

COMMITTEE ON CAPITAL MARKETS REGULATION

April 26, 2010

The Honorable Christopher Dodd
Chairman
United States Senate Committee on
Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Blanche Lincoln
Chairman
United States Senate Committee on
Agriculture, Nutrition and Forestry
355 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member
United States Senate Committee on
Banking, Housing and Urban Affairs
304 Russell Senate Office Building
Washington, DC 20510

The Honorable Saxby Chambliss
Ranking Member
United States Senate Committee on
Agriculture, Nutrition and Forestry
416 Russell Senate Office Building
Washington, DC 20510

A Blueprint for Compromise

Dear Chairman Dodd, Ranking Member Shelby, Chairman Lincoln and Ranking Member Chambliss:

The Committee on Capital Markets Regulation (Committee) has, since its establishment in 2005, provided empirical, independent research dedicated to improving the regulation of U.S. capital markets. In May 2009, the Committee published its report entitled, *The Global Financial Crisis: A Plan for Regulatory Reform* (May Report),¹ setting out 57 recommendations for enhancing the soundness and effectiveness of the U.S. financial regulatory framework. In addition, in March 2010, the Committee proposed a comprehensive approach to reducing systemic risk from over-the-counter derivatives in a letter to the Chairman and Ranking Members of the Senate Banking Committee and House Financial Services Committee (CCMR Derivatives Letter).² We now believe it would be useful to comment on the financial reform legislation recently reported to the Senate floor by the Senate Banking Committee (the Senate Banking bill) and the Senate Agriculture Committee (the Senate Agriculture bill). In essence, we aim to provide a blueprint for compromise.³

¹ COMM. ON CAPITAL MKTS. REGULATION, *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* (2009) [hereinafter CCMR PLAN FOR REGULATORY REFORM].

² Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Fin. Serv. Comm. (Mar. 4, 2010) [hereinafter CCMR Derivatives Letter].

³ The Committee notes that while there is broad consensus on the recommendations in this letter, there are some differences between Committee members. The views stated in this letter should not be attributed to any particular Committee member.

The Committee wishes to emphasize four crucial points:

1. **“Foam on the Runway.”** Unless we can be sure that new regulations will end the possibility that the failure of an interconnected firm could set off a chain reaction of failures, regulators must have the ability to bailout a failing institution, which may require insulating certain creditors or counterparties from some or all losses. The “foam” could come from a well-designed FDIC guarantee program, adequately collateralized Federal Reserve lending, or from government injected capital, losses on which would be recovered from the financial community after the fact, rather than the \$50 billion Liquidation Fund provided in the Senate Banking bill.
2. **Consumer Financial Protection Agency.** Although some Committee members disagree, most would recommend giving the Secretary of the Treasury, in addition to the Financial Stability Oversight Council, the right to veto a proposed CFPB policy on safety and soundness or systemic risk grounds, since this would help ensure that the financial system is protected from over-zealous regulation. If this proposal is accepted, most Committee members also believe the Treasury Secretary should be given the ability to override other financial regulatory agencies on the same grounds.
3. **Asset Thresholds, Not Systemic Risk Designations.** The Senate Banking bill now provides that firms designated as “systemically important” will be subject to enhanced supervision by the Federal Reserve. As an alternative, the Committee recommends that Federal Reserve oversight be determined by an asset threshold (such as the \$50 billion threshold set for banks) that is set low enough to include some firms that are not intuitively systemically important. This will decrease moral hazard and avoid creating funding advantages for the chosen “systemically important” institutions. The Financial Stability Oversight Council, upon a recommendation by the Secretary of the Treasury, could set asset thresholds for different industries. Appropriate regulation of non-bank financial firms would be determined after a Federal Reserve study, though some on the Committee believe at least some additional regulation will be necessary.⁴
4. **Derivatives.** The Committee is deeply concerned by the fact that the Senate Banking bill fails to address many key issues in the area of derivatives and as a result grants excessive discretion to regulators. What was designed by Senator Dodd as a placeholder seems to have become the Senate Banking Committee’s actual proposal. Given the importance of derivatives reform, the Committee urges the members of the Senate Banking Committee to return to the negotiating table.

The Committee also opposes provisions in the Senate Agriculture bill that would prohibit so-called swap entities from borrowing from the Federal Reserve or benefiting in a crisis from FDIC guarantees. Given the interconnectedness problem (i.e., the possibility that

⁴ While the majority of Committee members would support this approach, some Committee members disagree with allowing the Federal Reserve to supervise nonbanks at all, whether based on systemic risk designations or asset thresholds.

the failure of one firm can set off a chain reaction of failures), such assistance may be necessary to avoid a financial meltdown.

The Committee further notes that the Senate Agriculture bill would unnecessarily reintroduce significant legal uncertainty and resulting legal risk for market participants as to whether swaps and forwards are subject to regulation as futures contracts under the Commodity Exchange Act.

While these are our most important recommendations, the following summary provides a more complete overview of provisions in the proposed legislation the Committee supports, provisions the Committee believes can be improved, and provisions the Committee opposes. A detailed discussion follows.

HIGHLIGHTS

I. Provisions Supported by the Committee

- **Focus on Interconnectedness:** The Committee supports the Senate Banking bill's emphasis on the issue of interconnectedness, including its call for the newly created Financial Stability Oversight Council to identify risks that could arise from "large, interconnected" bank holding companies and nonbank financial companies, and to make recommendations concerning prudential measures to prevent such risks from materializing.
- **Securitization:** The Committee supports provisions in the Senate Banking bill that require originators and securitizers to keep "skin in the game" by retaining unhedged risk, with the total amount of risk retention based on underwriting quality. The Committee also supports greater loan-by-loan transparency and disclosure, though subject to differing requirements depending on the sophistication of eligible investors.
- **FDIC Guarantees:** The Committee supports provisions in the Senate Banking bill that allow the use of FDIC guarantees necessary to combat systemic risk and that limit the availability of such guarantees to solvent institutions.

II. Provisions That Can Be Improved

- **Derivatives⁵**
 - **Need for Comprehensive Reform.** The Committee is deeply concerned by the fact that the Senate Banking bill fails to address many key issues in the area of derivatives and as a result grants excessive discretion to regulators. What was designed by Senator Dodd as a placeholder seems to have become the Senate Banking Committee's actual proposal. The Senate Agriculture bill also suffers from the same problem.

⁵ The following overview of the Committee's recommendations is not exhaustive. The CCMR Derivatives Letter contains additional recommendations as well as detailed explanations of the Committee's views on derivatives.

- **Regulatory Jurisdiction.** Most Committee members recommend giving the Federal Reserve broad authority over derivatives clearinghouses, capital and margin requirements for derivatives that are not centrally cleared, as well as other aspects of derivatives regulation, due to its central role in monitoring and responding to systemic risk. The Senate Banking bill and the Senate Agriculture bill leave it unclear whether the Federal Reserve, on the one hand, or the CFTC and SEC, on the other, will have this jurisdiction.
- **Assistance for Swap Entities.** The Committee strongly recommends removing provisions in the Senate Agriculture bill that would prohibit swap dealers, major swap participants, swap execution facilities, national securities exchanges, or clearinghouses from borrowing from the Federal Reserve or benefitting in a crisis from FDIC guarantees.
- **Unacceptable Legal Uncertainty.** The Committee also recommends removing provisions in the Senate Agriculture bill that would unnecessarily reintroduce significant legal uncertainty and resulting legal risk for market participants as to whether swaps and forwards are subject to regulation as futures contracts under the Commodity Exchange Act.
- **Types of Contracts.** The central clearing mandate should be limited to contracts that are standardized and liquid. By contrast, the Senate Banking bill requires that derivatives counterparties centrally clear their trades unless no clearinghouse will accept their trades for clearing. In addition, the Senate Banking bill grants the CFTC and SEC complete discretion to require that any other group, category, type, or class of derivatives contracts be accepted for clearing.
- **Foreign Exchange Contracts.** Although some Committee members disagree, the majority of the Committee would oppose an unbounded, blanket exemption of all foreign exchange contracts from clearing requirements. In addition, the Committee would support an exemption for foreign exchange contracts with maturities of up to one month, where risks are limited, and would give the Federal Reserve the authority to extend the exemption for foreign exchange contracts with somewhat longer maturities. Neither the Senate Banking bill nor the Senate Agriculture bill takes this approach. The Senate Banking bill completely exempts foreign exchange derivatives, while the Senate Agriculture bill does not exempt even short-term foreign exchange contracts.
- **Clearinghouse Membership Standards.** Given that the failure of a major clearinghouse would itself pose a systemic risk, clearinghouses must maintain high membership standards to ensure safety and soundness. For this reason, clearinghouses should require members to have sufficient capital levels and proven proficiency in trading and operations. On the other hand, regulators should be given authority, to the extent they do not have it already, to monitor clearinghouse membership criteria to prevent existing clearinghouse members from establishing discriminatory membership standards. We believe the Senate Banking bill adequately addresses these issues.
- **Types of Counterparties.** The Committee believes the clearing requirement should apply to contracts between clearinghouse members. It should also apply to non-clearinghouse members, as guaranteed by clearinghouse members, with substantial net

counterparty exposures. While most Committee members believe that clearing requirements should apply to commercial firms in principle, they do not think firms should be required to clear contracts used to hedge commercial risk since there is limited (if any) market risk associated with such contracts. The Senate Banking bill and the Senate Agriculture bill each take a different approach.

