

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Treasury Financial Regulatory Reform Program – Further Discussion of Obama Administration's Proposed Legislation

As discussed in the [July 28, 2009 Alert](#), the Obama Administration, through the Treasury, released the text of proposed legislation for various elements of its financial regulatory reform program (the "Program") that it has submitted to Congress. The proposed legislation provides significant detail concerning many segments of the Program described in the Treasury's June 2009 White Paper (as discussed in the [June 23, 2009 Alert](#).) Many elements of the proposed legislation concerning the Program were described in the [July 28, 2009 Alert](#), and additional segments are discussed below. There continues to be significant Congressional and industry opposition to certain elements of the Program and some or all of the segments of the Program may not be enacted. The Treasury, however, is reportedly continuing to pursue these initiatives in their current form. The *Alert* will continue to cover

developments related to Treasury's proposals as well as significant Congressional proposals dealing with financial regulatory reform.

Proposed Legislation Regarding Asset-Backed Securitization

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed legislation](#). The proposed legislation is designed to implement recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (see the [June 23, 2009 Alert](#)).

Generally, the proposed legislation relating to asset-backed securitization would require the SEC and Federal banking agencies to implement detailed regulations and would effect two statutory changes of note. The key provisions of the proposed legislation are (1) a requirement that the SEC and the Federal banking agencies propose regulation requiring any bank or non-bank issuer or underwriter of an asset-backed security to retain an interest in at least 5% of the credit risk in such assets for a specified period, in a specified form and without hedging; (2) an amendment to Section 15 of the Securities Exchange Act of 1934 to require continued reporting by issuers of asset-backed securities even if the number of holders falls below 300; (3) a requirement that the SEC propose regulations requiring disclosure of standardized asset-level or loan-level data and standardized compensation and risk retention information; (4) a requirement that the SEC propose regulations on the use of representations and warranties in the asset-backed securities market that would require credit rating agencies to include additional analysis in their reports and would require disclosure permitting investors to identify originators with clear underwriting deficiencies; and (5) the elimination of the offering exemption for certain real estate mortgage notes and related participation interests under Section 4(5) under the Securities Act of 1933. These proposals are consistent with the securitization market goals expressed in the White Paper to require risk retention, to increase standardization and transparency, to require robust reporting by issuers of asset-backed securities, and to strengthen the regulation of credit rating agencies, but do not address the stated goal of alignment of compensation and performance other than by increasing disclosure of compensation to loan brokers and originators, or the stated goal of reducing regulators' use of credit ratings. The impact of these proposals, if adopted, on the securitization market will depend significantly on the nature and scope of the regulations that are developed to meet the requirements; accordingly, the *Alert* will continue to monitor developments in this area.

Proposed Legislation Establishing Financial Services Oversight Council

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted [proposed legislation](#) to Congress that would establish a new Financial Services Oversight Council (the "FSOC"). The FSOC would be comprised of the Secretary of the Treasury (who would serve as Chairman of the FSOC), the heads of the FRB and the FDIC, the Director of the new National Bank Supervisor (or, before its establishment, the Comptroller of the Currency and the Director of the Office of Thrift Supervision), and the heads of the new Consumer Financial Protection Agency, the SEC, the CFTC, and the Federal Housing Finance Agency.

The designated purposes of the FSOC are: (1) to advise and make recommendations to enhance the integrity, efficiency, orderliness, competitiveness and stability of U.S. financial markets and maintain investor confidence; (2) monitor the financial services marketplace to identify potential threats to the stability of the U.S. financial system; (3) facilitate inter-

agency information sharing and cooperation concerning domestic financial services policy developments, rulemaking, examinations, reporting, enforcement actions and other matters; (4) advise the FRB on designation of Tier 1 financial holding companies and systemically important financial market utilities; and (5) provide a forum for discussion and analysis of emerging issues and resolution of jurisdictional disputes.

The FSOC would meet at least quarterly and would have a permanent staff within the Treasury. The FSOC would have no independent enforcement authority. In addition, under the proposed legislation, the FSOC would be required to submit annual reports to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs, in which it would identify significant financial market developments and potential emerging risks.

Some members of Congress, the Chairman of the FDIC and other commentators have proposed that the FSOC's advisory and consultative role be strengthened substantially to provide a more robust counterweight to the authority of the FRB.

