



# BANKING LEGISLATION & POLICY

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## HIGHLIGHTS

This issue contains a detailed description of the ratification of the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#), including:

- [Creation of the Financial Stability Oversight Council](#)
- [Orderly Liquidation Authority for Regulators](#)
- [Transfer of Powers Among Regulators and Deposit Insurance Reform](#)
- [Enhanced Regulation for Banks and Holding Companies](#)
- [Supervision for Derivative Trading and Market Utilities](#)
- [Investor and Consumer Protections](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the second quarter of 2010](#).

## DODD-FRANK FINANCIAL REFORM ACT SIGNED INTO LAW

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ([H.R.4173](#)). The law features provisions to strengthen consumer and investor protection, mitigate systemic risk, improve corporate governance, enhance bank regulation, and outline new responsibilities of the Federal Reserve System and other federal regulators.

The final version is the result of a three-week conference to reconcile the Restoring Financial Stability Act of 2010 ([S. 3217](#)), approved

by the Senate in May 2010,<sup>1</sup> and the Wall Street Reform and Consumer Protection Act of 2009 ([H.R. 4173](#)), approved by the House in December 2009.<sup>2</sup> The conference text was largely based on the more recent Senate bill, but legislators merged in House provisions and a host of new amendments to create the most comprehensive and influential financial reform package since the Great Depression. The legislation leaves several hundred rules and studies to be completed by regulators over the next two years, further extending the impact of the law and the transformation of the financial industry's

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<sup>1</sup> For more information on the Restoring Financial Stability Act, see [Banking Legislation and Policy, Volume 29, Number 1](#).

<sup>2</sup> For more information on the Wall Street Reform and Consumer Protection Act, see [Banking Legislation and Policy, Volume 28, Number 4](#).

regulatory landscape. House Financial Services Chairman Barney Frank (D-Mass.) is expected to clarify certain provisions in a technical corrections bill later in the year to help ease the implementation of the overhaul.

The following analysis highlights the most important provisions in the law, as well as relevant changes from previous versions.

### **Financial Stability Act**

The Financial Stability Act establishes the Financial Stability Oversight Council, which will have the responsibility to promote market discipline, coordinate with other regulators to identify and respond to threats to financial stability, and resolve gaps in regulation. The council will consist of representatives with voting rights from nine federal financial regulators and an independent insurance expert. The legislation also establishes a new Office of Financial Research within the Department of the Treasury, which will support the council's efforts by coordinating the collection of data from bank holding companies (BHCs) and nonbank financial companies, conducting applied analysis and long-term research projects, and developing tools for risk measurement and monitoring.

The council will have the authority to place a systemically important financial institution under the supervision of the Federal Reserve. Nonbank institutions may be required to establish an intermediate holding company to be regulated by the Federal Reserve and may be required to divest holdings. The Federal Reserve, in consultation with the council, will tighten prudential standards for the large, interconnected BHCs and financial institutions it supervises. These firms will undergo annual stress tests and will be subject to credit exposure limits. Conferees added a House-passed provision that will require such institutions to maintain a leverage ratio of 15 to 1.

Conferees agreed to include an amendment that requires size- and risk-based capital requirements for BHCs and certain nonbank financial institutions to be at least as strong as regulations that apply to subsidiary banks. The amendment also exempts BHCs with less than \$15 billion in assets from a general rule that excludes trust-preferred securities from tier 1 capital. Larger BHCs will have five years to phase out their use of trust-preferred securities as part of tier 1 capital.

### **Orderly Liquidation Authority**

Title II establishes an Orderly Liquidation Authority to effectively dissolve troubled financial firms that are not already covered by Federal Deposit Insurance Corporation (FDIC) receivership and for which bankruptcy proceedings would adversely affect financial stability. The FDIC will broadly model the framework of the new authority after the U.S. Bankruptcy Code, as well as the procedures it uses for receivership of federally insured banks (defined in the [Federal Deposit Insurance Act](#)). The Treasury, the FDIC, and the Federal Reserve will work together to identify the firms and present their case for orderly liquidation for judicial review. Conferees rejected the inclusion of Fannie Mae, Freddie Mac, and other governmental entities in the definition of financial companies eligible for the liquidation mechanism.

In an effort to protect taxpayers from bearing the costs of a failing financial institution, the legislation mandates the inclusion of a repayment plan for each liquidation proposal that does not rely on any public funds and directs losses to creditors, shareholders, and all parties responsible for the institution's condition. The legislation allows the FDIC to help cover the costs of liquidation by issuing debt securities to the Treasury and by collecting from creditors that benefitted from the use of the Orderly Liquidation Authority instead of normal bankruptcy

proceedings. The FDIC will also have the ability to recoup losses from the sale of company assets and from a claw-back provision that reclaims payments to creditors in excess of liquidation value. As a last resort, the FDIC may assess a risk-based fee on large financial companies. The legislation creates an Orderly Liquidation Fund (OLF) to offset the costs of the new Liquidation Authority, but conferees eliminated a plan from the House version to pre-fill the fund with \$150 billion from risk-based assessments on large financial institutions.