- **Required Clearinghouse Membership.** Since clearinghouses reduce systemic risk by spreading losses among clearinghouse members, it is important that firms with substantial derivatives trading activity be required to join clearinghouses, if feasible. Most Committee members would therefore recommend that the proposed legislation require all firms that exceed certain “net exposure thresholds” (defined to exclude exposure from contracts used to hedge commercial risk) be made clearinghouse members if they are eligible. The Senate Banking bill does not contain any proposal regarding required clearinghouse membership.
- **Segregation of Initial Margin.** The Committee strongly favors segregation of initial margin. While legislation should not require initial margin for derivatives that are not centrally cleared to be held in segregated accounts (since counterparties who prefer this arrangement can bargain for it), dealers should be required to fully disclose collateral arrangements and offer counterparties the opportunity to segregate initial margin on a non-discriminatory basis with a custodian that is bankruptcy remote from the dealer. Both the Senate Banking bill and the Senate Agriculture bill differ from the Committee’s preferred approach in requiring segregation, if demanded by the counterparty, rather than encouraging it. Both bills could also be improved by emphasizing custodians’ bankruptcy remoteness from the dealer instead of independence, and by making clear that counterparties’ right to demand segregation applies to initial margin, not all collateral.
- **Transaction Reporting.** The Committee supports reforms that would make certain volume and position data publicly available. The Committee would allow a modest delay in reporting most trades that occur off exchange to permit a reduction of costs through a bunching procedure. The Committee would also allow the Federal Reserve to provide more substantial delays for public disclosure of transactions that are large compared to average volume or that involve contracts that infrequently trade. In general, the Committee would support a system that ensures trades remain anonymous and not individually identifiable. By contrast neither the Senate Banking bill nor the Senate Agriculture bill clearly recognizes the need for modest delays to permit application of a bunching procedure. But while the Senate Banking bill also fails to acknowledge the need for more substantial delays before public disclosure of block trades, the Senate Agriculture bill does call for time delays in the public reporting of cleared block trades that take into account “whether the public disclosure will materially reduce market liquidity.”
- **Derivatives Exchanges.** The Committee believes exchange trading should not be required, but encouraged where appropriate. To the extent that legislation involves an exchange-trading requirement, the only alternative to trading on an organized exchange should be trading on a platform along the lines of an “alternative trading system,” as defined by the SEC, or another venue that is appropriately regulated in light of the

transparency objectives of the legislation. The Senate Banking bill and the Senate Agriculture bill take a different approach than the Committee to the core issue by providing that swaps required to be cleared must also be traded on an exchange or the equivalent.

- **Scope and Number of Clearinghouses.** Most Committee members believe there are benefits from having multiple, well-capitalized clearinghouses, with strong margining procedures, organized by asset-class. However, some members question if there are risk management benefits associated with this approach and are concerned that an asset-class based organizational scheme would increase the transaction costs associated with central clearing. Neither the Senate Banking bill nor the Senate Agriculture bill addresses any of these issues.
 - **Capital and Margin Requirements.** The Committee recommends excluding firms from capital and margin requirements for derivatives if their net derivatives exposures (defined to exclude exposure from contracts used to hedge commercial risk) do not exceed designated thresholds. The Senate Banking bill approximates this approach by limiting capital and margin requirements to swap dealers and major swap participants.
 - **Acknowledgement of Disagreement.** The Committee acknowledges that there are differences among some Committee members on a few of the foregoing points. For instance, some Committee members argue that the Committee's position on clearing is too inflexible. They believe it would be better to encourage firms to clear using member guarantees rather than requiring them to become clearinghouse members themselves. They also argue the clearinghouse membership and related clearing requirements should not be triggered by a net exposure threshold but rather by a more holistic assessment of whether a company's derivatives portfolio poses systemic risk. On the other hand, some Committee members believe the clearing mandate should be more inclusive. They would prefer imposing an even broader clearing requirement on non-clearinghouse members, along the lines of H.R. 4173 (the House bill). They also believe the clearing requirement should apply to firms that use derivatives to hedge commercial risk.
- **Federal Reserve Lending**
 - The Committee supports provisions that seek to protect taxpayers from loss by requiring the Federal Reserve to make adequately collateralized loans. Indeed, the Senate Banking bill could be improved through the addition of even stronger language requiring Section 13(3) loans to be fully collateralized. When the Federal Reserve exercises its Section 13(3) authority to make collateralized loans, it should disclose detailed information about the collateral it requires and receives on a reasonably timely basis.
 - To the extent that the Federal Reserve is lending against adequate collateral, provisions in the Senate Banking bill (and House bill) that place procedural hurdles in the way of the Federal Reserve's use of its lender-of-last resort function are unnecessary and compromise the Federal Reserve's independence.

- **Resolution Authority**

- At the very least, the Senate Banking bill’s process for determining whether to apply the “Orderly Liquidation” procedures should be significantly streamlined. A better approach would be to expand Orderly Liquidation procedures to include all financial institutions, or all financial companies above an asset threshold set low enough to include some firms that are not intuitively systemically important.
- While the Senate Banking bill generally imposes reasonable losses on creditors—and should be commended for resisting the urge to impose losses on fully secured creditors—it should ensure that all insufficiently collateralized derivatives counterparties are exposed to the possibility of loss.
- Unless we can be sure that new regulations end the possibility that the failure of a sufficiently interconnected firm could set off a chain reaction of failures, regulators must have the ability to put “foam on the runway.” The foam could come from a well-designed FDIC guarantee program or from an “Orderly Liquidation Fund,” such as is contemplated in the Senate Banking bill.
- On the other hand, instead of capitalizing the Orderly Liquidation Fund *ex ante*, the Orderly Liquidation Fund should be capitalized on an “as needed” basis, with creditors and counterparties of failed institutions bearing resolution costs over a medium term.
- At a minimum, legislation should require that creditors and counterparties repay any amount they receive under the Orderly Liquidation procedures that exceeds what they would have obtained in bankruptcy.

- **Consumer Financial Protection**

- Assuming that a fully consolidated regulator (the USFSA discussed by the Committee) is off the table, the Committee supports an independent CFPA. Though the Senate Banking bill calls for an “autonomous” CFPA, the Committee believes that it is a mistake to establish the CFPA within the Federal Reserve, solely to obtain Federal Reserve funding, while depriving the Federal Reserve of any control over its policies, rules, or orders. This circumvents the appropriations process, and sets a bad precedent of earmarking Federal Reserve profits.
- Although some Committee members disagree, most believe the Secretary of the Treasury, in addition to the Financial Stability Oversight Council, should have the ability to block CFPA actions on grounds of “safety and soundness” or “systemic risk.” If this proposal is accepted, most Committee members also believe the Treasury Secretary should be given the ability to override other financial regulatory agencies on similar grounds.
- The CFPA’s authority should be extended to mortgage fraud on the borrower side, which appears to have been a major problem in the recent crisis.

- **Credit Rating Agency Reform**

- The Committee supports provisions in the Senate Banking bill establishing SOX-type governance controls for rating agencies, creating a separate commission dedicated to enforcing the new rating agency regulations, and providing for follow-up studies on various aspects of the credit rating industry.
- Nevertheless, the Committee believes the Senate Banking bill takes the wrong position on private rights of action against credit rating agencies. As a general matter, the Committee opposes mandating private rights of action under the securities laws because they serve no compensatory purpose. Assuming that private rights of action are permitted, however, credit rating agencies should not be deprived of the protections of the Private Securities Litigation Reform Act against frivolous litigation, which are intended to protect the very kind of forward-looking statement inherent in a credit rating.

III. Provisions Opposed by the Committee

- **Regulatory Reorganization and Systemic Risk Designations**

- The Committee would strongly consider creating a new U.S. Financial Services Authority (USFSA) to be responsible for supervision of all financial institutions and other aspects of the financial system, including market structure, permissible activities, and safety and soundness.⁶ Instead, the Senate Banking bill just reallocates responsibility among existing regulators.
- By combining the OCC, OTS, FDIC, SEC, and CFTC, the USFSA would promote regulatory consistency and rapid reform, avoid adverse competitive consequences in financial regulation, and keep the Federal Reserve focused on monetary policy and regulation of systemic risk.
- Although the Senate Banking bill dissolves the OTS and transfers its responsibilities to the Federal Reserve, OCC, and FDIC, it retains almost all of the other agencies we had leading up to the crisis, and then adds several new regulators, including the CFPB, the Financial Stability Oversight Council, the Office of Credit Ratings, and Office of National Insurance. This will exacerbate the problem of regulatory fragmentation in what is already a highly fragmented regulatory structure.
- The Committee is also concerned that the supermajority voting requirements and composition of the Financial Services Oversight Council do not give enough power to bank regulators in the general field of financial regulation.
- While the Committee is generally supportive of giving the Federal Reserve a larger role in the regulation of systemic risk, the Committee has deep concerns about a process giving it authority over institutions designated “systemically important.” Instead, the

⁶ The Committee developed the USFSA proposal in the May Report. It may not reflect the views of Committee members who have joined since May 2009.

Committee recommends that Federal Reserve oversight be determined by an asset threshold (like the \$50 billion threshold set for banks) set low enough to include some firms that are not intuitively systemically important. The Financial Stability Oversight Council, upon a recommendation by the Secretary of the Treasury, could set different asset thresholds for different industries. Appropriate regulation of non-bank financial firms would be determined after a Federal Reserve study, though some on the Committee believe at least some additional regulation will be necessary. However, the Committee acknowledges that some Committee members disagree with the idea of giving the Federal Reserve this authority, and rather than introduce a new layer of supervision would prefer instead to strengthen the role of current functional regulators.

- **Volcker Rules and Size Limits:** The Committee would eliminate the Volcker Rules and related size limitations because they will not contribute to the reduction of systemic risk and may stifle economic recovery by depriving private equity funds of over 10% of assets under management.
- **Corporate Governance:** The Senate Banking bill contains measures related to corporate governance, including a provision granting the SEC authority to issue rules allowing shareholders to put nominees on the company proxy. Without taking a view on the merits of proxy access, the Committee recommends limiting the scope of pending financial reform legislation to matters relevant to the financial system. Since proxy access does not fall into this category, most Committee members believe it should not be covered in this legislation.