Proposed Credit Rating Agency Reform Legislation

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed legislation](#) that would reform SEC regulation of credit rating agencies ("CRAs") by (a) requiring all CRAs to register with the SEC, (b) requiring CRAs to implement additional controls and procedures, including designation of a compliance officer, (c) increasing SEC oversight of credit rating agencies, (d) addressing conflicts of interest in the rating process and (e) providing for additional disclosure regarding credit ratings and the rating process. Under the proposed legislation, the Comptroller General would conduct a study regarding (1) the appropriateness of using credit ratings in federal, state and local securities and banking regulations and (2) alternative methods of compensating CRAs that could improve the accuracy of credit ratings. (In a related announcement, the Treasury indicated that it will work with the SEC and the President's Working Group on Financial Markets to determine where references to ratings can be removed from regulations.) The proposed legislation is designed to implement recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

Expanded NRSRO Registration and Regulation. Unlike the current system of registration, under which a CRA registers with the SEC only if it wants to qualify as a "nationally recognized statistical rating organization" (an "NRSRO") for purposes of various requirements under the federal securities laws, the proposed legislation would make registration mandatory for all CRAs. CRAs would be required to adopt procedures to manage conflicts of interest in the rating process, including governance measures. Each CRA would have to document its policies and procedures for the determining ratings, including internal controls and due diligence practices. Each CRA would have to designate a compliance officer responsible for overseeing the CRA's policies and procedures and addressing conflicts of interest and remediation of violations. The compliance officer would not be allowed to engage in any rating activities, marketing, sales, or setting of compensation. The compliance officer would also be responsible for producing an annual compliance report, which would accompany financial statements required to be filed with the SEC. SEC rules would govern the process of approving and revising ratings methodologies.

Expanded SEC Oversight. The proposed legislation directs the SEC to establish a separate office dedicated to credit rating agency oversight. For all CRAs, the SEC would review the credit ratings assigned and the internal controls, due diligence, and other procedures the CRAs would be required to maintain. The SEC would publish reports summarizing its findings from these reviews. The SEC would also conduct periodic reviews of each CRA's conflict of interest policy and code of ethics, and make those documents publicly available. The SEC would be required to adopt rules establishing "a system of payment for each nationally recognized statistical rating organization that requires that payments are structured to ensure that the nationally recognized statistical rating organization conducts accurate and reliable surveillance of ratings over time, as applicable, and that incentives for accurate ratings are in place." The SEC's rulemaking powers would include authority to specify records to be kept by CRAs.

Conflicts of Interest. The proposed legislation requires the SEC to adopt rules to prohibit, or require the disclosure and management of, a broad range of conflicts of interest involving compensation for ratings and relationships with issuers and underwriters and their affiliates. Similar to the rules governing public company auditors, a CRA and each of its affiliates and associated persons would be subject to prohibitions on the non-rating services they could provide an issuer, underwriter or placement agent that engaged the CRA to provide a rating. CRAs would have to adopt "look back" procedures for determining whether conflicts of interest for CRA personnel subsequently employed by issuers or underwriters influenced ratings. Under the proposed look back provision, if an issuer hired a rating agency employee and the employee had worked on ratings for that issuer in the preceding year, the rating agency would be required to conduct a review of ratings for that issuer to determine if any conflicts of interest influenced the rating, and adjust the rating as appropriate.

Disclosure. Under the proposed legislation, CRAs would have to make public disclosures designed to facilitate review of rating performance. CRAs would also have to disclose compensation received from parties such as issuers for individual ratings and in the aggregate over specified time periods. SEC rules would also require CRAs to make disclosures related to changes in ratings methodologies and procedures, and would mandate differentiation of ratings for structured products from those for non-structured products. The SEC would develop a form to accompany each rating assigned by a CRA in which the CRA would explain the methodology and data underlying the rating and would provide assessments of data reliability, the probability of default, the estimated severity of loss in the event of default and the sensitivity of a rating to changes in assumptions. The requirements for this report would be designed to facilitate comparisons across different securities and institutions. To address the concern that an issuer might attempt to "shop" among rating agencies by soliciting "preliminary ratings" from multiple agencies and then only paying for and disclosing the highest rating it received for its product, issuers would be required to disclose any preliminary credit ratings.

Existing Credit Rating Reform Initiatives. The SEC has already undertaken rulemaking initiatives consistent with the goals of the proposed legislation. In February 2009, the SEC adopted several measures to increase the transparency of NRSRO methodologies, strengthen disclosure of ratings performance, prohibit certain practices that create conflicts of interest, and enhance recordkeeping and reporting obligations to assist the SEC in performing its regulatory and oversight functions. The SEC also proposed to require NRSROs to disclose, on a delayed basis, ratings history information for 100% of all issuer-paid credit ratings. (For more on these rulemaking initiatives, see the [December 9, 2008 Alert](#).) In July 2008, the SEC proposed revisions to various rules and forms under the

federal securities laws that would eliminate references to credit ratings. More recently, in connection with proposing comprehensive reform of money market funds, the SEC again requested public comment on whether to eliminate references to ratings in the regulation governing money market mutual funds as a way to reduce reliance on ratings.

