consumers, and the extent to which the risks of a consumer financial product or service may disproportionately affect traditionally underserved consumers. The Bureau is further granted authority to gather and compile information regarding the organization, business conduct, markets, and activities of persons operating in consumer financial services markets, and to make such information public, as is in the public interest.

The Committee considers the monitoring and information gathering function to be an essential part of the Bureau's work. The Bureau must stay closely attuned to the marketplace for consumer financial products and services in order to effectively fulfill the purposes and objectives of this title.

Under this section, the Bureau is provided with access to the examination and financial condition reports made by a prudential regulator or other Federal agency having jurisdiction over a covered person. Similarly, a prudential regulator, State regulator or other Federal agency having jurisdiction over a covered person is provided with access to any examination reports made by the Bureau. The Bureau is required to take steps to ensure that proprietary, personal or confidential information is protected from public disclosure. In addition, the Bureau is required to assess the efficacy of its rules.

Section 1023. Review of Bureau regulations

This section provides for a process by which the Financial Stability Oversight Council may set aside a final regulation promulgated by the Bureau if, in the view of two-thirds of the Council, the regulation would put the safety and soundness of the banking system or the stability of the financial system at risk. Under this section, an agency represented by a member of the Council may peti-

tion the Council to stay the effectiveness of, or set aside, a regulation if the member agency filing the petition has attempted to work with the Bureau to resolve concerns regarding the effect of the rule on financial stability or safety and soundness of the banking system. Such petition is required to be filed with the Council not later than 10 days after the regulation has been published in the Federal Register. A decision by the Council to set aside a regulation prescribed by the Bureau shall render such regulation unenforceable.

Any such decision by the Council would be required to be done within certain specified time limits. A decision to issue a stay of, or set aside, a regulation is required to be published in the Federal Register as soon as practicable after the decision is made, with an explanation of the reasons for the decision. A decision by the Council to set aside a regulation prescribed by the Bureau is subject to judicial review.

This provision is designed to ensure that consumer protection regulations do not put the safety and soundness of the banking system or the stability of the financial system at risk. This provision is in addition to the significant consultation requirements included in Section 1022.

The Committee notes that there was no evidence provided during its hearings that consumer protection regulation would put safety and soundness at risk. To the contrary, there has been significant evidence and extensive testimony that the opposite was the case. Specifically, it was the failure by the prudential regulators to give sufficient consideration to consumer protection that helped bring the financial system down. In fact, it was the organizations that promote consumer protection that were urging that underwriting standards be tightened for both consumer protection and safety and soundness reasons, and it was the prudential regulators who ignored these calls.

For example, in testimony before the Committee (June 26, 2007), David Berenbaum from the National Community Reinvestment Coalition said, "For the past 5 years, community groups, consumer protection groups, fair lending groups, and all of our members in the National Community Reinvestment Coalition have been sounding an alarm about poor underwriting—underwriting that not only endangered communities, their tax bases, their municipal governments, their ability to have sound services and celebrate homeownership—but [underwriting that] was going to impact on the safety and soundness of our banking institutions themselves. Those cries for action fell on deaf ears, and here we are today."

An article in the *American Banker* ("Do Safety and Soundness and Consumer Protection Really Conflict?," by Cheyenne Hopkins, March 30, 2010) calls the banking industry argument that such a conflict exists "shaky." The article quotes Kevin Jacques who worked for 10 years in the Office of the Comptroller of the Currency, who said, ". . . I cannot recall a meeting I sat in where we worried about consumer protection and looked at safety and soundness and said the two are in conflict. . . ." A former New York Federal Reserve Bank official, Brad Sabel, agreed with this assessment, saying "In my experience I do not recall seeing a case where a consumer protection regulation was found to pose a threat to safe and sound operations of the banks."

Nonetheless, the Committee included this provision in order to reassure that the Bureau cannot put the safety and soundness or the stability of the financial system at risk.

Section 1024. Supervision of nondepository covered persons

Section 1024 establishes the scope of the Bureau's supervisory authority over certain nondepository institutions (nondepository covered persons). Oversight of these companies has largely been left to the States, and they are not currently subject to regular Federal consumer compliance examinations comparable to examinations of their depository institution competitors. According to one Treasury official, "The federal government spends at least 15 times more on consumer compliance and enforcement for banks and credit unions than for nonbanks—even though there are at least five times as many nonbanks as there are banks and credit unions." The Federal Trade Commission has approximately 70 staff members assigned to perform enforcement and monitoring functions for approximately 100,000 nondepository financial service providers nationwide. The FTC's authority to issue rules regarding unfair and deceptive practices is constrained by procedural requirements, and it does not have authority to conduct compliance exams, as bank regulators do. For that reason, it has brought fewer than 25 lawsuits in the last five years against mortgage originators, payday lenders and debt collectors.

The authority provided to the Bureau in this section will establish for the first time consistent Federal oversight of nondepository institutions, based on the Bureau's assessment of the risks posed to consumers and other criteria set forth in this section. Banks and other nondepository companies that provide consumer financial products or services should be held to the same minimum standards for complying with Federal consumer financial laws regardless of their corporate structure. Specifically, the Bureau will have the authority to supervise all participants in the consumer mortgage arena, including mortgage originators, brokers, and servicers and consumer mortgage modification and foreclosure relief services. These entities contributed to the housing crisis that led to the near collapse of the financial system. The Bureau will also have the authority to supervise larger nondepository institutions that offer or provide other consumer financial products and services. Larger nondepositories will be defined through a Bureau rulemaking and in consultation with the Federal Trade Commission. Nondepository covered persons that are subject to the Bureau's supervision authority will be required to register with the Bureau. This section does not apply to depository institutions.

Specifically, the Bureau will have the authority to supervise all participants in the consumer mortgage arena, including mortgage originators, brokers, and servicers and consumer mortgage modification and foreclosure relief services. These entities contributed to the housing crisis that led to the near collapse of the financial system. The Bureau will also have the authority to supervise larger nondepository institutions that offer or provide other consumer financial products and services. Larger nondepositories will be defined through a Bureau rule making and in consultation with the Federal Trade Commission. Nondepository covered persons that are subject to the Bureau's supervision authority will be required to

register with the Bureau. This section does not apply to depository institutions.

The Bureau will have the authority to require reports from and to conduct periodic examinations of nondepository covered persons described in section 1026(a) to assess compliance with Federal consumer financial laws, to obtain information about activities and compliance systems, and to detect and assess risks to consumers and markets for consumer financial products and services. The Bureau will exercise its authority by establishing a risk-based supervision program based on an assessment of the risks posed to consumers in certain product and geographic markets. In establishing the risk-based supervisory program, the Bureau will consider the asset size of the nondepository covered person, the volume of consumer financial product and service transactions it is engaged in, the risks to consumers of those products and services, and the extent to which the institution is overseen by State regulators.

Section 1024 provides that the Bureau's enforcement authority over larger nondepository covered persons, other than mortgage entities described in section 1024(a)(1)(A), is exclusive, although other Federal agencies may recommend (in writing) enforcement actions to the Bureau. Pursuant to a Memorandum of Understanding, the Bureau and the FTC will coordinate enforcement action of nondepository mortgage actors, including civil actions.

Section 1025. Supervision of very large banks, savings associations, and credit unions

Section 1025 grants the Bureau primary examination and enforcement authority over all insured depository institutions and credit unions with more than $10 billion in assets. This authority extends to the affiliates and service providers of these large depositories. The current consumer protection system divides jurisdiction and authority for consumer protection between many federal regulators, whose mission is not focused on consumer protection. The result has been that banks could choose the least restrictive consumer compliance supervisor. The fragmented regulatory structure also resulted in finger pointing among regulators and inaction when problems with consumer products and services arose. The authority granted to the Bureau under this section creates one federal regulator with consolidated consumer protection authority over the largest depository institutions, leaving regulatory arbitrage and inter-agency finger pointing in the past.

Specifically, the Bureau will have the authority to require reports from and to conduct periodic examinations of the largest depository institutions to assess compliance with Federal consumer financial laws, to obtain information about activities and compliance systems, and to detect and assess risks to consumers and markets for consumer financial products and services. In order to minimize regulatory burden, the Bureau is required to coordinate examination and enforcement activities with the appropriate prudential regulator, including coordinating the scheduling of examinations, conducting simultaneous examinations unless the financial institution requests otherwise, sharing draft reports, requiring reasonable opportunity (30 days) to comment, and requiring that concerns raised by the prudential regulator be considered prior to issuing a final report. The Bureau must also pursue arrangements and

agreements with State bank supervisors to coordinate examinations where appropriate.

Section 1025 also provides that any conflicts between regulators may be resolved by a governing panel. If the proposed supervisory determinations of the Bureau and the prudential regulator conflict, the examined financial institution may request that the agencies coordinate and present a joint statement of coordinated supervisory action. The agencies have 30 days to comply. If the agencies do not issue a joint statement, the financial institution may appeal to a governing panel 30 days after the joint statement is due. The governing panel would consist of a representative of the Board of Governors, the FDIC, the NCUA or OCC on a rotating basis (as long as that agency is not involved in the dispute) and a representative of the Bureau and the prudential regulator. The panel would have 30 days to provide a final determination to the financial institution.

Section 1026. Other banks, savings associations, and credit unions

Section 1026 provides that an insured depository institution or credit union with $10 billion in assets or less will continue to be examined for consumer compliance by its prudential regulator. The Bureau is authorized to ride along on a sample of examinations conducted by the prudential regulators, which will assist the Bureau in understanding the operations of smaller banks and credit unions. The Bureau would not have authority to take enforcement action. Section 1026 provides the Bureau access to reports by banks and credit unions under the $10 billion threshold to help it better understand the markets for consumer financial products and services, and to ensure that it is a fair and consistent market-wide rule writer.

Section 1027. Limitations on authorities of the Bureau; preservation of authorities

Section 1027 lays out the limits on the Bureau's authority with regard to certain entities and product types. These limitations make clear that the Bureau does not have authority over commercial transactions or the sale of nonfinancial goods or services.

Subsection (a) makes clear that the Bureau may not exercise any authority with respect to a merchant, retailer, seller or broker of nonfinancial good or service. However, the Bureau would have authority if such a person is significantly engaged in offering or providing any consumer financial product or service or is otherwise subject to an enumerated consumer law or other law that is transferred to the Bureau's authority. This subsection also allows a merchant to extend credit to a consumer for the purchase of a nonfinancial good or service without coming under the authority of the Bureau under this title. This has been described as allowing local merchants to "extend a tab" to a customer. Merchants may also collect these debts (or hire someone to do so), or sell such debts, if delinquent, without being subject to the Bureau's authority over those activities. This limitation would not extend to merchants who, for example, extend credit which exceeds the market value of the good or service offered or provided or who regularly extend credit that is subject to a finance charge and payable by written agreement in more than 4 installments.

Under this subsection, the Bureau would have no authority to issue rules or take enforcement action against merchants, retailers, or sellers of nonfinancial goods or services that are not engaged significantly in offering or providing consumer financial products or services. This makes clear that the Committee intends to exclude persons and businesses such as dentists, doctors, and small Main Street retailers that simply allow their customers to pay bills over time from the new authority of the Bureau. Such persons typically are not engaged significantly in offering or providing consumer financial products or services.

Finally, for the purposes of this section (a), the term "finance charge" is expected to be interpreted consistent with the current rules that implement the Truth in Lending Act, including appropriate exclusions from that term for charges for unanticipated late payment, delinquency, or default.

Subsection (b) clarifies that real estate brokerage activities are not covered by the Bureau except to the extent that a real estate broker is engaged in the offering of a consumer financial product or service or is otherwise subject to an enumerated consumer law or transferred authority.

Subsection (c) clarifies that retailers of manufactured housing and modular homes are not covered by the Bureau, except to the extent that a retailer is engaged in offering or providing a consumer financial product or service or is otherwise covered by a Federal consumer financial law.

Subsection (d) clarifies that accountants and tax preparers are not covered by the Bureau for certain activities.

Subsection (e) clarifies that attorneys are not covered by the Bureau to the extent they are engaged in the practice of law under the law of the State in which they are licensed. However, this exception to the Bureau's coverage does not extend to an attorney who is engaged in the offering of a consumer financial product or service or is otherwise subject to an enumerated consumer law or transferred authority.

Subsection (f) clarifies that persons regulated by a State insurance regulator are not covered by the Bureau except to the extent that such persons are engaged in the offering of a consumer financial product or service or are otherwise covered by a Federal consumer financial law.

Subsection (g) clarifies the authority of the Bureau with regards to employee benefit plans and certain other arrangements under the Internal Revenue Code of 1986, such as IRAs, certain education savings accounts, and others. The subsection preserves the authority of other existing agencies that regulate these programs. The subsection also prohibits the Bureau from exercising any authority with respect to these plans except in very limited circumstances. Any rulemaking could be done only after a joint request by the Secretary of Labor and the Secretary of the Treasury.

Subsection (h) clarifies that persons regulated by a State securities commission are not covered by the Bureau except to the extent that such persons are engaged in the offering of a consumer financial product or service or are otherwise subject to an enumerated consumer law or transferred authority.

Subsection (i) clarifies that persons regulated by the SEC are not covered by the Bureau. However, the SEC is required to consult

and coordinate with the Bureau with respect to any rule for the same type of product as, or competes directly with, a consumer financial product or service that is subject to the Bureau's jurisdiction. This is to ensure equivalent regulatory treatment and prevent regulatory arbitrage.

Subsection (j) clarifies that persons regulated by the CFTC are not covered by the Bureau. As in subsection (i), coordination and consultation are required for rule making regarding products of the same type or that compete with each other and fall under the Bureau's jurisdiction.

Subsection (k) clarifies that the Bureau has no authority with respect to a person regulated by the Farm Credit Administration.

Subsection (l) clarifies that activities relating to charitable contributions are not covered by the Bureau. However, activities not involving charitable contributions that are the offering or provision of any consumer financial product or service are covered.

Subsection (m) clarifies that the Bureau may not define engaging in the business of insurance as a financial product or service.

Subsection (n) clarifies that a number of persons that are described above may be a service provider and subject to certain requests for information.

Subsection (o) clarifies that nothing in this title shall be construed as conferring authority on the Bureau to establish a usury limit on an extension of credit or made by a covered person to a consumer unless explicitly authorized by law.

Subsection (p) preserves the authorities of the Attorney General of the United States.

Subsection (q) preserves the authorities of the Secretary of the Treasury with regards to a person who performs income tax preparation activities for consumers.

Subsection (r) preserves the authority of the FDIC and NCUA with regards to deposit and share insurance.

Section 1028. Authority to restrict mandatory pre-dispute arbitration

The Committee is concerned that consumers have little leverage to bargain over arbitration procedures when they sign a contract for a consumer financial product or service. The Bureau is therefore required by this section to conduct a study and provide a report to Congress on the use of mandatory pre-dispute arbitration agreements as they pertain to the offering or provision of consumer financial products or services. This section grants the Bureau authority to prohibit or impose conditions and limitations on certain arbitration agreements between a covered person and a consumer consistent with the results of the study if it is in the public interest. Additionally, the Bureau is prohibited from restricting consumers from entering into voluntary arbitration agreements after a dispute has arisen.

The bill empowers the Bureau to take a range of steps, which could include a prohibition, or could instead be to impose conditions or limitations. In addition, the Bureau may choose to focus on pre-dispute mandatory arbitration provisions in contracts for certain types of consumer financial products or services, such as mortgage loans. The Bureau has to justify any rule by finding it is in the public interest and for the protection of consumers.

Section 1029. Effective date

This section provides that this subtitle become effective on the designated transfer date.

Subtitle C—Specific Bureau Authorities

Section 1031. Prohibiting unfair, deceptive, or abusive acts or practices

This section authorizes the Bureau to prevent a covered person from engaging in or committing an unfair, deceptive or abusive act or practice in connection with a transaction with a consumer for a consumer financial product or service, or the offering thereof. The Bureau is authorized to prescribe rules to identify such acts or practices. In prescribing rules, the Bureau is required to consult with the Federal banking agencies, or other Federal agencies, as appropriate, concerning the consistency of the proposed rule with prudential, market, or systemic objectives administered by such agencies.

Current law prohibits unfair or deceptive acts or practices. The addition of "abusive" will ensure that the Bureau is empowered to cover practices where providers unreasonably take advantage of consumers. The Bureau could define acts or practices as abusive only if it has a factual basis to show that the act or practice either: (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of consumers' lack of understanding of material risks, costs, or conditions of the product, inability to protect their interests in selecting or using the product, or reasonable reliance on a covered person to act in the consumers' interest.

Section 1032. Disclosures

This section helps ensure that consumers receive effective disclosures relevant to the purchase of consumer financial products or services. Under this section, the Bureau is granted rulemaking authority to ensure that information relevant to the purchase of such products or services is disclosed to the consumer in plain language in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service. In prescribing rules, the Bureau is required to consider available evidence about consumer awareness, understanding of, and responses to disclosures or communications about the risks, costs, and benefits of consumer financial products or services. The Bureau is granted the authority to provide a model form of such disclosure standards, and a safe harbor is provided for covered persons that use model forms included with a rule issued under this section.

Under this section, a procedure is established to allow the Bureau to permit a covered person to conduct a trial disclosure program for the purpose of improving on any model disclosure forms issued to consumers to implement an enumerated consumer law. The Bureau is required to propose for public comment rules and model forms that combine Truth in Lending Act (TILA) and Real Estate Settlement Procedures Act (RESPA) disclosures.

Section 1033. Consumer rights to access information

This section ensures that consumers are provided with access to their own financial information. This section requires the Bureau to prescribe rules requiring a covered person to make available to consumers information concerning their purchase and possession of a consumer financial product or service, including costs, charges, and usage data. The information is required to be made available upon a consumer's request in an electronic form usable by the consumer.

Under this section, a covered person may not be required to make available any confidential or proprietary information, any information collected by the covered person for antifraud or anti-money laundering purposes, or any information that the covered person cannot retrieve in the ordinary course of business. This section does not impose a duty on covered persons to maintain or keep any information about a consumer.

Section 1034. Response to consumer complaints and inquiries

Section 1034 requires the Bureau to establish procedures, in consultation with the appropriate Federal regulatory agencies, for providing a timely response to consumer complaints or inquiries which include steps taken by the regulator in response to the complaint or inquiry, any responses received by the regulator from the institution, and any follow-up plans or actions by the regulator in response to the consumer complaint or inquiry.

In addition, this section requires very large banks and credit unions (as defined in section 1025) subject to supervision and primary enforcement by the Bureau to provide a timely response to the Bureau, the prudential regulators, and any other related agency concerning a consumer complaint or inquiry. This includes steps taken by the institution in response to the complaint or inquiry, responses received by the institution from the consumer, and any follow-up plans or actions by the institution in response to the consumer complaint or inquiry.

Section 1034 also requires these very large depository institutions to comply in a timely manner with a consumer request for information in the control or possession of the institution concerning the account of the consumer, not including any confidential commercial information, such as algorithms used to derive credit scores, information collected for the purpose of preventing fraud or other unlawful or potentially unlawful conduct, information required to be kept confidential by any other provision of law, or any nonpublic or confidential information, including confidential supervisory information.

Finally, this section requires the Bureau to enter into a Memorandum of Understanding with the appropriate Federal regulatory agencies to establish procedures by which very large depository institutions and relevant agencies shall comply with this section.

Section 1035. Private Education Loan Ombudsman

Section 1035 requires the Secretary of the Treasury, in consultation with the Director, to designate a Private Education Loan Ombudsman within the Bureau to provide timely assistance to borrowers of private education loans, and to disseminate information about the availability and functions of the Ombudsman to bor-

rowers, potential borrowers, and related institutions, agencies, and participants.

This section requires the Ombudsman to receive, review, and attempt to informally resolve complaints from borrowers of private student loans. It also ensures coordination with the student loan ombudsman established under the Higher Education Act of 1965 by requiring a Memorandum of Understanding no later than 90 days after the designated transfer date. The Private Education Loan Ombudsman will also compile and analyze data on borrower complaints regarding private education loans, and make recommendations to the Director, the Secretary of Treasury, the Secretary of Education, and relevant Congressional Committees.

Finally, the Ombudsman is required to prepare an annual report describing and evaluating its activities during the preceding year, and to submit the report on a consistent annual date to the Secretary of the Treasury, the Secretary of Education, and relevant Congressional Committees.

Section 1036. Prohibited acts

This section prohibits by law certain activities such as the selling or advertising of consumer financial products or services which are not in conformity with the sections of this title, the failure or refusal to provide information to the Bureau as required by law, and knowingly or recklessly providing substantial assistance to another person in violation of section 1031.

Section 1037. Effective date

This section provides that this subtitle become effective on the designated transfer date.

Subtitle D—Preservation of State Law

Section 1041. Relation to State law

Section 1041 confirms that the Consumer Financial Protection Act (CFP Act) will not preempt State law if the State law provides greater protection for consumers. Federal consumer financial laws have historically established only minimum standards and have not precluded the States from enacting more protective standards. This title maintains that status quo.

A strong and independent Bureau with a clear mission to keep consumer protections up-to-date with the changing marketplace will reduce the incentive for State action and increase uniformity. The Gramm-Leach-Bliley Act of 1999 set federal financial privacy standards and gave the States the authority to go further. Only three States have used that power, and banks' operations have not been impaired. If States can continue to provide new consumer protections as problems arise, and the Bureau has the authority to follow the market and keep Federal protection up-to-date, then the Bureau will be in a position to set a strong, consistent standard that will satisfy the States.

Additionally, State initiatives can be an important signal to Congress and Federal regulators of the need for Federal action. States are much closer to abuses and are able to move more quickly when necessary to address them. If States were not allowed to take the initiative to enact laws providing greater protection for consumers,

the Federal Government would lose an important source of information and reason to adjust standards over time.

For that reason, section 1041 also requires the Bureau to propose a rule making when a majority of the States has enacted a resolution requesting a new or modified consumer protection regulation by the Bureau. As part of the rule making, the Bureau is required to consult with federal banking agencies to determine whether the proposed regulation presents an unacceptable safety and soundness risk. The Bureau must also make public in the Federal Register its determination to act or not to act on the States' request.

Section 1042. Preservation of enforcement powers of States

Section 1042 grants authority to State attorneys general to enforce this Act against Federal and State chartered entities. State regulators are also authorized to take appropriate action against State chartered entities. The section also clarifies that the CFP Act does not limit any provision of any enumerated consumer law that relates to State authority to enforce Federal law. State attorneys general and regulators are directed to consult or notify the Bureau and the prudential regulators, when practicable, before initiating an enforcement action pursuant to this section. This section also confirms that the CFP Act has no impact on the authority of State securities or State insurance regulators regarding their enforcement actions or rulemaking activities.

Section 1043. Preservation of existing contracts

Section 1043 makes clear that the CFP Act shall not be construed to affect the applicability of any rule, order, guidance or interpretation by the OCC or OTS regarding the preemption of State law by a Federal banking law to any contract entered into by banks, thrifts, or affiliates and subsidiaries thereof, prior to the date of enactment of the CFP Act. This section is intended to provide stability to existing contracts.

Section 1044. State law preemption standards for national banks and subsidiaries clarified

Section 1044 amends the National Bank Act to clarify the preemption standard relating to State consumer financial laws as applied to national banks. This section does not alter the preemption standards for State laws of general applicability to business conduct. State consumer financial laws are defined as laws that directly and specifically regulate the manner, content, or terms and conditions of financial transactions or accounts with respect to consumers. The standard for preempting State consumer financial law would return to what it had been for decades, those recognized by the Supreme Court in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996 *Barnett*), undoing broader standards adopted by rules, orders, and interpretations issued by the OCC in 2004.

Specifically, this section sets out the three circumstances under which a State consumer financial law can be preempted: (1) when the State law would have a discriminatory effect on national banks or federal thrifts in comparison with the effect of the law on a bank or thrift chartered in that State; (2) if the State law, as described in the standard established by the Supreme Court in *Barnett*, "prevents or significantly interferes with a national bank's exercise of

its power;" or (3) the State law is preempted by another Federal law. A preemption determination pursuant to *Barnett* can be made by either a court or by the OCC on a case-by-case basis. The term "case-by-case basis" is defined to permit the OCC to make a single determination concerning multiple States' consumer financial laws, so long as the law contains substantively equivalent terms.

Prior to making a determination under the *Barnett* standard, the OCC must follow certain procedures when making a preemption determination. Prior to making such a determination the OCC must first consult with, and consider the views of, the Bureau. The determination by the OCC must also be based on substantial evidence supporting the finding that the provision meets the *Barnett* standard. After consulting with the Bureau, the OCC must make a written finding that a federal law provides a relevant substantive standard that would protect consumers if the State law was to be preempted. The federal standard does not have to be as strong as the State law that is being preempted.

