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Senate Passes Comprehensive Financial Reform Bill

On May 20, 2010, the United States Senate passed, by a margin of 59 to 39, the Restoring American Financial Stability Act of 2010 (the "Bill"), which is aimed at strengthening the U.S. financial system and preventing future crises. The Bill is comprehensive in scope, proposing significant changes to the structure of federal financial regulation and new substantive provisions that apply to a broad range of market participants, including public companies that are not financial institutions. Among other elements, the Bill includes proposals for executive compensation and corporate governance reform, hedge fund adviser registration, heightened regulation of over-the-counter derivatives and asset-backed securities and new rules for credit rating agencies. The Bill also proposes significant changes to the authority of the Federal Reserve Board and the Securities and Exchange Commission as well as enhanced oversight of large bank and non-bank financial institutions.

This memorandum summarizes the key provisions of the Bill, based on available sources. Prior to being signed into law, the Bill must be reconciled with a parallel bill passed by the House of Representatives last December. This process is expected to be completed in the coming weeks. The final bill is expected to more closely resemble the Senate Bill with some potentially significant changes.

Executive Compensation Reforms

The Bill proposes the following executive compensation reforms:

- *Say-on-pay*. Any proxy statement required by SEC rules to include compensation disclosure would be required to include a separate non-binding resolution subject to shareholder vote on the company's executive compensation as disclosed in the proxy statement. Say-on-pay resolutions would be required in proxy statements filed six months after enactment of the legislation.

- *Compensation committees.* Listed companies would be required, through new rules adopted by the stock exchanges, to have fully independent compensation committees, based on new independence standards that require consideration of the source of compensation for the director (such as any consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company. Compensation committees would be explicitly charged with hiring and overseeing compensation consultants, legal counsel and other committee

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advisors. Companies would have to provide appropriate funding for the retention of such advisors. When engaging compensation consultants, legal counsel or other advisors, compensation committees would be required to consider certain independence factors to be determined by the SEC, including factors that examine the relationship between the employer of the consultant or advisor and the company. Finally, companies would be subject to additional disclosure requirements regarding compensation consultants.

- *Executive compensation disclosures*. Companies would be required to disclose in their annual meeting proxy statements the relationship between executive compensation actually paid and a company's financial performance, taking into account any change in the value of the company's stock and dividends and other distributions. This disclosure could include a graphic representation of the required information. These proposed disclosures are similar to what is currently required under SEC rules, and thus it is unclear what, if any, additional disclosure would be needed. Companies would also be required to disclose (i) the median annual total compensation of all employees, other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of the median employee annual total compensation to that of the CEO.

- *Executive compensation clawbacks*. Listed companies would be required to develop, implement and disclose policies with respect to the clawback of incentive-based compensation paid to current or former executive officers following a restatement. These rules would apply to incentive-based compensation (including stock options) paid during the three-year period preceding the restatement. The recovery would be the amount in excess of what otherwise would have been paid to the officer. The proposed language in the Bill represents an expansion of the clawback provision contained in the Sarbanes-Oxley Act of 2002, which applies only to compensation received by the CEO and CFO during the twelve-month period following the first issuance of the restatement and only if the restatement resulted from misconduct (the clawback provision in the Bill would appear to apply to all restatements).

- *Hedging disclosure*. Companies would be required to disclose in their annual proxy statements whether any employee or director of the company is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted as compensation or otherwise held by the employee or director.

- *Bank holding company compensation restrictions*. Bank holding companies would be prohibited from providing executive officers, employees, directors or principal shareholders with compensation that is excessive or that could lead to material financial loss to the bank holding company.

With the exception of the say-on-pay requirements, the foregoing provisions require further action from the SEC, the stock exchanges or other regulators before they are operative. Many of the regulatory actions must be taken within a year of the enactment of legislation (except for the bank holding company compensation restrictions which must be effected within one and a half years after enactment); however, some of the provisions (such as the pay-for-performance, pay parity, hedging disclosure and clawback requirements) do not have explicit deadlines for action.