IV. Costs and U.S. Competitiveness

- The Committee is concerned that the significant additional costs the Senate Banking bill would impose on financial institutions may begin to erode the dynamism of the financial sector and hinder overall economic growth.
- The Committee is also worried about negative effects on U.S. competitiveness if regulation is not coordinated on a global level. Unilateral regulation threatens to drive capital offshore and could weaken the position of institutions headquartered in the U.S. in the international capital markets.

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DISCUSSION

1. Focus on Interconnectedness

The Committee supports the Senate Banking bill's emphasis on the issue of interconnectedness, including its call for the newly created Financial Stability Oversight Council to identify risks that could arise from "large, interconnected" bank holding companies and

nonbank financial companies,⁷ and to make recommendations concerning prudential measures to prevent such risks from materializing.⁸ The Senate Banking bill also suggests that the derivatives provisions will be framed in light of the understanding that “interconnectedness” among financial institutions raised “significant concerns” about counterparty risk during the crisis.⁹ The Committee believes that interconnectedness is at the heart of systemic risk and “Too Big to Fail,” and that a better understanding of interconnectedness will therefore decrease the likelihood of future bailouts.

2. Securitization and Credit Rating Agency Reform

A. Key Securitization Provisions in the Senate Banking bill

The Senate Banking bill proposes three broad groups of changes to existing securitization practices. First, it alters provisions for retention and ownership of securitization risk by requiring issuers of securitizations to preserve “skin in the game.” This provision mandates that securitizers¹⁰ or originators hold at least 5% of unhedged credit risk across all securitization transactions in which asset-backed securities are sold to third parties.¹¹ Moreover, regulators would have the ability to specify allocations of risk retention between lenders and securitizers to address different credit risks, the existence of incentives for imprudent asset origination, and the potential impacts of risk retention requirements on access to credit by consumers and businesses.¹²

Second, the Senate Banking bill attempts to improve disclosure requirements for securitizers by mandating increased asset-level data disclosures and disclosure of broker- or originator-specific data for each transaction (e.g., compensation and amount of risk retention).¹³ The draft requires any issuer of securitizations to perform due diligence analysis of the assets underlying the security and to disclose the nature of the analysis.¹⁴ Credit rating agencies would be required to disclose warranties and enforcement mechanisms available to investors for all reports issued on securitization deals.¹⁵

Finally, the Senate Banking bill lays out enforcement provisions for this new securitization regime. Under the Senate Banking bill, securitization regulations would be enforced by federal banking agencies for insured depository institutions, or the Securities and Exchange Commission (SEC) for other institutions.¹⁶

⁷ Restoring American Financial Stability Act of 2010, 111th Cong. § 112(a)(1)(A) (2010) [hereinafter Senate Banking bill].

⁸ *Id.* § 115(a)(1).

⁹ *Id.* § 702(a)(2).

¹⁰ “Securitizers” are typically wholesale banks that purchase loans from lenders and resell them as securitizations to third party investors.

¹¹ Senate Banking bill, *supra* note 7, § 941(b). This provision would not apply to classes of assets designated “reduced credit risk” by regulators. *Id.*

¹² *Id.*

¹³ *Id.* § 942(b).

¹⁴ *Id.* § 945.

¹⁵ *Id.* § 943(1)(A).

¹⁶ *Id.* § 941(b).

B. Evaluation of Securitization Provisions

The Senate Banking bill's new rules for securitizations are a significant improvement relative to the status quo, and are likely to improve the functioning of asset-backed securities markets. First, requiring that both originators and securitizers allocate unhedged "skin in the game" better aligns the incentives of issuers and investors, and is likely to produce higher-quality deals than those underwritten prior to the financial crisis. Second, the Senate Banking bill correctly recognizes that adverse issuer incentives exist at both the loan origination stage as well as the securitization stage, and suggests that both originators and securitizers should share some of the credit risks of the structures they create. Third, the Senate Banking bill wisely reserves the flexibility to adjust the total amount of securitization risk retained (relative to the 5% baseline rule) by originators and securitizers. Allowing the amount of risk retained to depend on the quality of underwriting should create incentives for more prudent underwriting and structuring of deals and promote balance sheet efficiency for originators and securitizers, all subject to greater regulatory oversight. Fourth, the Committee supports requirements for greater loan-by-loan transparency and disclosure, though subject to differing requirements depending on the sophistication of eligible investors. Such requirements are likely to provide investors, credit rating agencies, and other market participants with much-needed additional useful information about these transactions.

C. Key Credit Rating Agency Reform Provisions in the Senate Banking bill

The Senate Banking bill proposes four groups of changes to the existing structure of the credit rating industry. First, as Sarbanes-Oxley (SOX) did for auditors, the Senate Banking bill lays out rules designed to tighten internal controls and reduce conflicts of interest at credit rating agencies. On the controls front, the Senate Banking bill requires that credit rating agencies establish, maintain, enforce, and document effective internal control structures governing adherence to clearly articulated methodologies for determining ratings, and that CEOs of agencies must attest to the adequacy of these procedures in an annual report submitted to the SEC.¹⁷ It also directs the SEC to issue rules ensuring credit rating agency analysts are regularly tested for competence and experience in credit ratings.¹⁸ To reduce conflicts of interest, the Senate Banking bill enables the SEC to promulgate rules preventing the sales and marketing considerations of a credit rating agency from influencing its productions of ratings,¹⁹ and requires credit rating agencies to establish boards of directors on which at least half of the directors are independent.²⁰

Second, the Senate Banking bill imposes a number of requirements to improve transparency and consistency in credit rating analysis. The draft requires that credit rating agencies publish initial ratings and updates of ratings for all issuers, securities, and money market instruments. These ratings are required to be clear and informative (as measured by SEC standards), and the SEC will promulgate rules to ensure that procedures and methodologies used by credit rating agencies are transparent, consistent across different issues, and well-

¹⁷ Senate Banking bill, *supra* note 7, § 932(1)(B).

¹⁸ *Id.* § 936.

¹⁹ *Id.* § 932(3).

²⁰ *Id.* § 932(5).

communicated to users of credit ratings. For every rated security or issuer, credit rating agencies will be required to fill out a standardized SEC form for detailing its critical assumptions, data, qualitative and quantitative methodologies, and sources, and in cases where credit rating agencies use third party due diligence services for data relied on in the ratings process, the SEC will require certification and additional disclosure for the third party data provider.²¹

Third, the Senate Banking bill provides for enforcement mechanisms for the new credit ratings regime. Under the draft, the SEC has broad discretion to fine credit rating agencies or suspend or revoke registrations of credit rating agencies for particular classes of securities if ratings are consistently found to be inaccurate or financial and managerial resources are found lacking.²² The Senate Banking bill also creates a new Office of Credit Ratings within the SEC to administer the new regulations regarding credit rating agencies and regulate ratings' accuracy and conflicts of interest. This office will conduct annual examinations of credit rating agencies to ensure compliance with internal controls, ethics provisions, and conflict of interest rules, which shall be made public.²³

Finally, the Senate Banking bill changes, in several respects, the legal standards applicable to private rights of action against credit rating agencies. First, whereas the Credit Rating Agency Reform Act of 2006 protected credit rating agencies from private rights of action,²⁴ the Senate Banking bill provides that credit rating agencies will be subject to the "enforcement and penalty provisions" of the Securities Exchange Act of 1934 in the same manner and to the same extent as public accounting firms and securities analysts.²⁵ In addition, the Senate lowers the pleading standard for Securities Exchange Act claims (including 10b-5) brought against credit rating agencies to beneath the level established in the Private Securities Litigation Reform Act of 1995 (PSLRA). Under the PSLRA, pleadings are required to state "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,"²⁶ which is "knowingly" or "recklessly" for a 10b-5 claim.²⁷ Under the Senate Banking bill, however, a plaintiff would only need to plead facts giving rise to a strong inference that a credit rating agency knowingly or recklessly failed to conduct a "reasonable" investigation into the factual predicates for a particular rating.²⁸

²¹ *Id.* § 932(5).

²² *Id.* § 932(2)(H).

²³ *Id.* § 932(5).

²⁴ Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7(m).

²⁵ Senate Banking bill, *supra* note 7, § 933(a).

²⁶ 15. U.S.C. § 78u-4(b)(2).

²⁷ 17 C.F.R. § 240.10b-5 (1996). There is a circuit split on the scienter standard for 10b-5 claims, with some circuits holding that plaintiffs must show a strong inference of fraudulent intent (*see, e.g., Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000), *cert. denied*, 531 U.S. 102 (2000)), and other circuits maintaining that plaintiffs need only establish "deliberate recklessness" (*see, e.g., In re Silicon Graphics, Inc. Sec. Lit.*, 183 F.3d 970, 977 (9th Cir. 1999)). However, "deliberate recklessness" is the majority approach (Nic Heuer, Les Reese, and Winston Sale, *Securities Fraud*, 44 AM. CRIM. L. REV. 956, 964 (2007)).

²⁸ Senate Banking bill, *supra* note 7, § 933(b)(2).

D. Evaluation of Credit Rating Agency Reform Provisions in the Senate Banking bill

The Senate Banking bill represents an overall improvement in the governance of the credit rating industry. First, establishing SOX-type governance controls for rating agencies is a good idea since they (like auditors) perform a key “gatekeeper” role for financial markets. Second, as a corollary to implementing stricter oversight of the rating industry, establishing a separate office dedicated to enforcing the new rating agency regulations makes sense.

Despite these positive features, the Committee believes the Senate Banking bill takes the wrong positions on private suits against credit rating agencies. As a general matter, the Committee opposes mandating private rights of action under the securities laws. Strong enforcement of the securities laws should continue to come from public authorities, including the SEC. The Committee notes in this regard that recent reforms such as Regulation FD²⁹ and SOX³⁰ exclude private rights of action against other financial “gatekeepers.” But assuming private rights of action will be created, credit rating agencies should be on the same footing as others. For ratings of public offerings, credit rating agencies should face the same liability standard as underwriters and accountants under Section 11 of the Securities Act of 1933: strict liability for material misstatements or omissions unless they can establish a due diligence defense.³¹ For re-ratings of publicly traded securities and for ratings of privately placed securities, credit rating agencies should be liable under Section 10b-5 of the Securities Exchange Act of 1934 for material misstatements or omissions made knowingly and recklessly. Finally, there is no persuasive argument for excluding credit rating agencies from the PSLRA’s protections against frivolous lawsuits, which are intended to protect the very kind of forward-looking statement inherent in a credit rating.