The act prohibits the FDIC from directly bailing out financial institutions. It also bars the agency from taking equity interest in or becoming a shareholder of any financial company.

### **Transfer of Powers and Deposit Insurance Reforms**

Title III of the act follows the previously passed Senate and House bills' plan to abolish the Office of Thrift Supervision (OTS) and transfer its responsibilities to the Office of the Comptroller of the Currency (OCC), the FDIC, and the Federal Reserve. It keeps provisions from the House bill to preserve the thrift charter and to create the post of deputy comptroller to supervise thrifts for the OCC.

The Federal Reserve will supervise and regulate thrift holding companies and bank holding companies, along with applicable nonbank subsidiaries. The OCC will become the primary regulator for national banks and thrifts of all sizes. The FDIC will regulate all state-chartered thrifts and banks that are not members of the Federal Reserve System. These regulators will have the authority to assess fees on the financial entities they supervise to offset the cost of operations. In a last-minute change, conferees removed a risk-based fee for larger financial institutions to fund the act (see other plans for funding in the Pay It Back Act, Title XIII).

Title III also includes major changes to the [Federal Deposit Insurance Act](#). Conferees agreed to permanently increase the limit on federal deposit insurance for banks, thrifts, and credit unions to \$250,000, and made the change retroactive to January 1, 2008. The provision, which was not part of the original House or Senate bills, will benefit depositors of banks that failed before Congress temporarily raised the limit from \$100,000 to \$250,000 in October 2008. Additionally, the act eliminates the reserve ratio<sup>3</sup> cap for the FDIC's Deposit Insurance Fund (DIF) and increases the minimum reserve ratio from 1.15 percent to 1.35 percent of estimated insured deposits. Insured depository institutions with assets over \$10 billion will be charged higher premiums to rebuild the DIF.<sup>4</sup> Conferees adopted House language that replaced total deposits with average total assets as the assessment base for insured depository institutions, increasing the share of liability for larger banks with lower levels of domestic deposits.

In addition, conferees agreed to extend for two years most accounts under the Transaction Account Guaranty (TAG), a program started as part of the [Temporary Liquidity Guarantee Program](#) (TLGP) in 2008 to assist small businesses with operating cash balances in checking accounts. A House-approved provision to make it permanent was rejected. Both commercial banks and credit unions will have access to the unlimited federal guarantee for non-interest-bearing transaction accounts.

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<sup>3</sup> The reserve ratio is calculated as the amount of funds in the DIF over the amount of estimated insured funds in the nation's banks.

<sup>4</sup> In May 2009, the FDIC was allowed eight years to restore the reserve ratio of its DIF to the minimum 1.15 percent. In an effort to buffer the DIF against bank failures that would drain the account, the FDIC charged insured banks a 5-basis-point special assessment, totaling nearly \$5.6 billion; as of March 2010, the reserve ratio was still negative.

## Private Fund Investment Advisers Registration Act

Title IV of the act, the Private Fund Investment Advisers Registration Act, follows the Senate-passed version closely. The provision requires hedge fund and private equity advisers with more than \$150 million in assets to register with the Securities and Exchange Commission (SEC). Regulators will collect data — such as type and amount of assets held, use of leverage, counterparty credit risk exposure, trading and investment positions, and side arrangements — from registrants to evaluate systemic risk. The act extends the registration requirement to the class of “private advisers,” which were previously exempt in the [Investment Advisers Act of 1940, Section 203\(b\)](#). The act would not apply to family offices or advisers that counsel only venture capital funds.

## Federal Insurance Office Act

Title V of the act creates the Office of National Insurance within the Department of the Treasury; this office will gather information on the insurance industry and monitor its systemic risks. It will have the power to suggest that an insurer be regulated by the Federal Reserve as a nonbank financial company, and the director will serve as an adviser to the Financial Stability Oversight Council. It will not have rule-writing authority but will help coordinate domestic and international insurance policies. In a compromise between the House and Senate versions, the Office of National Insurance will be required to notify the Committees on Financial Services and Ways and Means of the House and the Committees on Banking, Housing, and Urban Affairs and Finance of the Senate if it intends to preempt state law.

Title V also includes regulations to streamline surplus lines of insurance and reinsurance on the state level.

