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Congress Passes Sweeping Financial Reform Bill

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In an effort to prevent another financial crisis, Congress recently passed the biggest overhaul of U.S. financial regulations since the 1930s. On June 30, 2010, the House of Representatives approved the reform bill by a 237-192 margin. On July 15, 2010, the Senate passed the bill 60-39. President Obama is expected to sign the bill into law within a matter of days, at which point the bill will become the Dodd-Frank Wall Street Reform and Consumer Protection Act.

An overview of key provisions of the bill follows:

Creating a Consumer Financial Protection Watchdog

Bureau of Consumer Financial Protection – The bill would create a new independent Bureau of Consumer Financial Protection ("BCFP") as an independent entity housed at the Federal Reserve. The BCFP would have the power to write rules for consumer protections governing all bank and non-bank financial institutions offering consumer financial services or products. The BCFP would also have the authority to examine and enforce regulations for banks and credit unions with assets over $10 billion and all mortgage-related businesses, payday lenders, and student lenders.

Preemption– The bill would allow states to impose their own stricter consumer protection laws on national banks. An exemption from state law would be granted if a state law "prevents or significantly interferes" with the bank's ability to do business. This represents a higher bar than federal regulators currently must meet to pre-empt state rules. State attorney generals would be able to sue to enforce consumer protection provisions under the new law, enforce regulations of the BCFP and bring enforcement actions for violations of non-preempted state laws.

Credit Score Disclosure– The bill would require that any person who uses a credit score as a factor to deny credit to a consumer, require a consumer to pay a higher interest rate on a loan, or prevent an applicant from being hired for a job must provide the consumer's or applicant's credit score to the consumer or applicant.

Addressing Systemic Risks via Financial Stability Oversight Council

New Financial Stability Oversight Council – The bill would establish a new, 10-member Financial Stability Oversight Council ("FSOC") to identify, monitor and address systemic risk posed by large, complex financial firms as well as products and activities that spread risk across firms. Non-bank financial firms who pose a risk to the financial stability of the United States would be subject to regulation by the Federal Reserve upon a two-third vote by the FSOC. The FSOC would also have the authority, by a two-third vote and as a last resort, to require a non-bank financial company to divest some of its holdings if it poses a substantial threat to the financial stability of the United States.

Leverage & Risk-Based Capital Requirements – The bill would require banks with more than $250 billion in assets to have reserves to protect against losses that are at least as strict as those that apply to smaller banks. Trust-preferred securities would only be included in Tier 2, not Tier 1, capital. However, the bill would grandfather trust-preferred securities for banks with under $15 billion in assets, enabling them to continue treating the securities as Tier 1 capital. Larger banks would have five years to phase-out trust-preferred securities as Tier 1 capital.

Ending "Too Big To Fail" Bailouts

Discourage Excessive Growth & Complexity – The bill would require the FSOC to monitor systemic risk and make recommendations to the Federal Reserve for increasingly strict rules for capital, leverage, liquidity, and risk management standards as companies grow in size and complexity.

Restrictions on Proprietary Trading – The bill would require regulators to implement regulations for banks, their affiliates and holding companies, to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and to limit relationships with hedge funds and private equity funds. Non-bank financial institutions supervised by the Federal Reserve would also have restrictions on proprietary trading, hedge fund and private equity investments.

Funeral Plans– The bill would require large, complex companies to periodically submit "funeral plans" for their rapid and orderly shutdown in the event of their economic failure. Companies that fail to submit acceptable plans would be subject to higher capital requirements and restrictions on growth and activity, as well as possible divestment.

Liquidation Procedure– The bill would give federal regulators new authority to seize and break up systemically significant financial companies whose failure or resolution in bankruptcy would have adverse effects on financial stability. The liquidation procedure would be run by the Federal Deposit Insurance Corporation ("FDIC"), but the Treasury Department, the FDIC, and the Federal Reserve would all have to agree to put a company into liquidation. The FDIC would only be able to borrow the amount of funds to liquidate the company that it expects to be repaid from the assets of the company being liquidated. Funds not repaid from the sale of the company's assets would be repaid first through the claw back from any payments to creditors that exceeded liquidation value and then assessments on large financial companies.

Improving Bank and Thrift Regulation

Volcker Rule – The bill would curb proprietary trading by the largest financial firms, though banks would be able to make de minimus investments in hedge and private-equity funds. Those investments would be limited to 3% or less of a bank's Tier 1 capital. Banks would be prohibited from bailing out a fund in which they are invested.