Section 1044 clarifies that nothing affects the deference that a court may afford to the OCC under the *Chevron* doctrine when interpreting Federal laws administered by that agency, except for preemption determinations. For a preemption determination, a reviewing court must assess the validity of the agency's preemption claim based on certain factors, as the court finds to be persuasive and relevant.

Section 1044 does not alter or affect existing laws regarding the charging of interest by national banks

Finally, the OCC is required to periodically publish a list of its preemption determinations.

Section 1045. Clarification of law applicable to nondepository institutions subsidiaries

Section 1045 clarifies that State law applies to State-chartered nondepository institution subsidiaries, affiliates, and agents of national banks, other than entities that are themselves chartered as national banks. Such entities are generally chartered by the States and therefore should be subject to State law.

Section 1046. State law preemption standards for federal savings associations and subsidiaries clarified

Section 1046 amends the Home Owners' Loan Act to clarify that State law preemption standards for Federal savings associations and their subsidiaries shall be made in accordance with the standard applicable to national banks.

Section 1047. Visitorial standards for national banks and savings associations

Section 1047 clarifies that a State attorney general may bring a judicial action against a national bank or Federal savings association to enforce Federal law, as permitted by such law, or nonpreempted State law, which is consistent with the provisions of the National Bank Act and Home Owners' Loan Act relating to visitorial powers. The United States Supreme Court affirmed this when it overturned a Federal preemption of States to enforce valid State laws against national banks in *Cuomo v. Clearing House Association*, 557 U.S. (2009) (Cuomo). The Court held that the Na-

tional Bank Act generally preempts "vistorial" supervisory powers by States over national banks, but that law enforcement powers are separate and not preempted by the National Bank Act. A State attorney general is required to consult with the OCC before bringing an action against a national bank or Federal savings association.

Section 1048. Effective date

Section 1048 provides that this subtitle becomes effective on the designated transfer date.

Subtitle E—Enforcement Powers

Section 1051. Definitions

Section 1051 defines certain key terms for the purposes of this subtitle.

Section 1052. Investigations and administrative discovery

Section 1052 provides the authority to the Bureau to issue subpoenas for documents and testimony. It also authorizes demands of materials and provides for confidential treatment of demanded material. Section 1052 provides for petitions to modify or set aside a demand, and for custodial control and district court jurisdiction.

Section 1053. Hearings and adjudication proceedings

Section 1053 provides the authority to the Bureau to conduct hearings and adjudication proceedings with special rules for cease-and-desist proceedings, temporary cease-and-desist proceedings, and for enforcement of orders in the United States District Court.

Section 1054. Litigation authority

Section 1054 provides the authority to the Bureau to commence civil action against a person who violates a provision of this title or any enumerated consumer law, rule or order.

Section 1055. Relief available

Section 1055 provides for relief for consumers through administrative proceedings and court actions for violations of this title, including civil money penalties.

Section 1056. Referrals for criminal proceedings

Section 1056 authorizes the Bureau to transmit evidence of conduct that may constitute a violation of Federal criminal law to the Attorney General of the United States.

Section 1057. Employee protection

Section 1057 provides protection against firings of or discrimination against employees who provide information or testimony to the Bureau regarding violations of this title.

Section 1058. Effective date

Section 1058 provides that this subtitle becomes effective on the designated transfer date.

Subtitle F—Transfer of Functions and Personnel and Transitional Provisions

Section 1061. Transfer of consumer financial protection functions

Section 1061 transfers functions relating to consumer financial protection from the Federal banking agencies (Federal Reserve, OCC, OTS and FDIC) and NCUA, the Department of Housing and Urban Development and the Federal Trade Commission to the Bureau.

Section 1062. Designated transfer date

Section 1062 identifies the date of transfer of functions to the Bureau as between 6 and 18 months after the date of enactment of the CFP Act and subject to a six month extension. It also requires that the transfer of functions be completed not later than 2 years after the date of enactment of the CFP Act.

Section 1063. Savings provision

Section 1063 clarifies that existing rights, duties, obligations, orders, and rules of the Federal banking agencies, the NCUA, the Department of Housing and Urban Development and the Federal Trade Commission are not affected by the transfer.

Section 1064. Transfer of certain personnel

Section 1064 provides for the transfer of personnel from various agencies to the Bureau and establishes employment and pay protection for two years. It also provides for continuation of benefits.

Section 1065. Incidental transfers

Section 1065 authorizes the Director of the Office of Management and Budget, in consultation with the Secretary of the Treasury, to make additional incidental transfers of assets and liabilities of the various agencies. The authority in this section terminates after 5 years.

Section 1066. Interim authority of the Secretary

Section 1066 provides the Secretary of the Treasury authority to perform the functions of the Bureau under the CFP Act until the Director of the Bureau is confirmed by the Senate.

Section 1067. Transition oversight

Section 1067 ensures an orderly and organized creation of the Bureau. It also requires the Bureau to submit an annual report to Congress, which shall include plans for the recruitment of a qualified workforce and a training and development program.

Subtitle G—Regulatory Improvements

Section 1071. Collection of deposit account data

Section 1071 authorizes the collection of deposit account data in order to promote awareness and understanding of the access of individuals and communities to financial services, and to identify business development needs and opportunities. In developing the rules prescribed under Section 1071, the Bureau should coordinate with the Federal banking regulators and the National Credit Union

Administration regarding the type and form of the deposit account data, as well as the method of collection, making every effort to avoid duplicative data collection requirements and minimize additional regulatory burden. Where substantially similar data is collected by the appropriate Federal banking regulator or the National Credit Union Administration, the Bureau should use this data. This section becomes effective on the designated transfer date.

Section 1072. Small business data collection

Section 1072 authorizes the Bureau to collect data on small businesses to facilitate enforcement of fair lending laws and to enable communities, governmental entities and creditors to identify business and community development needs and opportunities for women-owned and minority-owned small businesses. This section becomes effective on the designated transfer date.

Section 1073. GAO study on the effectiveness and impact of various appraisal methods

Section 1073 requires the GAO to conduct a study on various appraisal methods and the extent to which the usage of such methods impacts costs to consumers, conflicts of interest and home price speculation.

Section 1074. Prohibition on certain prepayment penalties

Section 1074 prohibits prepayment penalties on all residential mortgage loans that are not a qualified mortgage and restricts them on qualified mortgages. Qualified mortgages are defined to include residential mortgages that meet certain criteria, in particular with respect to the application of prepayment penalties.

Section 1075. Assistance for economically vulnerable individuals and families

Section 1075 amends the Financial Education and Counseling Grant Program established in the Housing and Economic Recovery Act of 2008 by expanding the target audience beyond "potential homebuyers" to "economically vulnerable individuals and families" and deletes the 5 organization limit.

Section 1076. Remittance transfers

Section 1076 amends the Electronic Fund Transfer Act to establish minimum protections for remittances sent by consumers in the United States to other countries (remittance transfers). Immigrants send substantial portions of their earnings to family members abroad. These senders of remittance transfers are not currently provided with adequate protections under federal or state law. They face significant problems with their remittance transfers, including being overcharged or not having the funds reach intended recipients. This section will require disclosures about the costs of sending remittance transfers to be displayed in storefronts and to be provided to senders prior to and after a transaction. An error resolution process for remittance transfers is also established.

Specifically, this section will allow consumers to compare costs by requiring remittance providers to post, on a daily basis, a model transfer for the amounts of $100 and $200 in their storefronts

showing the amount of currency, including fees, which would be received by the recipient of a remittance. It also will require consumers sending remittances to be provided with simple disclosures describing the amount of currency for the designated recipient and a promised date of delivery. In addition, it establishes an error resolution process for remittances that are not properly transmitted.

Subtitle H—Conforming Amendments

Section 1081. Amendments to the Inspector General Act

Section 1081 makes conforming amendments to the Inspector General Act to provide the Bureau with oversight by the Inspector General of the Board of Governors. This section becomes effective on the date of enactment of this Act.

Section 1082. Amendments to the Privacy Act of 1974

Section 1082 makes conforming amendments to the Privacy Act. This section becomes effective on the date of enactment of this Act.

Section 1083. Amendments to the Alternative Mortgage Transaction Parity Act of 1982

Section 1083 makes conforming amendments to the Alternative Mortgage Transaction Parity Act. The Alternative Mortgage Parity Act was passed in 1982 to preempt State laws and constitutions that prohibited adjustable rate mortgage (ARM) loans for Federally-chartered and State chartered entities. It also preempted State laws with respect to all "alternative" mortgages, including negative amortization loans and interest only loans. States were unable to regulate terms for mortgages which have proved to have had significant difficulty. The amendment continues to preempt State laws that would prohibit adjustable rate mortgages, but removes this preemption of other types of "alternative" mortgages or features, permitting States to legislate in this area.

Section 1084. Amendments to the Electronic Fund Transfer Act

Section 1084 makes conforming amendments to the Electronic Fund Transfer Act.

Section 1085. Amendments to the Equal Credit Opportunity Act

Section 1085 makes conforming amendments to the Equal Credit Opportunity Act.

Section 1086. Amendments to the Expedited Funds Availability Act

Section 1086 makes conforming amendments to the Expedited Funds Availability Act. It also increases the next-day funds availability amount under the Expedited Funds Availability Act from $100 to $200, and allows future adjustments for inflation.

Section 1087. Amendments to the Fair Credit Billing Act

Section 1087 makes conforming amendments to the Fair Credit Billing Act.

Section 1088. Amendments to the Fair Credit Reporting Act and the Fair and Accurate Credit Transactions Act

Section 1088 makes conforming amendments to the Fair Credit Reporting Act and the Fair and Accurate Credit Transaction Act.

Section 1089. Amendments to the Fair Debt Collection Practices Act

Section 1089 makes conforming amendments to the Fair Debt Collection Practices Act.

Section 1090. Amendments to the Federal Deposit Insurance Act

Section 1090 makes conforming amendments to the Federal Deposit Insurance Act.

Section 1091. Amendments to the Gramm-Leach-Bliley Act

Section 1091 makes conforming amendments to the Gramm-Leach-Bliley Act.

Section 1092. Amendments to the Home Mortgage Disclosure Act

Section 1092 makes conforming and other amendments to the Home Mortgage Disclosure Act. The amendments require new data fields to be reported to the Bureau, including borrower age, total points and fees information, loan pricing, prepayment penalty information, house value for loan to value ratios, period of introductory interest rate, interest-only or negative amortization information, terms of the loan, channel of origination, unique originator ID from the Secure and Fair Enforcement for Mortgage Licensing Act, universal loan identifier, parcel number to permit geocoding, and credit score.

Section 1093. Amendments to the Home Owners Protection Act of 1998

Section 1093 makes conforming amendments to the Home Owners Protection Act.

Section 1094. Amendments to the Home Ownership and Equity Protection Act of 1994

Section 1094 makes conforming amendments to the Home Ownership and Equity Protection Act.

Section 1095. Amendments to the Omnibus Appropriations Act, 2009

Section 1095 makes conforming amendments to the Omnibus Appropriations Act, 2009.

Section 1096. Amendments to the Real Estate Settlement Procedures Act

Section 1096 makes conforming amendments to the Real Estate Settlement Procedures Act.

Section 1097. Amendments to the Right to Financial Privacy Act of 1978

Section 1097 makes conforming amendments to the Right to Financial Privacy Act.

Section 1098. Amendments to the Secure and Fair Enforcement for Mortgage Licensing Act of 2008

Section 1098 makes conforming amendments to the Secure and Fair Enforcement for Mortgage Licensing Act of 2008.

Section 1099. Amendments to the Truth in Lending Act

Section 1099 makes conforming amendments to the Truth in Lending Act.

Section 1100. Amendments to the Truth in Savings Act

Section 1100 makes conforming amendments to the Truth in Savings Act.

Section 1101. Amendments to the Telemarketing and Consumer Fraud and Abuse Prevention Act

Section 1101 makes conforming amendments to the Telemarketing and Consumer Fraud and Abuse Prevention Act.

Section 1102. Amendments to the Paperwork Reduction Act

Section 1102 makes conforming amendments to the Paperwork Reduction Act.

Section 1103. Adjustment for inflation in the Truth in Lending Act

Section 1103 amends the Truth in Lending Act to cover transactions of up to $50,000 and allows future adjustments for inflation.

Section 1104. Effective date

Section 1104 provides that Sections 1083 through 1102 become effective on the designated transfer date.

Title XI—Federal Reserve System Provisions

Section 1151. Federal Reserve Act amendment on emergency lending authority

This section amends Section 13(3) of the Federal Reserve Act which governs emergency lending. Emergency lending to an individual entity is no longer permitted. The Board of Governors now is authorized to lend to a participant in any program or facility with broad-based eligibility. Policies and procedures governing emergency lending must be established by regulation, in consultation with the Secretary of the Treasury. The Treasury Secretary must approve the establishment of any lending program. Lending programs must be designed to provide liquidity and not to aid a failing financial company. Collateral or other security for loans must be sufficient to protect taxpayers from losses.

The Board of Governors must report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on any 13(3) lending program within 7 days after it is initiated, and periodically thereafter. The identities of recipients of emergency lending will be disclosed within 1 year of receipt of assistance, unless the Federal Reserve reports to Congress that disclosure would reduce the effectiveness of the program or facility or have other serious adverse effects, in which case the identities of recipients will be disclosed no later than 1 year after the

program terminates. The GAO will report to Congress evaluating whether a determination not to disclose recipient identities within a year is reasonable.

Section 1152. Reviews of special Federal Reserve credit facilities

This section amends Section 714 of Title 31, United States Code, to establish Comptroller General audits of emergency lending by the Board of Governors of the Federal Reserve under Section 13(3) of the Federal Reserve Act.

Section 1153. Public access to information

This section amends Section 2B of the Federal Reserve Act. The Comptroller General audits of 13(3) lending established under Section 1152 of this Act, the annual financial statements prepared by an independent auditor for the Board of Governors, and reports to the Senate Committee on Banking, Housing and Urban Affairs on 13(3) lending established under Section 1151 of this Act will be displayed on a webpage that will be accessed by an "Audit" link on the Board of Governors website. The required information will be made available within 6 months of the date of release.

Sections 1154–1155. Emergency financial stabilization debt guarantees

The FDIC will be able to guarantee the debt of *solvent* insured depositories and their holding companies under very strict conditions. The Board of Governors of the Federal Reserve and the Financial Stability Oversight Council must determine that there is a "liquidity event" that failure to take action would have serious adverse effects on financial stability or economic conditions, and that guarantees are needed to avoid or mitigate the adverse effects. The determination must be in writing and is subject to GAO audit. The FDIC may then set up a facility to guarantee debt, following policies and procedures determined by regulation, but the terms and conditions of the guarantees must be approved by the Secretary of the Treasury.

The Secretary will determine a maximum amount of guarantees, and the President may request Congress to allow that amount. If the President does not submit the request, the guarantees will not be made. Congress has 5 days to disapprove the request. Fees for the guarantees are set to cover all expected costs. If there are losses, they are recouped from those firms that received guarantees.

Section 1156. Additional related amendments

The FDIC may not exercise its systemic risk authority to establish any widely available debt guarantee program for which Section 1155 would provide authority.

If any firm defaults on a debt guarantee provided under section 1155, the FDIC shall appoint itself receiver of the company if it is an insured depository. If the defaulting firm is not an insured depository, the FDIC shall pursue one of two alternatives. Under the first alternative the FDIC will require consideration that the company be put into the resolution mechanism pursuant to Section 203, and require that the company file for bankruptcy if the FDIC is not appointed receiver within 30 days. Under the second alter-

native the FDIC will file a petition for involuntary bankruptcy on behalf of the defaulting company.

Section 1157. Changes to Federal Reserve governance

The Federal Reserve Act is amended to state that a member of the Board of Governors of the Federal Reserve shall serve as Vice Chairman for Supervision. The Vice Chairman, who will be designated by the President, by and with the advice and consent of the Senate, will develop policy recommendations regarding supervision and regulation for the Board, and will appear before Congress semi-annually to report on the efforts, objectives and plans of the Board with respect to the conduct of supervision and regulation.

The Federal Reserve Act is amended to give the Board of Governors of the Federal Reserve a formal responsibility to identify, measure, monitor, and mitigate risks to U.S. financial stability.

The Federal Reserve Act is amended to state explicitly that the Board of Governors of the Federal Reserve may not delegate to a Federal reserve bank its functions for establishing supervisory and regulatory policy for bank holding companies and other financial firms supervised by the Board.

To eliminate potential conflicts of interest at Federal reserve banks, the Federal Reserve Act is amended to state that no company, or subsidiary or affiliate of a company that is supervised by the Board of Governors can vote for Federal reserve bank directors; and the officers, directors and employees of such companies and their affiliates cannot serve as directors.

The Federal Reserve Act is amended to state that the Federal Reserve Bank of New York president, who is currently appointed by the district board of directors, will be appointed by the President, by and with the advice and consent of the Senate.

Title XII—Improving Access to Mainstream Financial Institutions

Section 1201. Short title

This section establishes the name of the title to be the "Improving Access to Mainstream Financial Institutions Act."

Section 1202. Purpose

This section establishes the purpose of this title to encourage initiatives for financial products and services that are appropriate and accessible for millions of Americans who are not fully incorporated into the financial mainstream. The Committee is concerned about lack of access to mainstream financial institutions for significant numbers of unbanked or underbanked individuals. About one in four families are unbanked or underbanked. Many are low- and moderate-income families that cannot afford to have their earnings diminished by reliance on high-cost and often predatory financial products and services. Underbanked consumers rely on non-traditional forms of credit including payday lenders, title lenders, or refund anticipation loans for financial needs. The unbanked are unable to save securely for education expenses, a down payment on a first home, or other future financial needs.

Section 1203. Definitions

Section 1204. Expanded access to mainstream financial institutions

Section 1204 authorizes programs intended to assist low- and moderate-income individuals establish bank or credit union accounts. This section authorizes the Treasury Secretary to establish a multiyear program of grants, cooperative agreements, financial agency agreements, and similar contracts or undertakings to promote initiatives designed to expand access to mainstream financial institutions by low and moderate income individuals. Entities eligible under this program include: 501(c)(3) organizations; federally insured depository institutions; community development financial institutions; State, local, or tribal government entities; and partnerships or other joint ventures comprised of one or more of these such entities. An eligible entity may, in participating in a program established by the Secretary under this section, offer or provide to low and moderate income individuals products or services including small-dollar value loans and financial education and counseling.

Section 1205. Low-cost alternatives to payday loans

Section 1205 will encourage the development of small, affordable loans as an alternative to more costly, predatory, payday loans. This section authorizes the Secretary to establish multiyear demonstration programs by means of grants, cooperative agreements, financial agency agreements, and similar contracts or undertakings with eligible entities to provide low-cost small loans to consumers that will provide alternatives to payday loans. Loans under this section are required to be made on terms and conditions and pursuant to lending practices that are reasonable for consumers. The authorization of a grant program under this section is intended to encourage the further development of affordable small loans that will assist working families by providing access to reasonable credit and providing financial education opportunities. Entities awarded a grant under this section are required to promote financial literacy and education opportunities, such as relevant counseling services, educational courses, or wealth building programs, to each consumer provided with a loan pursuant to this section.

Section 1206. Grants to establish loan-loss reserve funds

Section 1206 will enable Community Development Financial Institutions to establish and maintain small dollar loan programs by establishing a grant program within the CDFI Fund to encourage affordable small dollar lending through loan-loss reserve funds and provision of technical assistance. This section directs the CDFI Fund to make grants to CDFIs to establish loan-loss reserve funds to help CDFIs defray the costs of operating small dollar loan programs in order to help provide consumers access to mainstream financial institutions and provide payday loan alternatives. Loan-loss reserve funds enable financial institutions to maintain the necessary capital to offer small dollar loans in a prudentially sound manner. A CDFI receiving grants under this program must provide matching funds equal to 50% of the amount of any grant received under this section. Grants received by a CDFI under this section may not be used to provide direct loans to consumers, and may be

used to help recapture a portion or all of a defaulted loan made under the small dollar loan program.

This section further requires the Fund to provide technical assistance grants to CDFIs to support and maintain small dollar loan programs. Technical assistance grants help financial institutions defray the initial fixed costs of establishing a small dollar loan program and effectively implement grant activities.

This section sets requirements for the terms and conditions of loans made by participating institutions to ensure affordability and help underserved consumers improve their financial condition. Small dollar loan programs are defined as loan programs where a CDFI offers loans to consumers that do not exceed $2500; are required to be paid in installments; have no prepayment penalty; report to at least one national consumer reporting agency; and meet any other affordability requirement established by the Administrator of the Fund.

Section 1207. Procedural provisions

This section requires an eligible entity desiring to participate in a program or obtain a grant under this title to submit an application to the Secretary.

Section 1208. Authorization of appropriations

This section authorizes to be appropriated to the Secretary, such sums necessary to administer and fund the programs and projects authorized by this title. It further authorizes to be appropriated to the Fund for each fiscal year beginning in FY 2010, an amount equal to the amount of the administrative costs of the Fund for the operation of the grant program established under this title.

Section 1209. Regulations

This section authorizes the Secretary to promulgate regulations to implement and administer the grant programs and undertakings authorized by this title, including limiting the eligibility of entities as deemed appropriate for certain activities authorized in Section 1204.

Section 1210. Evaluation and reports to Congress

This section requires the Secretary to submit a report to the Senate Committee on Banking, Housing and Urban Affairs and the House Financial Services Committee containing a description of the activities funded, amounts distributed, and measurable results, as appropriate and available.

VI. HEARING RECORD

Since the beginning of the 110th Congress, the Committee on Banking, Housing, and Urban Affairs has held 79 hearings on topics surrounding the housing and economic crisis and financial regulatory reform.

Preserving the American Dream: Predatory Lending Practices and Home Foreclosures

Wednesday, February 7, 2007

Witnesses: The Reverend Jesse Jackson, President and Founder, RainbowPUSH Coalition; Mr. Harry H. Dinham, President, National Association of Mortgage Brokers; Mr. Hilary Shelton, Execu-

tive Director, National Association for the Advancement of Colored People; Mr. Martin Eakes, Chief Executive Officer, Self-Help Credit Union and the Center for Responsible Lending; Ms. Jean Constantine-Davis, Senior Attorney, AARP; Mr. Douglas G. Duncan, Senior Vice President of Research and Business Development, and Chief Economist, Mortgage Bankers Association; Ms. Delores King, Consumer, Ms. Amy Womble, Consumer.

Mortgage Market Turmoil: Causes and Consequences

Thursday, March 22, 2007

Witnesses:

Panel 1: Mr. Emory W. Rushton, Senior Deputy Comptroller and Chief National Bank Examiner, Office of the Comptroller of the Currency; Mr. Joseph A. Smith, North Carolina Commissioner of Banks and Chairman, Conference of State Bank Supervisors; Mr. Roger T. Cole, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System; Mr. Scott M. Polakoff, Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision; Ms. Sandra Thompson, Director of the Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation.

Panel 2: Mr. Brendan McDonagh, Chief Executive Officer, HSBC Finance Corporation; Mr. Sandy Samuels, Executive Managing Director, Countrywide Financial Corporation; Mr. Laurent Bossard, Chief Executive Officer, WMC Mortgage; Mr. L. Andrew Pollock, President, First Franklin Financial Corporation; Ms. Janis Bowdler, Senior Policy Analyst, National Council of La Raza; Mr. Irv Ackelsberg, Consumer Attorney; Ms. Jennie Haliburton, Consumer; Mr. Al Ynigues, Borrower.

Subprime Mortgage Market Turmoil: Examining the Role of Securitization

Tuesday, April 17, 2007

Witnesses: Mr. Gyan Sinha, Senior Managing Director and Head of ABS and CDO Research, Bear Stearns & Co. Inc.; Mr. David Sherr, Managing Director and Head of Securitized Products, Lehman Brothers; Ms. Susan Barnes, Managing Director of Ratings Services, Standard and Poor's; Mr. Warren Kornfeld, Managing Director, Residential Mortgage-Backed Securities Rating Group, Moody's Investors Service; Mr. Kurt Eggert, Professor of Law, Chapman University School of Law; Mr. Christopher L. Peterson, Assistant Professor of Law, Levin College of Law, University of Florida.

Ending Mortgage Abuse: Safeguarding Homebuyers

Tuesday, June 26, 2007

Witnesses: Mr. David Berenbaum, Executive Vice President, National Community Reinvestment Coalition; Professor Anthony Yezer, Department of Economics, George Washington University; Ms. Denise Leonard, Chairman and CEO, Constitution Financial Group, Inc. on behalf of the National Association of Mortgage Brokers; Mr. John Robbins, Chairman, Mortgage Bankers Association; Mr. Wade Henderson, President and CEO, Leadership Conference on Civil Rights; Mr. Alan Hummel, Senior Vice President and Chief Appraiser, Forsythe Appraisals, LLC on behalf of the Appraisal Institute; Mr. Pat V. Combs, President, National Association of RE-

ALTORS; Mr. Michael D. Calhoun, President, Center For Responsible Lending.