Other Legislation. A number of bills addressing credit rating reform have been introduced in Congress in 2009. [H.R. 1181](#) introduced in February 2009 would require the SEC to establish standards for, and a process for approving, classes of asset-backed securities and would require NRSROs to annually review each outstanding rating and provide a formal affirmation, re-rating or ratings removal. The bill would also require formal determinations by the SEC as part of its regular surveillance of NRSRO models, systems, assumptions, and performance. [H.R. 1445](#) introduced in March 2009 would give the SEC rulemaking power to require disclosures to NRSROs by originators, issuers and underwriters regarding the collateral underlying structured securities and to require public disclosure by NRSROs of historical default rates of all classes of financial products that they rate. [S.927](#) introduced in April 2009 would require the SEC to conduct an annual audit of each NRSRO and require each NRSRO to furnish an annual report that (a) reviews its rating procedures and methodologies, its adherence to those rating procedures and methodologies, how the NRSRO manages conflicts of interest and complies with the securities laws and (b) provides a narrative response agreeing or disagreeing with the SEC's audit results and a certification by a duly authorized senior executive officer of the NRSRO. [S.1073](#) (which has been introduced in the House as H.R.3214) is notably more extensive in its reach than the prior bills, but is not as comprehensive as the proposed legislation. S.1073 does, however, have many of the same features as the proposed legislation, including establishment of a separate SEC office dedicated to NRSROs, SEC oversight of the application of NRSRO methodologies and controls, NRSRO use of an SEC established form for disclosures about ratings, public disclosure by NRSROs of rating performance information, a compliance officer requirement and anti-conflict of interest measures including a one-year look back for an NRSRO employee subsequently employed by an issuer.

Proposed Legislation to Establish the Consumer Financial Protection Agency

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed legislation](#) that would establish a new consumer regulatory agency, the Consumer Financial Protection Agency (the "CFPA"), which would consolidate and expand the existing regulatory regime for consumer financial products. Rep. Barney Frank, Chairman of the House Financial Services Committee, has introduced the proposed legislation to that committee as [H.R. 3126](#). The House Financial Services Committee has already held hearings on the proposed legislation, but will not be able to pass the legislation out of committee before Congress' summer recess. The proposed legislation is designed to implement recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

The proposed legislation does not differ substantially from the White Paper. The most significant change from the White Paper is that under the proposed legislation the federal banking agencies retain jurisdiction over the Community Reinvestment Act. The proposed legislation also differs from the White Paper by referring to the agency that charters and supervises national banks rather than the proposed National Bank Supervisor.

The CFPA would combine the rule-writing, supervision and enforcement powers for consumer financial products currently spread among several federal agencies, which addresses what the Treasury asserts is a key weakness in the current regulatory system. Under the proposed legislation these combined consumer protection powers are separated from prudential supervision, which the Treasury believes creates no true conflicts despite the concerns to the contrary which have been vehemently expressed by both the financial services industry and the Federal banking agencies. The proposed legislation seeks to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services. The sole mission of the CFPA would be to protect consumers in the market for consumer financial products and services. If enacted in its current form, the proposed legislation would be one of the most significant changes to financial regulation in the last quarter century and would have broad effects beyond the financial services industry, as its regulations would apply to *anyone* offering consumer financial products.

Establishment of the CFPA. The CFPA would be established as an independent agency in the executive branch. All consumer financial protection functions (other than backstop enforcement authority) and personnel would be transferred from the Federal Trade Commission and the Federal banking agencies. The CFPA would have a five member board (the “CFPA Board”) composed of four members appointed by the President and the regulator of national banks (currently the Comptroller of the Currency, but if other sections of the proposed legislation are enacted, this seat would be held by the Director of the National Bank Supervisor). The Director of the CFPA would be appointed by the President from the members of the CFPA Board. The terms of the CFPA board members are staggered, however, unlike other boards such as the SEC or the FDIC, there is no provision to balance the political affiliation of the members of the CFPA Board. The proposed legislation also provides for the establishment of a Consumer Advisory Board comprised of outside experts that would advise and consult with the CFPA on consumer financial matters. Though the proposed legislation requires the CFPA to coordinate with other federal and state agencies, there is no explicit mechanism for resolving disputes with other agencies such as the federal prudential regulators.

CFPA Funding. The proposed legislation authorizes the CFPA to collect fees and assessments on a defined basis such as the outstanding volume of consumer credit accounts, total assets under management, or consumer financial transactions. The CFPA would also be able to obtain civil money penalties under the proposed legislation. Such civil money penalties would be deposited into a Consumer Financial Protection Agency Civil Penalty Fund to provide for payments to “victims of activities for which civil penalties have been imposed.”