3. Derivatives and Central Clearing

Until recently, the Committee understood that the derivatives provisions in the Senate Banking bill were designed by Senator Dodd as a placeholder for a bi-partisan compromise being negotiated by Senate Banking Committee members Reed and Gregg. There is now a significant chance that language originally intended as a placeholder could become the Senate Banking Committee’s final proposal on one of the central issues in financial reform. While the Committee supports several of the positions in the Senate Banking bill, the Committee is deeply concerned by the fact that the Senate Banking bill fails to address many key questions and as a result grants excessive discretion to regulators. The same is true of the Senate Agriculture bill. The following comparison emphasizes recommendations from the CCMR Derivatives Letter in areas where the

²⁹ According to the final rule, Regulation FD “is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.” Selective Disclosure and Insider Trading; Final Rule, 65 Fed. Reg. 51716, 51726 (Aug. 24, 2000).

³⁰ See, e.g., Louis E. Ebinger, *Sarbanes-Oxley Section 501(a): No Implied Private Right of Action, and a Call to Congress for an Express Private Right of Action to Enhance Analyst Disclosure*, 93 IOWA L. REV. 1919 (2008) (noting that there is no explicit private right of action against securities analysts in Sarbanes-Oxley, and courts are unlikely to imply such a right).

³¹ 15 U.S.C. § 77k(a)-(b). The Committee notes that there is no Section 11 liability in the context of private placements.

Senate Banking bill and the Senate Agriculture bill need to be strengthened. The CCMR Derivatives Letter contains additional recommendations as well as detailed explanations of the Committee's views on derivatives.

- **Regulatory Jurisdiction.** While some Committee members would support leaving oversight of derivatives with existing functional regulators, most Committee members believe the Federal Reserve should have broad authority over derivatives clearinghouses, capital and margin requirements for derivatives that are not centrally cleared, as well as other aspects of derivatives regulation, due to the Federal Reserve's central role in monitoring and responding to systemic risk.³²

Title VIII of the Senate Banking bill partly reflects this principle, assigning responsibility to the Federal Reserve over "clearing activities" that are determined by the Financial Stability Oversight Council to be systemically important.³³ However, Title VII of the Senate Banking bill would give the Commodities Futures Trading Commission (CFTC) and SEC broad authority to oversee derivatives regulation. As a result, the legislation leaves unsettled significant jurisdictional questions. Most Committee members strongly recommend clarifying and strengthening provisions in the Senate Banking bill giving the Federal Reserve exclusive authority in these areas.

Similarly, the Senate Agriculture bill gives both the CFTC and SEC partial responsibility for the regulation of derivative clearinghouses. The Senate Agriculture bill provides that clearinghouses that clear non-security based swaps will be regulated by the CFTC,³⁴ while clearinghouses for security-based swaps would be regulated by the SEC. This would force some credit default swaps into clearinghouses governed by one agency and others into clearinghouses governed by another, which is highly undesirable from the standpoint of reducing systemic risk. Again, most Committee members believe authority of clearinghouses should be given to the Federal Reserve.

- **Assistance for Swap Entities.** The Committee strongly recommends removing provisions in the Senate Agriculture bill that would prohibit the use of any federal funds—including advances from any Federal Reserve credit facility, discount window, or Section 13(3) loan, or FDIC insurance or guarantees—to assist swap dealers, major swap participants, swap execution facilities, national securities exchanges, or clearinghouses (collectively, swap entities).³⁵ Swap entities are at the center of the interconnectedness problem, and federal regulators must have the ability to lend or support them if their failure could set off a chain reaction. In particular, there is no reason to prevent the Federal Reserve from lending to swap entities (or other firms) that can provide adequate collateral. Furthermore, prohibiting assistance for swap entities will encourage firms to place their derivatives businesses into separate legal entities. Unless these separate legal entities can be guaranteed by a parent or an affiliate, limited capital will severely restrict their activities. But parent or affiliate guarantees

³² CCMR Derivatives Letter, *supra* note 2, at 11.

³³ Senate Banking bill, *supra* note 7, §§ 804(a)(1), 805(a).

³⁴ Wall Street Transparency and Accountability Act of 2010, 111th Cong. § 115 (2010) [hereinafter Senate Agriculture bill].

³⁵ *Id.* § 106.

would entail the creation of off-balance sheet liabilities, which would decrease transparency and hinder effective risk management. Thus, these provisions in the Senate Agriculture bill could exacerbate systemic risk.

- **Unacceptable Legal Uncertainty.** The Committee also recommends removing provisions in the Senate Agriculture bill that would unnecessarily reintroduce significant legal uncertainty and resulting legal risk for market participants as to whether swaps and forwards are subject to regulation as futures contracts under the Commodity Exchange Act.
- **Types of Contracts.** The central clearing mandate should be limited to contracts that are standardized and liquid. Contracts that are customized are poor candidates for central clearing due to the difficulty in pricing and setting margin requirements for such contracts. By contrast, the Senate Banking bill requires that derivatives counterparties clear unless no clearinghouse will accept their trades for clearing.³⁶ In addition, both the Senate Banking bill and the Senate Agriculture bill grant the CFTC and SEC complete discretion to require that any other group, category, type, or class of derivatives contracts be accepted for clearing.³⁷ Such provisions open the door to the possibility that the clearing requirement will not be limited to standardized and liquid contracts.
- **Foreign Exchange Contracts.** Although some Committee members disagree, the majority of the Committee would oppose an unbounded, blanket exemption of all foreign exchange contracts from clearing requirements. In addition, the Committee would support an exemption for foreign exchange contracts with maturities of up to one month, where risks are limited, and would give the Federal Reserve the authority to extend the exemption for foreign exchange contracts with somewhat longer maturities. Neither the Senate Banking bill nor the Senate Agriculture bill follows this approach. The Senate Banking bill completely exempts foreign exchange derivatives,³⁸ while the Senate Agriculture bill does not exempt even short-term foreign exchange contracts.³⁹
- **Clearinghouse Membership Standards.** Given that the failure of a major clearinghouse would itself pose a systemic risk, clearinghouses must maintain high membership standards that ensure safety and soundness. For this reason, clearinghouses should require members to have sufficient levels of capital and proven proficiency in trading and operations. On the other hand, regulators should be given authority, to the extent they do not have it already, to monitor clearinghouse membership criteria to prevent existing clearing members from establishing discriminatory membership standards.⁴⁰ Therefore, the Senate Banking bill should be commended for providing that, to be registered as a “derivatives clearing

³⁶ Senate Banking bill, *supra* note 7, §§ 713(a)(3), 753(a).

³⁷ Senate Banking bill, *supra* note 7, §§ 713(a)(3), 753(a); Senate Agriculture bill, *supra* note 34, §§ 113(a)(3), 203(a). The Senate Banking bill and the Senate Agriculture bill both set out a list of broad factors that regulators are supposed to consider in determining which contracts must be cleared, and then provide that regulators can also take into account “any other factor” they deem appropriate.

³⁸ Senate Banking bill, *supra* note 7, § 711(a)(2).

³⁹ Senate Agriculture bill, *supra* note 34, § 111(a)(21).

⁴⁰ CCMR Derivatives Letter, *supra* note 2, at 15.

organization,” a clearinghouse must establish “appropriate admission and continuing eligibility standards,” including “sufficient financial resources and operational capacity to meet obligations arising from participation.”⁴¹ The Committee also supports language in the Senate Banking bill dictating that clearinghouses’ “participation and membership requirements [must] be objective, publicly disclosed, and permit fair and open access.”⁴²

- **Types of Counterparties.** The Committee believes the clearing requirement should apply to contracts between clearinghouse members.⁴³ It should also apply to non-clearinghouse members, as guaranteed by clearinghouse members, with substantial net counterparty exposures.⁴⁴ While most Committee members believe that clearing requirements should apply to commercial firms in principle,⁴⁵ they do not think firms should be required to clear contracts used to hedge commercial risk since there is limited (if any) market risk associated with such contracts.⁴⁶ The Senate Banking bill and the Senate Agriculture bill each take a different approach.

The Senate Banking bill permits the CFTC or SEC to grant an exemption from central clearing where at least one of the counterparties (a) is not a swap dealer or majority swap participant and (b) does not meet the eligibility requirements of any derivatives clearing organization that clears the swap.⁴⁷ Furthermore, the Financial Stability Oversight Council would have the authority to prevent the CFTC or SEC from granting such an exemption if it believes that doing so would pose a threat to financial stability.⁴⁸ Given the absence of a persuasive argument for mandating central clearing where both of these conditions are met, the Senate Banking bill gives regulators too much discretion on this point.

The Senate Agriculture bill provides a clearing exemption for which only commercial companies are eligible. These include any firm who, “as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets services or commodities”⁴⁹ To the extent that the commercial end-user is using a derivative contract to “hedge commercial risk,” the commercial end-user may elect not to have the contract cleared. While most Committee members would support the fundamental decision to provide an exemption for contracts used to hedge commercial risk, they would not support an approach based on distinctions between different types of firms.

⁴¹ Senate Banking bill, *supra* note 7, § 713(b)(3).

⁴² *Id.*

⁴³ CCMR Derivatives Letter, *supra* note 2, at 14.

⁴⁴ *Id.* at 16-17.

⁴⁵ *Id.* at 16.