## Holding Company and Depository Institution Regulatory Improvements

Title VI of the act, the Bank and Savings Association Holding Company and Depository Institutions Regulatory Improvements Act, enhances supervision and places new restrictions on financial institutions.

The act weakens language from a Senate amendment known as the Protect Our Recovery Through Oversight of Proprietary (PROP) Trading Act.<sup>5</sup> The new provision directs regulators to prohibit insured depository institutions and their parent companies from proprietary trading and certain relationships with hedge funds and private equity funds. The act explicitly bans trades and relationships that involve a conflict of interest, expose the firm to too much risk, or pose a threat to financial stability, and provides a timeline for the divestiture of prohibited positions or relationships. However, the act allows a number of exemptions: institutions can trade on behalf of clients, to mitigate risk, and to enhance the safety of the institution or the financial system. Institutions can also continue to engage in transactions of government or government agency securities, small business investment companies, public welfare investments, and certain securities related to insurance companies. Conferees added a provision to allow *de minimis* investments of up to 3 percent of a bank’s tier 1 capital in hedge and private equity funds if the investment is less than 3 percent of the fund’s capital. Nonbank institutions are not subject to the same restrictions, but firms deemed systemically important by the Oversight Council that engage in proprietary trading or certain

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<sup>5</sup> The PROP Trading Act is similar to the President’s proposal, known as the [Volcker Rule](#). For more information on the PROP Trading Act of 2010, see [Banking Legislation and Policy, Volume 29, Number 1](#).

relationships with private funds will be required to abide by stricter capital regulations and other constraints determined by the Federal Reserve.

The act will strengthen supervision by requiring the Federal Reserve to examine nonbank subsidiaries with the same discretion as an examination of the parent company. It will also minimize regulatory arbitrage by requiring regulators to jointly approve a firm's charter conversion. Additionally, grandfathered unitary savings and loan holding companies could be required to establish intermediate holding companies to ensure proper regulation of their financial activities. The Federal Reserve will be charged with designing countercyclical capital requirements, which will require firms to build their reserves while the economy is growing and lower required reserves during a downturn.

The act includes a study and moratorium on new applications and changes in control for credit card banks, industrial loan companies, and other types of limited-purpose banks.<sup>6</sup> It bars any banking entity that serves directly or indirectly as an investment manager, adviser, organizer, or sponsor to a hedge fund or private equity fund from engaging in certain transactions with the fund, such as a loan or the purchase of assets from the fund. The act also tightens the restrictions described in Section 23A of the [Federal Reserve Act](#) by prohibiting derivative transactions with affiliates. The affected banking entities will be treated as a member bank and the related fund will be treated as an affiliate; transactions between the banking entities and related funds must be comparable to transactions by unaffiliated market

participants, as described under Section 23B of the [Federal Reserve Act](#).

In addition, the act includes concentration limits on banks' positions, elimination of the elective investment BHC framework, constraints on the size of allowable mergers, the addition of credit exposure from derivative transactions to banks' lending limits, and the repeal of the prohibition on payment of interest on demand deposits. Conferees approved a provision to prevent firms that underwrite asset-backed securities from also taking trade positions that are a conflict of interest.

### **Wall Street Transparency and Accountability Act**

Title VII of the act, the Wall Street Transparency and Accountability Act, gives more oversight of swaps to the Commodities Futures Trading Commission (CFTC) and the SEC. The act will require firms to trade most swaps through clearinghouses and on regulated public exchanges, as well as provide information on their activity in what had been an unregulated market. By imposing direct regulation on the products, instead of broader supervision at the entity level, the act essentially reverses the deregulation of over-the-counter derivatives from the [Commodity Futures Modernization Act of 2000](#). It also preserves the historical responsibilities of the CFTC (responsible for commodities-based swaps) and the SEC (responsible for securities-based swaps). Firms and traders with high trade volume and customized swaps will be subject to stricter regulatory standards, including position limits, higher capital levels, and additional reporting requirements. Nonfinancial companies that use derivatives to hedge legitimate commercial risks, known as "end users," will be exempt from the requirements.

Conferees rejected a Senate amendment to force commercial banks to spin off all swaps activities but included provisions that will require banks to shift a subset of derivatives to a separate

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<sup>6</sup> A limited-purpose bank is defined as a bank that offers only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market and for which a designation as a limited-purpose bank is in effect.

entity. Under the new provision, banks will be able to continue to hedge risk by trading interest rate or foreign exchange swaps.

The act establishes new adviser conduct and registration rules for swap dealers and major swap participants and expressly prohibits federal assistance to certain swap entities.