Scope and Authority of the CFPA. As in the White Paper, the proposed legislation gives the CFPA broad authority to regulate any person who engages directly or indirectly in a financial activity in connection with the provision of a consumer financial product or service (“Covered Persons”). This would include service providers and transaction processors for persons engaged in providing consumer financial products and services. However, neither investment products regulated by the SEC or the CFTC nor insurance products regulated by the states would be regulated by the CFPA. Under the proposed legislation, the CFPA would have exclusive rulemaking authority and primary enforcement powers for the Alternative Mortgage Transaction Parity Act, the Electronic Funds Transfer Act, the Equal Credit Opportunity Act (“ECOA”), the Fair Credit Reporting Act (except with respect to red flags, affiliate marketing and data disposal), the Fair Debt Collection

Practices Act, certain provisions of the Federal Deposit Insurance Act relating to disclosures by uninsured depository institutions, the privacy policy provisions of the Gramm-Leach-Bliley Act, the Home Mortgage Disclosure Act (“HMDA”), the Real Estate Settlement Procedures Act, the Secure and Fair Enforcement for Mortgage Licensing Act, the Truth in Lending Act and the Truth in Savings Act. The CFPA is further authorized to restrict mandatory pre-dispute arbitration for any dispute arising from its regulations or the foregoing statutes. When prescribing rules, the proposed legislation requires the CFPA to consider the potential benefits and costs to consumers and Covered Persons, including the potential reduction of consumer’s access to consumer financial products and services, and to consult with the Federal banking agencies. The proposed legislation also authorizes the CFPA to examine or require reports from Covered Persons and grants the CFPA access to reports of the Federal banking agencies. The proposed legislation further grants the CFPA certain specific authorities incorporated from the White Paper:

- The authority to prohibit unfair, deceptive or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service;
- The authority to require disclosures and other communications to customers describing the costs, benefits and risk associated with any consumer financial product or service, subject to a reasonableness standard;
- The authority to prescribe rules and issue orders and guidance regarding the sales practices for consumer financial products and services;
- The authority to establish standards and procedures for the approval of pilot disclosures by Covered Persons to consumers;
- The authority to require background checks, licensing, bonding, recordkeeping and other procedures for Covered Persons;
- The authority to impose duties on a Covered Person or its employees, agents or independent contractors; and,
- The authority to require Covered Persons to make available to a consumer information regarding that consumer;

The proposed legislation prohibits the CFPA from establishing a usury limit. However, the proposed legislation does grant the CFPA authority over transaction charges and fees.

Standard Consumer Financial Products or Services. One of the most controversial provisions of the proposed legislation would provide the CFPA with the authority to define standard (or “plain vanilla” as referred to in the White Paper) consumer financial products and services. The proposed legislation gives the CFPA the authority to require that Covered Persons offer standard products if the Covered Person is offering other consumer financial products or services of the same type. Consumers would be given warnings regarding the “heightened risks of alternative consumer financial products or services” and could decline such alternative products in favor of the standard product. Standard consumer financial products and services would have a presumption of suitability for consumers. Conversely, alternative consumer financial products and services may not be presumed to be suitable and would be subject to enhanced regulatory scrutiny. Many in financial services industry believe these provisions will stifle innovation in the markets for consumer financial

products and services. Despite these concerns, the Treasury continues to maintain that the proposed legislation is not inconsistent with financial innovation.

Relation with State Law. The proposed legislation does not contain any preemption of state law. Rather it sets a floor for consumer protection laws and allows states to adopt more restrictive laws so long as they are not inconsistent with the statutes and regulations of the CFPA. Further, the proposed legislation empowers, in consultation with the CFPA, the state attorneys general to bring civil actions for monetary or equitable relief for violations of the proposed legislation or any regulations of the CFPA. The proposed legislation also sets aside over 100 years of preemption for federally chartered financial institutions by providing that any consumer protection provision in state consumer laws of general application shall apply to national banks, federally-chartered thrifts and the subsidiaries of either, so long as such laws are not discriminatory against federally chartered institutions and are consistent with federal law. The proposed legislation also amends the National Bank Act and the Home Owners Loan Act to provide that visitorial powers would not prevent or restrict a state attorney general from demanding records or enforcing federal or state law, expanding on the U.S. Supreme Court's recent decision in *Cuomo v. The Clearing House Association, LLC* (as discussed in the [June 30, 2009 Alert](#).)

Enforcement Powers. The proposed legislation provides that the CFPA may enforce the statutes under its jurisdiction and its regulations through administrative proceedings or civil actions. Civil money penalties are authorized under the proposed legislation for (i) up to \$5,000 per day for a violation of an CFPA order or condition; (ii) up to \$25,000 per day for violations of any rule or regulation relating to standard consumer financial products and services or for any reckless violation of the laws and regulations of administered by the CFPA; or (iii) up to \$1,000,000 per day for knowing violations of the laws and regulations of administered by the CFPA. The proposed legislation further provides for the protection of employees of Covered Persons who provide information to the CFPA.

Private Rights of Action. The proposed legislation does not create any new private rights of action to enforce the regulations and statutes of the CFPA. However, existing private rights of action under the statutes for which the CFPA would have jurisdiction would be retained under the proposed legislation.

