Please contact any of the attorneys in our Financial Services or Legislative Groups if you have any questions regarding this Financial Services Alert.

Joseph T. Lynyak, III
jtlynyak@Venable.com
310.229.9660
202.344.4597

William J. Donovan
wjdonovan@Venable.com
202.344.4939

Suzanne Fay Garwood
sgarwood@Venable.com
202.344.8046

Financial Services Reform:
Next Step – Resolving the Differences

On Thursday, May 20th, the Senate passed its version of financial services regulatory reform by taking the House-passed "Wall Street Reform and Consumer Protection Act" (H.R. 4173) and amending it by replacing the House-passed language with the text of the "Restoring American Financial Stability Act of 2010" (S. 3217) as amended during four weeks of Senate debate. The Senate then voted to send the bill back to the House and requested that a Conference Committee be convened to resolve differences between the House-passed and Senate-passed versions of the bill. As adopted, the Senate version is over 1500 pages in length, and includes dozens of amendments debated on the Senate floor and incorporated into its version of the bill after it was reported by the Senate Committee on Banking, Housing and Urban Affairs.

The Senate-passed bill includes a plethora of individual authorities and limitations that will impact the operations of virtually every bank, thrift and other financial service provider. As of the date of this Alert, the leadership of the House and the Senate were conferring to schedule a Conference Committee to reconcile differences between the Senate-passed and House-passed versions of H.R. 4173, and comments by the House and Senate leadership evince an intent to complete the reconciliation process and finalize the legislation prior to the July congressional recess.

In the course of the next several weeks, stakeholders in the financial services industry will attempt—as part of the Conference Committee's deliberations—to win further modifications to the two regulatory reform bills. In that regard, it is important to note that—notwithstanding several reports to the contrary—in many areas the House and Senate versions of the legislation are not substantially dissimilar in content and approach from one another, which may mean that financial intermediaries seeking significant changes in the final legislation that emerges from the Conference Committee may only be successful at the margins.

In order to acquaint our clients and friends with an overview of the Senate version of the regulatory reform effort, we summarize below the major components of H.R. 4173 as passed by the Senate, which for discussion purposes is divided into the following topical areas:

- Prudent Regulation and Safeguards
- Banking Agency Reorganization
- Market and Operational Amendments
- The Consumer Financial Protection Bureau
- Miscellaneous Provisions

Prudent Regulation and Safeguards

Because the Senate elected not to strip the Federal Reserve Banks of their jurisdiction over smaller-sized bank holding companies, the "too big to fail" debate may ultimately have little impact on the majority of FDIC-insured institutions—except that the determination by the Senate to severely limit the ability of the federal government in the future to use taxpayers' funds to finance future systemic failure bail-outs will force all financial intermediaries to evaluate counterparty risk in those situations in which large, systemically risky institutions are involved.

For purposes of realistically appreciating the changes made by the Senate, it is useful to understand the interrelationship that will take place between the proposed systemic risk and resolution provisions and the federal securities laws.

In that regard, the Senate bill (as well as the House-passed version of H.R. 4173) adopts a "noisy regulatory" approach that is intended to prevent the federal banking agencies from hiding or ignoring possible systemic risk activities or concentrations presented by the companies they regulate. (Further, in recognition of the reality that financial intermediaries other than FDIC-insured institutions now may present systemic risk, the Senate version of H.R. 4173 creates a broader category of companies that may be regulated in order to avoid future systemic failures). To achieve this result, a "Council" is created that will participate in defining and promulgating criteria to identify systemically risky financial entities. In addition to that task, the Council is also empowered to require the Federal Reserve Board ("FRB") and the other financial regulators to aggressively wind-down or liquidate large companies that display enumerated systemic risk factors.

When this process is completed, large companies identified as possessing possible systemic risk attributes will be forced by applicable securities laws to discuss the implications of their status, including the likelihood that the FRB might utilize new "prompt corrective action" or "PCA" authority — the result of which would severely impact the operational flexibility and/or the viability of the targeted company going forward.

Assuming that this regulatory scheme is successful, market participants will become sensitized to the potential for counterparty risk because the result of being designated as having systemic risk characteristics would create the potential of severe counterparty losses should PCA enforcement be taken against a targeted institution or an actual liquidation occur. Among other things, this will force large financial intermediaries (*e.g.,* those identified as possibly posing systemic risk) to regularly describe to the market in securities filings how their operations are being managed in a prudent manner that will avoid PCA or more severe regulatory actions directed at their institutions.