Corporate Governance Reforms

The Bill proposes the following reforms to strengthen corporate governance:

- *Majority voting for director elections.* Listed companies would be required to adopt majority voting in uncontested director elections (with the plurality standard remaining for contested elections). Companies would have to require the resignation of any director who receives less than a majority vote in an uncontested election, unless the board unanimously declines to accept the director's resignation (in which case the company would have to disclose, within 30 days of the vote, the specific reasons why the board chose not to accept such resignation and why the decision was in the best interests of the company and its shareholders). The stock exchanges would have one year to adopt these requirements.

- *Proxy access.* The SEC would be given the explicit authority (but would not be required) to promulgate rules requiring companies to include nominees submitted by shareholders in proxy solicitation materials and to follow certain procedures in relation to such solicitation. We expect that the SEC will take final action on proxy access soon after the legislation is enacted.

- *Chairman and CEO disclosures.* Companies would be required to disclose in their annual proxy statements the reasons why the company has chosen to combine or separate the board chair and CEO positions. Although the Bill specifies that the SEC must adopt rules implementing this requirement within 180 days after enactment of the Bill, it appears that these provisions have already been substantially implemented by the SEC's 2009 amendments to its proxy rules.

- *Broker discretionary voting*. The stock exchanges would be directed to prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC. This provision would take effect immediately upon enactment of the Bill.

Hedge Fund Adviser Regulation

The Bill would require advisers to hedge funds with more than $100 million of assets under management to register with the SEC as investment advisers, and would eliminate the "private adviser exemption" from the Investment Advisers Act of 1940 for certain advisers with fewer than 15 clients. Registered advisers would be subject to reporting and recordkeeping requirements and periodic examination by the SEC staff. Information provided by registered advisers could be shared with the Financial Stability Oversight Council (discussed below) for assessment of systemic risk. The Bill provides exemptions for advisers to "private equity funds" and "venture capital funds" (each to be defined by the SEC); however, private equity funds would be required to maintain records and provide the SEC with periodic reports, and the SEC would have the authority to mandate recordkeeping and disclosure requirements for venture capital funds. Certain advisers to family offices, foreign advisers and advisers to small business investment companies would also be exempt from registration.

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The Bill would raise the assets under management threshold for federal regulation of investment advisers from $25 million to $100 million. This would increase the number of advisers under state supervision by approximately 28% and allow the SEC to focus its resources on newly registered investment advisers.

In addition, the Bill would direct the Government Accountability Office ("GAO") to submit a report to Congress on the feasibility of creating a self-regulatory organization to oversee advisers to private funds.

Regulation D; Accredited Investor Standard

The Bill would disqualify certain offerings from the protections of Regulation D under the Securities Act of 1933, as amended, if such offerings are made by certain "bad actors," defined as persons who (a) have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or a false filing with the SEC or (b) are barred from association with regulated entities or from engaging in the business of securities, insurance, banking or in savings association or credit union activities for fraud, manipulation or deception. This section replaces an earlier requirement that if the SEC failed to review a private offering relying on Regulation D within 120 days, the offering would lose its covered securities status and would be subject to state review (which could have substantially undermined the value of the safe harbor).

In addition, the Bill would modify the net worth standard in the definition of "accredited investor" to provide that the value of a person's primary residence would be excluded from the $1 million net worth requirement. The SEC would be directed to periodically review and modify the definition of "accredited investor," as appropriate, and the GAO would be required to submit a report to Congress on the appropriate criteria for accredited investor status and eligibility to invest in private funds.

Securitization Retention Requirements

Federal banking agencies and the SEC would be required to jointly prescribe standards that would require companies that issue mortgage-backed securities or similar products (other than products backed by qualified residential mortgages) to retain a material economic interest (at least 5%) in the credit risk of any such issuance unless the underlying loans meet certain prescribed reduced credit risk standards, in which case regulators could impose a lower threshold. Additionally, the Bill would require enhanced reporting and disclosure by the issuer regarding the quality of the assets underlying the securities.