The State of the Securities Markets

Tuesday, July 31, 2007

Witnesses: Honorable Christopher Cox, Chairman, Securities and Exchange Commission.

The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets

Wednesday, September 26, 2007

Witnesses

Panel 1: Honorable Christopher Cox, Chairman, Securities and Exchange Commission.

Panel 2: Mr. John Coffee, Adolf A. Berle Professor of Law, Columbia Law School; Dr. Lawrence J. White, Leonard E. Imperatore Professor of Economics, New York University; Mr. Micheal Kanef, Group Managing Director, Assett Finance Group, Moody's Financial Services; Ms. Vickie A. Tillman, Executive Vice President for Credit Market Services, Standard & Poor's.

Strengthening our Economy: Foreclosure Prevention and Neighborhood Preservation

Thursday, January 31, 2008

Witnesses

Panel 1: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Robert Steel, Under Secretary of Treasury for Domestic Finance, Department of the Treasury.

Panel 2: Doris Koo, President and CEO, Enterprise Community Partners, Inc; Michael Barr, Senior Fellow, Center for American Progress, and Professor of Law, University of Michigan Law School; Mr. Wade Henderson, President and CEO, Leadership Conference on Civil Rights; Mr. Alex Pollock, Resident Fellow, American Enterprise Institute.

The State of the United States Economy and Financial Markets

Thursday, February 14, 2008

Witnesses: Honorable Henry M. Paulson, Secretary of the Treasury; Honorable Christopher Cox, Chairman, Securities and Exchange Commission; Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System.

The State of the Banking Industry

Tuesday, March 4, 2008

Witnesses: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable John C. Dugan, Comptroller of the Currency, United States Treasury; Honorable John M. Reich, Director, Office of Thrift Supervision; Honorable JoAnn Johnson, Chairman, National Credit Union Administration; Honorable Donald Kohn, Vice Chairman, Board of Governors, Federal Reserve System; Mr. Thomas B. Gronstal, Superintendent of Banking, State of Iowa.

Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators

Thursday, April 3, 2008

Witnesses

Panel 1: The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System; Honorable Christopher

Cox, Chairman, Securities and Exchange Commission; Robert Steel, Under Secretary of Treasury for Domestic Finance, Department of the Treasury; Mr. Timothy F. Geithner, President, Federal Reserve Bank of New York.

Panel 2: Mr. James Dimon, Chairman and Chief Executive Officer, JP Morgan Chase; Mr. Alan D. Schwartz, President and Chief Executive Officer, The Bear Stearns Companies, Inc.

Restoring the American Dream: Solutions to Predatory Lending and the Foreclosure Crisis

Monday, April 7, 2008

Witnesses: The Honorable Michael Nutter, Mayor of Philadelphia, Pennsylvania; Ms. Yajaira Rivera, Philadelphia, Pennsylvania; Ms. Christina Anderson-Jones, Philadelphia, Pennsylvania; Ph.D. Ira Goldstein, Director, Policy and Information Services, The Reinvestment Fund; Mr. Brian A. Hudson, Sr., Executive Director, Pennsylvania House Finance Agency.

Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets

Thursday, April 10, 2008

Witnesses: Dr. Lawrence H. Summers, Charles W. Eliot University Professor, Harvard University; Dr. Dean Baker, Co-Director, Center for Economic and Policy Research; Ms. Ellen Harnick, Senior Policy Counsel, Center for Responsible Lending; Mr. Scott Stern, Chief Executive Officer, Lenders One, Incorporated; Dr. Douglas Elmendorf, Senior Fellow, The Brookings Institution.

Turmoil in U.S. Credit Markets Impact on the Cost and Availability of Student Loans

Tuesday, April 15, 2008

Witnesses: John (Jack) F. Remondi, Vice Chairman and Chief Financial Officer, Sallie Mae, Inc.; Mr. Tom Deutsch, Deputy Executive Director, American Securitization Forum; Ms. Patricia McGuire, President, Trinity Washington University; Ms. Sarah Flanagan, Vice President for Policy Development, National Association of Independent Colleges and Universities; Mark Kantrowitz, Publisher, FinAid.org.

Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets

Wednesday, April 16, 2008

Witnesses: Honorable Brian D. Montgomery, Federal Housing Commissioner and Assistant Secretary, Department of Housing and Urban Development; Mr. Art Murton, Director, Division of Insurance and Research, Federal Deposit Insurance Corporation; Mr. Scott M. Polakoff, Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision.

Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies

Tuesday, April 22, 2008

Witnesses

Panel 1: Honorable Christopher Cox, Chairman, Securities and Exchange Commission.

Panel 2: Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School; Dr. Arturo Cifuentes,

Managing Director, R.W. Pressprich & Co.; Mr. Stephen W. Joynt, President and Chief Executive Officer, Fitch Ratings; Ms. Claire Robinson, Senior Managing Director, Moody's Investors Service; Ms. Vickie A. Tillman, Executive Vice President for Credit Market Services, Standard & Poor's.

Turmoil in U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments

Thursday, April 24, 2008

Witnesses

Panel 1: Mr. Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System; Mr. Ethiopis Tafara, Director, Office of International Affairs, Securities and Exchange Commission.

Panel 2: Mr. David Marchick, Managing Director, The Carlyle Group; Mr. Paul Rose, Assistant Professor of Law, Moritz College of Law, Ohio State University; Ms. Jeanne S. Archibald, Partner, Hogan and Hartson LLP; Mr. Dennis Johnson, Director of Corporate Governance, California Public Employees' Retirement System.

Turmoil in the U.S. Credit Markets: Examining the Regulation of Investment Banks by the U.S. Securities and Exchange Commission

Wednesday, May 7, 2008

Witnesses

Panel 1: Mr. Erik Sirri, Director, Division of Market Regulation, Securities and Exchange Commission.

Panel 2: Honorable Arthur Levitt, Former Chairman, U.S. Securities and Exchange Commission; Mr. David Ruder, Former Chairman, U.S. Securities and Exchange Commission.

The State of the Banking Industry: Part II

Thursday, June 5, 2008

Witnesses: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable John C. Dugan, Comptroller of the Currency, United States Treasury; Honorable John M. Reich, Director, Office of Thrift Supervision; Honorable JoAnn Johnson, Chairman, National Credit Union Administration; Honorable Donald Kohn, Vice Chairman, Board of Governors, Federal Reserve System; Mr. Timothy J. Karsky, Commissioner/Chairman, North Dakota Department of Financial Institutions/ Conference of State Bank Supervisors.

Risk Management and its Implications for Systemic Risk

Thursday, June 19, 2008

Witnesses: Honorable Donald Kohn, Vice Chairman, Board of Governors, Federal Reserve System; Dr. Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission; Mr. Scott M. Polakoff, Deputy Director, Office of Thrift Supervision; Mr. Richard Bookstaber, Financial Author; Professor Richard Herring, Jacob Safra Professor of International Banking and Co-Director of the Wharton Financial Institutions Center, Wharton School, University of Pennsylvania; Mr. Kevin Blakely, President and Chief Executive Officer, Risk Management Association.

Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market

Wednesday, July 9, 2008

Witnesses: Mr. Patrick Parkinson, Deputy Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System; Mr. James Overdahl, Senior Economist, U.S. Securities and Exchange Commission; Ms. Kathryn E. Dick, Deputy Comptroller for Credit and Market Risk, Office of the Comptroller of the Currency; Dr. Darrell Duffie, Dean Witter Distinguished Professor of Finance, Stanford University, Graduate School of Business; Mr. Craig Donohue, Chief Executive Officer, Chicago Mercantile Exchange Group; Mr. Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, Outside Counsel to The Clearing Corporation; Mr. Robert G. Pickel, Executive Director and Chief Executive Officer, International Swaps and Derivatives Association, Inc.

Recent Developments in U.S. Financial Markets and Regulatory Responses to Them

Tuesday, July 15, 2008

Witnesses: Honorable Henry M. Paulson, Secretary of the Treasury; The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System; Honorable Christopher Cox, Chairman, Securities and Exchange Commission.

State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure

Tuesday, July 29, 2008

Witnesses

Panel 1: Honorable Steven M. Goldman, Commissioner, New Jersey Department of Banking and Insurance, on behalf of the National Association of Insurance Commissioners; Mr. Travis B. Plunkett, Legislative Director, Consumer Federation of America; Mr. Alessandro Iuppa, Senior Vice President, Zurich North America, on behalf of the American Insurance Association; Mr. John L. Pearson, Chairman, President, and Chief Executive Officer, The Baltimore Life Insurance Company, on behalf of the American Council of Life Insurers.

Panel 2: Mr. George A. Steadman, President and Chief Operating Officer, Rutherfoord Inc., on behalf of the Council of Insurance Agents & Brokers; Mr. Thomas Minkler, President, Clark-Mortenson Agency, Inc., on behalf of the Independent Insurance Agents & Brokers of America; Mr. Franklin Nutter, President, Reinsurance Association of America; Mr. Richard Bouhan, Executive Director, National Association of Professional Surplus Lines Offices.

Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities

Thursday, September 18, 2008

Witnesses

Panel 1: Mr. Lawrence Smith, Board Member, Financial Accounting Standards Board (FASB); Mr. John White, Director, Office of Corporate Finance, Securities and Exchange Commission; Mr. James Kroeker, Deputy Chief Accountant for Accounting, U.S. Securities and Exchange Commission.

Panel 2: Professor Joseph Mason, Hermann Moyse Jr. Endowed Chair of Banking, E.J. Ourso College of Business, Louisiana State University; Mr. Donald Young, Managing Director, Young and Company LLC, and former FASB Board Member; Ms. Elizabeth Mooney, Analyst, Capital Strategy Research, The Capital Group;

Mr. George Miller, Executive Director, American Securitization Forum.

Turmoil in US Credit Markets Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions

Tuesday, September 23, 2008

Witnesses: Honorable Henry M. Paulson, Secretary of the Treasury; The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System; Honorable Christopher Cox, Chairman, Securities and Exchange Commission; Honorable James B. Lockhart, III, Director, Federal Housing Finance Agency.

Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis

Thursday, October 16, 2008

Witnesses: Honorable Arthur Levitt, Jr., Senior Advisor, The Carlyle Group; Honorable Eugene A. Ludwig, Chief Executive Officer, Promontory Financial Group; Honorable Jim Rokakis, Treasurer, Cuyahoga County, Ohio; Honorable Marc H. Morial, President and CEO, National Urban League; Mr. Eric Stein, Senior Vice President, Center for Responsible Lending.

Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses

Thursday, October 23, 2008

Witnesses: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable Neel Kashkari, Interim Assistant Secretary for Financial Stability and Assistant Secretary for International Affairs, U.S. Department of the Treasury; Honorable James B. Lockhart, III, Director, Federal Housing Finance Agency; Honorable Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System; Honorable Brian D. Montgomery, Federal Housing Commissioner and Assistant Secretary, Department of Housing and Urban Development.

Oversight of the Emergency Economic Stabilization Act: Examining Financial Institution Use of Funding Under the Capital Purchase Program

Thursday, November 13, 2008

Witnesses: Ms. Anne Finucane, Global Corporate Affairs Executive, Bank of America; Mr. Barry L. Zubrow, Executive Vice President, Chief Risk Officer, JPMorgan Chase; Mr. Jon Campbell, Executive Vice President, Chief Executive Officer of the Minnesota Region, Wells Fargo Bank; Mr. Gregory Palm, Executive Vice President and General Counsel, The Goldman Sachs Group, Inc.; Mr. Martin Eakes, Chief Executive Officer, Self-Help Credit Union and the Center for Responsible Lending; Nancy M. Zirkin, Director of Public Policy, Leadership Conference on Civil Rights; Dr. Susan M. Wachter, Worley Professor of Financial Management, Wharton School of Business, University of Pennsylvania.

Examining the State of the Domestic Automobile Industry

Tuesday, November 18, 2008

Witnesses

Panel 1: Honorable Debbie Stabenow (D-MI), United States Senator.

Panel 2: Mr. Ron Gettelfinger, President, International Union, United Automobile, Aerospace and Agricultural Implement Work-

ers of America; Mr. Alan Mulally, President and Chief Executive Officer, Ford Motor Company; Mr. Robert Nardelli, Chairman and Chief Executive Officer, Chrysler LLC; Mr. G. Richard Wagoner, Jr., Chairman and Chief Executive Officer, General Motors; Dr. Peter Morici, Professor, Robert H. Smith School of Business, University of Maryland.

The State of the Domestic Automobile Industry: Part II

Thursday, December 4, 2008

Witnesses

Panel 1: Mr. Gene L. Dodaro, Acting Comptroller General, United States Government Accountability Office.

Panel 2: Mr. Ron Gettelfinger, President, International Union, United Automobile, Aerospace and Agricultural Implement Workers of America; Mr. Alan Mulally, President and Chief Executive Officer, Ford Motor Company; Mr. Robert Nardelli, Chairman and Chief Executive Officer, Chrysler LLC; Mr. G. Richard Wagoner, Jr., Chairman and Chief Executive Officer, General Motors; Mr. Keith Wandell, President, Johnson Controls, Inc.; Mr. James Fleming, President, Connecticut Automotive Retailers Association; Dr. Mark Zandi, Chief Economist and Cofounder, Moody's Economy.com.

Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform

Tuesday, January 27, 2009

Witnesses: Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School; Dr. Henry A. Backe, Jr., Orthopedic Surgeon, Fairfield, Connecticut; Ms. Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission; Ms. Linda Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission; Mr. Stephen Luparello, Interim Chief Executive Officer, Financial Industry Regulatory Authority; Mr. Stephen Harbeck, Interim Chief Executive Officer, Financial Industry Regulatory Authority.

Modernizing the U.S. Financial Regulatory System

Wednesday, February 4, 2009

Witnesses

Panel 1: Honorable Paul A. Volcker, Chair of the President's Economic Recovery Advisory Board, Former Chairman, Board of Governors of the Federal Reserve System.

Panel 2: Mr. Gene L. Dodaro, Acting Comptroller General, United States Government Accountability Office.

Pulling Back the TARP: Oversight of the Financial Rescue Program

Thursday, February 5, 2009

Witnesses: Mr. Gene L. Dodaro, Acting Comptroller General, United States Government Accountability Office; Honorable Neil M. Barofsky, Special Inspector General, Troubled Asset Relief Program; Professor Elizabeth Warren, Chair, Congressional Oversight Panel for the Troubled Asset Relief Program.

Oversight of the Financial Rescue Program: A New Plan for the TARP

Tuesday, February 10, 2009

Witnesses: Honorable Timothy Geithner, Secretary, United States Department of the Treasury.

Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections

Thursday, February 12, 2009

Witnesses: Mr. Travis B. Plunkett, Legislative Director, Consumer Federation of America; Mr. James C. Sturdevant, Esq., The Sturdevant Law Firm; Mr. Kenneth J. Clayton, Senior Vice President and General Counsel, Card Policy Council, American Bankers Association; Lawrence M. Ausubel, Professor of Economics, University of Maryland; Mr. Todd Zywicki, Professor, George Mason University School of Law; Mr. Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center.

Homeowner Affordability and Stability Plan

Thursday, February 26, 2009

Witnesses: Honorable Shaun Donovan, Secretary, U.S. Department of Housing and Urban Development.

Consumer Protections in Financial Services: Past Problems, Future Solutions

Tuesday, March 3, 2009

Witnesses: Mr. Steve Bartlett, President and CEO, Financial Services Roundtable; Honorable Ellen Seidman, Senior Fellow of New America Foundation, Executive Vice President of ShoreBank Corporation; Professor Patricia McCoy, George J. & Helen M. England Professor of Law, University of Connecticut School of Law.

American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation

Thursday, March 5, 2009

Witnesses: Honorable Donald Kohn, Vice Chairman, Board of Governors, Federal Reserve System; Mr. Scott M. Polakoff, Senior Deputy Director and Chief Operating Officer, Office of Thrift Supervision; Mr. Eric Dinallo, Superintendent, New York State Insurance Department.

Enhancing Investor Protection and the Regulation of Securities Markets

Tuesday, March 10, 2009

Witnesses: Mr. John Coffee, Adolf A. Berle Professor of Law, Columbia Law School; Mr. Lynn E. Turner, Former Chief Accountant, U.S. Securities and Exchange Commission; Mr. Timothy Ryan, President and CEO, Securities Industry and Financial Markets Association; Mr. Paul Schott Stevens, President and CEO, Investment Company Institute: Professor Mercer Bullard, Associate Professor and President, University of Mississippi School of Law and Fund Democracy; Mr. Robert G. Pickel, Executive Director and Chief Executive Officer, International Swaps and Derivatives Association, Inc.; Mr. Damon Silvers, Associate General Counsel, AFL–CIO; Thomas G. Doe, CEO, Municipal Market Advisors.

Perspectives on Modernizing Insurance Regulation

Tuesday, March 17, 2009

Witnesses: Mr. Michael McRaith, Director of Insurance, Illinois Department of Financial and Professional Regulation, on behalf of the National Association of Insurance Commissioners; Honorable Frank Keating, President and Chief Executive Officer, The Amer-

ican Council of Life Insurers; Mr. William R. Berkley, Chairman and Chief Executive Officer, W. R. Berkley Corporation, on behalf of the American Insurance Association; Mr. Spencer Houldin, President, Ericson Insurance Services, on behalf of the Independent Insurance Agents and Brokers of America; Mr. John Hill, President and Chief Operating Officer, Magna Carta Companies, on behalf of the National Association of Mutual Insurance Companies; Mr. Frank Nutter, President, The Reinsurance Association of America; Mr. Robert Hunter, Director of Insurance, The Consumer Federation of America.

Lessons Learned in Risk Management Oversight at Federal Financial Regulators

Wednesday, March 18, 2009

Witnesses: Mr. Scott M. Polakoff, Acting Director, Office of Thrift Supervision; Ms. Orice Williams, Director, Financial Markets and Community Investment, Government Accountability Office; Mr. Roger Cole, Director, Division of Banking Supervision and Regulation, Federal Reserve Board; Mr. Timothy Long, Senior Deputy Comptroller, Bank Supervision Policy and Chief National Bank Examiner, Office of the Comptroller of the Currency; Dr. Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission.

Modernizing Bank Supervision and Regulation

Thursday, March 19, 2009

Witnesses: Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency; Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System; Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable Michael E. Fryzel, Chairman, National Credit Union Administration; Mr. Scott M. Polakoff, Acting Director, Office of Thrift Supervision; Mr. Joseph A. Smith, North Carolina Commissioner of Banks and Chairman, Conference of State Bank Supervisors; Mr. George Reynolds, Chairman, National Association of State Credit Union Supervisors and Senior Deputy Commissioner, Georgia Department of Banking and Finance.

Current Issues in Deposit Insurance

Thursday, March 19, 2009

Witnesses

Panel 1: Mr. Art Murton, Director, Division of Insurance and Research, Federal Deposit Insurance Corporation; Mr. David M. Marquis, Executive Director, National Credit Union Administration.

Panel 2: Mr. William Grant, Chairman & CEO, First United Bank and Trust, Oakland, Maryland, on behalf of the American Bankers Association; Mr. Terry West, President and CEO, VyStar Credit Union in Jacksonville, Florida, on behalf of the Credit Union National Association; Mr. Steve Verdier, Senior Vice President, Independent Community Bankers of America; Mr. David J. Wright, CEO, Services Credit Union, Yankton, South Dakota, on behalf of the National Association of Federal Credit Unions.

Modernizing Bank Supervision and Regulation, Part II

Tuesday, March 24, 2009

Witnesses: Mr. William Attridge, President, Chief Executive Officer and Chief Operating Officer, Connecticut River Community Bank, on behalf of the Independent Community Bankers of Amer-

ica; Mr. Daniel A. Mica, President and Chief Executive Officer, Credit Union National Association; Mr. Aubrey Patterson, Chairman and Chief Executive Officer, BancorpSouth, Inc., on behalf of the American Bankers Association; Mr. Christopher Whalen, Managing Director, Institutional Risk Analytics; Ms. Gail Hillebrand, Senior Attorney, Consumers Union of U.S., Inc.

Enhancing Investor Protection and the Regulation of Securities Markets—Part II

Thursday, March 26, 2009

Witnesses

Panel 1: Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission; Honorable Fred Joseph, President, North American Securities Administrators Association.

Panel 2: Honorable Richard C. Breeden, Former Chairman, U.S. Securities and Exchange Commission; Honorable Arthur Levitt, Former Chairmen, U.S. Securities and Exchange Commission; Honorable Paul S. Atkins, Former Commissioner, U.S. Securities and Exchange Commission.

Panel 3: Mr. Richard Ketchum, Chairman and CEO, FINRA; Mr. Ronald A. Stack, Chair, Municipal Securities Rulemaking Board; Honorable Richard Baker, President and CEO, Managed Funds Association; Mr. James Chanos, Chairman, Coalition of Private Investment Companies; Ms. Barbara Roper, Director of Investor Protection, Consumer Federation of America; Mr. David G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association; Ms. Rita Bolger, Senior Vice President and Associate General Counsel, Standard & Poor's, Global Regulatory Affairs; President Daniel Curry, President, DBRS, Inc.

Lessons from the New Deal

Tuesday, March 31, 2009

Witnesses

Panel 1: Honorable Christina Romer, Chair, Council of Economic Advisors.

Panel 2: Dr. James K. Galbraith, Lloyd M. Bentsen Chair, Lyndon B. Johnson School of Public Affairs, University of Texas at Austin; Dr. J. Bradford DeLong, Professor of Economics, University of California Berkeley; Dr. Allan M. Winkler, Professor of History, Miami (Ohio) University; Dr. Lee E. Ohanian, Professor, University of California, Los Angeles.

Regulating and Resolving Institutions Considered 'Too Big to Fail'

Wednesday, May 6, 2009

Witnesses

Panel 1: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Mr. Gary Stern, President, Federal Reserve Bank of Minneapolis.

Panel 2: Honorable Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute; Honorable Martin N. Baily, Senior Fellow, Economic Studies, The Brookings Institution; Mr. Raghuram G. Rajan, Eric J. Gleacher Distinguished Service Professor of Finance, University of Chicago Booth School of Business.

Strengthening the S.E.C.'s Vital Enforcement Responsibilities

Thursday, May 7, 2009

Witnesses: Mr. Richard Hillman, Managing Director, Financial Markets and Community Investment, U.S. Government Accountability Office; Robert Khuzami, Esq., Director, Division of Enforcement, U.S. Securities and Exchange Commission; Professor Mercer Bullard, Associate Professor of Law, University of Mississippi School of Law; Mr. Bruce Hiler, Partner and Head of Securities Enforcement Group, Cadwalader, Wickersham and Taft LLP.

Manufacturing and the Credit Crisis

Wednesday, May 13, 2009

Witnesses

Panel 1: Mr. Leo Gerard, President, United Steelworkers; Mr. David Marchick, Managing Director, The Carlyle Group.

Panel 2: Mr. Eugene Haffely, CEO, Assembly and Test Worldwide, Inc.; Lieutenant General Larry Farrell, (USAF, Retired) President, National Defense Industrial Association; Mr. William Gaskin, President, Precision Metalforming Association.

Oversight of the Troubled Assets Relief Program

Wednesday, May 20, 2009

Witnesses: Honorable Timothy Geithner, Secretary, United States Department of the Treasury.

The State of the Domestic Automobile Industry: Impact of Federal Assistance

Wednesday, June 10, 2009

Witnesses: Mr. Ron Bloom, Senior Advisor on the Auto Industry, U.S. Department of the Treasury; The Honorable Edward Montgomery, White House Director of Recovery for Auto Communities and Workers, The White House.

The Administration's Proposal to Modernize the Financial Regulatory System

Thursday, June 18, 2009

Witnesses: Honorable Timothy Geithner, Secretary, United States Department of the Treasury.

Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks

Monday, June 22, 2009

Witnesses

Panel 1: Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission; Honorable Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission; Ms. A. Patricia White, Associate Director of the Division of Research and Statistics, Board of Governors of the Federal Reserve System.

Panel 2: Dr. Henry Hu, Allan Shivers Chair in the Law of Banking and Finance, University of Texas School of Law; Mr. Kenneth C. Griffin, Founder, President, and Chief Executive Officer, Citadel Investment Group, L.L.C.; Mr. Robert G. Pickel, Executive Director and Chief Executive Officer, International Swaps and Derivatives Association, Inc.; Mr. Christopher Whalen, Managing Director, Institutional Risk Analytics.

The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities

Wednesday, July 8, 2009

Witnesses: Mr. Jack Hopkins, President and Chief Executive Officer, CorTrust Bank National Association, Sioux Falls, SD on be-

half of the Independent Community Bankers of America; Mr. Frank Michael, President and CEO, Allied Credit Union, Stockton, CA on behalf of the Credit Union National Association; Mr. Arthur Johnson, Chairman and CEO, United Bank of Michigan, Grand Rapids, MI on behalf of the American Bankers Association; Mr. Ed Templeton, President and CEO, SRP Federal Credit Union, North Augusta, SC; Mr. Peter Skillern, Executive Director, Community Reinvestment Association of North Carolina.

Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation

Tuesday, July 14, 2009

Witnesses

Panel 1: Honorable Michael S. Barr, Assistant Secretary for Financial Institutions, U.S. Department of the Treasury.

Panel 2: Honorable Richard Blumenthal, Attorney General, State of Connecticut; Mr. Edward Yingling, President and CEO, American Bankers Association; Mr. Travis B. Plunkett, Legislative Director, Consumer Federation of America; Honorable Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute; Mr. Sendhil Mullainathan, Professor of Economics, Harvard University.

Regulating Hedge Funds and Other Private Investment Pools

Wednesday, July 15, 2009

Witnesses

Panel 1: Mr. Andrew J. Donohue, Director of the Division of Investment Management, U.S. Securities and Exchange Commission.

Panel 2: Mr. Dinakar Singh, Founder and Chief Executive Officer, TPG Axon Capital; Mr. James Chanos, Chairman, Coalition of Private Investment Companies; Mr. Trevor R. Loy, General Partner, Flywheel Ventures; Mr. Mark B. Tresnowski, Managing Director and General Counsel, Madison Dearborn Partners, LLC; Mr. Richard Bookstaber, Financial Author; Mr. Joseph Dear, Chief Investment Officer, California Public Employees' Retirement System.

Preserving Homeownership: Progress Needed to Prevent Foreclosures

Thursday, July 16, 2009

Witnesses

Panel 1: Honorable Herbert M. Allison, Jr., Assistant Secretary for Financial Stability, U.S. Department of the Treasury; Honorable William Apgar, Senior Advisor to the Secretary for Mortgage Finance, U.S. Department of Housing and Urban Development.

Panel 2: Ms. Joan Carty, President and CEO, The Housing Development Fund in Bridgeport, CT; Ms. Mary Coffin, Head of Mortgage Servicing, Wells Fargo; Ms. Diane E. Thompson, Of Counsel, National Consumer Law Center; Mr. Allen Jones, Default Management Executive, Bank of America Home Loans; Mr. Curtis Glovier, Managing Director, Fortress Investment Group; Mr. Paul S. Willen, Senior Economist and Policy Advisor, Federal Reserve Bank of Boston; Mr. Thomas Perretta, Consumer, State of Connecticut.

Establishing a Framework for Systemic Risk Regulation

Thursday, July 23, 2009

Witnesses

Panel 1: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission; Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System.

Panel 2: Ms. Alice Rivlin, Senior Fellow, Economic Studies, Brookings Institution; Dr. Allan H. Meltzer, Professor of Political Economy, Tepper School of Business, Carnegie Mellon University; Mr. Vincent Reinhart, Resident Scholar, American Enterprise Institute; Mr. Paul Schott Stevens, President and CEO, Investment Company Institute.

Regulatory Modernization: Perspectives on Insurance

Tuesday, July 28, 2009

Witnesses: Mr. Travis B. Plunkett, Legislative Director, Consumer Federation of America; Mr. Baird Webel, Specialist in Financial Economics, Congressional Research Service; Professor Hal Scott, Nomura Professor of International Financial Systems, Harvard Law School; Professor Martin Grace, James S. Kemper Professor of Risk Management, Department of Risk Management and Insurance, Georgia State University.

Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance

Wednesday, July 29, 2009

Witnesses: Ms. Meredith B. Cross, Director of the Division of Corporate Finance, U.S. Securities and Exchange Commission; Professor John C. Coates IV, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School; Ms. Ann Yerger, Executive Director, Council of Institutional Investors; Mr. John J. Castellani, President, The Business Roundtable; Professor J.W. Verret, Assistant Professor of Law, George Mason University School of Law; Mr. Richard C. Ferlauto, Director of Corporate Governance and Pension Investment, American Federation of State, County and Municipal Employees.

Strengthening and Streamlining Prudential Bank Supervision

Tuesday, August 4, 2009

Witnesses

Panel 1: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency; Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System; Mr. John Bowman, Acting Director, Office of Thrift Supervision.

Panel 2: Honorable Eugene A. Ludwig, Chief Executive Officer, Promontory Financial Group; Honorable Richard S. Carnell, Associate Professor, Fordham University School of Law; Honorable Martin N. Baily, Senior Fellow, Economic Studies, The Brookings Institution.

Examining Proposals to Enhance the Regulation of Credit Rating Agencies

Wednesday, August 5, 2009

Witnesses

Panel 1: Mr. Michael S. Barr, Assistant Secretary-Designate for Financial Institutions, U.S. Department of the Treasury.

Panel 2: Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School; Dr. Lawrence J. White, Leonard E. Imperatore Professor of Economics, New York University; Mr. Stephen W. Joynt, President and Chief Executive Officer, Fitch Ratings; Mr. James Gellert, President and CEO, Rapid Ratings; Mr. Mark Froeba, Principal, PF2 Securities Evaluations, Inc.

Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform

Monday, August 17, 2009

Witnesses

Panel 1: Mr. Craig Nelson, Investor, Stanford Securities, Alabama; Mr. Troy Lillie, Investor, Stanford Securities, Louisiana; Ms. Leyla Wydler, Former Vice President and Financial Advisor, Stanford Financial Group; Professor Onnig Dombalagian, George Denegre Professor of Law, Tulane University Law School.

Panel 2: Ms. Rose Romero, Regional Director, U.S. Securities and Exchange Commission; Mr. Daniel M. Sibears, Executive Vice President, Member Regulation Programs, Financial Industry Regulatory Authority (FINRA).

Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance

Thursday, September 10, 2009

Witnesses

Panel 1: H. David Kotz, Esq., Inspector General, U.S. Securities and Exchange Commission.

Panel 2: Mr. Harry Markopolos, Chartered Financial Analyst and Certified Fraud Examiner; Robert Khuzami, Esq., Director, Division of Enforcement, U.S. Securities and Exchange Commission; John Walsh, Esq., Acting Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.

Helping Homeowners Avoid Foreclosure

Monday, September 21, 2009

Witnesses

Panel 1: Honorable Shaun Donovan, Secretary, U.S. Department of Housing and Urban Development.

Panel 2: Honorable Anne Milgram, Attorney General of New Jersey; Ms. Marge Della Vecchia, Executive Director, New Jersey Housing and Mortgage Finance Agency; Ms. Phyllis Salowe-Kaye, Executive Director, New Jersey Citizen Action Board; Mr. Mario Vargas, Executive Director, New Jersey Puerto Rican Action Board; Mr. Edward Heaton, Homeowner from Springfield, New Jersey; Mr. Bryan Bolton, Senior Vice President, Loss Mitigation, CitiMortgage.

Emergency Economic Stabilization Act: One Year Later

Thursday, September 24, 2009

Witnesses

Panel 1: Honorable Herbert M. Allison, Jr., Assistant Secretary for Financial Stability (TARP), U.S. Department of the Treasury.

Panel 2: Honorable Neil M. Barofsky, Special Inspector General, Troubled Asset Relief Program; Mr. Gene L. Dodaro, Acting Comptroller General, United States Government Accountability Office; Professor Elizabeth Warren, Chair, Congressional Oversight Panel for the Troubled Asset Relief Program.

Strengthening and Streamlining Prudential Bank Supervision

Tuesday, September 29, 2009

Witnesses: Honorable Eugene A. Ludwig, Chief Executive Officer, Promontory Financial Group; Honorable Martin N. Baily, Senior Fellow, Economic Studies, The Brookings Institution; Honorable Richard S. Carnell, Associate Professor, Fordham University School of Law; Mr. Richard Hillman, Managing Director, Financial Markets and Community Investment, U.S. Government Accountability Office.

International Cooperation to Modernize Financial Regulation

Wednesday, September 30, 2009

Witnesses: Ms. Kathleen L. Casey, Commissioner, U.S. Securities and Exchange Commission; Mr. Mark Sobel, Acting Assistant Secretary for International Affairs, U.S. Department of the Treasury; Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System.

Securitization of Assets: Problems and Solutions

Wednesday, October 7, 2009

Witnesses: Professor Patricia McCoy, George J. & Helen M. England Professor of Law, University of Connecticut School of Law; Mr. George P. Miller, Executive Director, American Securitization Forum; Mr. Andrew Davidson, President, Andrew Davidson & Co.; Mr. J. Christopher Hoeffel, Executive Committee Member, Commercial Mortgage Securities Association; Dr. William Irving, Portfolio Manager, Fidelity Investments.

Future of the Mortgage Market and the Housing Enterprises

Thursday, October 8, 2009

Witnesses

Panel 1: Mr. Edward J. DeMarco, Acting Director, Federal Housing Finance Agency.

Panel 2: Mr. William Shear, Director, Financial Markets and Community Investment, U.S. Government Accountability Office; Mr. Andrew Jakabovics, Associate Director for Housing and Economics, Center for American Progress Action Fund; Dr. Susan M. Wachter, Worley Professor of Financial Management, Wharton School of Business, University of Pennsylvania; Honorable Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute.

Restoring Credit to Manufacturers

Friday, October 9, 2009

Witnesses: Mr. David Andrea, Vice President, Industry Analysis and Economics, Motor and Equipment Manufacturers Association; Mr. Robert C. Kiener, Director of Member Outreach, Precision Machined Products Association; Mr. Stephen P. Wilson, Chairman and CEO, LCNB National Bank.

Examining the State of the Banking Industry

Wednesday, October 14, 2009

Witnesses: Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency; Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Re-

serve System; Honorable Deborah Matz, Chairman, National Credit Union Administration; Mr. Timothy T. Ward, Deputy Director, Examinations, Supervision, and Consumer Protection, Office of Thrift Supervision; Mr. Joseph A. Smith, North Carolina Commissioner of Banks and Chairman, Conference of State Bank Supervisors; Mr. Thomas J. Candon, Deputy Commissioner, Vermont Department of Banking, Insurance, Securities and Health Care Administration, National Association of State Credit Union Supervisors.

The State of the Nation's Housing Market

Tuesday, October 20, 2009

Witnesses

Panel 1: Honorable Johnny Isakson (R-GA).

Panel 2: Honorable Shaun Donovan, Secretary, U.S. Department of Housing and Urban Development.

Panel 3: Ms. Diane Randall, Executive Director, Partnership for Strong Communities; Mr. Ronald Phipps, First Vice President, National Association of Realtors; Mr. Emile J. Brinkmann, Chief Economist and Senior Vice President for Research and Economics, Mortgage Bankers Association; Mr. David Crowe, Chief Economist, National Association of Home Builders.

Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues

Wednesday, October 28, 2009

Witnesses

Panel 1: Honorable Edward Kaufman, United States Senator.

Panel 2: James A. Brigagliano, Esq., Co-Acting Director of the Division of Trading and Markets, U.S. Securities and Exchange Commission; Mr. Frank Hatheway, Senior Vice President and Chief Economist, NASDAQ OMX; William O'Brien, Esq., Chief Executive Officer, Direct Edge; Mr. Christopher Nagy, Managing Director of Order Routing Sales & Strategy, Ameritrade; Mr. Daniel Mathisson, Managing Director and Head of Advanced Execution Services, Credit Suisse; Mr. Robert C. Gasser, President and Chief Executive Officer, Investment Technology Group; Mr. Peter Driscoll, Chairman, Security Traders Association; Mr. Adam C. Sussman, Director of Research, TABB Group.

Protecting Consumers from Abusive Overdraft Fees: The Fairness and Accountability in Receiving Overdraft Coverage Act

Tuesday, November 17, 2009

Witnesses: Mr. Mario Livieri, Consumer, State of Connecticut; Mr. Michael D. Calhoun, President, Center For Responsible Lending; Mr. Frank Pollack, President and CEO, Pentagon Federal Credit Union; Mr. John Carey, Chief Administrative Officer, Citibank NA; Ms. Jean Ann Fox, Director of Financial Services, Consumer Federation of America.

Hearing on the nomination of The Honorable Ben S. Bernanke

Thursday, December 3, 2009

Witnesses: The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System.

Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies

Tuesday, February 2, 2010

Witnesses: Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board; Honorable Neal S. Wolin, Deputy Secretary, U.S. Department of the Treasury.

Implications of the 'Volcker Rules' for Financial Stability

Thursday, February 4, 2010

Witnesses: Mr. Gerald Corrigan, Managing Director, Goldman Sachs; Professor Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship, Sloan School of Management, Massachusetts Institute of Technology; Mr. John Reed, Retired Chairman, Citigroup; Professor Hal Scott, Nomura Professor of International Financial Systems, Harvard Law School; Mr. Barry L. Zubrow, Executive Vice President, Chief Risk Officer, JPMorgan Chase.

Equipping Financial Regulators with the Tools Necessary to Monitor Systemic Risk

Friday, February 12, 2010

Witnesses

Panel 1: Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System.

Panel 2: Honorable Allan I. Mendelowitz, Founding Member, Committee to Establish the National Institute of Finance; Professor John C. Liechty, Associate Professor of Marketing and Statistics, Smeal College of Business, Pennsylvania State University; Professor Robert Engle, Stern School of Business, New York University; Mr. Stephen C. Horne, Vice President, Master Data Management and Integration Services, Dow Jones Business & Relationship Intelligence.

Restoring Credit to Main Street: Proposals to Fix Small Business Borrowing and Lending Problems

Tuesday, March 2, 2010

Witnesses

Panel 1: Honorable Carl Levin (D-MI), United States Senator; Honorable Debbie Stabenow (D-MI), United States Senator.

Panel 2: Mr. Arthur Johnson, Chairman and CEO, United Bank of Michigan, Grand Rapids, MI on behalf of the American Bankers Association; Mr. Eric Gillett, Vice Chairman and CEO, Sutton Bank, Attica, OH on behalf of the Independent Community Bankers Association; Mr. Raj Date, Executive Director, Cambridge Winter Center for Financial Institutions Policy.

VII. COMMITTEE CONSIDERATION

The Committee on Banking, Housing, and Urban Affairs met in open session on March 22, 2010, and by a vote of 13–10 ordered the bill reported, as amended.

VIII. CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

Section 11(b) of the Standing Rules of the Senate, and Section 403 of the Congressional Budget Impoundment and Control Act, require that each committee report on a bill contain a statement estimating the cost and regulatory impact of the proposed legislation. The Congressional Budget Office has provided the following cost estimate.

S. 3217—Restoring American Financial Stability Act of 2010

Summary: S. 3217 would grant new federal regulatory powers and reassign existing regulatory authority among federal agencies with the aim of reducing the likelihood and severity of financial crises.

The legislation would establish a program to facilitate the resolution of large financial institutions that become insolvent or are in danger of becoming insolvent when their failure is determined to threaten the stability of the nation's financial system (such institutions are known as systemically important firms). The program would be funded by fees assessed on certain large financial companies; an Orderly Liquidation Fund (OLF) of $50 billion would be accumulated, and in the event of a costly resolution, the fund would be replenished over time with future assessments.

A second new program would expand the authority of the Federal Deposit Insurance Corporation (FDIC) to provide government guarantees on a broad array of financial obligations of banks and bank holding companies if federal officials determine that market conditions are impeding the normal provision of financing to creditworthy borrowers (known as a liquidity crisis). Under the bill, participants in the program would be charged fees designed to recover the costs of the government guarantees.

Other provisions of S. 3217 would change how financial institutions and securities markets are regulated, create a new Bureau of Consumer Financial Protection (BCFP), broaden the authority of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), establish a grant program to encourage the use of traditional banking services, expand the supervision of firms that settle payments between financial institutions, and make many other changes to current laws.

Under the legislation, as under current law, there is some probability that, at some point in the future, large financial firms will become insolvent and liquidity crises will arise, and that those financial problems will present significant risks to the nation's broader economy. The cost of addressing those problems under current law is unknown and would depend on how the Administration and the Congress chose to proceed when faced with financial crises in the future; they could, for example, change laws, create new programs, appropriate additional funds, and assess new fees. Depending on the effectiveness of the new regulatory initiatives and new authorities to resolve and support a broad variety of financial institutions contained in S. 3217, enacting this legislation could change the timing, severity, and federal cost of averting and resolving future financial crises. However, CBO has not determined whether the estimated costs under the bill would be smaller or larger than the costs of alternative approaches to addressing future financial crises and the risks they pose to the economy as a whole.

Estimated Federal Budgetary Impacts

CBO estimates that enacting S. 3217 would increase revenues by $32.4 billion over the 2011–2015 period and by $75.4 billion over the 2011–2020 period and increase direct spending by $25.8 billion and $54.4 billion, respectively, over the same periods. In total, CBO estimates those changes would decrease budget deficits by $6.6 billion over the 2011–2015 period and by $21.0 billion over the 2011–

2020 period. In addition, CBO estimates that implementing the bill would increase spending subject to appropriation by $4.6 billion over the 2011–2015 period and $13.2 billion over the 2011–2020 period. Because enacting the legislation would affect direct spending and revenues, pay-as-you-go procedures apply.

Under S. 3217, the estimated reduction in budget deficits over the 2011–2020 period stems largely from industry assessments required to capitalize the OLF established by the bill to resolve systemically important firms. Those collections exceed the expected cost of liquidations during the capitalization period. After that time, a growing share of the budgetary resources for future liquidation activities would be derived from interest credited on balances in the OLF (with additional assessments collected only as needed to cover losses). Such intragovernmental interest payments are not budgetary receipts and do not affect the federal deficit. Thus, CBO estimates that the expenses of the OLF would ultimately exceed income from new assessments paid by financial firms, resulting in an increase in the deficit in those later years. Pursuant to section 311 of the Concurrent Resolution on the Budget for Fiscal Year 2009 (S. Con Res. 70), CBO estimates that the bill would increase projected deficits by more than $5 billion in at least one of the four consecutive 10-year periods starting in 2021.

Mandates

The bill would impose intergovernmental and private-sector mandates, as defined in the Unfunded Mandates Reform Act (UMRA), on banks and other private and public entities that participate in financial markets. The bill also would impose intergovernmental mandates by prohibiting states from taxing and regulating certain insurance products issued by companies based in other states and by preempting certain state laws. Because the costs of complying with some of the mandates would depend on future regulations that would be established under the bill, and because CBO has limited information about the extent to which public entities enter into swaps with unregulated entities, CBO cannot determine whether the aggregate costs of the intergovernmental mandates would exceed the annual threshold established in UMRA ($70 million in 2010, adjusted annually for inflation). However, CBO estimates that the cost of the mandates on private-sector entities would well exceed the annual threshold established in UMRA for such mandates ($141 million in 2010, adjusted annually for inflation) because the amount of fees collected would be more than that amount.

Page Reference Guide:

Sections
Major Provisions
Estimated Costs to the Federal Government
Basis of Estimate: Changes in Direct Spending and Revenues; Changes in Spending Subject to Appropriation
Pay-As-You-Go Considerations
Intergovernmental and Private-Sector Impact

Abbreviations used in the cost estimate:

BCFP—Bureau of Consumer Financial Protection
CFTC—Commodity Futures Trading Commission

DIF—Deposit Insurance Fund
FDIC—Federal Deposit Insurance Corporation
FSOC—Financial Stability Oversight Council
GAO—Government Accountability Office
OCC—Office of the Comptroller of the Currency
OFR—Office of Financial Research
OLF—Orderly Liquidation Fund
OTS—Office of Thrift Supervision
PCAOB—Public Company Accounting Oversight Board
SEC—Securities and Exchange Commission
SIPC—Securities Investor Protection Corporation

Major provisions:

Title I would establish the Financial Stability Oversight Council and the Office of Financial Research (OFR), both of which would be funded by assessments on certain financial and nonfinancial entities starting two years after the bill's enactment. For the first two years after enactment, the Federal Reserve would fund those activities.

Title II would establish a new program for resolving certain financial firms that are insolvent or in danger of becoming insolvent. The bill would create a fund, the OLF, from which the costs of liquidation would be paid. The FDIC would be directed to assess fees on private firms to build a $50 billion balance in the OLF within 10 years of the bill's enactment.

Title III would abolish the Office of Thrift Supervision (OTS) and change the regulatory oversight of banks, thrifts, and related holding companies by transferring authorities and employees among the remaining regulatory agencies.

Titles IV, VII, and IX would change and broaden the authority of the SEC to oversee activities and entities associated with the national securities exchanges.

Title V would establish an Office of National Insurance and set national standards for how states may regulate and collect taxes for a type of insurance that covers unique or atypical risks—known as "surplus lines" or "nonadmitted insurance." The bill also would establish national standards for how states regulate reinsurance—often referred to as insurance for insurance companies.

Titles VI would modify the regulation of bank, thrift, and securities holding companies.

Title VII would change and broaden the authority of the CFTC to regulate certain derivatives transactions on over-the-counter markets.

Title VIII would broaden the supervision of certain firms that settle payments between financial institutions.

Title X would establish the BCFP as an independent agency within the Federal Reserve to enforce federal laws that affect how banks and nonfinancial institutions make financial products available to consumers for their personal use. The BCFP would be funded by transfers from the Federal Reserve.

Title XI would establish a program to guarantee obligations of certain financial entities when federal officials determine that the economy faces a liquidity crisis. This title also would make changes to certain lending activities of the Federal Reserve.

Title XII would establish several grant programs to encourage certain individuals to increase their use of the federally insured banking system and community-based financial institutions.

Estimated cost to the Federal Government: The estimated budgetary impact of S. 3217 is shown in the following table. The cost of this legislation fall within budget functions 370 (commerce and housing credit), 450 (community and regional development), and 800 (general government).

TABLE 1.—ESTIMATED BUDGETARY IMPACT OF S. 3217, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

	By fiscal year, in billions of dollars—											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011–2015	2011–2020
CHANGES IN DIRECT SPENDING												
Estimated Budget Authority	4.0	6.3	5.6	5.1	5.4	5.6	5.5	5.3	5.8	6.5	26.4	55.2
Estimated Outlays	3.6	6.3	5.4	5.1	5.4	5.6	5.5	5.3	5.8	6.5	25.8	54.4
CHANGES IN REVENUES												
Estimated Revenues	1.8	6.4	7.9	8.0	8.3	8.5	8.8	8.9	8.7	8.1	32.4	75.4
NET CHANGES IN THE BUDGET DEFICIT FROM CHANGES IN DIRECT SPENDING AND REVENUES												
Estimated Impact on Deficit [a]	1.8	−0.1	−2.6	−2.9	−2.9	−2.9	−3.3	−3.7	−2.9	−1.6	−6.6	−21.0
CHANGES IN SPENDING SUBJECT TO APPROPRIATION												
Estimated Authorization Level	0.7	0.7	0.9	1.0	1.2	1.3	1.5	1.7	1.9	2.2	4.4	13.1
Estimated Outlays	0.8	0.7	0.9	1.0	1.2	1.3	1.5	1.7	1.9	2.2	4.6	13.2

[a] Positive numbers indicate increases in deficits; negative numbers indicate decreases in deficits.

Basis of estimate: For this estimate, CBO assumes that S. 3217 will be enacted before the end of fiscal year 2010, that the necessary amounts will be appropriated in each year, and that spending will follow historical patterns for activities of the FDIC, the Federal Reserve, and other agencies.

CBO estimates that the net decrease in the deficit as a result of the changes in revenues and direct spending would total $21.0 billion over the 2011–2020 period. Most of that amount, about $17.6 billion, would be generated by the assessments to build up the OLF and the spending of a portion of those funds.

About $4.9 billion of the net deficit decrease related to changes in direct spending and revenues would result from providing the SEC permanent authority to collect and spend certain fees and reclassifying discretionary spending and offsetting collections for the SEC as direct spending and revenues. Revenues from the fees would exceed the SEC's outlays. (Under current law, the SEC's authority to collect and spend fees is provided in annual appropriation acts; fee collections are recorded as offsetting collections, that is, a credit against the agency's spending). Fees collected by the SEC have historically exceeded the agency's spending; those excess collections currently offset discretionary spending in other areas of the budget. Consequently, changing the budgetary treatment of the SEC's spending and receipts would increase discretionary spending by removing that offset. CBO estimates that such spending would increase by about $11.8 billion over the 2011–2020 period. The $4.9 billion in net savings from the change in direct spending and revenues would be less than the increase in discretionary outlays because the SEC fees under S. 3217 would be lower than those projected under current law.

Changes in Direct Spending and Revenues

CBO estimates that enacting the legislation would increase revenues by $75.4 billion over the 2011–2020 period (see Table 2). About $43.9 billion of those revenues would be generated by assessments imposed by the FDIC, with the remainder arising from other activities under the bill. Specifically:

- Several provisions of the bill, most importantly those establishing the BCFP and reassigning supervisory responsibilities over financial institutions among the various regulators, would increase the net earnings of the Federal Reserve, which are recorded in the budget as revenues.
- Reclassification of fees collected by the SEC also would increase revenues, as would additional fees collected by the Public Company Accounting Oversight Board (PCAOB) and the Securities Investor Protection Corporation (SIPC).

