

BANKING LAW ALERT

FINANCIAL REFORM: Senate Bill 3217

June 2, 2010

On May 21st, by a vote of 59 to 39, the Senate passed the Restoring American Financial Stability Act of 2010 (Senate Bill 3217) to impose wide ranging reforms in the financial services industry. The Bill will impact virtually all providers and consumers of financial services. While the Bill addresses some of the more politically popular issues, such as the “too big to fail” dilemma, it fails to remedy other areas that were clearly complicit in the 2008 crisis, including Fannie Mae and Freddie Mac. The Senate bill must be reconciled with legislation passed by the House in December, with the intent that a final version be presented to the President by early July. Below is a summary of the key provisions in the Bill.

This Alert is provided to Clients and friends of the Firm. If you have questions regarding any of the items discussed, please contact one of the following attorneys:

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Regulation of Systemic Risk.

The Bill would create the Financial Stability Oversight Counsel ("FSOC") as an independent agency to monitor and respond to systemic risks created by complex companies, products and activities. The FSOC would be charged with (a) identifying risks to our entire financial system posed by the failure of large, interconnected bank and nonbank companies, (b) addressing the “moral hazard” issue by eliminating any expectation by shareholders or creditors that the U.S. government will backstop losses by large companies, and (c) responding to threats to the stability of our financial markets.

The Bill permits the FSOC, by two-thirds vote, to require that any nonbank financial company be supervised directly by the Federal Reserve. This allows the Fed to exert direct supervisory authority over institutions without any bank subsidiaries. The FSOC will be empowered to make these decisions not based on size alone, but on factors such as degree of leverage of the entity, the amount and nature of its financial assets and liabilities, and the extent and type of off balance sheet exposures.

The FSOC is also empowered to make recommendations to the Fed concerning capital standards and leverage requirements for nonbank companies supervised by the Fed, and large, interconnected bank holding companies. The FSOC may establish standards for those bank holding companies whose total assets exceed \$50 billion.

The Bill would also establish as a separate executive agency the Office of Financial Research to collect standardized data on financial firms of all types to support the activities of federal financial regulators.

Resolution of Failing Financial Firms.

One of the commonly cited shortcomings of the current regulatory structure is that no federal regulator is able to wind down a nonbank financial company in a manner similar to that of the FDIC when acting as receiver of a depository institution. The only option for large nonbank companies is protection under U.S. bankruptcy laws, such as occurred with Lehman Brothers Holdings in September, 2008. The Bill would grant this authority to the FDIC to force the orderly liquidation of large, failing financial institutions. Once a failing firm is placed under resolution authority, liquidation would be the only option and the company will not be kept open for operations. The FDIC would have the authority to discharge company management and liquidate its assets, resulting in a loss of investment by shareholders and unsecured creditors.

The Bill originally included a provision requiring that a bailout fund be established through an additional tax on large, interconnected companies. This fund would have been available to assist in an orderly settlement of a failing firm. As passed, the Bill does not include a provision for a bailout fund.

Bank and Holding Company Regulation.

Elimination of Thrift Charters

Much of the discussion regarding the need for regulatory reform is focused on the gaps created in the current system by the use of multiple federal and state regulators. The original bill proposed by Senate Banking Committee Chairman Chris Dodd would have required that all national bank and federal savings and loan holding companies with total assets of less than \$50 billion be supervised by the OCC rather than the Fed or OTS. Chairman Dodd also would have transferred regulation of all state chartered banks, including current member banks, to the FDIC.

As passed, the Bill eliminates the Office of Thrift Supervision and shifts regulatory authority over thrift holding companies to the Federal Reserve. The Fed also retains its oversight of national and state bank holding companies and state member banks. In addition to its oversight of national banks, the OCC would also supervise federal savings associations. The FDIC will supervise state savings associations and continue as the primary federal regulator of insured state nonmember banks.

De Novo Interstate Branching Authority

An important provision in the Bill that has received little attention allows both national and state banks to establish a de novo interstate branch if the law of that state would permit a state chartered bank to set up the branch. Currently, de novo branching is permitted only if the states grant reciprocity, with the alternative being acquisition of a bank charter in the desired state. This expanded branching authority is a carry-over from the Obama administration's original plan to permit de novo branching for all financial institutions with the elimination of the thrift charter as an option.

Interstate Acquisitions

The Bill requires that a bank holding company be both well-capitalized and well-managed (not merely adequately-capitalized and adequately-managed) in order to acquire an out-of-state bank. The Bill also requires that the acquired bank be both well-capitalized and well-managed after the acquisition.

Investment Advisors; Private Equity Activities.

Hedge fund advisors will be required to register with the Securities and Exchange Commission under title IV of the Bill. The Bill will also increase the asset threshold above which investment advisors are required to register with the SEC from the current \$25 million level to \$100 million in assets under management. Each state will continue to regulate advisors with less than \$100 million in assets under management. The stated reasons for the increase are to allow the SEC to focus its enforcement activities on the largest advisors that presumably create more of a risk to the financial system.

The Bill brings hedge fund advisors under SEC regulatory supervision by making a technical tweak to the Investment Advisors Act that currently exempts from registration any advisor with fewer than 15 clients. This raises concerns whether an individual providing investment advisory services for his or her family, or generations of a family, would be required to register. Section 409 of the Bill clarifies that an investment advisor for a "family office" will continue to be exempt from any registration requirements.