Data Collection. The proposed legislation requires financial institutions to collect certain additional data regarding deposit accounts, including the addresses of depositors and whether a deposit account is for a residential or commercial customer. The ECOA would be amended by the proposed legislation to require data collection relating to small business loans and women- and minority-owned small businesses. The proposed legislation also imposes additional HMDA data collection requirements.

Proposed Legislation for the Supervision of Systemically Important Payment, Clearing and Settlement Systems

As part of its financial regulatory reform program, the Obama Administration, through the Treasury, submitted to Congress [proposed legislation](#) that authorizes the Board of Governors of the Federal Reserve System (the "FRB") to designate systemically important payment, clearing and settlement systems and prescribe uniform standards for such systems. The proposed legislation is designed to implement recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

Designation of Systemically Important Payment, Clearing and Settlement Systems. Pursuant to the proposed legislation, the FRB may designate a financial market utility (defined by the proposed legislation as a person who operates a payment, clearing or settlement system) or payment, clearing or settlement activity as, or likely to become, systemically important. A systemically important system is one that if it failed or was disrupted would create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system. In making these determinations, the proposed legislation instructs the FRB to consider (i) the aggregate monetary value of transactions carried out through the financial market utility or the payment, clearing or settlement activity; (ii) the relationship, interdependencies and other interactions of the financial market utility or payment, clearing or settlement activity with other financial market utilities or payment, clearing or settlement activities; (iii) the effect of the failure or disruption of the financial market utility or payment, clearing or settlement activity would have on the financial market; (iv) the recommendation of the Financial Services Oversight Council; and (v) such other considerations as the FRB determines to be necessary. A designation that a financial market utility or payment, clearing or settlement activity is systemically important is subject to reevaluation, rescission, notice and an opportunity to be heard.

Standards for Systemically Important Payment, Clearing and Settlement Systems. The proposed legislation authorizes the FRB to prescribe risk management standards governing the operations of designated systemically important financial market utilities or payment, clearing or settlement activities. These standards would be designed to promote robust risk management, promote safety and soundness, reduce systemic risk and support the stability of the broader financial system. Such standards could address risk management policies and procedures, margin, collateral, capital and default policies and procedures, and the ability to complete timely clearing and settlement of financial transactions.

Operations of Designated Financial Market Utilities. The proposed legislation authorizes the FRB to maintain accounts and provide services for designated financial market utilities, including allowing such financial market utilities to have access to borrow from the discount window. The FRB may also exempt a designated financial market utility from the reserve requirements of the Federal Reserve Act, or modify such requirements to apply to designated financial market utilities.

Examination and Enforcement. The proposed legislation provides for an annual examination of a designated financial market utility by the federal agency with primary jurisdiction over the designated financial market utility under banking, securities or commodity futures laws. Service providers to a designated financial market utility may also be examined in connection with their provision of integral services to that designated financial market utility. The proposed legislation also authorizes the appropriate federal regulator to examine a financial institution engaged in systemically important payment, clearing or settlement activities. These examinations of designated financial market utilities, service providers and financial institutions would be conducted in consultation with the FRB, which has back-up examination powers. Under the proposed legislation, designated financial market utilities will be subject to the same manner of enforcement actions as insured depository institutions. Financial institutions engaging in systemically important payment, clearing or settlement activities would also be subject to enforcement actions. The FRB also has back-up enforcement powers relating to designated financial market utilities and systemically important payment, clearing or settlement activities.

Requests for Information, Reports or Records. The proposed legislation authorizes the FRB to require any financial market utility or financial institution engaged in systemically important payment, clearing or settlement activities to submit information to FRB to allow the FRB to determine whether the financial market utility or financial institution engaged in systemically important payment, clearing or settlement activities is systemically important. Financial market utilities and financial institutions engaged in systemically important payment, clearing or settlement activities may be required to make regular reports to the FRB. Such reports may be disclosed by the FRB to the appropriate federal regulator who supervises the designated financial market utility or financial institution engaged in systemically important payment, clearing or settlement activities. Such federal regulators are also authorized to share their reports with the FRB.

Proposed Legislation Revising the FRB's Authority to Provide Emergency Funding under Section 13 of the Federal Reserve Act

The Treasury submitted [proposed legislation](#) to Congress that would amend the third paragraph of Section 13 of the Federal Reserve Act (the "FRA") to place a restriction on the FRB's currently almost unlimited authority to provide emergency funding through the FRB's discount window to financial institutions (as well as other firms) under economic stress (*i.e.*, a firm is "unable to secure adequate credit accommodations from other banking institutions").

The proposed legislation would amend Section 13 of the FRA to require that the FRB obtain the prior written approval of the Secretary of the Treasury before extending any such funding.

Proposed Legislation to Enhance SEC Authority and Heighten Investor Protection and Advocacy

The Obama Administration, through the Treasury, has submitted to Congress [proposed legislation](#) that is intended to clarify and strengthen the SEC's authority in several areas of the federal securities laws. The proposed legislation is designed to implement several recommendations made in the Treasury's June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)).