⁴⁶ *Id.*

⁴⁷ Senate Banking bill, *supra* note 7, §§ 713(a)(3), 753(a). “Swap dealer” is defined as any person engaged in the business of buying and selling swaps for such person’s own account, through a broker or otherwise, other than a person that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business. A “major swap participant” is any person who is not a swap dealer and (i) who maintains a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing, or otherwise mitigating commercial risk; or (ii) whose failure to perform under the terms of its swaps would cause significant credit losses to its swap counterparties. *Id.* §§ 711(a)(2), 751(6).

⁴⁸ *Id.* §§ 713(a), 753(a).

⁴⁹ Senate Agriculture bill, *supra* note 34, §§ 113(a)(3), 203(a).

- **Required Clearinghouse Membership.** Since clearinghouses reduce systemic risk by spreading losses among clearinghouse members, it is important that institutions with substantial derivatives trading activity be required to join clearinghouses, if feasible. Most Committee members would therefore recommend that the proposed legislation require all firms that exceed certain “net exposure thresholds” (defined to exclude exposure from contracts used to hedge commercial risk) be made clearinghouse members if they are eligible.⁵⁰ The Senate Banking bill does not contain any proposal regarding required clearinghouse membership.
- **Segregation of Initial Margin.** The Committee strongly favors segregation of initial margin. While legislation should not require initial margin for derivatives that are not centrally cleared to be held in segregated accounts (since counterparties who prefer this arrangement can bargain for it), dealers should be required to fully disclose collateral arrangements and offer counterparties the opportunity to segregate initial margin on a non-discriminatory basis with a custodian that is bankruptcy remote from the dealer.⁵¹ The Senate Banking bill provides that, at a counterparty’s request, a swap dealer must segregate funds provided by the counterparty as initial margin or collateral for uncleared derivatives and maintain such funds with an independent third-party custodian.⁵² Such segregation is to be made available on “fair and reasonable terms on a non-discriminatory basis.”⁵³ Similarly, the Senate Agriculture bill would require a swap dealer or major swap participant to notify its counterparty at the beginning of a transaction that the counterparty has the right to require segregation “of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty” and to have such funds or property maintained with an independent, third-party custodian.⁵⁴ Thus, both the Senate Banking bill and the Senate Agriculture bill differ from the Committee’s preferred approach in requiring segregation, if demanded by the counterparty, rather than encouraging it. Both bills could also be improved by emphasizing custodians’ bankruptcy remoteness from the dealer instead of independence, and by making clear that counterparties’ right to demand segregation applies to initial margin, not all collateral.
- **Transaction Reporting.** The Committee supports reforms that would make certain volume and position data publicly available.⁵⁵ The Committee would allow a modest delay in reporting most trades that occur off exchange to permit a reduction of costs through a bunching procedure. The Committee would also allow the Federal Reserve to provide more substantial delays for public disclosure of transactions that are large compared to average volume or that involve contracts that infrequently trade (block trades). In general, the Committee would support a system that ensures trades remain anonymous and not individually identifiable. By contrast neither the Senate Banking bill nor the Senate Agriculture bill clearly recognizes the need for modest delays to permit application of a

⁵⁰ CCMR Derivatives Letter, *supra* note 2, at 15.

⁵¹ *Id.* at 18-19.

⁵² Senate Banking bill, *supra* note 7, §§ 718, 754.

⁵³ Senate Banking bill, *supra* note 7, §§ 718, 754.

⁵⁴ Senate Agriculture bill, *supra* note 34, § 114(c).

⁵⁵ CCMR Derivatives Letter, *supra* note 2, at 24-25.

bunching procedure.⁵⁶ But while the Senate Banking bill also fails to clearly acknowledge the need for more substantial delays before public disclosure of block trades,⁵⁷ the Senate Agriculture bill does call for time delays in the public reporting of cleared block trades that take into account “whether the public disclosure will materially reduce market liquidity.”⁵⁸

- **Derivatives Exchanges.** The Committee believes exchange trading should not be required, but encouraged where appropriate.⁵⁹ To the extent that legislation involves an exchange-trading requirement, the only alternative to trading on an organized exchange should be trading on a platform along the lines of an “alternative trading system,” as defined by the SEC, or another venue that is appropriately regulated in light of the transparency objectives of the legislation. The Senate Banking bill⁶⁰ and the Senate Agriculture bill⁶¹ take a different approach than the Committee to the core issue by providing that swaps required to be cleared must also be traded on an exchange or the equivalent.
- **Scope and Number of Clearinghouses.** Most Committee members believe there are benefits from having multiple, well-capitalized clearinghouses, with strong margining procedures, organized by asset-class.⁶² However, some members question if there are risk management benefits associated with this approach and are concerned that an asset-class based organizational scheme would increase the transaction costs associated with central clearing. The Senate Banking bill and Senate Agriculture bill do not address the optimal number and scope of clearinghouses.
- **Capital and Margin Requirements.** The Committee recommends excluding firms from capital and margin requirements for derivatives if their net derivatives exposures (defined to exclude exposure from contracts used to hedge commercial risk) do not exceed designated thresholds. The Senate Banking bill approximates this approach by limiting capital and margin requirements to swap dealers and major swap participants.⁶³
- **Acknowledgement of Disagreement.** The Committee acknowledges that there are differences among Committee members on some of the foregoing points. For instance, some Committee members argue that the Committee’s position on clearing is too inflexible. They believe it would be better to encourage firms to clear using member guarantees rather than requiring them to become clearinghouse members themselves. They also argue the clearinghouse membership and related clearing requirements should not be triggered by a net exposure threshold but rather by a more holistic assessment of whether a company’s derivatives portfolio poses systemic risk. On the other hand, some Committee members

⁵⁶ Senate Banking bill, *supra* note 7, §§ 713(a)(3), 753(a); Senate Agriculture bill, *supra* note 34, § 116.

⁵⁷ The Senate Banking bill says that the Commission shall make available to the public, “in a manner that does not disclose the business transactions and market positions of any person, aggregate data on swap trading volumes and positions ...” Merely omitting the names of the parties to a transaction would not sufficiently address concerns in the context of block trades. Senate Banking bill, *supra* note 7, §§ 714, 753(h).

⁵⁸ Senate Agriculture bill, *supra* note 34, § 117.

⁵⁹ CCMR Derivatives Letter, *supra* note 2, at 25-26.

⁶⁰ Senate Banking bill, *supra* note 7, §§ 713(a), 753(a).

⁶¹ Senate Agriculture bill, *supra* note 34, § 113(d)(1).

⁶² CCMR Derivatives Letter, *supra* note 2, at 21-22.

⁶³ Senate Banking bill, *supra* note 7, §§ 717(a), 753(d).

believe the clearing mandate should be more inclusive. They would prefer imposing an even broader clearing requirement on non-clearinghouse members, along the lines of the House bill. They also believe the clearing requirement should apply to firms that use derivatives to hedge commercial risk.

4. FDIC Guarantees

The Senate Banking bill gives the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve the ability to determine, at the request of the Secretary of the Treasury, that a “liquidity event”⁶⁴ has occurred that justifies the creation of certain emergency stabilization measures.⁶⁵ This determination must be based on evidence that a liquidity event exists, that “failure to take action would have serious adverse effects on financial stability or economic conditions in the United States,” and that emergency stabilization measures are needed to “avoid or mitigate potential adverse effects on the United States financial system or economic conditions.”⁶⁶ Emergency stabilization measures shall take the form of “widely available program[s] to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies ... during times of severe economic distress.”⁶⁷

The Committee believes that the use of guarantees is appropriate only when needed to combat systemic risk and that guarantees should not be used to prop up insolvent institutions.⁶⁸ The Committee commends the Senate Banking bill for reflecting a very similar approach to these issues.

5. Federal Reserve Lending

The Federal Reserve has been the object of intense scrutiny since its decision to use its emergency lending powers to respond to the financial crisis. Much of the Federal Reserve’s emergency lending was conducted pursuant to Section 13(3) of the Federal Reserve Act,⁶⁹ which allows the Federal Reserve in “unusual and exigent circumstances” to lend to any individual, partnership or corporation, provided that such loans must be “secured to the satisfaction of the Federal Reserve Bank.”⁷⁰ This provision does not restrict who can borrow or specify particular levels of collateral; instead, the judgment of the adequacy of collateral is left entirely to the discretion of the Federal Reserve.

⁶⁴ Defined as: (a) a reduction in the usual ability of financial market participants to (i) sell a type of financial asset without a significant reduction in price or (ii) to borrow using that type of asset as collateral without a significant increase in margin; or (b) a significant reduction in the usual ability of financial and nonfinancial market participants to obtain unsecured credit. Senate Banking bill, *supra* note 7, § 1155(g)(4).

⁶⁵ *Id.* § 1154(a)(1).

⁶⁶ *Id.* § 1154(a)(2).

⁶⁷ *Id.* § 1155(a).

⁶⁸ See, e.g., Glenn Hubbard, Hal Scott & Luigi Zingales, *Banks Need Fewer Carrots and More Sticks*, WALL. ST. J., May 6, 2009 (arguing that the FDIC should take over insolvent banks instead of renewing guarantees of their short term debt).

⁶⁹ See Pub. L. No. 110-343, § 129, 122 Stat. 1396-97 (2008).

⁷⁰ 12 U.S.C. § 343.

Many commentators, including former Federal Reserve Chairman Paul Volcker, have questioned the Federal Reserve's authority to engage in such emergency lending. Apart from the legal question, the Federal Reserve's assumption of credit risk by lending against insufficient collateral may compromise its independence by: (a) making the Federal Reserve more dependent on the Treasury for support in carrying out its core functions, including the conduct of monetary policy; (b) jeopardizing the ability of the Federal Reserve to finance its own operations, and thus increasing its reliance on budgetary support from the government; (c) tarnishing the Federal Reserve's image and financial credibility in the event that the Federal Reserve ends up with minimal or negative capital; and (d) subjecting the Federal Reserve to greater political pressures.