Regulation of Over-the-Counter Derivatives

The Bill introduces significant direct regulation of over-the-counter ("OTC") derivatives transactions. Among the most notable proposals affecting the OTC derivatives markets are:

- *Clearing and trading*. The Bill mandates central clearing of standardized OTC derivatives. Trades subject to mandatory clearing also would have to be executed on exchanges or registered "swap execution facilities." Non-standardized OTC derivatives would be exempt from the central clearing and exchange trading requirements but still would be subject to reporting and recordkeeping obligations.

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The Bill also includes a limited end-user exemption to central clearing and exchange trading requirements that would be available to certain non-financial firms.

- *Regulation of market participants.* Market participants in the OTC derivatives market that fall within the definitions of "swap dealer" or "major swap participant" would be subject to registration, capital, margin and operational requirements. Each swap dealer would be required to disclose certain information to its counterparties, including risks, fees and remuneration, and conflicts of interest associated with the trades. The Bill also raises the standard of care owed by swap dealers to their counterparties by imposing business conduct requirements on OTC derivatives trades.

- *Margin requirements*. For cleared OTC derivatives, initial and variation margin would have to be segregated from a swap dealer's or the clearing party's proprietary assets. For non-security based trades that are not cleared, a swap dealer would be obligated to segregate initial margin with an independent third-party custodian if so requested by the counterparty. Segregated assets could not be re-hypothecated.

- *Position limits.* The Bill authorizes the Commodity Futures Trading Commission and the SEC to establish aggregate position limits that restrict the number or size of positions in OTC derivatives any person can hold.

- *Swap dealer spin-off.* The Bill includes the "spin-off clause" first included in the more recent Senate Agricultural Committee draft. The provision prohibits the extension of any federal assistance, including access to the Federal Reserve discount window or FDIC deposit insurance, to swap dealers, major swap participants, or derivatives-related trading facilities or clearing organizations. One effect of this prohibition is that depository institutions would have to spin-off their derivatives trading activities into a separate entity (which may be an affiliate) in order to maintain eligibility for FDIC deposit insurance.

- *Fiduciary duties.* The Bill would impose a fiduciary duty on swap dealers that enter into OTC derivatives trades with a federal or state governmental entity or agency or a pension plan, endowment or retirement plan.

- *Market manipulation.* The Bill would create a private right of action against swap dealers for market manipulation in the futures and derivatives market.

- *Grandfathering of existing trades.* OTC derivatives trades entered into prior to the enactment of the Bill would not be subject to central clearing and trading requirements or to position limits. The Bill also provides that, unless specifically provided for in their bilateral trading agreements, counterparties may not treat the enactment or the requirements of the Bill as a termination event or similar event that would permit the early termination or modification of any grandfathered transaction.

The Bill contains more restrictive provisions relating to the OTC derivatives markets than the earlier bill proposed by the Senate Banking Committee in March and the bill that was adopted by the House of Representatives in December 2009. The final legislation following reconciliation, including many of the defined terms, position limits and margin requirements, will have to be clarified by detailed regulations to be issued by the CFTC and the SEC. These agencies will have 180 days from the date of the final enactment of legislation to jointly implement the provisions of the Bill.

Financial Stability Oversight Council and Office of Financial Research

The Bill seeks to mitigate the systemic risk of financial collapse through several legislative and regulatory initiatives, the most substantial of which would be the creation of a nine voting member Financial Stability Oversight Council (the "Council") chaired by the Treasury Secretary and composed of federal financial regulators, an independent insurance industry expert and, as a non-voting member, the director of the newly established Office of Financial Research described below. The Council would monitor the U.S. financial markets in order to identify systemic financial risks, promote market discipline and respond to emerging threats. The Council would be authorized to:

- identify systemically important domestic and foreign non-bank financial companies whose material financial distress would pose a risk to the financial stability of the United States and require (with a 2/3 vote of the Council) the regulation of such companies by the Federal Reserve;

- make recommendations to the Federal Reserve for more stringent rules for capital, liquidity, risk management and other requirements applicable to systemically important non-bank financial companies and bank holding companies with $50 billion or more in assets;

- approve (with a 2/3 vote of the Council) a decision by the Federal Reserve to require a systemically important non-bank financial company or a bank holding company with $50 billion or more in assets to limit or terminate certain activities or, in extreme cases, to divest certain of its holdings, if the company poses a grave threat to the financial stability of the United States; and

- identify systemically important clearing, payment and settlement systems to be regulated by the Federal Reserve.