Consistent Standards for Broker-Dealer and Investment Adviser Conduct towards Clients. Consistent with the White Paper's recommendations, the proposed legislation would address the issue of harmonizing investment adviser and broker-dealer regulation by giving the SEC broad authority to promulgate rules establishing that brokers, dealers and investment advisers providing investment advice shall act solely in the interest of the customer or client without regard to any interest of the broker, dealer or investment adviser. The proposed legislation would also require the SEC to take steps to facilitate the provision of clear disclosures to investors about the scope of their relationship with their investment professionals and to examine and, if necessary, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers and investment advisers) that it deems contrary to the public interest and interest of investors.

Mandatory Arbitration. The proposed legislation would give the SEC authority to prohibit or impose conditions or limitations on the use of mandatory arbitration clauses for clients of

any broker, dealer, municipal securities dealer or investment adviser if the SEC finds such prohibition, imposition or limitation to be in the public interest and for the protection of investors. The proposed legislation does not reflect the White Paper's recommendation that prior to exercising that authority the SEC conduct a study on whether mandatory arbitration negatively affects the resolution of legitimate investor complaints and should be limited or modified.

Pre-Sale Disclosures for Investment Company Sales. The proposed legislation would authorize the SEC to promulgate rules designating the information that must precede the sale of registered investment company shares. This provision implements the White Paper's recommendation to require the delivery of adequate information to allow investors to make informed decisions but falls short of the White Paper's recommendation that these disclosures include a summary prospectus.

Consumer Testing of Disclosure and Rules. Consistent with the White Paper, the proposed legislation would make express the SEC's authority to engage in consumer testing, including engaging in temporary or experimental programs, to evaluate its rules and programs and for considering, adopting, or engaging in rules or programs under the major federal securities laws. This element of the proposed legislation would confirm and codify the authority that the SEC has increasingly exercised in various recent initiatives such as the summary prospectus and the proposed point of sale disclosures.

Expanded Whistleblower Protections. The proposed legislation gives the SEC the authority to establish a whistleblower fund that pays for information leading to enforcement actions that result in significant financial rewards. It would also give the SEC the authority to reward non-governmental and certain non-criminal whistleblowers who provide original information to the SEC in an action that yields monetary sanctions exceeding \$1 million. Any reward and its amount would be discretionary on the SEC's part, with the amount not to exceed 30% of the monetary sanction. The proposed legislation establishes an SEC investor protection fund within the Treasury that could be used to fund the program as well as investor education initiatives designed to help investors protect themselves against securities law violators.

The proposed legislation would establish a cause of action for whistleblowers seeking redress for harassment or discrimination experienced because of their whistleblowing activities, with relief to include reinstatement, twice the amount of back pay, and litigation costs. Under the proposed legislation, information provided to the SEC by the whistleblower would remain confidential and privileged until it is required to be disclosed to the defendant in a proceeding brought by the SEC or the enumerated government entities with which the SEC could share the information without compromising its confidential or privileged nature.

Liability Standards/Aiding and Abetting. The proposed legislation codifies and harmonizes aiding and abetting causes of action under the federal securities laws. The SEC currently may bring actions against persons who aid and abet securities laws violations under the 1934 Act and Advisers Act. The proposed legislation would provide specific authority to bring similar actions under the 1933 Act and the 1940 Act. In so doing, the proposed legislation clarifies the legal standard for such cases as one in which a person has knowingly or recklessly aided or abetted a violation under those statutes. In addition, the proposed legislation clarifies that the SEC can obtain penalties under these provisions.

Collateral Bars. The proposed legislation would expand the scope of the collateral bar sanction currently available to the SEC to cover a broader range of sectors of the securities industry namely, investment advisers, broker-dealers municipal securities dealers, transfers agents and nationally recognized statistical rating organizations.

Investor Advisory Committee. The proposed legislation would make permanent the SEC's newly created Investment Advisory Committee ("IAC"), which at its first meeting on July 27, 2009 discussed certain of the issues raised by the proposed legislation, including establishing a consistent fiduciary duty standard for investment professionals and mutual fund point of sale disclosures. The new legislation codifies the establishment, appointment process and stated purpose of the committee which is to advise and consult the SEC on (1) regulatory priorities and issues regarding new products, trading strategies, fee structures and the effectiveness of disclosures; (2) initiatives to protect investor interests; and (3) initiatives to promote investor confidence in the integrity of the marketplace. The proposed legislation would require the IAC to meet a minimum of at least twice yearly and more, if needed, at the behest of the SEC.