In addition to this expanded regulatory approach to identify and deal with systemic risk, the FDIC has been granted the authority—in a somewhat convoluted hybrid approach in conjunction with the bankruptcy courts—to liquidate systemically risky companies. However, in a victory for larger institutions that will be initially identified as potentially having systemic risk characteristics, the Senate elected not to "pre-fund" a systemic resolution fund, but rather, to authorize the imposition of a resolution assessment after the fact.

Banking Agency Reorganization

As noted above, in a significant victory for the Federal Reserve Banks, the Senate deleted from its bill a proposal by Senator Dodd that would have stripped primary jurisdiction from the Federal Reserve Banks for bank holding companies with assets of less than $50 billion dollars. Instead, the Federal Reserve Banks have retained their regulatory jurisdiction—based upon the rather dubious argument that direct oversight of smaller bank holding companies is necessary in order to support the economic oversight mission of the Federal Reserve Banks.

However, the aftermath of banking crises virtually always results in restructuring proposals, and in this instance there appears to be universal agreement by both the House and the Senate to eliminate the Office of Thrift Supervision ("OTS") as a separate banking agency by merging it into the Office of the Comptroller of the Currency ("OCC").

While this process may take approximately two years to complete, several significant regulatory changes will occur that will impact thrift institutions:

- First, thrift holding companies will become subject to supervision by the Federal Reserve Board and will be required to comply with many of the rules governing bank holding companies.

- Second, state savings associations will be directly regulated by the FDIC, and federal savings associations will become supervised by the OCC.

- Third, the Senate legislation virtually emasculates the value of HOLA preemption that will seriously call into question the continued value of maintaining the federal thrift charter—and which may eventually encourage many federal thrifts to consider converting to another charter form. (Mutual thrifts may encounter even more regulatory pressure because the mutual form of corporate existence is not well understood by the surviving federal banking agencies).

Finally, as is typical in comprehensive banking legislation, there is included a potpourri of provisions that are will impose additional restrictions on the operation of FDIC-insured institutions, including: (a) limitations on industrial loan companies; (b) expanded applicability of Sections 23A and 23B on the operations of banks and thrifts; and (c) imposing the lending limitations of Section 84 of the National Bank Act on state-chartered banks.

However, also included in the Senate-passed bill are several reforms that may benefit certain classes of banks, including a substantially revised FDIC deposit assessment rule that will favor smaller institutions, as well as a liberalization of interstate branching rules currently imposed on banks. (It is in dealing with these types of limited regulatory areas that possible changes during the Conference Committee process may be most effective).

Market and Operational Amendments

While the structural and operational changes adopted by the Senate will be discussed in detail in a subsequent Alert, these changes when implemented will significantly affect the functions of virtually all financial intermediaries.

It is noteworthy that the Senate floor debate ultimately did not result in any compromise with the banking industry over two key concerns. The first issue is the approach taken by both the House and Senate bills for secondary market sales and securitizations that would require that entities securitizing assets retain a percentage ownership—which might effectively foreclose participation by many smaller entities from accessing the secondary market. (Thankfully, two amendments on the floor of the Senate eliminated the imposition of a specific retention percentage and allows several of the federal agencies to issues regulations defining risk retention requirements for certain categories of residential mortgages and commercial real estate loans.)

The second approach strongly opposed by banks and other financial intermediaries would regulate the derivatives functions of most companies by requiring that they be conducted on an exchange (along with probable margin requirements and similar operational restrictions), and would prohibit commercial banks from conducting derivatives trading activities except through affiliates. (Related to these proposals was the impact of the so-called "Volcker Rule," which would limit proprietary trading by banks).

Finally, as a backlash to the compensation practices of many large financial institutions that received government bail-out funds, executive compensation regulations would be imposed, which for FDIC-insured institutions would provide the federal banking regulators with the authority to object to excessive compensation. In regard to all financial institutions and their holding companies subject to SEC jurisdiction, enhanced shareholder input regarding the appropriate levels of compensation being paid, as well as increased investor protections are created.

The Consumer Financial Protection Bureau

In perhaps no other area will financial intermediaries be affected on a day-to-day basis as much as by the consumer protection provisions of the Senate bill. In that regard, in a strategic determination to address other areas of the legislation deemed potentially more damaging to the banking industry, the authority and structure of the Bureau of Consumer Financial Protection ("BCFP") emerged from the Senate floor debate substantially unscathed.