The Office of Financial Research would be charged with collecting financial data and delivering to Congress annual assessments of systemic financial risk. Although the office would be located within the Treasury, its director would be appointed by the President, with the advice and consent of the Senate, to six-year terms. The office would have the authority to issue regulations supporting its own data collection, and would be required to issue regulations standardizing the scope and format of data collected by the agencies represented on the Council. The expense of the Office of Financial Research and the Council would be funded by assessments on systemically important non-bank financial companies and bank holding companies with $50 billion or more in assets.

Reorganization of Financial Regulators

In order to increase the accountability of individual federal regulators and eliminate the ability of financial institutions to "shop" for the least burdensome of overlapping regulatory regimes, the Bill would (i) eliminate the Office of Thrift Supervision (the "OTS"), which currently oversees savings and loan associations, credit unions and savings banks (collectively referred to as "thrifts") and (ii) transfer the responsibilities of the OTS to the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency. As a result of these changes:

- the Federal Reserve would gain supervisory authority over all thrift holding companies and their non-depository institution subsidiaries and rulemaking authority related to thrift holding companies and affiliate transactions and tying arrangements by thrifts; pursuant to a late amendment, the Federal Reserve would retain regulatory authority over all bank holding companies and state banks that are members of the Federal Reserve system;

- the FDIC would gain supervisory authority over all state thrifts and would continue to regulate insured state banks that are not members of the Federal Reserve system; and

- the Office of the Comptroller of the Currency would gain supervisory authority over all federal thrifts and rulemaking authority over all thrifts and would continue to regulate all national banks.

Systemic Regulation and Emergency Powers

The Bill would address systemic risk of financial collapse by:

- imposing new standards (including more stringent prudential standards, limits on credit exposure and disclosure requirements) for the activities and structure of systemically important non-bank financial companies and bank holding companies with $50 billion or more in assets;

- requiring systemically important non-bank financial companies and bank holding companies with $50 billion or more in assets to submit (i) plans for their rapid and orderly shutdown in the event of material financial distress or failure (so-called "living wills") and (ii) periodic reports on the nature of their credit exposure to other such companies and the nature of the credit exposure of other such companies to them;

- requiring systemically important non-bank financial companies, and bank holding companies with $50 billion or more in assets, to limit their aggregate credit exposures to any unaffiliated company to 25 percent of the capital stock and surplus such company;

- requiring publicly traded systemically important non-bank financial companies and publicly traded bank holding companies with $10 billion or more in assets to establish risk committees;

- requiring non-bank financial companies under the Federal Reserve's supervision or bank holding companies with $50 billion or more in assets to receive the approval of the Federal Reserve for acquisitions of direct or indirect control of any voting shares of a company engaged in non-banking activities and having total assets of $10 billion or more;

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- prohibiting financial companies that, as of January 1, 2010, were bank holding companies with $50 billion or more in assets and received TARP funds from avoiding enhanced Federal Reserve supervision by dropping their banks (the so-called "Hotel-California" rule);

- providing for an orderly liquidation of a failed bank, the cost of which would be funded through a subsequent levy on large financial companies and not through taxpayer money;

- creating an Office of Financial Research within the Treasury Department to support the Council's work by collecting financial data and conducting economic analysis;

- updating the Federal Reserve's "lender of last resort" authority to permit emergency lending programs or facilities for the purpose of providing liquidity to the financial system for institutions with sufficient collateral and not to aid a failing financial company;

- permitting the FDIC to establish a broad program to guarantee the debt of solvent banks and thrifts and their holding companies upon a determination by the Federal Reserve and the Council that there is a "liquidity event" and that failure to take action would have serious adverse effects on financial stability or economic conditions; and

- prohibiting banks from including trust-preferred securities as Tier 1 capital.

The Senate eliminated a provision contained in the prior Banking Committee bill that would have created a $50 billion bailout fund for rescuing or liquidating large failing financial institutions.