### **Payment, Clearing, and Settlement Supervision Act**

Title VIII allows the Federal Reserve to issue rules that will regulate payment, clearing, and settlement activities among financial institutions determined systemically important by the Financial Stability Oversight Council. The SEC and CFTC will have regulatory authority over the market utilities in the sectors that they oversee (securities and commodities, respectively). A market utility is defined as an entity that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions; the Chicago Mercantile Exchange, for example, would continue to be regulated by the CFTC, unless it was ever deemed systemically important by the Oversight Council. The Federal Reserve will serve as a back-up examiner and enforcement authority for noncompliant financial institutions and as an emergency authority over a designated financial market utility if it poses a risk to financial stability.

### **Investor Protections and Improvements to the Regulation of Securities**

Title IX of the act contains numerous provisions to simultaneously vet and enhance the SEC, as well as grant it more authority to protect investors, regulate securities, and improve corporate governance.

The act mandates studies of the SEC's management and internal supervisory controls. It

also creates new advocates for investors in the roles of an Investment Advisory Committee and the Office of Investor Advocate in the SEC.

In addition, the SEC will examine nationally recognized statistical ratings organizations (NRSROs) annually, require full disclosure of rating methodologies, increase liability for biased ratings, and prohibit certain activities with conflicts of interest. Conferees found a middle ground in allowing investors to sue NRSROs for "knowingly or recklessly" issuing a rating. A House proposal was tougher on the NRSROs, while precedent had been easier on the agencies. A new Office of Credit Ratings at the SEC will have the power to fine or deregister noncompliant NRSROs.

The act includes many provisions that direct the SEC to improve the corporate governance of the entities it supervises. For example, the SEC could grant shareholders proxy access to nominate directors or give them the opportunity to cast non-binding votes on pay for executives of companies they own. The SEC will also have the authority to offer rewards to whistle-blowers who report securities violations. Conferees agreed to give the SEC authority to write laws concerning fiduciary duties for brokers who give investment advice after the SEC completes a six-month study of the industry; a House proposal to implement the duties without a prior study was rejected. However, the act directly increases oversight and requires fiduciary duty of municipal advisers.

The legislation also requires issuers and originators of asset-backed debt to retain some of the credit risk they package or sell. A compromise reached in conference deliberations requires such parties to hold a 5 percent stake in their products. Mortgage lenders that offer lower-risk loans and avoid nonstandard features, such as negative amortization, interest-only payments, and balloon payments, will be exempt from the risk retention requirement as well as loans guaranteed by the

Federal Housing Administration, the Department of Agriculture, and the Department of Veterans Affairs. Conferees also included a provision that allows regulators to consider exemptions for commercial mortgage-backed securities.

### **Consumer Financial Protection Act**

Title X, the Consumer Financial Protection Act, establishes an independent Bureau of Consumer Financial Protection that will regulate all providers — bank and nonbank — of consumer financial products and services, as well as offer public education and assistance programs. The bureau will have the authority to write and enforce rules to preserve access to fair, transparent, and competitive products and services in the consumer finance industry.

The bureau will be funded by and placed within the Federal Reserve, which will be prohibited from interfering with the bureau; the House language to create a stand-alone agency was rejected. The bureau's director will be appointed by the President and confirmed by the Senate.

All consumer protection powers from seven other federal agencies will be transferred to the new bureau. Its purview will extend to credit, savings, payment, and other consumer financial products and services; it will not cover investment products, insurance products, or the auto industry. It will have the authority to supervise, in coordination with other prudential regulators, providers such as mortgage-related firms, credit card and student lenders, and banks and credit unions with over \$10 billion in assets; other regulators will retain oversight of the activities of smaller banks. Automobile companies, other sellers of nonfinancial goods, real estate brokers, accountants, and other related financial service providers are exempt from bureau regulation. The bureau will not have the authority to set usury limits.

State laws and enforcement powers, unless inconsistent with federal laws, will be preserved. Conferees sided with Senate language to clarify state law preemption standards for national banks and subsidiaries. Federal regulation can preempt state consumer financial law on a case-by-case basis if the state law discriminates against national banks and if it violates the standard established by the 1996 U.S. Supreme Court case decision, [\*Barnett Bank of Marion County, N.A., v. Nelson, Florida Insurance Commissioner, et al.\*, 517 U.S. 25](#).<sup>7</sup> However, the act does not allow federal law to preempt state law for subsidiaries or affiliates of national banks, which contradicts what the Supreme Court decided in [\*Watters, Commissioner, Michigan Office of Insurance and Financial Services v. Wachovia Bank, N.A., et al\*](#)<sup>8</sup> in 2007. The act preserves the ability of state attorneys general and other state authorities to enforce laws against national banks.