House Chairmen Issue Concept Paper on Legislation for Derivatives Regulation Reform

On July 30, 2009, Congressman Collin Peterson, Chairman of the House Agriculture Committee, and Congressman Barney Frank, Chairman of the House Financial Services Committee, released a [concept paper](#) on forthcoming legislation addressing derivatives regulation. The paper outlines principles for a new U.S. regulatory regime for derivatives. Under the proposal, "strong incentives" (such as "significantly higher" margin and capital charges for non-standard or not centrally cleared or exchange-traded transactions) would encourage derivatives trading to move onto an exchange or an electronic platform. Clearing through a regulated clearinghouse would be mandatory with limited exceptions. And, "robust oversight" would include trade reporting, regulation of clearinghouses for derivatives (by a market regulator, and away from the Federal Reserve, in the case of credit default swaps ("CDS")) and a role for the Financial Services Oversight Council (discussed elsewhere in this issue) to "resolve disputes" between the SEC and CFTC over authority over new products and joint regulation of existing products.

To supplement its "incentives," the new regime would give regulators the authority to prohibit or further regulate transactions not traded on an exchange or centrally cleared, and "in order to prevent abuse," a regulator would be authorized to impose position limits and ban non-dealers from buying credit protection. The concept paper targets regulation of so-called naked CDS – the proposed regime would prohibit buying credit protection without ownership of referenced securities, a position in a related index or a bona fide economic interest to be protected – and would require reporting of short interests in CDS. However, the concept paper leaves open the question of whether centralized clearing and other measures offer an alternative to banning naked CDS contracts. In addition, the concept paper fails to address key issues such as which of the CFTC and the SEC will have authority over which derivative products, clearinghouses, reporting and other relevant matters.

In the proposed regime, U.S. regulators would coordinate with their non-U.S. counterparts to establish international standards for clearinghouses and otherwise harmonize new OTC derivatives regulation internationally. The Treasury would be authorized to restrict access

the U.S. banking system for institutions from jurisdictions with lower capital-related standards or standards that “promote reckless market activity.”

The principles outlined in the concept paper are generally consistent with priorities set out in the Treasury’s June 2009 White Paper on financial regulatory reform (as discussed in the [June 23, 2009 Alert](#)). The concept paper and the White Paper share goals such as addressing gaps and inconsistencies in the regulation of derivatives by the SEC and CFTC, preventing activities in the derivatives market from being a “source of contagion through the financial sector,” promoting transparency and preventing market manipulation. The concept paper also echoes recommendations from the Committee on Capital Markets Regulation’s report “[The Global Financial Crisis A Plan for Regulatory Reform \(5/26/09\)](#),” which include not prohibiting CDS contracts categorically, introducing mandatory centralized clearing (with some exceptions) and increased capital requirements for non-standard transactions, including those contracts settled outside the centralized clearing process.

GAO Issues Report on Federal Oversight of Leverage

The Government Accountability Office (the “GAO”) released a report (the “Report”) on the role of leverage in the current financial crisis and federal oversight of leverage pursuant to a requirement in the Emergency Economic Stabilization Act of 2008. In preparing the Report, the GAO reviewed the following: (1) how leveraging and deleveraging by financial institutions may have contributed to the current financial crisis; (2) regulations adopted by federal financial regulators to try to limit the use of leverage by financial institutions, and how regulators oversee the institutions’ compliance with the regulations; and (3) any limitations the current crisis has revealed in regulatory approaches used to restrict leverage and regulatory proposals to address them.

The Report notes that the causes of the current financial crisis remain subject to debate and additional research. Nevertheless, the Report also notes that some studies have suggested that leverage steadily increased within the financial sector before the crisis began around mid-2007, and that banks, securities firms, hedge funds, and other financial institutions have since sought to deleverage and reduce their risk, thereby compounding the current crisis. In particular, some studies have suggested that deleveraging by selling financial assets could trigger downward spirals in financial asset prices, and that deleveraging by restricting new lending could contribute to the crisis by slowing economic growth. However, other theories also provide possible explanations for the sharp price declines. For example, the current market prices may be the result of asset prices reverting to their fundamental values after a period of overvaluation, or they may reflect uncertainty surrounding the true value of the assets. In this regard, the Report concludes that because the crisis is complex, “no single theory is likely to fully explain what occurred or rule out other explanations.” The Report also notes that financial regulators and market participants interviewed by the GAO had mixed views about the effects of deleveraging in the current crisis.

With respect to capital adequacy regulations, the Report states that the crisis has revealed limitations in existing regulatory approaches used to restrict leverage. For example, the Report notes that, although large banks and broker-dealers generally held capital above the minimum regulatory capital requirements prior to the crisis, regulatory capital measures did not always fully capture certain risks. As a result, a number of these institutions did not hold capital commensurate with their risks, and some lacked adequate capital or liquidity

when the crisis began. Federal financial regulators have acknowledged the need to improve the risk coverage of the regulatory framework and are considering reforms, including through international efforts to revise the Basel II capital framework. Basel II, as it will be implemented in the U.S., allows for increased reliance on risk models for determining capital needs for certain large institutions. Although the crisis highlighted concerns about the ability of such models to adequately measure risks for capital adequacy purposes, the Report notes that regulators have not formally assessed the extent to which Basel II reforms proposed by U.S. and international regulators may address these concerns. According to the Report, such “an assessment is critical to ensure that Basel II reforms, particularly those that would increase reliance on complex risk models for determining capital needs, do not exacerbate regulatory limitations revealed by the crisis.”