CBO estimates that enacting the legislation would increase direct spending by $54.4 billion over the 2011–2020 period (see Table 2). About $19.4 billion of that amount would result from allowing the SEC to spend certain fees without annual appropriation action. Additional costs would be incurred by establishing the BCFP, the Financial Stability Oversight Council, and the OFR; broadening the regulatory duties of the PCAOB; increasing the amount the SIPC may borrow from the Treasury; authorizing the FDIC to provide loan guarantees to financial institutions; and creating a program to

make awards to individuals providing certain information to the SEC.

TABLE 2.—NET CHANGES IN THE BUDGET DEFICIT FROM CHANGES IN DIRECT SPENDING AND REVENUES UNDER THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

	By fiscal year, in billions of dollars—											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011–2015	2011–2020
NET CHANGES IN THE BUDGET DEFICIT FROM CHANGES IN DIRECT SPENDING AND REVENUES [a]												
Orderly Liquidation Authority	2.4	0.2	−2.1	−2.8	−2.7	−2.6	−2.9	−3.3	−2.5	−1.2	−5.0	−17.6
Securities and Exchange Commission Regulation	−0.7	−0.5	−0.4	−0.4	−0.5	−0.5	−0.5	−0.5	−0.5	−0.5	−2.5	−4.9
Consumer Financial Protection	*	0.1	0.1	0.4	0.4	0.4	0.4	0.4	0.4	0.5	1.0	3.2
Emergency Financial Stability	*	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.8
Changes Among Financial Regulators	*	−0.2	−0.4	−0.5	−0.5	−0.5	−0.5	−0.6	−0.6	−0.6	−1.5	−4.3
Other Financial Oversight and Protection	*	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.7	1.3
Financial Stability Oversight	*	*	*	0.1	0.1	*	*	*	*	*	0.3	0.4
Other Provisions Affecting the Federal Reserve	*	*	*	*	*	*	*	*	*	*	*	0.1
Total Net Change in the Budget Deficit	1.8	−0.1	−2.6	−2.9	−2.9	−2.9	−3.3	−3.7	−2.9	−1.6	−6.6	−21.0
CHANGES IN REVENUES												
Orderly Liquidation Authority [b]	0	4.2	5.2	5.1	5.2	5.2	5.2	5.1	4.8	4.0	19.7	43.9
Securities and Exchange Commission Regulation	1.8	1.9	2.1	2.2	2.3	2.5	2.7	2.9	2.9	3.0	10.3	24.4
Consumer Financial Protection	0	0	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.4	1.2
Changes Among Financial Regulators	0	0.2	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	1.7	4.6
Other Financial Oversight and Protection	0	*	*	*	*	0.1	0.1	0.2	0.2	0.2	0.1	0.8
Financial Stability Oversight	0	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.5
Other Provisions Affecting the Federal Reserve	*	*	*	*	*	*	*	*	*	*	*	−0.1
Total Revenues	1.8	6.4	7.9	8.0	8.3	8.5	8.8	8.9	8.7	8.1	32.4	75.4
CHANGES IN DIRECT SPENDING												
Orderly Liquidation Authority:												
Estimated Budget Authority	2.4	4.4	3.1	2.3	2.4	2.5	2.2	1.8	2.3	2.9	14.6	26.3
Estimated Outlays	2.4	4.4	3.1	2.3	2.4	2.5	2.2	1.8	2.3	2.9	14.6	26.3
Securities and Exchange Commission Regulation:												
Estimated Budget Authority	1.5	1.5	1.7	1.8	1.9	2.1	2.3	2.4	2.5	2.5	8.3	20.1
Estimated Outlays	1.1	1.5	1.6	1.7	1.9	2.0	2.2	2.4	2.5	2.5	7.8	19.4
Consumer Financial Protection:												
Estimated Budget Authority	0.1	0.1	0.3	0.6	0.6	0.6	0.6	0.6	0.6	0.6	1.5	4.6
Estimated Outlays	*	0.1	0.2	0.5	0.6	0.6	0.6	0.6	0.6	0.6	1.4	4.5
Emergency Financial Stability:												
Estimated Budget Authority	*	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.8
Estimated Outlays	*	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.8

TABLE 2.—NET CHANGES IN THE BUDGET DEFICIT FROM CHANGES IN DIRECT SPENDING AND REVENUES UNDER THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010—Continued

	By fiscal year, in billions of dollars—											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011–2015	2011–2020
Changes Among Financial Regulators:												
Estimated Budget Authority	*	0.1	0.1	*	*	*	*	*	*	*	0.2	0.3
Estimated Outlays	*	0.1	0.1	*	*	*	*	*	*	*	0.2	0.3
Other Financial Oversight and Protection:												
Estimated Budget Authority	*	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.8	2.2
Estimated Outlays	*	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.8	2.2
Financial Stability Oversight:												
Estimated Budget Authority	*	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5	0.9
Estimated Outlays	*	*	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.5	0.9
Total Changes in Direct Spending:												
Estimated Budget Authority	4.0	6.3	5.6	5.1	5.4	5.6	5.5	5.3	5.8	6.5	26.4	55.2
Estimated Outlays	3.6	6.3	5.4	5.1	5.4	5.6	5.5	5.3	5.8	6.5	25.8	54.4

[a] Positive numbers indicate increases in deficits; negative numbers indicate decreases in deficits.

[b] The legislation could affect federal tax receipts under the Internal Revenue Code. However, there are a number of uncertainties regarding potential effects of the use of a bridge financial company by the Federal Deposit Insurance Corporation on the tax attributes of a failed financial institution. It is not possible to determine whether the use of a bridge financial company would provide a tax result that is more or less favorable than bankruptcy, which is the current-law alternative. Therefore, the staff of the Joint Committee on Taxation is not currently able to estimate the changes in tax revenue that would result from this provision of the bill.

Note—* = between −$50 million and $50 million. Components may not sum to totals because of rounding.

Orderly Liquidation Authority

Title II would create new government mechanisms for liquidating systemically important financial firms that are in default or in danger of default. CBO estimates that implementing those provisions would, on balance, reduce the deficit by $17.6 billion over the 2011–2020 period.

Under conditions outlined in the bill, the FDIC would be authorized to enter into various arrangements necessary to liquidate such firms, including organizing bridge banks that would be exempt from federal and state taxation. Funding for those transactions would come from an Orderly Liquidation Fund (OLF) established by the legislation and built up from compulsory assessments paid by private firms (which would be classified as revenues) and interest earned on fund balances (which would be invested in Treasury securities). If fund balances were insufficient to finance transactions that the FDIC deemed appropriate, necessary amounts would be borrowed from the Treasury up to a specified amount. Amounts borrowed would be based on a formula tied to the value of the assets of the liquidated firms and would be repaid through future assessments.

The bill would direct the FDIC to assess upfront fees sufficient to establish the OLF at the level of $50 billion within 10 years after enactment but would allow the agency to extend that deadline if any losses to the fund are incurred during that period. The size of the fund would be adjusted periodically for inflation.

CBO's estimate of the cost of the resolution authorities provided under the bill represents the difference between the expected values of spending by the OLF to resolve insolvent firms and assessments collected by the OLF. Those expected values represent a weighted average of various scenarios regarding the potential frequency and magnitude of systemic financial problems. Although the estimate reflects CBO's best judgment on the basis of historical experience, the cost of the program would depend on future economic and financial events that are inherently unpredictable. Moreover, the timing of the cash flows associated with resolving insolvent firms is also difficult to predict. It might take several years, for example, to replenish the funds spent to liquidate a complex financial institution. As a result, some of the proceeds from asset sales or cost-recovery fees related to financial problems emerging in any 10-year period might be collected beyond that period. All told, actual spending and assessments in each year would probably vary significantly from the estimated amounts—either higher or lower than the expected-value estimate provided for each year.

Although the probability that the federal government would have to liquidate a financial institution in any year is small, the potential costs of such a liquidation could be large. Measured on an expected-value basis, CBO estimates that net direct spending for potential liquidation activities, which includes recoveries from the sale of assets acquired from liquidated institutions but excludes revenues from assessments, would be $26.3 billion through 2020. As a result, the expected timeframe for fully capitalizing the fund is longer than 10 years. CBO's estimate of assessments reflects the effects of the interest earnings of the OLF (an estimated $7 billion), which would reduce the amount that firms would have to pay to capitalize the fund, and assumes that the FDIC would adjust the

size of the fund every year to account for inflation. CBO estimates that revenues from assessments paid to capitalize the fund and cover any losses would total about $44 billion through 2020, net of effects on payroll and income taxes.[1] Under CBO's estimate, the OLF would have a balance of about $45 billion at the end of 2020, including the value of assets acquired in the course of liquidating financial institutions.

Securities and Exchange Commission Regulation

Titles IV, VII, and IX would change and expand the regulatory activities of the SEC. The bill also would grant that agency permanent authority to collect and spend certain fees; under current law, this authority is provided in annual appropriation acts. Based on information from the agency, CBO estimates that enacting those provisions would increase direct spending by $19.4 billion over the 2011–2020 period. Of that amount, CBO estimates that $16.9 billion would support the agency's current activities. The balance, $2.5 billion, would be incurred to carry out the new and expanded authorities under the bill. CBO estimates that enacting the provisions also would increase revenues by $24.4 billion over the 2011–2020 period. Taken together, CBO estimates that the provisions would decrease deficits by $4.9 billion over the 2011–2020 period.

Most of that decrease in the deficit—about $4.3 billion—would be from fees collected that would be unavailable to the agency for spending. The reduction in budget deficits from changes in direct spending and revenues would probably be accompanied by increases in discretionary spending, as discussed later in this estimate.

Reclassification of Fees. Under the bill, the SEC's authority to collect fees would be permanent rather than being provided through annual appropriation action as is the case under current law. The bill would authorize the SEC to assess fees for securities trading activities sufficient to cover the agency's annual operating expenses, plus an additional amount to maintain a reserve that would be limited to 25 percent of the following year's budget. The bill also would authorize the SEC to collect fees to register securities in amounts sufficient to meet targets set in the legislation. Those collections would be recorded in the budget as revenues; amounts collected by the SEC that exceed annual spending limits plus the reserve amount would not be available for the agency to spend. CBO assumes that the agency would set fees at levels sufficient to meet its budgetary, statutory, and reserve requirements each year.

Additional Regulatory Authority. The bill also would broaden the SEC's authority to regulate activities and entities associated with the securities markets. Among other things, the bill would require advisers to private funds and organizations that trade in or facilitate certain derivatives transactions to register with the SEC, and it would broaden the SEC's oversight of credit rating agencies and advisers for municipal issues. CBO estimates that those addi-

[1] The total amount collected from assessments is estimated to be about $58 billion through 2020. But such assessments would become an additional business expense for companies required to pay them. Those additional expenses would result in decreases in taxable income somewhere in the economy, which would produce a loss of government revenue from income and payroll taxes that would partially offset the revenue collected from the assessment itself.

tional activities would cost about $2.5 billion over the 10-year period. CBO estimates that more than 800 staff positions would be added over several years to meet the agency's additional regulatory authority (a 22-percent increase over current staffing levels). This estimate assumes that the SEC generally would follow its regular examination cycle and established examination procedures for regulating advisers to private funds.

Consumer Financial Protection

Title X would establish the Bureau of Consumer Financial Protection as an autonomous entity within the Federal Reserve. The bureau would enforce federal laws related to consumer financial protection by establishing rules and issuing orders and guidance. CBO estimates that creating the BCFP would increase budget deficits by $3.2 billion over the 2011–2020 period.

The bureau would be authorized to:

- Examine and regulate insured depository institutions and credit unions with more than $10 billion in assets;
- Request reports from insured depository institutions and credit unions with $10 billion in assets or less, and participate in the examinations performed by the regulators of those institutions; and
- Supervise large nondepository institutions, mortgage lenders, brokers, and financial service providers.

The bureau would coordinate examinations with other federal or state regulators of the institutions. Similar functions and the personnel who now perform those duties at federal agencies and the Federal Reserve would be transferred to the new bureau.

The bill would require the Board of Governors of the Federal Reserve to fund the BCFP through transfers from the earnings of the Federal Reserve. The amounts transferred would be limited to a percentage, starting at 10 percent in 2011 and increasing to 12 percent in 2013 and thereafter, of the 2009 total operating expenses of the Federal Reserve, adjusted annually for inflation. In CBO's judgment, the costs of the BCFP should be reported as expenditures in the federal budget (rather than a reduction in revenues) because the BCFP would be independent of the Federal Reserve and its activities would be separate and distinct from the Federal Reserve's responsibilities for monetary policy and financial regulation. Therefore, CBO estimates that the provisions of title X would increase direct spending by $4.5 billion over the 2011–2020 period. That estimate is based on the Federal Reserve's reported 2008 operating expenses, the most recent information available.

Based on information from the Federal Reserve, CBO estimates that about 515 staff positions would be transferred from the Federal Reserve to the BCFP to carry out the new regulatory authorities. CBO estimates that this transfer of staff would reduce the Federal Reserve's operating expenses by $1.2 billion over the 2011–2020 period, increasing remittances from the Federal Reserve to the Treasury (which are recorded in the federal budget as revenues) by that amount.

Emergency Financial Stability

In 2008, the FDIC established a temporary program to guarantee certain obligations of insured depository institutions, holding com-

panies that include insured depository institutions, and some affiliates of those firms. (The program remains open to some new participants, and significant potential liabilities remain from existing participants.) Participants pay an upfront fee set to offset expected losses, and any shortfall will be recovered through an assessment on all FDIC-insured institutions. Conversely, in the event that any excess fees are collected, those amounts will revert to the Deposit Insurance Fund (DIF) and may be spent or used to reduce future deposit insurance premiums. The program provides two types of guarantees: one program, which expires in December 2012, is for newly issued, senior unsecured debt, and the other, which expires in December 2010, is for amounts in certain non-interest-bearing accounts.

Title XI would provide a new statutory framework for similar, but potentially much broader, assistance. Under the bill, the FDIC would be authorized to establish a guarantee program if the Federal Reserve, the Secretary of the Treasury, and the FDIC determine that a liquidity crisis warrants use of such authority. Although the types of firms eligible to participate would be similar to those eligible under the existing FDIC program, the bill would not limit the types or duration of financial obligations that could be guaranteed. Firms still would be required to pay an upfront fee for the guarantees, but any shortfall would be recovered solely from program participants rather than all FDIC-insured institutions. In addition, any excess fees would be deposited in the U.S. Treasury and would not be available to be spent.

CBO's estimate of the cost of those provisions reflects the expected value of the costs of such guarantees relative to the expected value of the costs that would be incurred under current law. CBO expects that, in the absence of this legislation, the FDIC would respond to any future liquidity crises by implementing guarantee programs similar to those it adopted in 2008. The costs of this program, like those that would result from implementing the liquidation authorities in title II, would depend on circumstances that are difficult to predict. In addition, cash flows over the 10-year period would depend, as for title II, on the lag between potential spending for losses and the collection of fees to offset those costs. Therefore, while this estimate reflects CBO's best judgment regarding expected costs, the actual costs would probably vary significantly from the amount estimated for any given year.

Based on historical experience, we expect that the probability of systemic liquidity problems in any year is small. In the event of liquidity crises, however, the legislation would authorize the FDIC to take a broader range of actions that could generate losses that would take some time to recover. In particular, CBO expects that limiting the recourse for cost-recovery fees to program participants would cause the FDIC to recoup losses over a long period of time to avoid placing large burdens on a small set of firms. Altogether, CBO estimates that enacting those provisions would increase net direct spending by $0.8 billion over the 2011–2020 period relative to current law.

Changes Among Financial Regulators

Title III would change the regulatory regime for supervising banks, thrifts, and related holding companies. It would abolish the

Office of Thrift Supervision (OTS) and reduce the number of firms regulated by the Federal Reserve. Supervision of firms with consolidated assets of less than $50 billion that currently are regulated by the OTS and the Federal Reserve would be transferred to the Office of the Comptroller of the Currency (OCC) or the FDIC, depending on each firm's charter. The Federal Reserve would continue regulating bank holding companies with assets totaling above $50 billion and also would supervise thrift holding companies exceeding that threshold. Other provisions would direct agencies to complete the transition within 18 months after enactment; authorize spending of unobligated balances held by the OTS for transition and other costs; and allow the OCC to enter into agreements without regard to existing laws governing the disposition of real or personal property. Finally, the bill would require all of those agencies, including the Federal Reserve, to charge fees to cover supervisory expenses.

CBO estimates that implementing those provisions would reduce the deficit by an estimated $4.3 billion over the next 10 years. CBO expects that changes in costs that would result from transferring personnel among the banking agencies would have no net budgetary impact because they would be offset by corresponding changes in the amounts collected from regulated institutions. The net budgetary impact of this title would result from:

- Collecting fees from firms currently regulated by the Federal Reserve, which CBO estimates would average about $500 million a year or a total of $4.6 billion over the 2011–2020 period;
- Spending of the unobligated balances held by the OTS over the 2011–2020 period, which CBO estimates would total about $150 million, net of certain existing liabilities; and
- Financing the acquisition of buildings and other property for OCC operations, which CBO estimates would result in a net increase in direct spending of $150 million over the next 10 years.

This title would change direct spending and revenues because of the way banking agencies are funded. Under current law, costs incurred by the OCC, OTS, and FDIC are recorded in the budget as direct spending and are offset by receipts from annual fees or insurance premiums. The budgetary effects of the Federal Reserve's activities are recorded as changes in revenues (governmental receipts). After accounting for changes in agency workloads and the implementation of new supervisory fees, CBO estimates that most of the budgetary impact of those changes would be recorded in the budget as an increase in revenues.

Other Financial Oversight and Protections

The bill would change the authorities of the PCAOB and SIPC, which provide oversight and various protections in the financial markets. The bill also would establish a program to give awards to individuals who provide information to the SEC about violations of securities laws. CBO estimates that taken together, those provisions would increase budget deficits by $1.3 billion over the 2011–2020 period.

In particular, the bill would establish a whistleblower program at the SEC that would award a portion of penalties collected in cer-

tain proceedings brought for violation of securities laws to individuals providing information leading to the imposition of the penalties. Based on information from the SEC, CBO estimates that this program would cost about $100 million per year once the regulations are in place. We estimate that enacting the award program would increase direct spending by $0.9 billion over the 2011–2020 period.

The bill would expand the authority of the PCAOB to oversee the auditors of brokers and dealers that are registered with the SEC; those provisions also would increase fees collected by the PCAOB to support examination activities. Based on information from the PCAOB, CBO estimates that the additional oversight and examination requirements would increase the agency's costs by about $25 million per year and that the agency would increase fees charged to brokers and dealers to cover those additional costs. CBO estimates that enacting the PCAOB provisions would increase direct spending by $0.2 billion over the 2011–2020 period and increase revenues, net of income and payroll tax offsets, by a similar amount over the same period. The net effect on the deficit as a result of the PCAOB provisions would be less than $0.1 billion.

The bill would raise the amount that SIPC would be authorized to borrow from the Treasury. Under current law, SIPC makes payments from fee collections and reserves to investors that are harmed when a brokerage firm fails and customers' assets are missing. In the event collections and reserves are insufficient to cover the losses, SIPC is authorized to borrow up to $1 billion from the Treasury; the bill would raise that borrowing limit to $2.5 billion. SIPC would repay any amounts borrowed by raising fees paid by brokers and dealers that are registered with the SEC; such fees are recorded in the budget as revenues.

Based on information from SIPC, CBO estimates that the agency would probably exercise some of the additional borrowing authority provided in this title during the next 10 years. We estimate that borrowing additional funds would increase direct spending by about $1.0 billion over the 2011–2020 period. Further, we estimate that SIPC would recover that cost by raising fees, thus increasing revenues over the same period by $0.7 billion; CBO estimates that the net effect of this provision would be to raise budget deficits by $0.3 billion over the 2011–2020 period.

Financial Stability Oversight

Title I would establish a new council and office in the Department of the Treasury to oversee the financial markets. The Financial Stability Oversight Council, led by the Secretary of the Treasury, would be responsible for identifying risks to the financial stability of the United States, facilitating information sharing and setting oversight priorities among regulators, and potentially directing the Federal Reserve to supervise additional financial institutions that it does not currently regulate. The council would rely upon the OFR, also established in the bill, to collect information on financial markets and to provide independent research.

Based on amounts spent by other councils and agencies that provide similar levels of analysis and support, CBO estimates that that those new functions would cost about $75 million annually. We expect that the office would steadily expand its staff and budg-

et over a three- to four-year period before it reached that level of effort. We estimate that those functions would cost $0.3 billion over the 2011–2015 period and $0.7 billion over the 2011–2020 period.

Title I also would allow the OFR to enter into enhanced-use lease arrangements with nonfederal partners to acquire new facilities. Based on the experience of other agencies with similar authorities, CBO expects that such leases would involve significant federal commitments. We estimate that the OFR would use its enhanced-use leasing authorities to build one general-purpose office building at a net cost of $0.2 billion over the 2011–2015 and 2011–2020 periods. CBO expects that the remaining construction costs would be covered by fee collections after 2020.

To fund the OFR and the council, the legislation would establish a Financial Research Fund within the Treasury. For the first two years after enactment, the costs of the council and the OFR would be paid by the Federal Reserve. In CBO's judgment, those costs should be recorded as expenditures in the federal budget because, like the BCFP, the council and the OFR would be independent of the Federal Reserve and their activities would be distinct from the Federal Reserve's responsibilities for monetary policy and financial regulation. Starting in 2013, the Secretary of the Treasury would collect an assessment from certain bank holding companies and nonbank financial companies supervised by the Federal Reserve that would be sufficient to cover the operating expenses of the OFR and the council.

CBO estimates that collecting the assessment, net of income and payroll tax offsets, would increase revenues by $0.2 billion over the 2011–2015 period and $0.5 billion over the 2011–2020 period. On balance, we estimate that enacting title I would increase budget deficits by $0.3 billion over the 2011–2015 period and $0.4 billion over the 2011–2020 period.

Other Provisions Affecting the Federal Reserve

CBO estimates that the requirements in a number of titles would result in incremental costs to the Federal Reserve, thereby reducing remittances to the Treasury (which are recorded in the budget as revenues). Based on information from the Federal Reserve, CBO estimates that those provisions would reduce revenues by about $0.1 billion over the 2011–2020 period. CBO expects the costs under title I to occur only in the first few years; in all other cases, the costs are expected to be ongoing. The key provisions of this sort are:

- The Chairman of the Board of Governors would be a member of the Financial Stability Oversight Council, and Federal Reserve staff could be assigned to support the work of the council.
- Under title VI, the Federal Reserve would incur costs to supervise any qualifying securities holding companies that elect to be supervised by the Federal Reserve. Additionally, the Federal Reserve would develop, in conjunction with other federal banking agencies, the regulations to implement restrictions regarding investments by banking organizations in private equity funds and hedge funds and the proprietary trading activities of banking organizations.
- Title VII would expand the rule-making requirements for the Federal Reserve related to capital and margin requirements for swap dealers and major swap participants that are banks.

• Title VIII would likely increase the workload of the Federal Reserve to supervise systemically important entities that are involved in settling payments between financial institutions.

Changes in Spending Subject to Appropriation

CBO estimates that implementing the legislation would increase spending subject to appropriation by about $4.6 billion over the 2011–2015 period (see Table 3). Most of this additional spending would result from the proposed reclassification of fees and spending by the SEC, leading to a reduction in discretionary spending by the SEC and a greater reduction in discretionary offsetting collections from SEC fees.

Reclassification of SEC Fees and Spending

Enacting the bill would change the budgetary classification of fees collected by the SEC from offsetting collections (amounts netted against discretionary appropriations) to revenues. In addition, because the legislation would authorize the SEC to spend all the fees it collects without further appropriation, the need to appropriate funds for the SEC's operations would be eliminated. Historically, fees collected by the SEC have exceeded the agency's authorized spending limits.

CBO estimates that the proposed reclassification of fees and spending would reduce discretionary spending by $5.7 billion over the 2011–2015 period and reduce offsetting collections by $9.6 billion over the same period. Taken together, those reductions would increase net spending subject to appropriation by about $4.0 billion over the 2011–2015 period and by $11.8 billion over the 2011–2020 period because the reduction in amounts that offset spending would exceed the reduction in authorized spending levels. (As described on page 10, the new permanent authority to levy fees and spend the proceeds would decrease deficits by an estimated $2.5 billion over the 2011–2015 period and by $4.9 billion over the 2011–2020 period.)