In addition, the bureau will act as a consumer advocate and educator by researching the industry and responding to complaints about financial services and providers. It will also provide services related to increasing financial literacy.

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<sup>7</sup> In the Barnett Bank case, a federal law allowing national banks to sell insurance in small towns conflicted with a state law that prohibited the practice in most cases. Past cases had established a precedent that prevents broad federal law from preemption of a state law prohibiting the sale of insurance by national banks, unless the federal statute expressly relates to the business of insurance. In the Barnett Bank case, the Supreme Court decided that the precedent did not apply and that “under ordinary pre-emption principles, the federal statute pre-empts the state statute”; it allowed Barnett Bank to continue its insurance operations in small towns.

<sup>8</sup> In the Wachovia Bank case, the Supreme Court decided that the mortgage business of Wachovia and any of its subsidiaries is under the federal supervision of the OCC; therefore, Wachovia Bank and its subsidiaries are not required to abide by individual states' reporting or licensing regimes.

Besides creating the consumer finance watchdog, Title X includes regulation on fees involved with payment card transactions. The act grants the Federal Reserve the authority to prescribe regulations regarding payment card network fees and interchange from electronic debit transactions to ensure that the fees are “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” Issuers with less than \$10 billion in assets will be exempt. Currently, interchange fees are set by credit card networks, such as Visa and MasterCard. The act allows merchants to set minimum charges (up to \$10) for the use of payment cards or to offer discounts for the use of alternative forms of payment but prohibits merchants from discriminating between issuers.

### **Federal Reserve System Provisions**

Title XI of the act identifies changes to governance and transparency at the Federal Reserve Board and throughout the Federal Reserve System. The legislation commissions the Government Accountability Office (GAO) to conduct a one-time audit of emergency loans and other actions during the financial crisis (since December 1, 2007) within a year of enactment. Conferees rejected a tougher House amendment to allow audits of monetary policy decisions, information that is still protected under the Federal Banking Agency Audit Act (enacted in 1978 as [Public Law 95-320](#)).

The act also eliminates the voting rights of commercial bank representatives in selecting presidents of regional Federal Reserve Banks. These leaders will be selected by directors that are representatives of the public, known as class B and C directors. Conferees rejected Senate language to make the president of the Federal Reserve Bank of New York a political appointee.

In addition, the act creates the position of vice chairman of supervision, which will be chosen by the President from the existing members of the Board of Governors of the Federal Reserve.

Title XI also alters the ways in which the Federal Reserve and the FDIC can respond to a liquidity crisis. The act mandates changes to the emergency lending policies described in Section 13(3) of the [Federal Reserve Act](#) and eliminates the Federal Reserve’s ability to lend to individual firms and insolvent entities. The Federal Reserve will retain the power to create broad programs and facilities to preserve liquidity but will need to get approval from the secretary of the Treasury first. It must also provide justification and details of the transactions to Congress. The act subjects the Federal Reserve to ongoing audits of future special credit facilities, discount window lending, and open market operations but allows a two-year lag before releasing identifying information.

The act also mandates that the FDIC and the secretary of the Treasury collaborate on new policies and procedures governing debt guarantee programs and that together they set the terms and conditions of future programs. If the Federal Reserve and the FDIC determine that emergency action is necessary to stabilize the economy (by two-thirds majority of each board), the FDIC will create programs to guarantee debt of solvent insured banks according to the new policies. Congress must approve the pre-established limit to the FDIC guarantees. The act includes a “fast track” plan for expedited congressional action in time-sensitive cases. The FDIC will assess fees on all participants of a debt guarantee program to offset its losses and costs, although it can borrow from the Treasury if necessary.

### **Improving Access to Mainstream Financial Institutions**

Title XII, the Improving Access to Mainstream Financial Institutions Act, authorizes the secretary of the Treasury to establish grants and cooperative agreements for financial products and services that are appropriate and accessible for underserved populations, including low-cost alternatives to payday loans. It allows the secretary of the Treasury to implement programs to enhance access to mainstream depository institutions and to establish loan-loss reserve funds.

### **Pay It Back Act**

Title XIII reduces Troubled Asset Relief Program (TARP) authorization from \$700 billion to \$475 billion and prohibits spending for new initiatives in the program. The savings from TARP and the increase in the DIF assessment from Title III will help offset the costs of the financial system overhaul. A \$19 billion Financial Crisis Assessment Fund that was initially approved by the Conference Committee, but removed before the bill was presented to the House, called for the Financial Stability Oversight Council to impose a risk-based annual fee on financial companies with more than \$50 billion in consolidated assets and financial companies that manage hedge funds with over \$10 billion in managed assets.

