



## Reconciliation: A Summary Scorecard on Regulatory Reform (*Part I*)

For some weeks now, US Senate and House conferees have been involved in a delicate, but sometimes bare-knuckled, process of reconciliation. The Conference Committee, charged with reconciling differences between the version of the financial regulatory reform bill passed by the House of Representatives in December 2009 and the bill passed in late May 2010 by the Senate, has had to tackle quite a number of controversial, and often arcane, matters. All-encompassing reconciliation—at least one that brings about real consensus and leaves proponents of an initiative feeling elevated by having been able to be heard and having achieved lasting compromise—is elusive. We are often reminded that where there has been real reconciliation, one shouldn't “keep score” about who got his or her way. We'll confess we've been keeping score. Herewith is a brief scorecard on what we regard as some of the most significant issues considered by the Conference Committee to date. This is a summary only. Over the course of the next few days, more complete analysis will follow. More information on regulatory reform measures is available from our dedicated webpage at <http://www.mofo.com/resources/regulatory-reform/>.

### Corporate Governance

The House and Senate bills included corporate governance and compensation provisions that could potentially affect all public companies, reflecting concerns arising from the financial crisis with respect to the adequacy of corporate governance and the processes for determining executive pay. The House and Senate bills principally differed in the scope of the reforms contemplated—the House bill focused mainly on compensation issues with a few governance provisions included as well, while the Senate bill contemplated much more wide-ranging governance changes. The Conference Committee agreed that public companies must include in their proxy statements a resolution for a non-binding vote on executive compensation required to be disclosed, while giving shareholders an option as to how frequently such “Say on Pay” votes occur for each company. The Conference Committee also agreed to include a provision from the House bill that would direct the SEC to issue rules that would require enhanced disclosure in any proxy or consent solicitation material by which shareholders are asked to approve an acquisition, merger, or similar transaction, regarding any agreements or understandings concerning compensation, along with a required advisory vote on such agreements or understandings. The House and Senate bills took differing approaches to the highly controversial issue of whether shareholders that meet specified criteria should have the right to include their own nominees on a company's proxy statement. The Conference Committee agreed to provide that the SEC could adopt rules for proxy access, without setting specific criteria. While the Conference Committee agreed to other corporate governance provisions of the bills, such as provisions with respect to compensation consultant independence and compensation clawbacks, the Conference Committee did not agree to a controversial provision of the Senate bill that would have required public companies to utilize a majority voting standard in the uncontested election of directors.

## Fiduciary Duty

The House bill requires the SEC to impose a fiduciary duty on broker-dealers providing personalized investment advice to retail clients. This would harmonize standards applicable to broker-dealers and those applicable to investment advisers. The Senate bill requires the SEC to conduct a study regarding the standards of care applicable to broker-dealers and to investment advisers.

The outcome: The Conference Committee agreed to require the SEC to conduct a study within six months of enactment of the legislation and expressly empowered the SEC to impose a fiduciary duty on broker-dealers.

## Interchange

The Durbin Amendment in the Senate bill included limitations on interchange fees for debit card transactions and other limitations on restrictions that may be imposed on merchants with respect to payment card transactions. The House bill did not address these issues. In a compromise worked out between Durbin and some of the House conferees, the amount of interchange fees would be limited to an amount that is “reasonable and proportional” to the incremental issuer’s cost incurred with respect to the transaction plus certain fraud related costs. This limitation would not apply to payment card network fees. In addition, the compromise would exempt government-administered payment programs and reloadable prepaid cards. The compromise also would prohibit an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed to a single network or restricting a merchant from routing an electronic debit transaction for processing over any payment card network that may process the transaction.

## Covered Bonds

The final bill approved by the Conference Committee includes provisions to establish a statutory framework for US banks to issue covered bonds. The provisions of the bill are quite similar to the provisions of the bill that Rep. Scott Garrett introduced in the House of Representatives in March. The Secretary of the Treasury is designated as the regulator of covered bonds. Upon the receivership of a bank that has issued covered bonds, the “cover pool” would be separated from the estate of the failed bank and administered under the trusteeship of the Secretary for the benefit of bondholders and others secured by the cover pool. The receiver of the failed bank would receive a residual interest in the separate estate. “Eligible assets” in a cover pool include assets from any one of the following asset classes: residential mortgage loans, commercial mortgage loans, state or municipal obligations, auto loans or leases, student loans and credit and charge card receivables. Unlike the March bill, this bill would not allow a securitized form of an asset to be included in the cover pool. The bill also includes a requirement for the Federal Reserve Board to conduct a study of whether Federal Reserve banks should be authorized to make liquidity advances to a separate estate in order to make payments on the related covered bonds. This bill does not follow the March bill in exempting covered bonds from the Federal securities laws.