Changes to Federal Reserve Oversight

In addition to the regulatory authority described above, the Bill would require Federal Reserve to supervise systemically important non-bank financial companies. With respect to foreign non-bank financial companies, the Federal Reserve's oversight would extend only to their U.S. activities and their U.S. subsidiaries. The Bill also proposes the following changes to the Federal Reserve:

- the Board of Governors would be responsible for identifying, measuring, monitoring and mitigating risks to financial stability;

- a new Vice Chairman for Supervision would develop policy recommendations regarding supervision and regulation;

- companies (and their subsidiaries and affiliates) under Federal Reserve Board supervision would be prohibited from voting for directors of the Federal Reserve banks and from serving as directors of such banks;

- the President of the New York Federal Reserve Bank would be appointed by the President of the United States with the advice and consent of the Senate; and

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- the Federal Reserve would have the authority to limit interchange fees (the fees that merchants are charged for accepting debit cards) to a "reasonable and proportional level."

The Volcker Rule: Restrictions on Bank Investments and Proprietary Trading

The Bill incorporates the so-called Volcker rule (initially proposed by former Federal Reserve Chairman Paul Volcker), which would generally prohibit an insured depository institution, its direct or indirect parent, a bank holding company, or a subsidiary thereof from engaging in proprietary trading and investing in and sponsoring hedge funds and private equity funds. We note that the Bill does not make the Volcker rule self-executing; rather, it would require banking regulators to implement the rule after a six-month period of study by the Council (regulators would have nine months thereafter to adopt final rules). Financial institutions covered by the rule would have at least two years from the date of any final regulations to cease or divest their relevant businesses to comply with the rule. One concern that has been voiced is that the Volcker rule would create a competitive advantage for foreign financial institutions that are not subject to the rule provided that their investments or activities are conducted solely outside the United States.

Resolution Authority

The Bill would create an orderly liquidation mechanism for financial institutions modeled largely on the resolution authority for insured depository institutions in the Federal Deposit Insurance Act whereby, the FDIC would be granted resolution authority in extreme cases to break-up large, failing U.S. financial companies and act as the receiver of the failed companies' assets. The appointment of the FDIC as receiver would be conditioned on the Treasury Secretary, upon recommendation by a 2/3 vote of each of the board of governors of the Federal Reserve and the board of directors of the FDIC (or the SEC, in the case of a broker-dealer), (i) making a determination that the company is in default or danger of default and that no viable private sector alternative is available to prevent serious adverse effects on U.S. financial stability and (ii) obtaining either the consent of the company's board of directors or an order from the U.S. District Court for the District of Columbia. The FDIC would be required to obtain Congressional approval for loan guarantees to failing banks. Additionally, the Bill clarifies that the new FDIC resolution authority would apply to broker-dealers that are members of the Securities Investor Protection Corporation ("SIPC") and attempts to create a framework for providing the same protection for customer property as would be provided in normal SIPC proceedings.

Credit Rating Agency Regulation

The Bill would create an Office of Credit Ratings within the SEC to oversee and examine credit rating agencies and promulgate new rules for internal controls, independence, transparency and penalties for poor performance. Nationally recognized credit rating agencies would be required to establish, maintain, enforce and document an effective internal control structure and submit an annual internal controls report to the SEC. Additionally, nationally recognized credit agencies would have to publicly disclose (i) when a material change is made to, or a material error is identified in, a ratings procedure or methodology and (ii) their methodologies, use of third parties' due diligence and ratings track record. The Bill would also authorize the SEC to penalize credit rating agencies for failing to consistently produce accurate ratings and would establish a private

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right of action against rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts by obtaining analysis from an independent source.

The SEC would also be required to establish a new self-regulatory organization for credit rating agencies called the Credit Rating Agency Board. The Board would be charged with designating certain credit rating agencies as qualified to rate certain structured finance products and assigning the task of providing initial credit ratings for structured finance products to particular credit rating agencies. The assignment process is designed to address problems with the traditional issuer-paid approach to securing credit ratings. While issuers of structured finance products would be required to receive initial ratings through the Credit Rating Agency Board, they would be permitted to procure additional ratings without Board control.