The act also mandates that idle American Recovery and Reinvestment Act (ARRA) funds and proceeds from the sale of Fannie Mae, Freddie Mac, and Federal Home Loan Bank obligations purchased during the financial crisis go toward deficit reduction.

### **Mortgage Reform and Anti-Predatory Lending Act**

Title XIV, the Mortgage Reform and Anti-Predatory Lending Act, enhances regulation of

residential and high-cost mortgages, including mortgage origination and servicing. It aims to protect consumers from unfair and deceptive practices while encouraging appropriate mortgage products.

The act directs the Federal Reserve to prescribe regulations barring steering incentives and offering unreasonable or deceptive mortgages to unqualified consumers. Residential mortgage originators will be required to verify and document that consumers can reasonably afford a mortgage, using a payment schedule that fully amortizes the loan over the term. They will be prohibited from charging prepayment penalties on most loans and from taking compensation that varies based on the terms of the loan, except the amount of the principal. Conferees agreed to include House language that exempts loans made or guaranteed by the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture, and the Rural Housing Service.

The Expand and Preserve Home Ownership Through Counseling Act in Title XIV creates the Office of Housing Counseling within the Department of Housing and Urban Development. The new office will target traditionally underserved populations and address the entire process of homeownership, including the decision to purchase a home, issues arising during the period of ownership, and the sale or disposition of the home.

The act also places extra restrictions on the use of both high-cost and high-risk mortgages and sets new home appraisal standards. Although the act does not offer reforms for government-sponsored entities Fannie Mae and Freddie Mac, it acknowledges their problems and calls for future reform.

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## **Federal Legislation**

### ***Proposed Legislation***

#### *Small Business Jobs and Credit Act of 2010*

On June 17, the House of Representatives passed the Small Business Jobs and Credit Act of 2010 ([H.R.5297](#)). The bill was introduced by House Financial Services Committee Chairman Barney Frank (D-Mass.) on May 13 and supplemented with the Small Business Jobs Tax Relief Act of 2010 ([H.R.5486](#)), which the House passed on June 15. The new legislation seeks to increase the availability of credit for small businesses and provide tax incentives for small business job creation. It would authorize the secretary of the Treasury to establish a \$30 billion Small Business Lending Fund that includes repayment incentives for small banks and bank holding companies to increase lending to small businesses. For example, a bank that increases lending to small businesses would pay a lower dividend or interest rate on the government funds it receives. In addition, the legislation would increase the tax deductions for new businesses from \$5,000 to \$20,000 and raise the capital gains deduction on certain small business stock from 50 to 100 percent. The Small Business Jobs and Credit Act was referred to the Senate Committee on Finance.

#### *FHA Reform Act of 2010*

On June 10, the House of Representatives passed the FHA Reform Act of 2010 ([H.R. 5072](#)). The bill, which was introduced April 20, would attempt to replenish the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund to its mandated level of 2 percent of insured assets. This would be accomplished by increasing annual mortgage insurance premiums and restructuring the fund's administration and oversight. The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

## **Federal Regulation**

### ***Securities and Exchange Commission***

#### *New Rule to Prohibit "Pay to Play" Practices by Investment Advisers*

On July 1, the SEC adopted a new rule and amendments ([SEC Release](#)) under the [Investment Advisers Act of 1940](#) to curtail "pay to play" practices by any investment adviser registered with the SEC or unregistered under section 203(b)(3) of the Advisers Act. The new rule, 206(4)-5, bars advisers from receiving compensation for providing advisory services for a government entity within two years of a contribution to certain politicians. Advisers are also prohibited from paying certain third parties or soliciting contributions from others in an effort to seek advisory business from political parties or government entities. Other rule amendments require registered advisers to maintain records of the political contributions made by the adviser or other influential employees.

#### *Board of Governors of the Federal Reserve*

##### *Final Amendment to Regulation Z to Implement the Credit CARD Act*

On June 15, the Board of Governors of the Federal Reserve issued [a final rule](#) amending Regulation Z to limit penalties that can be charged to credit card users. The rule caps late payment penalties at \$25, unless the customer is a repeat offender. The penalty fee for a violation cannot exceed the dollar amount associated with the violation (e.g., the issuer cannot charge \$25 if the customer is late making a payment for \$20). The rule also bans inactivity fees and prevents issuers from charging multiple fees for a single violation. The rule was required by the Credit Card Accountability and Disclosure (CARD) Act of 2009 ([Public Law No. 111-24](#)) and

becomes effective on August 22, 2010. For information on other rules issued in compliance with the Credit CARD Act, see [Banking Legislation and Policy, Volume 29, Number 1](#).