Essentially, the BCFP will be an independent entity within the FRB, and will have transferred to it regulatory and rulemaking authority over virtually every federal consumer protection statute and provider of consumer financial services and products. Significantly, the BCFP will be under the direction of just one individual, a "Director", who will be appointed by the President and subject to confirmation by the Senate for a 5-year term and subject to removal for cause. In an effort to guard against the potential for mischief that could occur should the Director fail to reasonably balance the needs of both the consumer financial services industry and consumers, the Senate-passed bill does give the Financial Stability Oversight Council authority to set aside a final regulation promulgated by the BCFP 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.

Several provisions regarding the BCFP require particular attention:

- First, in a series of *very* complicated provisions, federal preemption has been seriously weakened—and a strong argument may be made that the legislation may create a *de facto* presumption against preemption on a go-forward basis. For example, while existing charter preemption will not be affected as to existing loans and deposits, the OCC's ability to preempt state law is reduced to a case-by-case analysis and in a manner that "arguably" adopts the Supreme Court's approach in *Barnett Banks*. (An amendment adopted as part of the Senate debate slightly improved the preemption rule as originally drafted by the Senate Committee on Banking, Housing and Urban Affairs.)

- Second, state Attorneys General are granted expanded jurisdiction to enforce not only non-preempted state laws against national banks and federal thrifts, but federal consumer protection laws as well (and operating subsidiaries would now be precluded from making use of charter preemption).

Besides these changes, it should be noted that the BCFP is provided the authority to determine that any consumer product or service is an “unfair, deceptive or abusive” act or practice. This means that the BCFP will be authorized not only to regulate terms and conditions of consumer products and services through its broad rulemaking authority, but also to prohibit *specific* terms and conditions of consumer products and services that are otherwise authorized by state or federal laws.

Finally, while these provisions will ultimately change the consumer financial services industry, the process by which these changes will be implemented may be slow. Among other things, consumer protection personnel at other federal agencies must be transferred to the BCFP, which at best will be a time-consuming process. Also, in a notable success for the banking industry, jurisdiction for examining banks and thrifts below $10 billion dollars will remain with the federal banking agencies and not with the BCFP. Similarly, even though the BCFP will have the theoretical jurisdiction to examine and supervise all consumer financial service companies (except for those industry sectors that were successful in obtaining an exemption from direct supervision and examination), the BCFP may lack an effective examination staff for the foreseeable future—which means that the BCFP will be forced to delegate to existing state and federal regulatory agencies the responsibility for continuing to examine their current supervised entities.

In this respect, the BCFP may initially operate in a manner that is strikingly similar to the current operation of the Federal Trade Commission—which focuses its resources on a narrow range of high-profile targets. (Note that the House version of the regulatory reform bill treats the FTC more favorably by expanding portions of the FTC’s statutory authority and arguably maintaining the FTC’s continuing role in consumer protection).

Miscellaneous Provisions

The Senate legislation includes as part of the Department of the Treasury an Office of Federal Insurance, which appears to be a placeholder that allows the insurance industry to resolve its internal debate on whether, and to what extent, it wants to create a federal insurance charter and thereby avoid the regulation of insurance on a state-by-state basis. In the meantime, the newly created Office of Insurance will have minor data-gathering and analysis responsibilities (but is provided a seat on the Council, described above).

By a floor amendment, the Senate also incorporated into its version of H.R. 4173 numerous mortgage lending restrictions similar to the provisions included in the House-passed version of the bill. Even though the FRB has recently proposed numerous procedural and substantive restrictions pursuant to its UDAP authority under the Truth-in-Lending Act and Regulation Z, the inclusion of these provisions is an indication of the frustration felt by Congress regarding the failure of the federal agencies to protect consumers in a deregulated environment.

Through our Financial Services and Legislative Groups, lawyers at Venable have actively been monitoring these developments and their impact on the various business models employed by financial intermediaries. We will continue to provide updates as the Conference Committee process proceeds.

Please note that the Senate and House versions of the bills are voluminous and hence this summary should be viewed as an overview of numerous regulatory provisions that will require significant analysis. For example, it is likely that the banking industry will continue to press for modifications addressing interchange fees, minimum capital requirements for holding companies, broker compensation and the push-out requirement for derivatives activities.

In the months ahead, Venable will be providing additional analysis of the legislation as finally adopted, including discussion of how the implementation of the various provisions will impact the various sectors of the financial services industry.

Of course, please call any member of Venable's Financial Services or Legislative Groups if you have any questions or comments.

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