The Senate Banking bill would institute several important changes in the control of Federal Reserve lending. First, the Senate Banking bill would amend Section 13(3) of the Federal Reserve Act by requiring the Federal Reserve, in consultation with the Secretary of the Treasury, to write regulations ensuring that "the collateral for emergency loans is of sufficient quality to protect taxpayers from loss."⁷¹

The Committee agrees with Senator Dodd that taxpayers should be protected from loss by requiring the Federal Reserve to make adequately collateralized loans. Indeed, the Senate Banking bill could be improved through the addition of even stronger language requiring Section 13(3) loans to be fully collateralized. Additionally, when the Federal Reserve exercises its Section 13(3) authority to make collateralized loans, it should disclose detailed information, as was recently disclosed for loans made to AIG,⁷² about the collateral it requires and receives on a reasonably timely basis. However, the focus on the "quality" of collateral received is misplaced. A junk bond with a par value of one hundred might be adequate collateral if only valued at twenty cents on the dollar for such purpose.

Second, the Senate Banking bill inserts procedural hurdles in the way of the Federal Reserve's exercise of its lender-of-last resort function. Specifically, the Senate Banking bill would require the Federal Reserve to obtain the approval of the Secretary of the Treasury before establishing new liquidity facilities.⁷³ However, the Senate Banking bill does not follow the House bill in prohibiting the Federal Reserve from authorizing, and the Secretary of the Treasury from approving, any Section 13(3) extension of credit without the belief that there is a "99 percent likelihood that all funds disbursed or put at risk," together with "all interest due on any funds," will be repaid.⁷⁴

In the Committee's view, the House bill's "99 percent" confidence requirement is more ambiguous than helpful. More generally, the Committee believes that, to the extent that the Federal Reserve is loaning against adequate, high quality collateral, procedural safeguards, such as the requirement that the Federal Reserve obtain approval from Treasury, unnecessarily limit

⁷¹ Senate Banking bill, *supra* note 7, § 1151(6).

⁷² On March 31, 2010, the Federal Reserve posted the CUSIP number, descriptor, and the current principal balance or notional amount outstanding for all positions in the Maiden Lane portfolios. Press Release, Fed. Reserve Bank of N.Y., New York Fed Releases Additional Information on Maiden Lane Portfolios (Mar. 31, 2010), *available at* <http://www.newyorkfed.org/newsevents/news/markets/2010/ma100331.html>.

⁷³ Senate Banking bill, *supra* note 7, § 1151(6).

⁷⁴ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (as passed by the U.S. House of Representatives, Dec. 11, 2009) § 1701 (amending the Federal Reserve Act by inserting § 13(c)(2)(A)-(B)).

the Federal Reserve's independence and flexibility to respond to a crisis. The requirement of public disclosure of the Federal Reserve's collateral policies and the collateral it takes is a more effective discipline on the use of discretion.

Finally, the Senate Banking bill, much like the House bill, would prevent the Federal Reserve from making bailout loans. The Senate Banking bill would amend Section 13(3) such that extensions of credit thereunder would be available to “financial market utilit[ies] that the Financial Stability Oversight Council determines [are], or [are] likely to become, systemically important, or any program or facility with broad-based eligibility.”⁷⁵ The Senate Banking bill would also require the Federal Reserve, in consultation with the Secretary of the Treasury, to implement policies to ensure that emergency lending authority is used “for the purpose of providing liquidity to the financial system, and not to aid a failing financial company.”⁷⁶

With respect to existing loans, the Committee has recommended that any existing Federal Reserve loans to the private sector that are uncollateralized or insufficiently collateralized be transferred in an orderly fashion to the balance sheet of the federal government through asset purchases by the Treasury from the Federal Reserve.⁷⁷ While the Federal Reserve's ability to print money means it cannot go bankrupt, any losses it incurs on insufficiently collateralized loans ultimately represent losses to U.S. taxpayers. The Federal Reserve regularly remits billions in profits to the Treasury⁷⁸—including approximately \$47.4 billion for 2009⁷⁹—and, without these amounts, taxpayers would have to make further contributions to the general revenue absent spending cuts.

6. Consumer Financial Protection

In the May 2009 Report, the Committee concluded that a consumer financial protection agency (CFPA) should exist, either as a division within a consolidated financial regulator or as a self-standing third independent agency.⁸⁰ Assuming that a consolidated regulator is off the table (the USFSA discussed by the Committee), the Committee supports an independent CFPA. The Senate Banking bill takes a different approach, establishing an autonomous CFPA within the Federal Reserve, purely to allow the Federal Reserve to fund its operations out of Federal Reserve profits—but the Federal Reserve would have no say over operations.⁸¹

⁷⁵ Senate Banking bill, *supra* note 7, § 1151(2)-(5).

⁷⁶ *Id.* § 1151(6).

⁷⁷ COMM. ON CAPITAL MKTS. REGULATION, RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE 4 (2009); *see also* KENNETH N. KUTTNER, COMM. ON CAPITAL MKTS. REGULATION, THE FEDERAL RESERVE AS LENDER OF LAST RESORT DURING THE PANIC OF 2008, at 12 (2008); Willem Buitter, *Can Central Banks Go Broke?*, POL'Y INSIGHT, May 2008, at 11.

⁷⁸ Federal Reserve Act, 12 U.S.C. §§ 289–90.

⁷⁹ Press Release, Bd. of Governors of the Fed. Reserve Sys. (Apr. 21, 2010), *available at* <http://www.federalreserve.gov/newsevents/press/other/20100421b.htm>.

⁸⁰ CCMR PLAN FOR REGULATORY REFORM, *supra* note 1, at 210. Although the Senate Banking bill calls for the creation of a “Consumer Financial Protection Bureau,” we use the more popular shorthand “CFPA” throughout this letter.

⁸¹ Senate Banking bill, *supra* note 7, §§ 1011(a), 1011(c).

A. Organizational Structure

The Committee does not think it is wise to establish the CFPA as an autonomous bureau within the Federal Reserve, while depriving the Federal Reserve of any control over policies, rules, or orders issued by the CFPA. The Senate Banking bill provides that the Federal Reserve Board of Governors may not intervene in any matter or proceeding before the CFPA, appoint or remove any officer or employee of the CFPA, or merge or consolidate any function of the CFPA with any office or division of the Federal Reserve Board of Governors or Federal Reserve Banks.⁸² The Senate Banking bill further provides that no rule or order of the CFPA shall be subject to approval or review by the Federal Reserve Board of Governors and no recommendations and testimony to Congress shall be subject to approval, comment, and review by any U.S. office or agency, including the Federal Reserve Board of Governors, if it includes a statement indicating that the views expressed reflect only the views of the CFPA and do not necessarily reflect those of the Federal Reserve Board of Governors or of the President.⁸³ Such formalistic disclaimers still would permit the CFPA to act in the name of the Federal Reserve, which could serve to damage the Reserve Board's reputation, a risk that establishing a fully independent CFPA would avoid.

B. Systemic Risk and Safety and Soundness Overrides

If the CFPA is functionally autonomous, a key question is whether there will be a check on CFPA decisions that could undermine the safety and soundness of the banking system or that threaten financial stability more generally. In this situation, the Senate Banking bill provides that the Financial Stability Oversight Council has the power to veto the CFPA on the basis of a 2/3 vote of its members.⁸⁴ However, four of the nine members of the Council will be the Chairman of the Consumer Financial Protection Bureau, Chairman of the Securities and Exchange Commission, Chairman of the Commodity Futures Trading Commission, and an independent member with insurance expertise.⁸⁵ Since the 2/3 voting requirement would allow non-bank regulators to prevent the Financial Stability Oversight Council from blocking a CFPA action on grounds of safety and soundness or systemic risk, the Committee recommends amending the voting procedure to require a simple majority. This would bring the Senate version of the Financial Stability Oversight Council closer to the House version, whose membership is more heavily weighted toward bank regulators⁸⁶ and which can generally act by majority vote.⁸⁷ Although some Committee members disagree, most believe an even better alternative would be to give the Secretary of the Treasury, in addition to the Financial Stability Oversight Council, the right to veto a proposed CFPA policy on safety and soundness or systemic risk grounds, since this would help ensure that the financial system is protected from over-zealous regulation. If this

⁸² *Id.* § 1012(c)(2).

⁸³ *Id.* § 1012(c)(3)-(4).

⁸⁴ *Id.* § 1023(c)(3).

⁸⁵ *Id.* § 111(b)(1).

⁸⁶ The Financial Services Oversight Council that would be created by the House bill would include the head of the National Credit Union Administration but does not call for an independent member with insurance expertise. H.R. 4173, *supra* note 74, § 1001(b)(1).

⁸⁷ *Id.* § 1004(b).

proposal is accepted, most Committee members also believe the Treasury Secretary should be given the ability to override other financial regulatory agencies on the same grounds.

C. Funding

The Senate Banking bill provides that the Board of Governors of the Federal Reserve shall transfer to the CFPB, from the combined earnings of the Federal Reserve System, an amount determined solely by the Director of the CFPB (and not by the Federal Reserve) to be reasonably necessary in carrying out its duties.⁸⁸ The current Senate Banking bill authorizes a budget of 10% of the Federal Reserve system's budget, or currently \$430 million a year,⁸⁹ with an annual upward inflationary adjustment.⁹⁰

Funding the CFPB outside the appropriations process establishes an undesirable precedent from the standpoint of political accountability. It is also worth noting that the Senate Banking bill calls for the Federal Reserve to provide funding to the Office of Financial Research,⁹¹ which in turn funds the Financial Stability Oversight Council.⁹² Once this precedent is set, Congress may be tempted to expand the practice of earmarking portions of the Federal Reserve's income for off-budget financing. It would be far better for the CFPB (as well as the Office of Financial Research and the Financial Stability Oversight Council) to be funded through normal appropriations.