### ***Federal Deposit Insurance Corporation***

#### *Contingent Resolution Plans Proposed for Subsidiaries of Large, Complex Institutions*

On May 11, the Federal Deposit Insurance Corporation (FDIC) proposed rules that would increase reporting requirements for insured depository institutions that are subsidiaries of large and complex financial parent companies ([75, Federal Register, pp.27464-471](#)). The FDIC would require institutions with over \$10 billion in total assets that are owned by parent companies with more than \$100 billion in total assets to submit a contingent resolution plan that outlines how the depository institution would be separated from the parent company. The plan would have to identify potential complications of separating the entities, as well as offer solutions to effectively break the institution apart. The new information would enable the FDIC to be prepared if those firms ever required orderly liquidation. The Dodd-Frank Wall Street Reform and Consumer Protection Act ([H.R.4173, Title I, Sub. C, Sec. 165](#)) includes a similar provision and gives the Federal Reserve and the FDIC joint authority to issue rules for nonbank financial companies and large bank holding companies to submit a functional resolution plan.

### ***Multiple Sponsors***

#### *Federal Regulators Jointly Issue Final Guidance on Incentive Compensation*

On June 21, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the FDIC published [a collection of proposals](#) to help financial organizations implement incentive compensation plans that do not encourage excessive risk-taking. The guidance seeks to help companies properly balance risk and reward within an effective governance framework and covers the compensation of executives and other employees who affect the risk profile of an organization. The Dodd-Frank Wall Street Reform and Consumer Protection Act ([H.R.4173, Title IX, Sub. E](#)) includes provisions on this issue, as well. It gives joint authority to federal regulators to examine compensation structures of covered financial institutions with less than \$1 billion in assets and prohibit certain compensation arrangements. The act will also require securities issuers to have independent compensation committees and publish information regarding the relationship between performance and executive compensation paid. In addition, certain shareholders will have the opportunity to cast nonbinding votes on the compensation of executives.

#### *Federal Regulators Jointly Issue Final Guidance on Correspondent Concentration*

On April 30, the Federal Reserve, the OCC, the OTC, and the FDIC outlined their expectations for correspondent concentration risks (CCR) of financial institutions ([75, Federal Register, pp. 23764-771](#)). The guidance includes instructions to identify, monitor, and manage credit and funding concentration to other institutions, as well as the indirect exposure to other institutions' affiliates. The Dodd-Frank Wall Street Reform and Consumer Protection Act ([H.R.4173, Title I, Sub. C, Sec. 165](#)) includes a similar provision, requiring certain nonbank financial companies and large bank holding companies to submit credit exposure reports to the Federal Reserve, the new Financial Stability Oversight Council, and the FDIC. The act will also bar those institutions from having credit exposure that exceeds 25 percent of a company's capital stock.

*FDIC and SEC Propose Regulations on “Safe Harbor” Conditions and Other Requirements for Securitizations*

On April 7, the SEC proposed changes to [Regulation AB](#) and other rules regarding the offering process, disclosure, and reporting for asset-backed securities (ABS) ([75, Federal Register, pp. 23328-514](#)). The proposals would strip the mandate to reference credit ratings for shelf registrations,<sup>9</sup> require issuers to retain 5 percent of the securities they sell, and demand more transparency for shelf registrations and public offerings of asset-backed securities. The proposal also seeks to give investors more time to consider “transaction-specific information” by changing the filing deadlines for ABS offerings and requiring more information about the pooled assets within the securities.

The board of the FDIC approved a notice of proposed rulemaking on a related issue on May 11: the treatment of securities originated by an insured depository institution during the conservatorship or receivership process after September 30, 2010 ([75, Federal Register, pp.27471-87](#)).<sup>10</sup> Certain securitizations had historically been protected from FDIC repudiation, but recent changes in accounting standards prompted the FDIC to adjust its former rules. The new proposal preserves the historical protections and adds safe harbor protections for securities that meet certain disclosure, transaction structures, documentation, and retention standards. Residential mortgage-backed securities (RMBS) would be subject to even tighter standards than the others. For example, the FDIC proposed that banks set aside a 5 percent reserve fund to act as a warrantee during the first year of RMBS issuance. Banks would also be required to disclose any competing ownership interests in other loans secured by the same property and to defer compensation for rating agencies.