In an effort to curb reliance on credit ratings, the Bill would also require that references to credit ratings be removed from certain statutes and that the SEC conduct studies on, among other things, the standardization of credit ratings.

Consumer Financial Protection Bureau

The Bill would create a Consumer Financial Protection Bureau (the "CFPB") within the Federal Reserve with a director appointed by the President of the United States. The CFPB would be authorized to regulate the offering and provision of consumer financial products and services. The CFPB would function as a consumer "watchdog." It would be authorized to autonomously write consumer protection rules under the federal consumer financial laws. The CFPB would also be empowered to examine and enforce regulations for banks and credit unions with assets of $10 billion dollars or more and all mortgage-related businesses and non-bank financial companies (*e.g.*, payday lenders, debt collectors and consumer reporting agencies), with carve-outs for certain regulated entities, such as broker-dealers and insurance companies. By creating the CFPB, the Bill would consolidate consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, the OTS (which will be eliminated by the Bill), the FDIC, the Federal Reserve, the National Credit Union Administration and the Federal Trade Commission. The Obama Administration had originally proposed a stand-alone consumer protection agency. This concept is featured in the House version of the bill and the present debate centers around whether housing the CFPB inside the Federal Reserve would give the CFPB the necessary autonomy to serve as an effective consumer watchdog. Furthermore, there is considerable debate about the scope of the CFPB's powers over non-bank lenders such as auto-dealers, which unsuccessfully lobbied the Senate for exclusion from CFPB oversight (the House bill includes such an exemption).

Improving Investor Protections at the SEC

The Bill would require the SEC to submit an annual assessment of its internal supervisory controls to Congress and would create a program within the SEC to encourage employees to provide confidential suggestions on improving the SEC and report securities violations by offering internal whistleblowers a financial reward of between 10% and 30% of any funds recovered. The Bill would establish an Investor Protection Fund designed to grow to up to $200 million from monies collected from violators of securities laws. Additionally, the Bill would create an Office of Investor Advocate who would advocate for investor protection issues to the SEC and a committee to advise the SEC on its regulatory priorities.

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Office of National Insurance

The Bill would create an Office of National Insurance within the Department of the Treasury to monitor all aspects of the insurance industry, coordinate international insurance matters and recommend insurers that should be treated as systemically important to the Council. The new Office of National Insurance would have principally information-gathering powers and would not have general supervisory or regulatory authority over the business of insurance.

Additional Reforms

In addition to the foregoing, the Bill proposes the following noteworthy reforms:

- *Broker-dealer regulation*. The Bill would direct the SEC to continue to study the relative standards of care that apply to broker-dealer and investment advisers, respectively, but would not go so far as to impose a fiduciary duty on broker-dealers. The Bill also addresses securities lending, portfolio managing and point of sale disclosure.

- *Municipal securities advisers*. Municipal advisers would be subject to SEC registration and new antifraud rules.

- *SEC self-funding*. The SEC budget would no longer be subject to the Congressional appropriations process.

- *State consumer protection claims*. The Bill would give states more power to pursue consumer protection cases against national banks and thrifts.

- *Mortgage broker and loan underwriter regulation*. The Bill would prohibit mortgage brokers and originators from being compensated based on loan yields and require lenders to verify a borrower's ability to repay based on the maximum interest rate allowed on the first five years of the loan. The Bill also prohibits loan originators from financing closing costs if they receive compensation from a third party as well as the borrower.

- *Whistleblower Protection*. The Bill would add a new Section 21F to the Securities Exchange Act of 1934, as amended, encouraging whistleblowers to provide original, independently derived information leading to successful enforcement action of the securities laws. Modeled after the successful IRS Whistleblower Program enacted in 2006, the new Section 21F would entitle whistleblowers to a percentage of any monetary penalty exceeding $1 million. The Bill also creates a private right of action for whistleblowers against employers that retaliate.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to David S. Huntington ((212) 373-3124), Mark S. Bergman (44-20-7367-1601), Robert M. Hirsh ((212) 373-3108) or Manuel S. Frey ((212) 373-3127).