## Securitization

The final bill approved by the Conference Committee contains many of the same provisions relating to securitization contained in the Senate bill. Securitizers will be required to retain not less than 5% of the credit risk for any asset transferred, sold or conveyed through the issuance of an asset-backed security but less than 5% if the originator of such assets meets the underwriting standards defined by regulation. The risk retained may not be hedged directly or indirectly. The Conference Committee bill also allows regulators to allocate the risk retention percentage between the securitizer and the originator of the underlying assets. The Conference Committee bill requires regulators to establish risk retention requirements for CDOs, securities collateralized by CDOs, and other similar instruments and requires that a study be performed to examine the macroeconomic effects of the risk retention requirements. The Conference Committee bill exempts from the risk retention requirements any residential, multi-family, or health care facility mortgage loan asset, or securitization based directly or indirectly on such assets, which are insured by the federal government or an agency of the federal government. Freddie

Mac, Fannie Mae, and the federal home loan banks are excluded from the definition of federal government agency. The risk retention exemption in the Senate bill for “qualified residential mortgages” was eliminated in the Conference Committee bill. The credit risk retention regulations required to be established pursuant to the Conference Committee bill would become effective for residential mortgage-backed securities one year after adoption of final rules under the risk retention provisions of the statute, and for other asset classes two years after adoption of final rules under the risk retention provisions of the statute.

The disclosure provisions of the Conference Committee bill remain unchanged from the Senate bill. Securitizers will be required to disclose both fulfilled and unfulfilled repurchase requests and to file registration statements stating that the issuer has performed due diligence on the underlying assets and disclosing the nature of that analysis. Credit rating agencies issuing any reports accompanying a credit rating of a securitization will be required to provide a description of the representations, warranties, and enforcement mechanisms available to investors, and an explanation of how those differ from representations, warranties, and enforcement mechanisms in issuances of similar securities.

### Regulation of Private Funds and Related Matters

Both the House and the Senate bills generally provided for the registration of private fund advisers, imposed restrictions on the relationships of certain financial institutions with private funds and required reporting and record-keeping requirements. There were a number of important differences between the House and the Senate bills. The Senate version provided additional exemptions for venture capital and private equity funds, as well as for single family offices.

The outcome: The Conference Committee agreed that registration will be required for advisers to private funds (including hedge funds and private equity funds) not otherwise exempted by a new exception for advisers having less than \$150 million in assets under management. The exemptions for advisers to venture capital funds, advisers to single family offices, and advisers to small business investment companies remained. An adviser to clients that are not funds would be exempt from registration only if the adviser has less than \$100 million in assets under management. A limited exception for “foreign private advisers” remained. Enhanced record-keeping and reporting requirements also will be mandated in order to permit the SEC and other regulators to make systemic risk assessments.

### Capital Requirements

Both the House bill and the Senate bill imposed stricter risk-based capital requirements on financial institutions. The House bill required a maximum 15-to-1 leverage ratio for systemically important firms. The Senate bill did not include a leverage ratio; however, it included a provision requiring that the Federal Reserve establish enhanced risk-based capital and leverage requirements and also permitted the Financial Stability Oversight Council to recommend that other bank regulators impose heightened capital standards for the firms under their supervision. The Senate bill included the controversial Collins amendment, which, among other things, imposed the same capital requirements for bank holding companies that are applicable at the bank level. This would mean that certain securities, including trust preferred securities, would no longer qualify as Tier 1 capital. The amendment also raised concerns for foreign banks, for the intermediate US holding companies of international banks, and for smaller banks.

The outcome: Adoption of the maximum 15-to-1 leverage ratio for systemically important firms; adoption of the Senate bill version of the regulatory capital provisions, with significant modifications to the provisions that were contained in the Collins amendment; bank holding companies that have consolidated assets under \$15 billion are exempt from certain requirements relating to changes in capital requirements; larger bank holding companies will have five years to phase out use of trust preferred securities for Tier 1 capital purposes; clarification that the Collins amendment provisions were not intended to be applied to foreign banks; and a requirement for a study to be conducted relating to contingent capital instruments.

## Conclusion

In order for all of these (and the other many) provisions included in the financial regulatory reform bill to be implemented, additional rule-making will be required. As to certain provisions, a new “scorecard” may be called for once an assessment of the implementing rules can be undertaken.

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## Contacts

Contact your Morrison & Foerster lawyer with any questions.

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