The SEC and FDIC offered the complementary securitization proposals to increase transparency and reduce arbitrage in the market. The same topic is addressed in the [Dodd-Frank Act](#), which includes provisions that improve the transparency and safety of the securities market and directs federal banking agencies to “jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk” for assets it sells. The act gives the same 5 percent ceiling as the proposals by the SEC and FDIC but includes more exemptions. The SEC’s version is broader than both the FDIC and the Dodd-Frank versions in that it covers the so-called “shadow banking sector.”<sup>11</sup>

*Proposed Expansion of Community Reinvestment Act Funds to Depository Institutions*

On June 17, the Federal Reserve, the OCC, the OTS, and the FDIC proposed changes to the Community Reinvestment Act (CRA) that would encourage depository institution support for communities with the highest foreclosure levels and vacancy rates ([75, Federal Register, pp. 36016-22](#)). The proposal would allow banks to receive CRA funds that had previously been given only to state and local governments for approved neighborhood stabilization activities.

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<sup>9</sup> A shelf registration is defined as a registration of new issue that can be prepared in advance so that the issue can be offered more quickly in the future.

<sup>10</sup> During a conservatorship or receivership, the FDIC has the statutory authority to repudiate certain contracts of an insured financial institution to be “legally excused from further performance” but not to reclaim or recover financial assets transferred in connection with a securitization.

<sup>11</sup> The shadow banking sector consists of nonbank financial institutions that have played an increasingly large role in intermediation but are generally unregulated.

## ***Federal Housing Finance Agency***

### *Proposed Terms of Conservatorship and Receivership for Fannie Mae, Freddie Mac, and Federal Home Loan Banks*

On July 6, the Federal Housing Finance Agency (FHFA) issued a [notice of proposed rulemaking](#) that clarifies the basic authorities of conservatorship and receivership for housing-related government-sponsored enterprises (GSEs),<sup>12</sup> such as Fannie Mae and Freddie Mac, which have been under FHFA conservatorship since 2008. The conservator or receiver would secure and preserve the assets of the entity in default and operate the entity, according to its mission, in a sound manner. The FHFA based its proposal on the FDIC's resolution framework for conservatorship and receivership of failed banks,<sup>13</sup> including the priority of claimants. For example, if an entity is unable to fulfill all of its obligations, shareholders and holders of equity interest will be the last in line to recover their claims. In addition, the FHFA would have power over the enforcement and repudiation of contracts and the authority to transfer or sell any asset or liability of the regulated entity in default. An entity under conservatorship would be prevented from making a capital distribution, unless permitted by the director of the FHFA.

## **Judicial Decisions**

### ***Supreme Court Rulings***

#### *SEC to Remove Public Company Accounting Oversight Board Members At-Will*

On June 28, the Supreme Court of the United States ruled that a provision defining the rules for appointing and removing directors of the Public Company Accounting Oversight Board (PCAOB) violates the Constitution's separation-of-powers principles; it was a partial agreement and partial reversal from the case tried in the Court of Appeals ([Free Enterprise Fund v. Public Company Accounting Oversight Board](#), No. 08-861).

The PCAOB, established by the Sarbanes-Oxley Act of 2002, determines audit and ethics standards and has regulatory power over all accounting firms that participate in the audits of public companies. The board is designated as a private nonprofit corporation, but its five members are selected by the SEC.

The decision stated that the PCAOB's two layers of "good-cause" protection, which simultaneously prevents the SEC from removing a PCAOB member without good cause and prevents the President from removing a member of the SEC without good cause, limits the President's ability to oversee the board and leaves the board's powers unchecked. However, the court held that the appointment process for PCAOB members was constitutional.

The resolution of the case severs from law the unconstitutional fragment and grants the SEC the authority to remove PCAOB members at-will, rather than for good cause. The ruling does not affect the legality of the PCAOB itself, and its operations will continue without interruption; it also preserves the bulk of the Sarbanes-Oxley Act.

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<sup>12</sup> The [Housing and Economic Recovery Act of 2008](#) established the FHFA as an independent agency of the federal government and granted it regulatory authority over all housing-related GSEs. The FHFA's proposal abides by the act's directive for it to establish a framework for conservatorship and receivership that fosters a "liquid, efficient, competitive, and resilient" housing finance market.

<sup>13</sup> For more information on the FDIC's role as receiver, see the [FDIC Resolution and Receivership Rules](#) and [Chapter 7 of the FDIC's Resolutions Handbook](#).

### ***Circuit Court Rulings***

#### *TILA Requires Credit Card Issuers to Settle Disputes Only with Obligors*

On May 19, the U.S. Court of Appeals for the Ninth Circuit ruled that, under the Truth in Lending Act (TILA), credit card issuers need to settle billing disputes only with customers who meet the legal definition of “obligor” ([\*Edwards v. Wells Fargo and Co.\*](#), 9th Cir., No. 06-16892, 5/19/10). The court ruled that TILA does not require the issuers to contact or respond to requests from the person who actually made the disputed purchase if that person is not the obligor, such as a family member who is authorized to use a card linked to the account but who is not personally liable for the charges.