TABLE 3.—CHANGES IN SPENDING SUBJECT TO APPROPRIATION UNDER THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

	By fiscal year in millions of dollars—					
	2011	2012	2013	2014	2015	2011–2015
CHANGES IN SPENDING SUBJECT TO APPROPRIATION						
Reclassification of SEC Fees and Spending:						
Spending:						
Estimated Authorization Level	−1,117	−1,139	−1,167	−1,198	−1,233	−5,854
Estimated Outlays	−949	−1,136	−1,163	−1,193	−1,228	−5,669
Offsetting Collections:						
Estimated Authorization Level	1,733	1,733	1,885	2,052	2,235	9,638
Estimated Outlays	1,733	1,733	1,885	2,052	2,235	9,638
Total Reclassification of SEC Fees and Spending:						
Estimated Authorization Level	616	594	718	854	1,002	3,784
Estimated Outlays	784	597	722	859	1,007	3,969
Regulation of Over-the-Counter Derivatives:						
Estimated Authorization Level	18	55	75	76	77	301
Estimated Outlays	16	51	73	76	77	293
Access to Mainstream Financial Institutions:						
Estimated Authorization Level	57	57	58	59	60	291
Estimated Outlays	15	57	58	59	59	248

TABLE 3.—CHANGES IN SPENDING SUBJECT TO APPROPRIATION UNDER THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010—Continued

	By fiscal year in millions of dollars—					
	2011	2012	2013	2014	2015	2011–2015
Federal Insurance Office:						
Estimated Authorization Level	2	2	2	2	2	10
Estimated Outlays	1	2	2	2	2	9
Grants to Prevent Misleading Marketing:						
Authorization Level	8	8	8	8	8	40
Estimated Outlays	1	3	7	7	8	26
Reports:						
Estimated Authorization Level	8	3	1	1	1	14
Estimated Outlays	7	4	1	1	1	14
Total Changes:						
Estimated Authorization Level	709	719	862	1,000	1,150	4,440
Estimated Outlays	824	714	862	1,004	1,154	4,558

Note: Components may not sum to totals because of rounding

Regulation of Over-the-Counter Derivatives

Title VII would require certain derivatives transactions to take place on registered exchanges and would place new registration and reporting requirements on entities that trade in or facilitate such transactions. This title would broaden the authority of the CFTC to regulate entities and activities related to those transactions.

Based on information from the CFTC, CBO estimates that implementing those broader authorities would cost $293 million over the 2011–2015 period, assuming appropriation of the necessary amounts. CBO estimates that the agency would add 235 employees by fiscal year 2013 to write regulations and to undertake the additional oversight and enforcement activities required under the bill. That would amount to a roughly 40 percent increase over 2010 staffing levels.

Access to Mainstream Financial Institutions

Title XII would authorize the appropriation of such sums as may be necessary to establish several programs aimed at increasing access to and usage of traditional banking services in lieu of alternative financial services such as nonbank money orders and check cashing, rent-to-own agreements, and payday lending. Based on pilot programs operated by the private sector and information collected by the FDIC, CBO estimates that this effort would cost $248 million over the 2011–2015 period, assuming appropriation of the necessary amounts.

Federal Insurance Office

Title V would establish the Federal Insurance Office within the Department of the Treasury to monitor the insurance industry and to coordinate federal policy on insurance issues. The bill also would authorize the Secretary of the Treasury to enter into international agreements to harmonize regulations on the insurance industry. Based on information from the Treasury, CBO estimates that implementing those provisions would cost $9 million over the 2011–2015 period, subject to the appropriation of the necessary amounts.

Grants To Prevent Misleading Marketing

Title IX would authorize the appropriation of $8 million in each of fiscal years 2011 through 2015 for grants to states to protect elderly citizens from misleading marketing of financial products. CBO estimates that implementing this provision would cost $26 million over the 2011–2015 period.

Reports

The bill would require the Government Accountability Office (GAO) to prepare more than 20 reports on a wide range of topics, including financial literacy, oversight of financial planners, and disclosures by issuers of municipal securities. The bill also would require GAO to audit the BCFP annually. Based on information from the agency, CBO estimates that each report would cost, on average, $500,000 and would be completed within the time allotted in the bill. CBO estimates that implementing the reporting provisions in the bill would cost $14 million over the 2011–2015 period, assuming appropriation of the necessary amounts.

Pay-as-you-go considerations: The Statutory Pay-As-You-Go Act of 2010 establishes budget reporting and enforcement procedures for legislation affecting direct spending or revenues. The net changes in outlays and revenues that are subject to those pay-as-you-go procedures are shown in the following table.

CBO ESTIMATE OF PAY-AS-YOU-GO EFFECTS FOR S. 3217, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, AS ORDERED REPORTED BY THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS ON MARCH 22, 2010

	By fiscal year, in billions of dollars—											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011–2015	2011–2020
	NET INCREASE OR DECREASE (−) IN THE DEFICIT											
Statutory Pay-as-You-Go Impact[a]	1.8	−0.1	−2.6	−2.9	−2.9	−2.9	−3.3	−3.7	−2.9	−1.6	−6.6	−21.0

[a] Positive numbers indicate increases in deficits; negative numbers indicate decreases in deficits.

Intergovernmental and private-sector impact: The bill would impose intergovernmental and private-sector mandates, as defined in UMRA, on banks and other private and public entities that participate in financial markets. The bill also would impose intergovernmental mandates by prohibiting states from taxing and regulating certain insurance products issued by companies based in other states and by preempting certain state laws. Because the costs of complying with some of the mandates would depend on future regulations that would be established under the bill, and because CBO has limited information about the extent to which public entities enter into swaps with unregulated entities, CBO cannot determine whether the aggregate costs of the intergovernmental mandates would exceed the annual threshold established in UMRA ($70 million in 2010, adjusted annually for inflation). However, CBO estimates that the total amount of fees alone that would be collected from private entities would well exceed the annual threshold established in UMRA for private-sector mandates ($141 million in 2010, adjusted annually for inflation).

Mandates That Apply to Both Intergovernmental and Private-Sector Entities

Some mandates in the bill would affect both public and private entities, including pension funds and public finance authorities. The cost of complying with the mandates is uncertain and would depend on the nature of future regulations and the range of entities subject to them.

Consumer Financial Protection. The bill would authorize the BCFP to regulate banks and credit unions with assets over $10 million, all mortgage-related businesses (housing finance agencies, lenders, servicers, mortgage brokers, and foreclosure operators), and all large nonbank financial companies (such as payday lenders, debt collectors, and consumer reporting agencies). The BCFP would enforce federal laws related to consumer protection by establishing rules and issuing orders and guidance. Bank and nonbank entities that offer financial services or products would be required to make disclosures to customers and submit information to the BCFP. The bill also would require certain financial institutions to maintain records regarding deposit accounts of customers and would prohibit prepayment penalties for residential mortgage loans.

Regulation of Over-the-Counter Derivatives Markets. The bill would impose several requirements on public and private entities such as pension funds, swap dealers, and other participants in derivatives markets. For example, the bill would place new requirements on derivatives; require reporting by entities that gather trading information about swaps, organizations that clear derivatives, facilities that execute swaps, pension funds, and swap dealers; and establish capital requirements for pension funds, swap dealers and major swap participants.

Regulation of Financial Securities. The bill would require entities (including public finance authorities) that sell products such as mortgage-backed securities to hold at least 5 percent of the credit risk of each asset that they securitize. Under the bill, the BCFP could exempt classes of assets from the retention requirement. The bill also would require issuers of securities to disclose information to the SEC about the underlying assets and to analyze the quality of those assets.

Mandates That Apply Only to Intergovernmental Entities

Prohibition on Investments by Small Public Entities. The bill would impose a mandate on public entities that invest more than $25 million but less than $50 million by prohibiting them from entering into swaps with entities that are not federally regulated.

The costs of complying with this mandate would be equal to the difference between the cost of entering into a swap with an unregulated entity and the cost of entering into one with a regulated entity, but because CBO has limited information about the extent to which public entities enter into such arrangements, we have no basis for estimating the cost of complying with this mandate.

Prohibition on Taxation of Surplus Lines. The bill would establish national standards for how states may regulate, collect, and allocate taxes for a type of insurance that covers unique or atypical risks—known as surplus lines or nonadmitted insurance. The bill also would establish national standards for how states regulate re-

insurance. As defined in UMRA, the direct costs of a mandate include any amounts that state and local governments would be prohibited from raising in revenues as a result of the mandate. The direct costs of this mandate would be the amount of taxes on premiums for surplus lines issued by out-of-state brokers that states would be precluded from collecting.

While there is some uncertainty surrounding the amount of tax that states currently collect, the portion of the surplus lines market that would be affected, and the flexibility available to states after enactment of the bill, CBO estimates that forgone revenues would total less than $50 million, annually, beginning one year after enactment. For the purpose of estimating the direct cost of the mandate, CBO considered the taxes that the industry estimates it is paying and the revenues that states, as a whole, would no longer be able to collect as a result of the bill.

Prohibition on Fees for Licensing Brokers. The bill would prohibit states from collecting licensing fees from brokers of surplus lines unless states participate in a national database of insurance brokers. CBO estimates that the costs of participating in the database would be small.

Regulation of Reinsurance. The bill would prohibit states other than the state where a reinsurer is incorporated and licensed from regulating the financial solvency of that reinsurer, if that state is accredited by the National Association of Insurance Commissioners. The bill also would limit the way states regulate insurers that purchase reinsurance. Those mandates would impose no direct costs on states.

Preemption of State Laws. The bill would preempt state laws that affect the offer, sale, or distribution of swaps as well as consumer protection and insurance laws. The preemptions would be mandates as defined in UMRA, but they would impose no duty on states that would result in additional spending.

Mandates That Apply Only to Private Entities

Orderly Liquidation Fund. Under the bill, the largest financial companies would be required to pay assessments totaling up to $50 billion into the OLF over the 10 years after the bill's enactment. Those companies also would have to submit plans to regulators for how they could be liquidated in the event of a failure. Because of the target size of the fund, CBO estimates that the cost of complying with the mandates would greatly exceed the annual threshold for private-sector mandates in each of the first five years the mandate is in effect.

Security and Exchange Commission Fees. The bill would increase the amount of fees collected by the SEC, and such an increase would impose a mandate on participants in securities markets. The cost of the mandate would be the incremental increase in such fees compared to current law. CBO estimates that increase would total at least $650 million over the first five years that the mandate is in effect.

Financial Stability Oversight. The Financial Stability Oversight Council would have the authority to require the Federal Reserve to supervise nonbank companies that may pose risks to the financial stability of the United States. The council also would have the authority to require a large bank holding company that poses

a risk to the financial stability of the United States to meet certain conditions and to terminate certain activities. In addition, the Federal Reserve would be required to establish standards for nonbank financial companies and large bank holding companies regarding capital and liquidity requirements, leverage and concentration limits, credit exposure, and remediation. The cost of complying with these mandates is uncertain and would depend on the details of future regulations.

Beginning two years after the bill's enactment, certain bank holding companies and nonbank financial companies supervised by the Federal Reserve would be required to pay an assessment to the Secretary of the Treasury to cover the operating expenses of the Council and the Office of Financial Research. Based on information from the Treasury Department, CBO estimates that the cost of complying with the mandate would total about $70 million per year.

Regulation of Certain Financial Companies. The regulation of some financial companies (including some banks, thrifts, and related holding companies) would be transferred to different federal agencies, including the OCC and the FDIC. Companies that are currently regulated by the Federal Reserve would be required to pay new fees and meet the requirements of their new regulator. CBO estimates that the amount of additional fees paid by those companies would amount to about $500 million per year.

Federal regulators would be required to implement rules for banks, their affiliates and bank holding companies, and other financial companies to prohibit proprietary trading, sponsoring, and investing in hedge funds and private equity funds, and limiting relationships with hedge funds and private equity funds. Because the requirements on such companies would depend on future rules and regulations, CBO cannot estimate the cost of complying with the mandates.

Companies supervised by the Federal Reserve also would be prohibited from voting for directors of the Federal Reserve Banks. CBO expects there would be no cost to comply with that mandate.

Regulation of Financial Market Utilities. The legislation would require persons who manage or carry out payment, clearing, and settlement activities among financial institutions to meet uniform standards that would be established by the Federal Reserve regarding the management of risks and clearing and settlement activities. The cost of complying with the standards would depend on those future regulations.

Office of National Insurance. The bill would require insurance companies to provide data and information to the Office of National Insurance, which would also have subpoena authority. The cost of the mandates would be small.

Regulation of Securities Markets. The bill would broaden the SEC's authority to regulate entities and activities associated with securities markets.

Regulation of Advisers to Hedge Funds. The bill would require hedge fund advisers that manage over $100 million in assets to register with the SEC. According to industry experts, the expenses for those advisers to prepare for the registration process would probably average less than $30,000 per firm. Based on information from the SEC regarding the number of firms that could be affected

by the requirement, CBO estimates that the cost of the mandate would fall below the annual threshold established in UMRA.

Mandatory Arbitration. The bill would authorize the SEC to prohibit mandatory predispute arbitration agreements between brokers, dealers, municipal financial advisers and their clients. Based upon information from industry sources, CBO expects that if the SEC were to impose such a mandate, the incremental cost to those entities of using the court system instead of arbitration could be significant.

Deficiencies in Regulation. The bill would require the SEC to establish regulations to address any deficiencies it finds in the regulation of brokers, dealers, and investment advisers. The cost of the mandates, if any, would depend on future rules and regulations.

Other Financial Oversight and Protections. The cost of each of the following mandates on securities markets would be small, relative to the annual threshold. The bill would:

- Change the makeup of the Municipal Securities Regulatory Board and require municipal securities advisers to register with the SEC;
- Require auditors of broker-dealers to register with PCAOB and allow it to charge higher regulatory fees;
- Require members of a compensation committee for companies that issue securities to be independent; require companies to provide for an annual nonbinding vote on executive pay and disclose to shareholder the relationship between executive pay and performance; and require companies to have a compliance officer;
- Place additional requirements on the election of directors to the board of a company; and
- Require credit rating agencies to provide public disclosures about methods used to determine credit ratings and the performance of those ratings; to meet education requirements for analysts; and to institute policies to address conflicts of interest.

Previous CBO estimates: CBO has transmitted several cost estimates for bills ordered reported by the House Committee on Financial Services containing provisions that are similar to provisions in the Restoring American Financial Stability Act of 2010. CBO also published estimates of the direct spending and revenue effects of the Wall Street Reform and Consumer Protection Act of 2009, which consolidated and amended the individual bills and contained additional provisions.

On December 9, 2009, CBO transmitted an estimate for the Wall Street Reform and Consumer Protection Act of 2009 as ordered reported by the House Committee on Rules on December 8, 2009. Earlier, on December 4, 2009, CBO published an estimate for the Wall Street Reform and Consumer Protection as introduced on December 2, 2009.

On July 30, 2009, CBO transmitted an estimate for H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, as ordered reported by the House Committee on Financial Services on July 28, 2009. H.R. 3269 contains provisions that are similar to subtitle E of title IX of the Restoring American Financial Stability Act.

On November 3, 2009, CBO transmitted an estimate for H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, as ordered reported by the House Committee on Financial Services on October 15, 2009. On November 6, 2009, CBO transmitted an estimate for H.R. 3795, the Derivatives Markets Transparency and Accountability Act of 2009, as reported by the House Committee on Agriculture on October 21, 1998. Both House bills contain provisions that are similar to title VII of the Senate bill.

On November 13, 2009, CBO transmitted an estimate for H.R. 3818, the Private Fund Investment Advisers Registration Act of 2009, as ordered reported by the House Committee on Financial Services on October 27, 2009. H.R. 3818 contains provisions that are similar to title IV of the Senate bill.

On December 3, 2009, CBO transmitted an estimate for H.R. 3126, the Consumer Financial Protection Agency Act of 2009, as ordered reported by the House Committee on Financial Services on October 22, 2009. H.R. 3126 contains provisions that are similar to title X of the Senate bill.

On December 3, 2009, CBO transmitted an estimate for H.R. 3890, the Accountability and Transparency in Rating Agencies Act, as ordered reported by the House Committee on Financial Services on October 22, 2009. H.R. 3890 contains provisions that are similar to subtitle C of title IX of the Senate bill.

On March 11, 2010, CBO transmitted an estimate for H.R. 2609, the Federal Insurance Act of 2009, as ordered reported by the House Committee on Financial Services on December 2, 2009. H.R. 2609 is nearly identical to subtitle A of title V of the Senate bill.

Estimate prepared by: Federal Costs: Kathleen Gramp, Susan Willie, Matthew Pickford, Daniel Hoople, and Wendy Kiska; Federal Revenues: Barbara Edwards; Impact on State, Local, and Tribal Governments: Elizabeth Cove Delisle; Impact on the Private Sector: Paige Piper/Bach, Brian Prest, and Sam Wice.

Estimate approved by: Theresa Gullo, Deputy Assistant Director for Budget Analysis.

IX. REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(b), rule XXVI, of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact of the bill.

NUMBER OF PERSONS COVERED

The reported bill would promote the financial stability of the United States through multiple measures designed to work together to improve accountability, resiliency, and transparency in the financial system by: establishing an early warning system to detect and address emerging threats to financial stability and the economy, enhancing consumer and investor protections, strengthening the supervision of large complex financial companies and providing a mechanism to liquidate such companies should they fail without any losses to the taxpayer, and regulating the massive over-the-counter derivatives market.

Among those who would benefit from the provisions in the reported bill include the participants in the U.S. financial system, such as consumers of financial products who would be empowered to make more informed choices through better disclosures, and in-

vestors in the capital markets who would be better protected through greater transparency and improved corporate governance. Taxpayers would be protected as well, by ending the possibility that individual companies could be bailed out as they were in 2008 during the financial crisis when regulators did not have the ability to liquidate large, interconnected financial companies in an orderly way. A large, complex financial company that fails will either go through bankruptcy, or in the rare, exceptional case where the bankruptcy of such financial company would threaten financial stability, the company will be liquidated in an orderly fashion by the FDIC with funding from the financial services industry, not from the taxpayers.

Under the reported bill, those who provide financial services would benefit as well since the bill seeks to ensure that financial companies operate in a safer, sounder manner through tougher oversight and accountability without jeopardizing the financial system through risky, irresponsible practices. Companies such as AIG, Lehman Brothers, and Bear Stearns would likely not have collapsed and put the entire financial system in jeopardy had they been under appropriately stringent supervision that limited the dangerous financial activities in which they engaged.

Regulated financial companies will continue to be regulated, with the larger, more complex and interconnected financial companies facing increasingly stringent supervision. (Smaller banks, on the other hand, should not be subject to additional regulation.) While the overall thrust of the reported bill is to close gaps in regulations and provide robust supervision to rein in abusive practices by the weakly regulated or unregulated financial companies that led to the financial crisis, some financial companies may see their regulations rationalized and streamlined through the consolidation of holding company and prudential supervision that aims to reduce unnecessary duplication. Certain financial companies that previously have not been subject to robust regulation (or any regulation in some cases), including some Wall Street firms and those financial companies operating within the unregulated "shadow" banking system, will be subject to supervision for the first time or become subject to tougher oversight so that their risky activities do not trigger another financial crisis.

ECONOMIC IMPACT

By promoting financial stability through a broad range of improvements, it is anticipated that the reported bill would have a positive economic impact overall by building a solid foundation upon which the financial system and the economy of the United States could continue to grow in a sustainable fashion, with reduced likelihood of, and mitigated impact from, any potential financial crises.

The costs of the last financial crisis to American workers, homeowners, and economy have been enormous: 8 million jobs were lost, more than 7 million homes entered foreclosure, and $13 trillion in American household wealth vanished. The reported bill seeks to improve the financial architecture of the U.S. to minimize or eliminate the likelihood of the recurrence of a financial crisis of such proportions. While no legislation could eliminate altogether economic cycles and periods of financial instability, the strengthened

infrastructure for the financial system contemplated by the reported bill is intended to make the system more resilient and resistant to the adverse effects of financial instability.

A number of provisions in the reported bill would impact the U.S. economy positively. For instance, the comprehensive regulation and rules for how the OTC derivatives market operates would protect taxpayers and inject greater transparency into U.S. markets, attracting foreign investment and increasing U.S. competitiveness. Increasing the use of central clearinghouses and exchanges as well as setting appropriate margining, capital, and reporting requirements will provide safeguards for American taxpayers and the financial system as a whole. The overall result would be reduced costs and risks to taxpayers, end users, and the financial system as a whole.

The provision to prohibit banks and bank holding companies from proprietary trading and sponsoring and investing in hedge funds and private equity funds also would serve to protect taxpayers and reduce risks in the financial system. When losses from high-risk activities are significant, they can threaten the safety and soundness of individual banks and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses. In addition, when banks engage in these activities for their own accounts, there is an increased likelihood that they will find that their interests conflict with those of their customers. This prohibition therefore will reduce potential taxpayer losses at financial companies protected by the federal safety net, and reduce threats to financial stability, by lowering the financial companies' exposure to risk. The provision also would prevent financial companies protected by the federal safety net, which have a lower cost of funds, from directing those funds to high-risk uses.

The creation of the Consumer Financial Protection Bureau (CFPB) would provide a level playing field for banks and nonbank financial companies that sell financial products and services to consumers, subjecting them to uniform rules and consistent enforcement for the benefit of consumers. It will do so without creating an undue burden on banks and credit unions. The CFPB would enable consumers to get clear and effective disclosures in plain English and in a timely fashion so that they can shop for the best consumer financial products and services. The CFPB would stop regulatory arbitrage—it will write rules and enforce those rules consistently, without regard to whether a mortgage, a credit card, an auto loan, or any other consumer financial product or service is made by a bank, a credit union, a mortgage broker, an auto dealer, or any other nonbank financial company, so that a consumer can shop and compare products based on quality, price, and convenience without having to worry about getting trapped by fine print into an abusive deal. The CFPB would have been able to head off the subprime mortgage crisis that directly led to the financial crisis, because the CFPB would have been able to see and take action against the proliferation of poorly underwritten mortgages with abusive terms. The CFPB therefore serves to provide another safeguard for the U.S. economy, taxpayers, and consumers.

Several provisions in the bill work together to strengthen the supervisory infrastructure of the U.S. financial system, reduce the

likelihood that an individual financial company would become systemically dangerous, and protect taxpayers from losses if a financial company fails. The Financial Stability Oversight Council and the Office of Financial Research would monitor the financial system for emerging risks. The Federal Reserve would provide supervision to unregulated financial companies that the Council determines could threaten financial stability, and impose heightened prudential standards—"speed bumps"—such as capital, liquidity, and leverage requirements. If a financial company fails but its bankruptcy would threaten the financial system, instead of bailing out such company with taxpayer dollars, the FDIC would be able to step in and liquidate the company with funds from the largest, riskiest financial companies and then recover any losses from a broader set of large, risky financial companies, if there are any losses after selling off the assets of the failed company in an orderly fashion to avoid a "fire sale." Taxpayers thus would not be at risk from the failure of a financial company, and no financial company would be too big to fail.

PRIVACY

The reported bill is not expected to have an adverse impact on the personal privacy of individuals.

PAPERWORK

The reported bill seeks to minimize any increase in paperwork requirements. A number of provisions require regulators, before they can require reports or obtain information from financial companies, to first consult with and obtain such reports or information from other regulators or other sources to avoid unnecessary duplication and administrative burden.

X. CHANGES IN EXISTING LAW (CORDON RULE)

On March 22, 2010 the Committee unanimously approved a motion by Senator Dodd to waive the Cordon rule. Thus, in the opinion of the Committee, it is necessary to dispense with the requirement of section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

MINORITY VIEWS OF SENATOR SHELBY, SENATOR BENNETT, SENATOR BUNNING, AND SENATOR VITTER

April 30, 2010

Background

Chairman Christopher J. Dodd submitted the *"Restoring Financial Stability Act of 2010"* (the "bill" or the "reported bill") to the Senate Committee on Banking, Housing and Urban Affairs ("Committee") on March 15, 2010. Although this bill has been improved since a discussion draft was first introduced in November of 2009, we cannot support it in its current form. On March 22, the bill was voted out of Committee without the support of any Republican members. The Committee did not hold a legislative hearing on the bill. A review of the hearing list set forth in the majority report reveals that the Committee did not hold substantive hearings on most of the provisions in this bill. Although the Committee prepared this legislation to address the causes of the financial crisis of 2008, the Committee has not conducted a single investigation into any aspect of the crisis. Furthermore, although the Committee authorized the creation of the Financial Crisis Inquiry Commission (S. 386) to study the causes of the crisis, the Commission will not report back to Congress with its findings and recommendations until later this year. None of the Commission's work informed the Committee's consideration of the reported bill. As a process matter, we believe that the Committee has yet to conduct the factual inquiries and develop the legislative record for a bill of this importance. We also note that the reported version of the bill differed in several substantive instances from the bill that the Committee approved. The discussion below is based on the bill that was actually approved by the Committee.