D. Jurisdiction Over Mortgage Fraud and Other Matters

The Senate Banking bill provides the CFPB with significant and exclusive authority over aspects of the mortgage origination and securitization process. The CFPB is directed to propose model disclosures for the disclosures required under the Truth in Lending Act and the Real Estate Settlement Procedures Act of 1974, into a single integrated disclosure for mortgage loan transactions covered by those laws.⁹³ It is given authority to take actions against covered persons⁹⁴ committing or engaging in unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer or for a consumer financial product or service.⁹⁵ The scope of this authority includes those involved in the origination, brokering, or servicing of consumer mortgage loans.⁹⁶ Although Section 1027 limits coverage over real estate brokers, accountants, and attorneys, coverage is limited only to the extent that they are not engaged in the offering or provision of any consumer financial product or service.⁹⁷ These provisions, taken as a whole,

⁸⁸ Senate Banking bill, *supra* note 7, § 1017(a)(1).

⁸⁹ *Id.* § 1017(a)(2)(A)(i)-(iii); Press Release, Bd. of Governors of the Fed. Reserve Sys., Reserve Bank income and expense data and transfers to the Treasury for 2009 (Jan. 12, 2010).

⁹⁰ Senate Banking bill, *supra* note 7, § 1017(a)(2)(B).

⁹¹ *Id.* § 155(d)(2).

⁹² *Id.* § 118.

⁹³ *Id.* § 1032(f).

⁹⁴ *Id.* § 1002(6)(A) (“any person that engages in offering or providing a consumer financial product or service”), (B) (“any affiliate of such person described in subparagraph (A) if such affiliate acts as a service provider to such person”).

⁹⁵ *Id.* § 1031(a).

⁹⁶ *Id.* § 1024.

⁹⁷ *Id.* § 1027.

constitute a significant step forward in addressing the current state of fragmentation across the U.S. financial regulatory framework with respect to the regulation of mortgage loan underwriting and securitization.

Nevertheless, the Committee believes the current proposal does not go far enough. While there is significant evidence of fraud in the mortgage market, we simply do not know whether borrowers, brokers, or lenders are generally at fault for misrepresentations about employment, debt and income, and intention to occupy a home.⁹⁸ However, in a study cited during the January 14, 2010 hearing of the Financial Crisis Inquiry Commission, the Financial Crimes Enforcement Network of the United State Treasury Department found that, of the suspicious activity reports related to mortgage fraud filed between January 1, 2009 and June 30, 2009, 43% of the individuals purported to have committed mortgage loan fraud were borrowers and approximately 9% were customers.⁹⁹ While some instances of borrower fraud may occur because brokers and lenders either fail to perform appropriate diligence or provide active encouragement, it is highly unlikely that financial service providers bear full responsibility. To fully consolidate the regulation of mortgage loan fraud, increase regulatory efficiency, and reduce regulatory burdens on the public, the Committee recommends granting the CFPB parallel authority to address mortgage fraud on the borrower side.

Finally, to avoid regulatory duplication, the Committee suggests clarifying that servicing of pensions, which is already regulated by the Department of Labor and other agencies, does not fall under the mandate of the CFPB.

7. Resolution Procedures

The Senate Banking bill creates a new resolution framework covering failing and failed financial institutions.¹⁰⁰ The draft mandates that if a specified financial company is deemed to pose a systemic risk to U.S. financial stability and to be in default or in danger of default,¹⁰¹ it must be resolved by the FDIC through a special “Orderly Liquidation” procedure.¹⁰² Financial companies in distress that do not meet the systemic risk test or are otherwise excluded will be resolved pursuant to the Bankruptcy Code.¹⁰³ While the Committee recognizes the importance of sound resolution procedures as a means of reducing systemic risk, it believes the Senate Banking bill falls short in failing to: (a) cover all financial institutions; (b) expose undercollateralized derivatives counterparties to sufficient risk of loss; and (c) provide a fair, efficient procedure for

⁹⁸ According to a BasePoint Analytics study of three million mortgages originated between 1997 and 2006, employment, debt and income, and intention to occupy a home are the most common areas for fraud in mortgage applications. BasePoint Analytics LLC, *A Study on Mortgage Fraud and the Impacts of a Changing Financial Climate* (2006).

⁹⁹ BSA Advisory Group, Fin. Crimes Enforcement Network, Issue 16, *The SAR Activity Review: Trends Tips and Issues* 6 (Oct. 2009).

¹⁰⁰ Senate Banking bill, *supra* note 7, §§ 201-211.

¹⁰¹ Additional considerations that must be taken into account include whether there exists a viable private alternative to prevent the company’s default and how the financial stability of the U.S. would be impacted by the effects of special resolution on the company’s creditors, counterparties, and shareholders. *Id.* § 203(b).

¹⁰² *Id.* § 204.

¹⁰³ *Id.* § 202(d).

the raising of resolution funds. Some Committee members also question whether the FDIC is best suited to resolve wind-downs in all financial sectors.

A. Covered Financial Companies

While the Committee believes that any special resolution process should apply to all financial institutions, the Senate Banking bill's Orderly Liquidation procedure applies to only some, since to be subject to the procedure, financial institutions must meet several criteria. First, they must be "financial companies," a heading that explicitly includes banks, nonbanks that the proposed Financial Stability Oversight Council subjects to the Federal Reserve's supervision,¹⁰⁴ companies mainly engaged in financial activities, and the subsidiaries of the foregoing.¹⁰⁵ Most financial institutions, including broker-dealers and hedge funds, qualify as financial companies under the draft. The second criterion, however, is far more restrictive. To qualify as a "covered financial company," a "financial company" cannot be an insured depository institution¹⁰⁶ and must, on the recommendation of the Federal Reserve and FDIC, be determined by the Secretary of Treasury to, *inter alia*, be in default or in danger of default and pose a serious threat to the financial stability of the country.¹⁰⁷ Upon such a determination, if the covered financial company is not an insurance company,¹⁰⁸ an "Orderly Liquidation Authority Panel" composed of three U.S. Bankruptcy Court judges must decide whether the company should be liquidated under the Orderly Liquidation procedure.¹⁰⁹ Only if the panel determines that the Secretary correctly considered the covered financial company to be in default or in danger of default can the FDIC be appointed to liquidate the company under the special procedure.¹¹⁰ The panel's decision can be appealed to both the Court of Appeals and subsequently, the Supreme Court, which both have 30 days to render judgment.¹¹¹

Because of this complex designation process, it may be difficult to predict in advance of financial distress whether the Orderly Liquidation procedure will apply to a given financial institution that is not subject to the draft's only explicit exemptions (for insured depository institutions and insurance companies). Moreover, once trouble does arise, the determination process may take too long to enable the FDIC to realize any value from an eventual liquidation of the company, which may rapidly deteriorate in the wake of a default, in no small part because, absent assurances of a quick and orderly liquidation, investors and creditors might become skittish about the company's prospects and preemptively liquidate collateral and other assets, destroying any residual going-concern value.

At the very least, the Senate Banking bill's cumbersome process for determining whether to apply the Orderly Liquidation procedure should be significantly streamlined to encourage

¹⁰⁴ The draft authorizes the Council to order the Federal Reserve to supervise a nonbank financial company based on a number of considerations that are largely related to the nature and size of the company's exposure. *Id.* §§ 113(1)-(2).

¹⁰⁵ *Id.* § 201(11).

¹⁰⁶ *Id.* § 201(7)(B).

¹⁰⁷ *Id.* §§ 201(7)(A), 203(b).

¹⁰⁸ The Senate Banking bill provides that even if an insurance company is classified as a covered financial company, it will be liquidated under state law. *Id.* § 203(e).

¹⁰⁹ *Id.* § 202(a).

¹¹⁰ *Id.* § 202(b)(1)(A)(iii).

¹¹¹ *Id.* § 202(b)(2).

more certainty of outcome before failure and speedy and appropriate action afterwards. A better approach would be to create new special resolution procedures that apply to all financial institutions, or all financial companies above an asset threshold set low enough to include some firms that are not intuitively systemically important. The FDIC would then have the authority to deal with failed financial companies through a broad range of procedures, including purchase and assumption as well as liquidation. While the FDIC would generally be required to pursue a resolution that minimizes resolution costs, it would also have authority, as now provided in the Federal Deposit Insurance Act,¹¹² to use alternative procedures in cases of systemic risk. This would merely build on the FDIC's current system for dealing with banks. Bankruptcy courts have neither the expertise nor public resources to achieve least cost resolution.

B. Imposition of Losses

The Orderly Liquidation procedure generally imposes losses on creditors in a reasonable fashion. Under the Orderly Liquidation procedure, the FDIC must act to preserve the financial stability of the country, not the company,¹¹³ ensure shareholders are not paid until all other claims are settled,¹¹⁴ and compensate unsecured creditors in a manner consistent with the draft's priority schedule,¹¹⁵ which provides for the satisfaction of administrative expenses and amounts owed to the U.S. before unsecured claims.¹¹⁶ While the FDIC can treat any amount that exceeds the fair market value of a secured asset as an unsecured claim,¹¹⁷ it cannot reduce the value of a fully secured claim, that is, a claim where the asset exceeds the fair market value of the amount owed.¹¹⁸ In including such a restriction, the authors of the Senate Banking bill should be commended for resisting the urge to impose losses on secured creditors and for not incorporating the provision found in the House bill that provides that up to 10% of certain secured claims may be treated as unsecured.¹¹⁹ The Committee believes that the Senate Banking bill takes the right approach since subjecting secured creditors to the possibility of a haircut may discourage lending to distressed institutions and increase the probability of a chain reaction of failures. Nonetheless, some Committee members argue that the Senate Banking bill may unfairly disadvantage certain creditors because it gives the FDIC too much discretion over the transfer of assets and liabilities from a covered financial company to a bridge financial company.¹²⁰ These Committee members fear that with such broad discretion, the FDIC will pick and choose among creditors, in a manner that will penalize particular parties and distort the way investors value debt.