Oversight Changes – The Office of Thrift Supervision would be eliminated within one year, with oversight of savings and loans transferred to the Office of the Comptroller of the Currency and oversight of savings and loan holding companies transferred to the Federal Reserve. The Federal Reserve would retain its oversight of community banks. The bill would empower the Federal Reserve to supervise the largest, most complex financial companies to ensure that the government understands the risks and complexities of firms that could pose a risk to the broader economy.

Deposit Insurance Reforms– The bill would permanently increase the level of deposit insurance for banks, thrifts and credit unions to $250,000, retroactive to January 1, 2008.

Creating Transparency & Accountability for Derivatives

Central Clearing and Exchange Trading– The bill would provide the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") with the authority to regulate over-the-counter derivatives. The bill would require that many routine derivatives be traded on exchanges and routed through clearinghouses. The SEC and CFTC would be required to pre-approve contracts before clearinghouses could clear them. However, customized swaps could still be traded over-the-counter, but would have to be reported to central repositories so regulators could get a broader picture of what is going on in the market.

Increased Enforcement Authority **–** The bill would impose new capital, margin, reporting, record-keeping and business conduct rules on firms that deal in derivatives.

Raising Standards & Regulating Hedge Funds

SEC Registration– The bill would require hedge funds and private equity advisors to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk.

Greater State Supervision – The bill would also raise the asset threshold for federal regulation of investment advisers from $30 million to $100 million, which would most likely significantly increase the number of advisors under state supervision.

Creating New Office of Credit Ratings

New Office of Credit Ratings – The bill would create an Office of Credit Ratings at the SEC with its own compliance staff and authority to fine agencies. The bill would require organizations rated by the Nationally Recognized Statistical Ratings Organization to disclose their methodologies, their use of third parties for due diligence efforts and their ratings track record. The bill would prohibit compliance officers from working on ratings, methodologies or sales. Investors would be able to sue ratings agencies for a knowing or reckless failure to investigate the facts or obtain analysis from an independent source. The SEC would be authorized to deregister an agency for providing bad ratings over time.

Strengthening Shareholder Rights & Corporate Governance

Vote on Executive Pay and Golden Parachutes– The bill would give shareholders the right to a non-binding vote on executive pay and golden parachutes.

Proxy Access– The bill would give the SEC authority to grant shareholders proxy access to nominate directors.

Independent Compensation Committees– The bill would require stock exchanges to include in their listing requirements that companies have compensation committees who have authority to hire compensation consultants in order to strengthen their independence from the executives they are rewarding or punishing and who include only independent directors.

Internal Controls– The bill would exempt public companies with market caps less than $75 million from complying with Section 404(b) of the Sarbanes-Oxley Act, which requires independent auditors to report on management's assessment of the effectiveness of internal controls over financial reporting.

Reforming the Federal Reserve

Emergency Lending – The bill would limit the Federal Reserve's 13(3) emergency lending authority by prohibiting emergency lending to an individual entity and would prohibit loans to insolvent firms. The bill would authorize the Government Accountability Office to conduct a one-time audit of all emergency lending that took place during the financial crisis.

Transparency/Disclosure – The bill would require the Federal Reserve to disclose counterparties and information about amounts, terms and conditions of 13(3) and discount window lending, and open market transactions on an on-going basis, with specified time delays.

Limits on Debt Guarantees– In order to prevent bank runs, the bill would authorize the FDIC to guarantee debt of solvent insured banks after i) a two-third majority of the Federal Reserve Board and the FDIC board determine there is a threat to financial stability; ii) the Treasury Secretary approves terms and conditions and sets a cap on overall guarantee amounts; and iii) the President initiates an expedited process for Congressional approval.

Creating a New Office of National Insurance

Federal Insurance Office – The bill would create the Office of National Insurance with the Treasury Department, which would gather information about the insurance industry, including access to affordable insurance products by minorities, low- and moderate- income persons and underserved communities.

Reducing Risks Posed by Securities

Skin in the Game – The bill would require companies that sell products like mortgage-backed securities to retain at least 5% of the credit risk, unless the underlying loans meet standards that reduce risk.

Tackling the Effects of the Mortgage Crisis

Neighborhood Stabilization Program – The bill would provide $1 billion to states and localities to combat the impact on neighborhoods of the foreclosure crisis, such as falling property value and increased crime, by rehabilitating, redeveloping and reusing abandoned and foreclosed property.

Emergency Mortgage Relief – The bill would provide $1 billion for bridge loans to qualified unemployed homeowners with reasonable prospects for reemployment to help cover mortgage payments until they are reemployed.

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