We offer these dissenting views on the reported bill because of our strong belief that the bill contains serious flaws and will undermine the long-term health of the U.S. economy. The reported bill's shortcomings include its: institutionalization of government bailouts; creation of vast and unaccountable new bureaucracies with unprecedented power and scope; faulty financial regulatory structure; imposition of costly and unnecessary regulation on American businesses; abrogation of the bankruptcy code in favor of a resolution process based not on law and precedent, but rather on the whims of un-elected regulators; authorization of data collection and monitoring of American consumers that undermines traditional civil liberties; creation of barriers-to-entry in financial services that will further concentrate market-share in the largest financial insti-

tutions; over-reliance on the judgment of regulators; proliferation of costly and needless litigation; mandating of significant new costs on small businesses; establishment of new barriers to capital formation by small businesses; slanting of corporate government rules in favor of special-interest investors; and failure to address the massive problems at Fannie Mae and Freddie Mac.

A detailed explanation of the reasons for Republican opposition to the reported bill is set forth in this document.

Title I: Financial Stability

Title I of the reported bill establishes a council of federal financial regulators, the Financial Stability Oversight Council ("FSOC" or "Council"), for systemic risk regulation (Section 111). The overall mission and structure of the FSOC is sound. The FSOC would formally bring together for the first time all federal financial regulators to improve financial regulation, maintain and monitor financial stability, promote market discipline, and coordinate the response of the federal government to future financial crises. The FSOC will enable coordination and communication across the U.S. financial regulatory system.

The particular authorities granted to the FSOC, however, are troubling because they entrench "too big to fail" financial institutions as a permanent part of the U.S. financial system, thereby perpetuating the unfair advantages these large institutions enjoy over their smaller competitors and increasing the risk of U.S. financial system instability. The FSOC is empowered to designate bank holding companies with over $50 billion in consolidated assets for heightened regulation by the Federal Reserve ("Fed") (Sections 115 and 165). The FSOC also can designate nonbank financial companies for regulation by the Fed.

The definition of a "nonbank financial company" is broad. The term includes all companies, other than bank holding companies, organized in the U.S. or a U.S. state that are substantially engaged in activities that are financial in nature. All such companies whose material financial distress in the judgment of at least two thirds of the FSOC would "pose a threat to the financial stability of the United States" would be subject to the FSOC designation and Fed regulation (Section 113). The FSOC systemic designation and follow-on Fed regulation could apply to broker-dealers, hedge funds, pension funds, insurance companies, and savings and loan holding companies (Sections 113 and 165).

This special designation for nonbank financial companies and large bank holding companies will result in these financial institutions receiving unfair marketplace advantages. Market participants will interpret this special regulation as an implicit government guaranty that prevents these firms from failing. These expectations will be reinforced by the expanded authorities that the reported bill grants to regulators to support designated financial institutions, including the ability, as provided in Titles II and XI, to subsidize creditors, lend against questionable collateral, and issue debt guarantees. The implicit stamp of approval that designated financial institutions will receive from this regulatory restructure will allow them to obtain a lower cost of funds and other unfair advantages. These advantages will lead to higher shareholder profits and lower

counterparty risk. Such firms will grow larger and subsume smaller firms who do not have these advantages. As these large firms grow, the ability of the government to resolve them without taxpayer support diminishes. If a financial institution grows too large and constitutes too much of some aspect of financial intermediation, the U.S. economy may not be able to withstand its liquidation. For example, the Federal government has had difficulty addressing Fannie Mae and Freddie Mac because they comprised a majority stake of the U.S. housing finance market. The reported bill may replicate this phenomenon for the rest of the U.S. financial marketplace.

In addition, the reported bill establishes a $50 billion fund intended to be used in the resolution of a select group of large financial institutions. The select group that contributes to the fund will be perceived by markets as having special protection and will receive unfair funding advantages. Indeed, Treasury Secretary Timothy Geithner warned that " . . . standing fund would create expectations that the government would step in to protect shareholders and creditors from losses. In essence, a standing fund would be viewed as a form of insurance for those stakeholders."[259]

Title I of the reported bill also establishes the Office of Financial Research ("OFR") (Section 151). The office is fundamentally flawed, as it poses a grave danger to the civil liberties of the American people. It has an independent and unaccountable head with the authority to collect any and all information from any and all financial companies (Section 153). The office even has subpoena power (Section 153). No branch of government has oversight of this office (Section 152). Given the private and personal nature of information being collected and monitored by this office, judicial oversight should be mandated.

Advocates for the Office of Financial Research claim $500 million will be used to purchase servers adequate to store and analyze data on all financial transactions in the United States. An additional $500 million will be required to staff and operate the office. The unrealistic expectation is that this office will identify future asset bubbles and work with financial regulators to mitigate them before the pre-identified risks manifest as financial instability events. But that is not the entirety of the mission.

The advocates of the office openly claim that the office will result in cost savings for Wall Street financial institutions. The claim is that standardizing data reporting will dramatically reduce back office costs (costs associated with verifying details of trades with counter parties) and costs associated with maintaining reference databases (legal entity and financial instrument databases). The reported bill requires the office to share data with Wall Street financial institutions. Morgan Stanley estimates that implementation of a program like the OFR will result in a 20% to 30% savings in its operational costs.[260]

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[259] Press Release, United States Department of the Treasury, October 29, 2009.

[260] "FAQs: Role of the NIF, Value and Cost." *Committee to Establish the National Institute of Finance.* 10 Mar. 2010. <http://www.ce-nif.org/faqs-role-of-the-nif/role-of-the-nif-value-and-cost>.

Title II: Orderly Liquidation Authority

Title II of the reported bill would institutionalize bailouts by granting the Executive Branch and federal regulatory agencies permanent authority to rescue firms and their creditors and shareholders. Rather than curtailing the ability of the federal government to bail out companies, this legislation would set the stage for repeated and potentially larger government bailouts in the future. The limited tools that regulators used during the recent crisis, often at the very edge of, if not beyond, their statutory authorities, would be augmented with new and broader authorities that explicitly empower regulators to bail out firms and their creditors and shareholders.[261]

The centerpiece of these new bailout authorities is the reported bill's new resolution authority. It would authorize the Secretary of the Treasury to place any financial company into an administrative resolution process with the Federal Deposit Insurance Corporation ("FDIC") serving as the receiver (Section 203). As the receiver, the FDIC, with the consent of the Secretary of the Treasury, is explicitly authorized to pay creditors and shareholders of the company more than they would be entitled to receive in bankruptcy (Section 210(d)(4)). Paying creditors and shareholders more than they are entitled to is the very definition of a bailout. The reported bill states that the FDIC should conduct resolutions with "a strong presumption" that creditors and shareholders bear losses (Section 204). It does not mandate that they take all of the losses.

The reported bill claims that it is "protecting taxpayers from bailouts," but it notably does not claim to end bailouts. Instead, it grants the FDIC the authority to impose assessments on financial companies to pay for bailouts of creditors and shareholders. Thus, the reported bill provides a permanent source of funding for bailouts while claiming that it protects taxpayers. According to the Congressional Budget Office ("CBO"), however, the assessments would be tax deductible.[262] As a result, taxpayers are directly on the hook to cover the costs of a resolution. To the extent the assessments actually are paid by financial companies, the American public still picks up the tab. First, CBO has indicated that the assessments will result in reduced compensation for employees at assessed companies.[263] Second, the assessments will be passed down (like all business taxes) to the consumers in the form of higher prices. It does not matter whether the funds to pay creditors and shareholders additional amounts come directly from taxpayers in the form of taxes or indirectly from the public in the form of assessments on financial companies. The end result is the same: the

[261] Despite clear legislative language to the contrary, the FDIC has interpreted the systemic risk exception under the Federal Deposit Insurance Act (12 U.S.C. 1823(c)(4)(G)) as authorizing the FDIC to provide broad financial assistance to financial institutions, including billions of dollars in debt guarantees. Similarly, although Section 13(3) of the Federal Reserve Act prohibits the Board of Governors from making equity investments in partnerships and corporations, the Board of Governors has interpreted its lending authority as authorizing it to lend to special purpose vehicles that invest in assets of failed firms, even though such lending has the economic characteristics of equity.

[262] Congressional Budget Office, *Cost Estimate: S. 3217 Restoring American Financial Stability Act of 2010*, April 21, 2010.

[263] *Id.*

American people will pay for the losses of the investors of large financial institutions.

By establishing a mechanism to bail out creditors and shareholders, the reported bill will worsen the too big to fail problem that plagues our financial markets. If creditors and shareholders know that the FDIC will bail them out using this resolution authority, they will impose far less market discipline on these firms (such as imposing conditions on the firm before they invest, removing management, or selling their interests in the firm). After all, if the government will be there to ensure that creditors and shareholders do not take losses if the company fails, any funds that investors spend to monitor their investments would needlessly reduce their ultimate profits. And, because investors will abstain from disciplining these too big to fail firms, the firms will attract ever larger amounts of capital, allowing them to grow bigger and giving them a competitive advantage over their smaller competitors who investors believe are not too big to fail. Moreover, investors will have incentives to take greater risks, as they will reap all of the gains while losses will be transferred to other firms by the resolution authority. In total, this is the same recipe that produced the colossal failures of Fannie Mae and Freddie Mac, necessitating a government rescue that has cost taxpayers more than $127 billion to date.[264] Accordingly, far from ending bailouts, the reported bill's resolution authority actually will make our financial system less safe, more susceptible to crises, and more dependent on bailouts.

The reported bill's resolution authority also suffers from numerous technical problems. The bill does not provide any mechanism for ensuring that the resolution authority is not used to bail out creditors and shareholders of non-financial firms. Presently, the reported bill would allow a non-financial firm to be resolved under its resolution authority if (1) it is a subsidiary of a financial company, or (2) the Secretary of the Treasury determines that the company was "primarily" engaged in activities that are financial in nature. The Secretary's determination on whether a company is "primarily" engaged in financial activities is not reviewable, leaving the door open for misuse of the resolution authority. No evidence has been presented to the Committee that supports the use of the resolution authority to resolve non-financial companies.

Further, the reported bill does not provide any check on the FDIC as receiver for a covered financial company. There are no provisions that would permit the removal of the FDIC as receiver if the FDIC performs poorly in executing its duties under this title.

In addition, the reported bill does not guard against the use of the resolution authority to bail out politically influential creditors and shareholders. The FDIC, with the consent of the Treasury Secretary, can treat similarly situated creditors and shareholders differently, including paying some creditors and shareholders 100 percent (or more) of their claims while paying others only the amount

[264] Federal National Mortgage Association. (2009) 12/31/2009 SEC Form 10–K Annual Report. ("When Treasury provides the additional funds that have been requested, we will have received an aggregate of $75.2 billion from Treasury. The aggregate liquidation preference on the senior preferred stock will be $76.2 billion, which will require an annualized dividend of approximately $7.6 billion.") Federal Home Loan Mortgage Corp. (2010). 2/24/2010 SEC Form 10–Q Quarterly Report. ("To date, we have received an aggregate of $50.7 billion in funding under the Purchase Agreement.")

they would have received in bankruptcy. This would allow the FDIC and the Treasury Secretary to bail out politically favored creditors and shareholders such as foreign governments or politically influential investors.

Finally, the reported bill contains no provisions to ensure that the directors, senior executives, and regulators of any financial company placed into resolution are held accountable. For example, there are no provisions that address the priority of the claims of directors and senior executives. In addition, the bill lacks any provisions requiring an evaluation of the performance of the primary regulators of a covered financial company to hold the regulatory staff accountable for any failings in their supervision of a covered financial company.

Title III: Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

Title III of the reported bill creates a cumbersome financial regulatory structure that reinforces expectations that large financial institutions are too big to fail and that contains significant gaps in regulatory oversight. By stripping the Fed of all banking regulatory authority except for bank holding companies with assets of more than $50 billion, the reported bill signals to market participants that large financial institutions have a special regulator, the Fed, which will not allow any of those institutions to fail. These expectations are reinforced by the fact that the Fed has the authority, and has demonstrated recently the willingness, to provide funding through the discount window and Section 13(3) of the Federal Reserve Act to prevent its regulated entities from failing.

The reported bill also contains a significant regulatory gap because it does not automatically apply heightened regulatory standards to large savings and loan holding companies in Section 165 as it does for large bank holding companies. The majority claims heightened regulatory standards are needed for our largest financial institutions. Yet their reported bill exempts savings and loan holding companies from Section 165. In fact, it is possible to read Section 165 as a prohibition on applying heightened standards developed for large bank holding companies to savings and loan holding companies. This is of particular concern given the fact that several savings and loans holding companies are among the largest financial institutions in the country and contributed to financial instability, including American International Group ("AIG") and G.E. Capital. For these and all other savings and loan holding companies, the majority relies on the wisdom and judgment of future regulators to determine through a Financial Stability Oversight Council vote whether to apply heightened regulatory standards. A superior approach would be to apply heightened regulatory standards to all holding companies with an insured depository institution. In addition, the construct in the reported bill is unworkable for savings and loan holding companies that also undertake significant commercial activities. The Fed is not an appropriate regulator for commercial activities. The reported bill fails to clarify or address the regulation of savings and loan holding companies.

Title IV: Regulation of Advisers to Hedge Funds and Others

Title IV of the reported bill has identified hedge funds as potential systemic risks. To address these risks, the bill imposes a requirement that hedge fund advisers with more than $100 million under management register with the Securities and Exchange Commission ("SEC" or "Commission"). Hedge funds have not been identified as a cause of the financial crisis and investors in failed funds were not bailed out.

Regulators should have better information about hedge funds, but hedge fund advisor registration is not the appropriate approach, and the SEC is not the proper regulator to carry out systemic risk oversight. The SEC's responsibilities are protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets. The SEC is not a systemic risk regulator, and when it tried to be with the Consolidated Supervised Entity program, it failed.[265]

It is likely that investors will treat SEC registration as an SEC seal of approval. Fraudulent hedge fund advisors likely will use registration as a marketing tool.[266] Investor protection is an important job for the SEC, but its resources are not endless, and the SEC notoriously is unable to inspect its current stable of advisors on a regular basis.[267] Hedge funds are open only to wealthy investors on the theory that those investors can hire people to advise them about investments and that, ultimately, they can afford to lose money. Investors who do not meet the wealth threshold or who choose to invest in more closely regulated vehicles can invest in public investment companies. Limited SEC resources should not be diverted from regulated public investment companies, such as mutual funds, in order to monitor hedge fund advisors, as the reported bill proposes to do. If the SEC is spending its resources in this manner, it will not be long before investors that do not meet the accredited investor threshold start demanding to be allowed to invest in hedge funds. It will be hard to counter the argument that

[265] Of the firms regulated by the SEC under its Consolidated Supervised Entities ("CSE") program, one collapsed and its creditors were bailed out by the Fed (Bear Stearns), one failed and was sold in bankruptcy (Lehman Brothers), one was rescued in a merger (Merrill Lynch), and two converted to bank holding companies to obtain a rescue from the Fed's discount window (Goldman Sachs and Morgan Stanley). The CSE program never was authorized by Congress. It was created by the SEC in 2005 to provide consolidated regulation to those select firms to allow them to avoid consolidated supervision under European Union regulation. The record of the SEC's CSEs programs must certainly stand as among the greatest regulatory failures in financial history, especially if one considers that the financial crisis started in September 2007 with the failure of two investment funds sponsored by Bear Stearns. Its record should serve as a reminder of the systemic problems and financial crises that flawed regulatory structures and agencies can produce. While well conceived regulation can enhance markets, poorly conceived regulation, especially when the regulation involves a captured regulator, can have devastating effects on the overall economy, financial stability, and the financial well-being of millions of Americans.

[266] Bernard Madoff used the fact that the SEC had inspected his firm as a way to reassure skeptical investors. See SEC Office of Investigations, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme—Public Version, Aug. 31, 2009, at 427 (available at: http://www.sec.gov/news/studies/2009/oig-509.pdf) ("In addition, private entities who conducted due diligence stated that Madoff represented to them that the SEC had examined his operations when they raised issues with him about his strategy and returns.").

[267] See, e.g., Testimony by Mary Schapiro, Chairman of the Securities and Exchange Commission, before the Subcommittee on Financial Services and General Government of the House Committee on Appropriations (Mar. 17, 2010) (available at: http://www.sec.gov/news/testimony/2010/ts031710mls.htm) ("It is important to note, however, that even with an increase in the number of exams these additional resources will enable us to conduct, we anticipate examining only nine percent of SEC registered investment advisers and 17 percent of investment company complexes in FY2011.").

they should have access to investments on which the SEC is spending its investigative resources.

The reported bill also exempts venture capital and private equity advisors, but delegates to the SEC the difficult task of defining what those terms mean. The SEC, as part of its failed attempt several years ago to require hedge fund advisors to register, distinguished hedge funds from other types of funds by looking to the length of the investor lock-up period. In order to avoid registration, some hedge funds simply extended their lock-up periods beyond the two year cut-off. Investors' ability to exit a fund with which they were dissatisfied was thus curtailed. The reported bill may perpetuate this problem.

The reported bill is not the right way to achieve the objective of giving the appropriate regulator the information necessary to assess the potential systemic risks posed by large hedge funds, and it threatens to divert the SEC from its core mission.

Title V: Insurance

Title V would establish an Office of National Insurance ("ONI"). This office would remedy the lack of insurance expertise in the Executive Branch revealed during the insurance crises triggered by the September 11, 2001 terrorist attacks and by the failure of AIG in 2008. As was revealed during the Committee's March 5, 2009 hearing on the Fed's rescue of AIG, the problems at AIG were not limited to the company's derivatives operations in its Financial Products division. As discussed further in Title VI, there were also serious problems with several of AIG's insurance companies due to the collapse of their massive securities lending operation. In light of the serious ramifications that the failure of an insurance company can have on our financial system, as demonstrated by the collapse of AIG, we believe that among the issues that the reported bill presently mandates the director of ONI to study, there should be a study of the adequacy of state guaranty funds to handle the failure of large, interconnected, and international insurance companies.

Title VI: Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions

Title VI of the reported bill contains improvements to the regulation of bank and savings and loan holding companies and depository institutions. What notably is lacking in Title VI is any provision to enhance regulatory oversight of large insurance companies. During the financial crisis, several prominent insurance companies received a Federal bailout through the TARP program. In addition, the collapse of AIG revealed serious shortcomings in the regulation of large, interconnected, and international insurance companies. The failure of AIG was due, in large part, to the massive securities lending operation that several state-regulated AIG insurance companies ran collectively. Documents submitted at the Committee's sole hearing on AIG indicated that several of these insurance companies would have been insolvent had not the Fed re-capitalized them as part of its bailout. The record revealed that the problems at AIG were well-known by its regulators at the Office of Thrift Supervision and by state insurance commissioners, but they failed to

take sufficient action to prevent the collapse of the company.[268] In addition, it has recently been revealed that Treasury Secretary Geithner was informed personally by AIG of the company's problems weeks before AIG received a bailout from the Fed.[269] The Secretary also failed to take preventive action. While insurance regulation is a complex matter and our state system largely has functioned well for nearly two hundred years, the size and international reach of many insurance companies has raised legitimate questions, including whether reforms are needed to reflect changes in the marketplace. The failure of the reported bill to include provisions to ensure the proper oversight of large, interconnected, and international insurance companies like AIG is a glaring omission.

It is also worth noting that the reported bill remains silent with respect to the implementation of prompt corrective action during the economic downturn. Enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991, prompt corrective action was designed to protect the Deposit Insurance Fund by requiring regulators to resolve failing banks before they incur substantial losses. An examination of the material loss reviews for the FDIC's resolution of banks over the past 3 years reveals that the resolution of banks regularly results in losses of 20 to 30 percent of assets.[270] Under prompt corrective action, regulators are required to close any bank whose capital falls below 2 percent of tangible net equity. The Committee has yet to hold a single hearing on the effectiveness of regulators in implementing prompt corrective action despite the substantial risks to the taxpayers involved.

The Committee also has failed to develop a record to demonstrate a link between proprietary trading and financial instability during the housing and credit market crisis. Yet, the reported bill contains a broad prohibition on proprietary trading. Insured depository institutions benefit from a government provided deposit insurance subsidy so robust activity restrictions, including proprietary trading limitations, may be warranted. But, the policy rationale for extending a proprietary trading ban beyond insured depositories is less compelling as non-insured depository institutions should not benefit from the government subsidies provided by the FDIC.

Title VII: Improvements to Regulation of Over-the-Counter Derivatives Markets

In addressing the regulation of the U.S. over-the-counter ("OTC") derivatives market, the reported bill is flawed in its objectives and the mechanics for achieving those objectives. Rather than focusing on the key goals of regulatory access and authority and greater use of central clearing, the bill attempts to restructure dramatically the OTC derivatives market. It does so without adequate regard for potentially severe unintended consequences, which include increasing

[268] Senate Committee on Banking, Housing, and Urban Affairs, "American International Group: Examining what went wrong, government intervention, and implications for future regulation," March 5, 2009.

[269] Sorkin, Andrew Ross, "Too Big To Fail" p. 207, 235, (Viking 2010).

[270] Under Section 38(k) of the Federal Deposit Insurance Act, the inspector general for the appropriate Federal banking agency must make a written report reviewing the agencies supervision and implementation of prompt corrective action whenever the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution. The term "material loss" is defined as a loss that exceeds the greater of $25 million or 2 percent of an institution's total assets at the time the FDIC was appointed receiver.

systemic risk and outsourcing jobs to markets overseas, harming the U.S. economy.

The reported bill, despite its purported commitment to regulatory transparency, does not even reach significant segments of the OTC derivatives market. For example, a large percentage of the OTC market consists of foreign exchange derivatives which are explicitly carved out of the bill. Similarly, the definition of a "swap," which determines the bill's coverage, omits a category of swaps that, before now, has been included in the definition.[271] Rather than casting a wide net and then making appropriate exclusions, the bill leaves significant portions of the OTC swaps market in the dark.

The bill will have deleterious effects in the derivatives markets and in the marketplace as a whole. The highly international swaps market, which already is well established in Europe and Asia, may simply move offshore and beyond U.S. regulators' reach to a jurisdiction with a more rational regulatory regime.[272] Corporations that currently use derivatives to manage their risk and may not be able to access foreign markets may choose simply not to manage their risk at all. Unhedged corporate risks will result in higher prices and greater price volatility for consumers, and less innovation and capital investment. Companies that cannot withstand a large unhedged risk may fail, resulting in large job losses. Alternatively, corporations may continue to use derivatives subject to the bill's strict requirements for collateral. Setting aside collateral in the required amounts will cause companies, already having a difficult time raising capital, to forgo other valuable uses of their capital. The effect on the real economy and the job market would be substantial. One estimate suggests that mandatory clearing and margining would force companies to set aside $900 billion in capital that would otherwise be used to build factories, hire workers, and fund research and development.[273]

The reported bill, by imposing bank-style capital requirements that are as strict or stricter for non-bank entities, likely will drive some of these entities out of the market and concentrate the market further among the dealers who already have established a powerful foothold in the market. Capital requirements are not necessary for non-banks that do not have access to federal deposit insurance or another form of federally subsidized insurance in the event of default.

The reported bill is rooted in a presumption that central clearing is always risk-reducing. While central clearing can reduce risk and

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[271] Specifically, the Gramm-Leach-Bliley Act treated as a "swap agreement" any agreement, contract, or transaction that "provides for the purchase or sale, on a fixed or contingent basis, of any commodity, currency, instrument, interest, right, service, good, article, or property of any kind." These are not "swaps" in the reported bill.

[272] Less-established overseas markets, such as Malaysia, have also expressed interest in attracting OTC derivatives trades. See, e.g., Financial Times, "Malaysia bourse plans derivatives boost" (April 27, 2010) (available at: http://www.ft.com/cms/s/0/5fdb7ab8-5222-11df-8b09-00144feab49a.html).

[273] See, e.g., Keybridge Research, An Analysis of the Business Roundtable's Survey on Over-the-Counter Derivatives (Apr. 14, 2010) (available at: http://www.businessroundtable.org/sites/default/files/BRT%20OTC%20Derivatives%20Survey%20284%2014%2010%29.pdf) (finding that "a 3% margin requirement on OTC derivatives could be expected to reduce capital spending by $5 to $6 billion per year, leading to a loss of 100,000 to 120,000 jobs, including both direct and indirect effects"); Letter from the Natural Gas Supply Association and the National Corn Growers Association to Senate Majority Leader Reid, Senator Lincoln, and Senator Chambliss (April 15, 2010) (available at: http://www.ngsa.org/newsletter/pdfs/2010%20Press%20Releases/16-Corn%20Growers%20Join%20Drumbeat%20Against%20Mandatory%20Clearing.pdf).

should be encouraged, its abilities to do so should not be overstated. First, some clearinghouses may be stronger than others. A clearinghouse that is poorly run and poorly regulated may not be a strong counterparty. Second, even a well-regulated clearinghouse is not a riskless counterparty.[274] Third, there is no basis for the bill's categorical claim that there is "a greater risk to the swap dealer or major swap participant and to the financial system arising from the use of swaps that are not centrally cleared" that warrants "substantially higher capital requirements" for swaps that are not centrally cleared. Fourth, specialized dealers in bilateral markets can monitor and manage the risks of complex, illiquid derivatives contracts and complex, opaque counterparties more effectively than all-purpose clearinghouses that are designed to clear standardized liquid contracts among clearing members.