The original proposal also contained troubling provisions that would have added unnecessary uncertainty to the private placement exemption under Rule 506 of Regulation D. This exemption allows for unregistered offerings of securities to be sold by an issuer on a nonpublic basis provided certain conditions are satisfied. Under Rule 506, for example, an issuer may sell to an unlimited number of "accredited investors", which are generally individuals with a net worth of at least \$1 million or a specified level of annual income, plus 35 non-accredited investors. The current definition allows an individual to include the equity in his or her primary residence to reach the \$1 million level. Section 412 of the Bill would exclude an individual's home equity in applying this test. The Bill also requires that the SEC adjust the \$1 million level for inflation, if necessary, upon a review in four years from the date of enactment and every four years thereafter.

Office of National Insurance.

Although the Bill does not create a national insurance charter, it creates an Office of National Insurance to be housed within the Treasury Department, with the stated functions of monitoring the insurance industry, identifying issues or gaps in the regulation of insurers, and recommending insurance companies to be subject to regulation as a nonbank financial company.

Moratorium on Limited Purpose Banks.

The Bill imposes a three-year moratorium on the approval of certain deposit insurance applications by the FDIC. This applies only to applications for any industrial bank, credit card bank or trust bank that is controlled by a nonbanking commercial firm (*i.e.*, any company that derives at least 15% of its revenue from non-financial activities).

Charter Conversions.

A perceived flaw in the current regulatory system is the availability of forum shopping, under which an institution could change charters if it believes it can receive more lenient treatment from another regulator. The Bill will prohibit any charter conversion in the event the converting institution is subject to enforcement action by either its state or federal regulator.

Corporate Governance.

The Bill institutes a number of corporate governance reforms. These include providing shareholders the right to a nonbinding vote on executive compensation ("Say on Pay") requiring that directors be nominated by a majority vote in uncontested elections, encouraging bifurcation of the roles board chairman and CEO, mandating independent compensation committees, and requiring policies providing for a clawback of executive compensation paid if based on inaccurate financial statements.

Consumer Financial Protection.

The Bill creates the Bureau of Consumer Financial Protection ("BCFP") to regulate the offering and provision of consumer financial products or services. The BCFP will be housed within the Federal Reserve and its director will be appointed by the president, subject to Senate confirmation.

The BCFP will be authorized to write and implement rules to protect consumers of financial products and services, supervise and enforce those laws, develop and publish information on the risks to consumers and address consumer complaints. For this purpose, a "financial product or service" will include those used by consumers primarily for "personal, family or household purposes." Specifically, this would include extensions of credit and loan servicing, deposit-taking activities, check cashing, and providing financial advisory services. The BCFP will seek to identify unfair, deceptive and abusive practices in connection with transactions for consumer financial products or services and may prescribe model disclosure requirements to serve as a safe harbor for providers.

The BCFP has primary supervisory authority for compliance with its regulations by banks with more than \$10 billion in assets, and many nonbank institutions including mortgage lenders, mortgage brokers, payday lenders and debt collectors. The primary federal regulator of smaller institutions (assets of \$10 billion or less) will retain supervisory and enforcement authority over

those firms. The BCFP may, however, require periodic reports on smaller companies for data collection purposes.

The Bill includes a number of exemptions from supervision by the bureau. For example, the Bill exempts any small business if it (1) extends credit directly to a consumer to allow the consumer to purchase a nonfinancial product or service, (2) does not sell the resulting debt, and (3) meets the relevant standard to be considered a small business under the Small Business Act. Other exemptions apply to real estate brokerages, accountants and tax return preparation services, attorneys, state-regulated insurance agencies, and employee benefit and compensation plans. A proposed amendment that would have exempted automobile dealers was not included.

The Bill also includes amendments to the truth and lending act ("TILA") to require lenders to obtain "verified and documented information" on any mortgage application to establish that a consumer has a reasonable ability to repay the loan, in addition to paying taxes, insurance and assessments. Lenders are instructed to obtain income tax forms, payroll receipts, bank records and other documents from third parties to verify this information.

Federal Preemption: Exportation of Interest Rates.

The Bill preserves the federal preemption of state interest rate limits, similar to the provision in the House bill.

Leverage and Risk-Based Capital Requirements.

The applicable federal regulators are required to establish minimum leverage and risk-based capital requirements applicable to banks, bank holding companies and systemically important nonbank financial companies. The current leverage and risk-based capital requirements applicable to banks (not holding companies) will serve as minimum permissible levels.

The applicable minimum ratios would be as follows:

- (i) Leverage Ratio – 3% for institutions rated “1”; 4% for all others to be “adequately capitalized”, and 5% for “well capitalized”
- (ii) Tier 1 Capital Ratio – 4% for “adequately capitalized” and 6% for “well capitalized”
- (iii) Total Capital Ratio – 8% for “adequately capitalized” and 10% for “well capitalized”

As drafted, this would mean that neither banks nor holding companies could include either trust preferred or TARP preferred in Tier 1 capital. Most commentators believe that the final version of the law will grandfather in existing trust preferred securities.

Deposit Insurance.

The Bill fundamentally overhauls the way deposit insurance assessments are calculated by basing those fees on an institution's average total assets less its tangible equity, rather than on its insured deposits.

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