The Report also discusses how the existing regulatory framework, as well as other factors, might have contributed to cyclical leverage trends that potentially exacerbated the financial crisis. For example, minimum regulatory capital requirements, as currently structured, may not provide appropriate incentives for banks to build capital buffers in benign markets when it is relatively less expensive to do so. While regulators are considering several options to counteract this procyclicality, the Report notes that implementation of these proposals presents challenges.

The Report also notes that the crisis has reinforced the need to focus greater attention on systemic risk and the potential for financial market disruptions, not just firm failures, to be a source of systemic risk. In order to ensure that there is a systemwide approach to addressing leverage-related issues across the financial system, the Report recommends that, as Congress moves toward establishing a systemic risk regulator, it should consider the merits of assigning to such regulator the responsibility for (i) measuring and monitoring systemwide leverage and (ii) evaluating options to limit procyclical leverage trends.

Furthermore, the Report recommends that the federal banking agencies assess the extent to which Basel II reforms may “address risk evaluation and regulatory oversight concerns associated with advanced modeling approaches used for capital adequacy purposes.” The Report notes that the GAO received written comments from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the SEC, all of whom generally agreed with the Report’s conclusions and recommendations.

OCC Issues Interpretive Letter regarding the Exchange of Real Property Acquired for Debt Previously Contracted

The OCC issued Interpretive Letter #1118 (“Letter #1118”), permitting a national bank (the “Bank”) to exchange real property acquired for a debt previously contracted (“DPC”) for an interest in an entity that would dispose of the real property. The Bank had purchased participations secured by townhouse units in a townhouse apartment complex, and subsequently acquired an interest in the units (the “DPC Interests”) when the borrower defaulted. The Bank and several other financial institutions with fractional interests in townhouse units at the complex decided to contribute their DPC Interests to an LLC (“LLC”) to manage and dispose of the real estate. In this case, the Bank contended that by exchanging the DPC Interest for an interest in the LLC, which would wholly own the property interests making up the entire townhouse complex, it would be better able to recover its loan loss and to dispose of the property. Furthermore, the LLC would operate and maintain the complex as a whole, rather than each individual bank’s bearing

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responsibility to operate and maintain its individual units in the townhouse complex, providing each of the banks with cost savings through efficiencies. The OCC concluded that the Bank has authority under 12 U.S.C. §§ 24(Seventh) and 29 to engage in this exchange.

Letter #1118 reiterates that national banks may exchange permissibly acquired DPC real property for other types of real or personal property, provided, *inter alia*, that the exchange is made in good faith. OCC precedent has required that the exchange for other property must improve the ability of the Bank to recover, or otherwise limit, its loan loss. Such determinations are specific to each DPC property and the associated exchange.

The OCC provided that approval of the exchange was subject to certain conditions. First, prior to making the exchange, the Bank's directors must determine that the exchange is in the best interests of the Bank and would improve the ability of the Bank to recover, or otherwise limit, its loan loss. Second, prior to making the exchange, the Bank must notify its OCC Supervisory Office, in writing, of the proposed exchange and must receive written notification of supervisory non-objection, based on an evaluation of the adequacy of the Bank's risk management and measurement systems and controls to enable the Bank to exchange for, hold, and dispose of the LLC interest in a safe and sound manner, and an evaluation of any other supervisory considerations relevant to the exchange. Third, the Bank may not further exchange the LLC interest for an interest in any other real or personal property. Fourth, the Bank must ensure that the LLC complies with the provisions of the OCC's OREO regulation, 12 C.F.R. Part 34, Subpart E, including obtaining a current appraisal on the property. Fifth, the Bank must dispose of its interest in the LLC no later than five years from the date it acquired title to the DPC Interests, unless granted an extension by the OCC.

OTHER ITEMS OF NOTE

FTC Extends Compliance Date for Red Flags Rule to November 1, 2009

The FTC [announced](#) that it has extended the compliance date for its red flags rule (16 CFR 681) until November 1, 2009. This delay does not affect other federal agencies' enforcement of the original November 1, 2008 compliance deadline for institutions subject to their oversight. The announcement refers readers to a [FAQ](#) on the rule.

Client Alert on SEC Actions Regarding Short Sales

Goodwin Procter issued a [Client Alert](#) discussing the SEC's recent action making Rule 204 of Regulation SHO permanent, eliminating Form SH filing obligations for institutional investment managers and announcing plans to make short sale transactions and volume information publicly available through SRO websites.

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