Moreover, most participants in the OTC market, such as hedge funds and commercial end users, do not clear directly through a clearinghouse. As a result, even when they clear a derivative, they do not directly face the clearinghouse. Instead, they clear through a firm that is a member of the clearinghouse. Such indirect access to clearinghouses exposes a market participant to credit risk associated with that clearing member and its other customers. In the event of the failure of the clearing member or one of its customers, other customer assets may be at risk. Certain protections can be put in place to minimize the likelihood of loss for non-defaulting customers, but some level of risk remains. As the CME Group notes, "While the policies applicable to the segregation of customer monies for products traded in regulated markets are specifically designed to protect customers from the consequences of a clearing member's failure, they do not always provide complete protection should the default be caused by another customer at the firm."[275]

The reported bill improperly delegates significant policy decisions to regulators and raises the possibility of arbitrary implementation. For example, market participants' statuses as "major swap participants" would turn on the judgment of regulators, who would have an incentive to make their regulatory reach extend as far as possible. Moreover, because a "major swap participant" is defined, in part, by whether a person would cause his or her counterparties "significant credit losses," a person's status will depend, in part, on how well its counterparties manage risk. This approach will undermine, rather than enhance, market discipline.

The bill, in trying to address systemic risk concerns, gives rise to a new set of concerns. As soon as one clearinghouse starts clearing a swap, there will be a presumptive mandate to clear the swap. In other words, clearinghouses' profit-driven, competitive decisions on when to start clearing which products would drive the clearing mandate. Moreover, the bill would require the SEC and the Com-

[274] For example, last year, the Federal Reserve Board of Governors assigned a 20 percent risk weighting to ICE Trust, which is the same risk weighting that the individual members of the clearinghouse typically get. See letter from the Federal Reserve Board of Governors to Cleary, Gottlieb, Steen and Hamilton LLP (June 5, 2009) (available at: http://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/2009/20090605.pdf) ("Exposures to ICE Trust in the form of Margin and [Guaranty Fund] Contributions are not materially riskier than exposures to the participants themselves, and the exposures to ICE Trust, therefore, need not be subject to higher risk weights.").

[275] CME Group, CME Clearing Financial Safeguards (available at: http://www.cmegroup.com/clearing/files/financialsafeguards.pdf)

modity Futures Trading Commission ("CFTC") to identify swaps that clearinghouses had not asked for permission to clear that, in the judgment of the SEC and CFTC, should be accepted for clearing. By allowing the regulators to force clearinghouses to accept swaps for clearing, the bill could force clearinghouses to accept for clearing swaps the risks of which they do not understand. Pressuring clearinghouses into clearing in this manner could sow the seeds for a clearinghouse failure sometime in the future.

The reported bill makes it very difficult for anyone to get an exemption from clearing and exchange trading requirements. It allows the SEC and CFTC, with prior approval by the FSOC, to exempt a swap if one of the parties is not a swap dealer or major swap participant and does not meet the eligibility requirements of a clearing organization. Faced with the prospect of a long, burdensome exemptive process, the bill will dissuade corporations from using swaps to offset their risks. Even if a corporation succeeds in getting an exemption from the clearing requirement, it will be subject to margin requirements unless it can obtain an exemption. Exemptions only will be available for swaps that fit within the narrow and technically complex Generally Accepted Accounting Principles hedging category.

The reported bill requires that cleared swaps also be traded on an exchange or exchange-like facility. This requirement will effect a significant change in market structure. End users will face higher, not lower, costs as their dealers will find it more difficult to lay off the risk that they take on. Indeed, the exchange trading requirement may cause dealers to retain more risk on their books. Other markets have been allowed to develop in a manner that serves the interests of investors. Proponents of an exchange trading requirement cite improved price transparency. Exchange trading is not necessary for transparency, however. Through a system like the TRACE system employed in the corporate bond market, valuable post-trade transparency can be communicated to investors for use in assessing execution quality, marking their books, and assessing pricing in future transactions. SEC Chairman Mary Schapiro and independent academics have embraced a TRACE-like solution for the OTC derivatives market.[276]

Title VIII: Payment, Clearing, and Settlement Supervision

Title VIII of the reported bill would give the Council broad power to identify financial market utilities and payment, clearing or settlement activities that it deems to be now, or likely to become, systemically important. Those entities and activities would then be subject to risk regulation by the Fed's Board of Governors. This title is another example of the bill's inclination to leave difficult decisions to regulators. Forcing regulators to determine when someone or something ought to be regulated is an inappropriate delegation of Congressional power. Moreover, a regulator charged with the task of identifying regulatory targets has every incentive to

[276] See "Stronger regulation would help bring financial swaps out of the shadows," Washington Post OpEd by Mary Schapiro (April 2, 2010) (available at: *http://www.washingtonpost.com/wp-dyn/content/article/2010/04/01/AR2010040102801.html*), and the statement of the Shadow Financial Regulatory Committee on Derivatives, Clearing and Exchange-Trading (April 26, 2010) (available at: http://www.aei.org/docLib/Statement%20No.%20293-%20Derivatives-%20Clearing%20and%20Exchange%20Trading.pdf).

cast its net wide to obtain additional jurisdiction and avoid accusations of regulatory timidity in the event of a future problem.

The egregiousness of this title's delegation of Congressional decision-making derives largely from the broad manner in which key terms are defined. "Payment, clearing and settlement activities," for example, include any "activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions." Such an activity is "systemically important" if "the failure of or disruption to [that activity] could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system." With definitions like these guiding the Council, it could decide to assign any aspect of the financial market to the Fed.

Once an entity or activity is identified, the Fed is given broad authority to set risk management standards that can address any areas that the Fed deems necessary to promote risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system. In other words, this title gives the Fed unfettered discretion to regulate entities and activities that the Council determines "are, or are likely to become, systemically important." Private enterprises that are deemed to be of systemic importance will have to get preapproval from the Fed before making any material changes in their operations.

Lack of regulatory accountability contributed to the recent financial crisis. This title exacerbates the problem by allowing the Council to bring the Fed into significant sectors of the financial system as a back-up regulator. If a problem arises, both the Fed and the relevant supervisory agency will have someone else to blame. A more sensible approach would be for Congress to identify the existing financial market utilities and payment, clearing and settlement activities that merit greater oversight and provide the appropriate regulator with the appropriate authority. The Council could be given the authority to identify additional systemically important utilities and activities and make regulatory recommendations to Congress.

Title IX: Investor Protections and Improvements to the Regulation of Securities

Title IX of the reported bill is a "Christmas tree" of amendments to the securities laws, many of which are not related to the recent crisis and will not help to prevent another crisis. In addition, many were not the subject of Committee hearings. Some of these issues are important and warrant consideration by Congress and the SEC in the future. Considering them now as part of this bill is a distraction from the issues that are central to the bill and deserve Congress's undivided attention. Some of the issues that appear in Title IX have been on special interest wish lists for many years. The reported bill offers a convenient vehicle to pass them into law without the scrutiny they deserve.

Subtitle A establishes a permanent investment advisory committee at the SEC to advise the Commission on setting and implementing its regulatory priorities and promoting investor confidence. The intention may be good, but the statute implements it in a man-

ner that ensures that special interests that may not serve investors' interests have a seat at the SEC rulemaking table. It also establishes an Office of Investor Advocate to serve the same function as the SEC's existing Office of Investor Education and Advocacy.

Subtitle B relates to enforcement issues. It includes a provision to protect and reward SEC whistleblowers. The value of whistleblowers was illustrated vividly by the role of Harry Markopolos in identifying the Madoff fraud, even though his warnings to the SEC went unheeded. Nevertheless, as established in the bill, the whistleblower provision does not afford the SEC with appropriate discretion and would force the SEC to devote considerable resources to defending its decisions with respect to whistleblower awards. For example, the bill would require the SEC to pay whistleblowers not less than ten percent of the monetary sanctions collected and would allow dissatisfied whistleblowers to appeal to the United States Court of Appeals.

Subtitle B also rolls back the National Securities Market Improvement Act by giving state regulators a role in regulating Regulation D offerings and by instituting a lengthy pre-approval process for such offerings which are available only to accredited investors. Legitimate entrepreneurs will be unable to fund their projects or will be forced to struggle through a slow and unpredictable bureaucratic process before they can raise money. At a time when the economy is weak and jobs are scarce, financial reform legislation should attempt to encourage capital formation and innovation, not discourage it by erecting new obstacles for our entrepreneurs.

Subtitle C attempts to address credit rating agencies. The bill's approach only would aggravate the over-reliance problem, however, undermining one of the key recommendations of the Treasury white paper on financial reform.[277] The bill also undermines the objectives of the 2006 Credit Rating Agency Reform Act, which focused on increasing competition, improving disclosure, and addressing conflicts of interest. The reported bill cites the systemic importance of, and investor reliance on, credit ratings as a justification for giving the SEC a new role, monitoring the accuracy of credit ratings. Excessive investor reliance on credit ratings was at the root of the recent crisis. Encouraging greater reliance on credit ratings by promising that the SEC will identify and punish inaccurate rating agencies is exactly the opposite of what a financial reform bill ought to achieve. Reducing investors' perceptions that the SEC is looking over the shoulders of the credit rating agencies to ensure that they are doing a good job would help to encourage investors to do their own due diligence. Some of the bill's attempts to address conflicts of interest, such as imposing strict independence requirements for boards of directors and qualification standards for credit rating analysts, will discourage competition by setting up barriers to entry for credit rating agencies considering registering as nationally recognized statistical rating organizations. The bill also includes a new liability standard for *all* credit rating agencies, which will make credit rating agencies an easy target for lawsuits. This

[277] See "Financial Reform: A New Foundation," U.S. Department of Treasury (available at: *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf*), page 44, "We propose several initiatives . . . reducing the incentives for over-reliance on credit ratings."

provision also is likely to harm competition and the value of credit ratings.

The reported bill also threatens a healthy return of the securitization markets. The centerpiece of Subtitle D is a five percent risk retention requirement for securitizations. The requirement is a one-size-fits-all solution in a very diverse securitization marketplace. In combination with accounting and bank capital rule changes, a risk retention requirement could force the entire securitization to be retained on bank balance sheets for accounting and capital purposes. Securitizations would then become economically unworkable. The bill would permit less than five percent risk retention in cases in which the originator complies with underwriting standards set by the SEC, along with the bank regulators. A more sensible approach would direct bank regulators to set underwriting standards that include a down payment requirement for all residential mortgages.[278] The SEC, a disclosure regulator, should focus its efforts on improving disclosure about the underlying assets in a securitization pool to enable investors to conduct due diligence, rather than instilling in investors a sense of complacency by an arbitrary risk retention requirement.

Subtitle E addresses executive compensation in a number of unproductive ways. First, it requires public companies to have annual votes on executive compensation. This one-size-fits-all solution imposed at the federal level tramples over state corporate law, forces shareholders to pay for something that they may not want, and exacerbates short-term thinking. The subtitle also imposes a requirement on public companies to disclose the ratio of the median employee compensation to the chief executive officer's compensation. Although provisions like this appeal to popular notions that chief executive officer salaries are too high, they do not provide material information to investors who are trying to make a reasoned assessment of how executive compensation levels are set. Existing SEC disclosures already do this. More generally, the subtitle's prescriptive approach hinders corporations from devising policies that work for the unique circumstances of their corporations.

Subtitle G likewise forces all public corporations to adopt uniform approaches to corporate governance regardless of whether those approaches would serve the needs of shareholders and without regard for the central role of states in establishing corporate governance standards. Subtitle G imposes a majority voting requirement for directors of public corporations, without any evidence that majority voting benefits shareholders. In fact, AIG, Washington Mutual, Lehman Brothers, Citigroup, Merrill Lynch, Bank of America, and Wachovia all required majority voting *before* the financial crisis. Special interest groups hope that the majority voting requirement will work in conjunction with the bill's proxy access requirement to give them special access to corporate boardrooms. Proxy access is designed to permit shareholders to put their nominees for the board on the company ballot at the company's ex-

[278] *See* John C. Dugan, Comptroller of the Currency, Speech before the American Securitization Forum (Feb. 2, 2010) (available at: http://www.occ.treas.gov/ftp/release/2010–13a.pdf) ("But while lax underwriting is plainly a fundamental problem that needs to be addressed, mandatory risk retention for securitizers is an imprecise and indirect way to do that, and is by no means guaranteed to work. How much retained risk is enough? And what type of retained risk would work best—first loss, vertical slice, or some other kind of structure?").

pense. Mandating proxy access raises investor protection concerns because all shareholders are forced to fund campaigns by one shareholder to gain representation on the board and because directors are supposed to represent the interests of the shareholders as a whole, not particular special interests. Despite these concerns, some shareholders already are able to choose to implement proxy access. Changes in state law have made it possible for shareholders to tailor proxy access provisions that work for their particular corporations. A federal proxy access mandate is not needed and would deprive shareholders of the very voice it purports to give them.

Subtitle H of the reported bill deals with municipal securities, an area that warrants attention. Nevertheless, the subtitle includes some troubling features. Fines collected for enforcement violations would be shared between the SEC and the Municipal Securities Rulemaking Board. Allowing these entities to profit from their enforcement actions provides them with a profit motive for bringing cases, which would harm the credibility of the agency.

Subtitle I of the bill would, among other things, expand the mission of the Public Company Accounting Oversight Board ("PCAOB") to include overseeing auditors of broker-dealers. Because the PCAOB is still working on fulfilling its initial mission, a large influx of new registrants will pose additional resource challenges. To minimize this burden, the legislation should not extend to auditors of Introducing Brokers, who do not handle customer funds.

Subtitle J of the bill would remove the SEC from the appropriations process and permit it to fund itself through the fees and assessments that it collects. It could set its budget at any level that it determined proper and exceed that budget at its discretion. In the event the SEC spends more than its budget, it is permitted, but not required, to notify Congress of the amount of additional money and anticipated uses of that money. In the wake of some of the largest regulatory failures in the SEC's history and the embarrassing scandal involving senior SEC officials repeatedly downloading pornography on government computers during the height of the financial crisis, it is surprising that Congress would decide to make the SEC less accountable. Additional resources are warranted for the SEC's important responsibilities, but they should be accompanied by a responsibility to account to Congress for how those resources are spent.

Title X: Bureau of Consumer Financial Protection

Title X creates a massive new entity whose power and autonomy have no current equivalent anywhere else in the Federal government. The Bureau of Consumer Financial Protection ("Bureau") will have no meaningful coordination with the safety and soundness regulators to ensure that banks will not fail or be critically weakened as a result of a consumer rule. Indeed, the Bureau would have the authority to trump the safety and soundness regulators, thereby creating instability in our nation's financial system. The manner in which the legislation separates safety and soundness and consumer protection regulation is similar to the regulatory structure of Fannie Mae and Freddie Mac. In that instance, the Department of Housing and Urban Development (HUD) set consumer

standards while the Office of Federal Housing Enterprise Oversight regulated for safety and soundness. Ultimately, the consumer standards set by HUD undermined the solvency of Fannie and Freddie. Fannie and Freddie are currently the largest recipients of bailout funds.

Under the reported bill, the Bureau would regulate every aspect of financial transactions. The Bureau would have enormous reach into Main Street companies like orthodontists, home repair and renovation contractors, and anyone else who extends credit in more than four installments. It would set lending standards; determine what type of documents lenders could use; and require banks to make a certain percentage of their loans to specific, politically favored borrowers (i.e., housing authorities or "green" businesses). The Bureau could force all lenders to use the same lending forms and terms and conditions.

The reported bill provides the Bureau with an enormous taxpayer-provided funding source without executive or congressional oversight of its budget. The legislation states that the budget for the new Bureau shall be 12 percent of the overall operating budget of the Federal Reserve System for fiscal year 2009. This would allow the Bureau to command approximately $650 million of Fed resources. Currently, the Office of the Comptroller of the Currency ("OCC") has an overall operating budget of $750 million, and the OCC handles both consumer protection supervision and prudential supervision.

The reported bill also undermines more than a century of precedent on preemption with respect to national banks. Presently, state laws that conflict with the National Bank Act are pre-empted because Congress has long sought to create a national financial market and ensure the efficient regulation of national banks. The reported bill, however, effectively eliminates preemption and allows states to set their own regulations under certain circumstances. Furthermore, the bill requires the OCC and the courts to determine on a case-by-case basis which state laws are pre-empted, which will create significant legal uncertainty and generate unnecessary litigation. In addition, the bill would allow State Attorneys General to bring class action suits against national banks, usurping the responsibility of federal regulators and creating even more needless litigation.

Finally, the Bureau poses a threat to Americans' civil liberties. Under Section 1022, the new Bureau would collect any information it chooses from businesses and consumers, including personal characteristics and financial information. Americans could be required to provide the new consumer agency with written answers, under oath, to any question posed by the Bureau regarding their personal financial information. The Bureau would have the authority to monitor transactions such as personal deposit account activity, credit card usage, and how much an individual spends on groceries. This is a massive new grant of authority for an entity whose budget is derived from taxpayer funds.

Title XI: Federal Reserve System Provisions

During the recent financial crisis, the FDIC put American taxpayers at risk by guaranteeing *trillions* of dollars of private debt.

Title XI of this bill seeks to institutionalize such guarantees, under the rubric of "emergency financial stabilization" authority, providing permanent authority to put taxpayer resources at risk to insure private debt whenever the Fed and FDIC deem it appropriate. No regulator should be allowed to expose taxpayers to trillions of dollars of risk without express approval from Congress.

During the crisis, the Fed contributed to creating moral hazard by vastly expanding use of its discount window to fund a variety of financial market participants, including some over which it had no oversight. The Fed also created new lending facilities to direct liquidity and credit to markets that were deemed most stressed and systemically important. The Fed ballooned its balance sheet from a pre-crisis level of around $800 billion to over $2.2 *trillion*. Those resources are not free. Those resources are liabilities of the Fed, created through the Fed's money creation powers, and are therefore also liabilities of taxpayers. This bill seeks to institutionalize Fed support to whichever market segment it and the Treasury deem to be in need of liquidity. The Fed may make loans and take collateral that the Fed finds is to its "satisfaction."

The Fed does need to perform its lender of last resort function but should only do so to *briefly* assist firms who are solvent and in need of liquidity that cannot readily be obtained in the open market. The lender of last resort function of a central bank does not involve long-term loans to insolvent firms based on questionable collateral. Yet, this bill seeks to enshrine the Fed's ability to lend to "any program or facility with broad-based eligibility," taking as collateral whatever satisfies the Fed. The broad-based and vague language governing the Fed's emergency lending authorities is an invitation for future governments to avoid hard decisions and shift them to the Fed. With trillions of dollars of taxpayer resources likely to be on the line, the language in the bill governing the Fed's emergency lending power is far too loose.

Furthermore, the reported bill expands and codifies the FDIC's broad ability to guarantee the debt of depositories and of depository holding companies in a loosely defined "liquidity event." The amounts of the guarantees are unlimited. The President may, or may not, submit a report to Congress on the FDIC's plan to issue guarantees. Most troubling, however, is that there is no requirement that a company that receives guarantees and defaults on its obligations be taken into an FDIC receivership, bankruptcy, or resolution. Thus, the FDIC and Treasury could prop up whatever companies they choose. Moreover, there is ample room to grant debt guarantees in routine stressful, yet not crisis, circumstances given the broad definitions.

We believe that the Treasury Secretary and the Fed should be required to enter into an "Accord" to establish clear rules on the use of 13(3) of the Federal Reserve Act and the Fed's balance for fiscal purposes.

Title XII: Improving Access to Mainstream Financial Institutions

Title XII was inserted quietly into the Dodd bill at the last minute as part of the manager's amendment during the Committee mark-up. It was not considered by the Committee. Title XII creates a grant program that would give certain financial institutions, and

others, taxpayer dollars to "recapture a portion or all of a defaulted loan" (Section 1206). The purpose of the grant program is to encourage certain financial institutions, and others, to get low- and moderate-income individuals to establish accounts at their institutions. We do not support using taxpayer dollars to pay financial institutions to attract new customers, and then cover the losses if the new customers default on the loans. This is an iteration of "heads Wall Street wins, tails the taxpayer loses." This is replicating on a smaller scale the precise practices that led to the bailouts of Fannie Mae and Freddie Mac.

Government sponsored entities

Fannie Mae and Freddie Mac played major roles in the financial crisis. Combined, these two institutions represent nearly $5.5 trillion in business, and they have been in conservatorship since September 6, 2008.[279] Despite this, the reported bill does nothing to address the future of the Government Sponsored Enterprises.

In doing so, the reported bill leaves uncertainty in the secondary mortgage market. As Fannie Mae and Freddie Mac have such a large influence on the market, private sector investment will not achieve optimal levels until investors are certain as to the future of these institutions. By remaining silent on their futures, the reported bill prevents the private sector from fully committing to the secondary mortgage market. Without a properly functioning secondary mortgage market, additional pressure falls upon the GSEs, the Federal Housing Administration, the Veterans Administration and Ginnie Mae. This additional pressure grows these entities, concentrating risk with the taxpayer rather than in the private sector, and increases the difficulty of reforming Fannie Mae and Freddie Mac.

Despite this, the reported bill takes no interim steps to protect taxpayers. On December 24, 2009, the Treasury Department and the Federal Housing Finance Administration ("FHFA") announced that the Preferred Stock Purchase program would be amended to "allow the cap on Treasury's funding commitment under these agreements to increase as necessary to accommodate any cumulative reduction in net worth over the next three years." It further allowed Fannie Mae and Freddie Mac higher portfolio holdings than previously mandated.[280]

The reported bill also does nothing to increase the accountability of Fannie Mae and Freddie Mac, nor those operating them. The President has yet to nominate anyone to officially run the FHFA, who acts as conservator, and the Office of Special Inspector General of FHFA remains vacant. Thus, there is no one politically accountable to the public for the operation of these multi-trillion dollar entities. By remaining silent on any interim taxpayer protections or oversight provisions, the reported bill allows for the continued unlimited bailout of Fannie Mae and Freddie Mac.

If nothing is to be done to address the future of the GSEs in the reported bill, it would be useful to establish new investigative over-

[279] Monthly Summary Report, February 2010, Fannie Mae, and Monthly Volume Report, February 2010, Freddie Mac.

[280] Press Release: "Treasury Issues Update on Status of Support for Housing Programs," U.S. Treasury Department, December 24, 2010.

sight that would provide regular updates to the Congress and to the American people. Limits governing the taxpayer funding available to Fannie and Freddie and the portfolio holdings of these institutions should be reestablished. A process to ensure that future agreements of this nature are approved by Congress also should be established. Finally, a deadline should be given to the President for the submission of a plan outlining his ideas for the ultimate reform of Fannie Mae and Freddie Mac to ensure that the timeline does not continue to slip.

Variation between the bill as reported and the specific changes to the bill approved by Committee action

The reported bill contains numerous substantive changes that were not approved by the Committee. Among these are:

1. Reducing the number of hours from 48 to 24 that the Secretary has to provide a report to Congress following the appointment of the FDIC as receiver for a financial company (Section 203(c));
2. Removing the provision that made the consent of a company's directors or shareholders to the appointment of a receiver constitute a company being "in default or in danger of default" (Section 203(c));
3. Prohibiting the FDIC from taking equity interest in a covered financial company (Section 206);
4. Removing language that made liquidation of a covered financial company optional and replacing it with language that makes liquidation mandatory (Section 210);
5. Removing language that gave the FDIC the discretion to put an institution into bankruptcy or resolution if it defaulted on a debt guarantee provided under Title VI and replacing it with language that makes such action mandatory (Section 1156); and
6. Changing language to allow the Fed to lend to "participants" rather than "programs" under Section 13(3) of the Federal Reserve Act (Section 1151).

These are non-technical changes that should have been made only through direct Committee action.

Conclusion

We are disappointed in the Committee's decision to report the bill in its current form for Senate consideration. Even the bill's proponents recognize that the reported bill is rife with substantive and technical problems. We believe that the reported bill's deficiencies are so significant that it will be impossible to correct them on the Senate floor. We would readily support a properly designed bipartisan financial reform bill. Unfortunately, the reported bill is not such a bill. In fact, with respect to the bill's treatment of the problems of too big to fail and bailouts, the bill's language promises a future clouded with moral hazards in financial markets, with unfair and undemocratic funding advantages for a select few large financial institutions, and with institutionalized bailout authorities. In the aftermath of the economic crisis of 2008, we believe that it is the responsibility of Congress to take action to prevent such a

crisis from occurring again. This bill not only fails in that regard, it in fact makes future crises more likely.

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