The Committee is also concerned about the Senate Banking bill's protection of derivatives counterparties. The Senate Banking bill provides that, as under current law governing FDIC-insured banks,¹²¹ the FDIC can transfer either all or none of a failing bank's "qualified

¹¹² 12 U.S.C. § 1823(c)(4)(G).

¹¹³ Senate Banking bill, *supra* note 7, § 206(1).

¹¹⁴ *Id.* § 206(2).

¹¹⁵ *Id.* § 206(3).

¹¹⁶ *Id.* § 210(b)(1).

¹¹⁷ *Id.* § 210(a)(3)(D).

¹¹⁸ *Id.* § 210(b)(5).

¹¹⁹ H.R. 4173, *supra* note 74, § 1609(a)(4)(D)(iv), (v).

¹²⁰ Senate Banking bill, *supra* note 7, § 210(h)(5)(E). For example, the FDIC can discriminate between creditors if it determines that such action is necessary to "contain or address serious adverse effects to the financial stability of the United States." *Id.* § 210(h)(5)(E)(i)(IV).

¹²¹ 12 U.S.C. § 1821(e)(9).

financial contracts”¹²² to a healthy institution,¹²³ but the Senate Banking bill extends from one to five days the period during which holders of qualified financial contracts are stayed from exercising contractual termination, liquidation, or netting rights.¹²⁴ Some Committee members argue that this five-day stay could change the way investors price repos with covered financial companies and could limit the availability of funding for these institutions. Furthermore, the Committee is concerned that the requirement to transfer “all or none” of a bank’s qualified financial contracts would enable a counterparty to a systemically important bank to avoid losses even if it held an “in-the-money” derivatives portfolio that was insufficiently collateralized. As the Committee believes that inadequately collateralized parties should bear losses in the event of a company’s failure, the “all or none” requirement is misguided.

It is also inconsistently applied because the Senate Banking bill subjects all non-systemically important financial institutions, including banks, to the Bankruptcy Code,¹²⁵ which does not take an “all or none” approach and does impose losses on insufficiently collateralized counterparties. Because of the differing treatment of derivatives under the Bankruptcy Code and the Orderly Liquidation procedure, parties will be incentivized to trade with financial companies that they view as likely to be deemed “systemically important.” The perverse side effect of this incentive may be the further concentration of risk. To avoid this undesirable outcome, the Senate should ensure that all undercollateralized derivatives counterparties are exposed to the possibility of loss.

The Senate Banking bill’s extension of the Bankruptcy Code to non-systemically important banks raises some difficult questions about the authority of the FDIC. For instance, the FDIC currently has a duty to take “prompt corrective action” when it believes a bank is in danger of failing.¹²⁶ Will the FDIC continue to have this duty if the resolution of small banks is governed by the Bankruptcy Code? Further, in line with its mandate to employ a least-cost resolution approach,¹²⁷ the FDIC presently may employ its funds to assist with the resolution of insolvent banks. Thus, where it is cheaper to subsidize the purchase of an insolvent bank than to liquidate and pay off depositors, the FDIC can use its funds to provide such a subsidy. Will the FDIC continue to do so once small banks are subject to the normal bankruptcy regime? The Senate Banking bill leaves these questions unanswered.

C. Procedure Funding

Unless we can be sure that new regulations end the possibility that the failure of a sufficiently interconnected firm could set off a chain reaction of failures, regulators must have the ability to put “foam on the runway.” On the other hand, the Committee believes there are problems with the mechanism the Senate Banking bill has chosen for capitalizing the Orderly Liquidation Fund. The Senate Banking bill calls for the FDIC to raise \$50 billion for the fund

¹²² These contracts are defined broadly enough to include any major type of derivative. Senate Banking bill, *supra* note 7, § 210(c)(8)(D)(i).

¹²³ *Id.* § 210(c)(9).

¹²⁴ *Id.* § 210(c)(10)(B)(i).

¹²⁵ *Id.* § 202(d).

¹²⁶ 12 U.S.C. § 1831o(a).

¹²⁷ 12 U.S.C. § 1823(c)(4).

during an “initial capitalization period,”¹²⁸ through risk-based assessments on bank holding companies with assets greater than \$50 billion and on nonbank financial companies supervised by the Federal Reserve.¹²⁹ Additionally, the draft authorizes the FDIC to borrow from the Treasury in an amount that cannot exceed the sum of the cash in the Orderly Liquidation Fund and 90% of the assets of covered financial companies available to repay the fund.¹³⁰ If the fund falls below its \$50 billion target after the initial capitalization period, the FDIC must impose additional risk-based assessments.¹³¹

The Committee believes that the timing of the Orderly Liquidation Fund’s financing is ill-conceived, and is encouraged by reports that the Administration is urging Senate Democrats to change course.¹³² Though there may be merits to placing money in the fund before it is needed, these advantages are dwarfed by the uncertainty of the costs of any resolution. Indeed, as illustrated by the large gap between the target size of the Senate and House fund, which calls for \$150 billion to be raised,¹³³ there seems to be little agreement as to what might be needed to finance special resolutions. The initial capitalization requirement should be eliminated in favor of an “as-needed” provision akin to Section 210(o)(1)(C) of the Senate Banking bill, which empowers the FDIC to impose further risk-based assessments on both eligible financial companies and consolidated financial companies with assets over \$50 billion if the fund falls below its target size.

In addition to the lack of clarity on the cost of resolutions, concerns about moral hazard also lead the Committee to disfavor a pre-funded mechanism. In signaling to creditors that the government is willing to bail out institutions, a pre-capitalized resolution fund may encourage risky behavior. This worry about potential moral hazard is shared by Treasury Secretary Geithner, who told the House Financial Services Committee that *ex ante* funding “would create expectations that the government would step in to protect shareholders and creditors from losses.”¹³⁴

Finally, a pre-capitalized Orderly Liquidation Fund creates a standing temptation to use fund money for other purposes. The Committee acknowledges that the Senate Banking bill includes some safeguards against this possibility. First, the Fund would be established as a separate account within the Treasury.¹³⁵ Second, the Senate Banking bill restricts the use of the proceeds of the Fund to “actions authorized by this title.”¹³⁶ And third, the FDIC is directed to manage the Fund in accordance with policies and procedures that it has established and that have been approved by the Secretary of the Treasury.¹³⁷ Nevertheless, judging from the history of

¹²⁸ Senate Banking bill, *supra* note 7, §§ 210(n)(5)-(6).

¹²⁹ *Id.* § 210(o)(1)(b).

¹³⁰ *Id.* §§ 210(n)(9)-(10).

¹³¹ *Id.* § 210(o)(1)(c).

¹³² Jim Kuhnhen, *Treasury: Drop \$50 billion fund from banking bill*, ASSOCIATED PRESS, Apr. 16, 2010.

¹³³ H.R. 4173, *supra* note 74, § 1602(9).

¹³⁴ *Hearing Before the H. Fin. Services Comm.*, 111th Cong. (Oct. 29, 2009) (written testimony of Timothy Geithner, Secretary of the Treasury), available at <http://www.ustreas.gov/press/releases/tg335.htm>.

¹³⁵ Senate Banking bill, *supra* note 7, § 210(n)(1).

¹³⁶ These include “the orderly liquidation of covered financial companies, payment of administrative expenses, the payment of principal and interest [borrowed from the Treasury], and the exercise of the authorities of the [FDIC] under this title.” *Id.*

¹³⁷ *Id.* §§ 203(d), 210(n)(3).

state legislatures “raiding” pre-financed state guaranty funds, the concern about the possibility that the Orderly Liquidation Fund proceeds will be put to other purposes may not be idle.

Separate from issues about the timing of funding, the Committee is concerned about the potential for cross-subsidization between different types of financial institutions. While the bill authorizes the FDIC to take into account a number of considerations when imposing an assessment on an eligible company, including the company’s financial condition,¹³⁸ the company’s type,¹³⁹ and other factors the FDIC deems appropriate,¹⁴⁰ the Committee is worried that one class of companies may end up paying for the resolution of another class. For example, even if only large banks fail, hedge funds that are “eligible financial companies” will be liable for risk-based assessments. Conversely, in the wake of hedge fund failures, banks may end up subsidizing the hedge fund industry. The risk of such subsidization is particularly pronounced for insurance companies, which cannot be resolved under the Orderly Liquidation procedure but may nonetheless be called upon for as-needed assessments if they possess more than \$50 billion in assets.¹⁴¹ In light of such incongruities, the Committee believes that stronger protections need to be put into place to ensure particular companies do not bear a larger risk-based assessment than is warranted.

One way of achieving this goal would be to have the creditors and counterparties of particular failed institutions fund the cost of resolution. This approach not only reduces the risk of cross-subsidization but also promotes market discipline. While some worry that creditors and counterparties of failed institutions may not be able to bear potentially high resolution costs, this concern can be mitigated by allowing such costs to be amortized over a medium term. At a minimum, legislation should require that creditors and counterparties repay any amount they receive under the Orderly Liquidation procedures that exceeds what they would have obtained in bankruptcy.

8. Regulatory Reorganization

There are two key questions with respect to regulatory reorganization: who should supervise various financial institutions, and who should be responsible for systemic risk regulation?

A. Regulatory Fragmentation

Regulatory fragmentation hinders effective management of systemic risk and facilitates regulatory arbitrage. As stated in the Committee’s October 13, 2009 letter to Chairman Frank and Ranking Member Bachus, the Committee believes that the current fragmentation across the U.S. financial regulatory framework, evidenced by more than 100 different agencies regulating and supervising the financial markets, has given rise to an incoherent regulatory approach that has proved damaging and costly for the U.S. economy. Despite extensive proliferation of regulatory agencies, many important areas of the financial markets have been left without

¹³⁸ *Id.* § 210(o)(4)(D).

¹³⁹ *Id.* § 210(o)(4)(F).

¹⁴⁰ *Id.* § 210(o)(4)(H).

¹⁴¹ *Id.* § 210(o)(1)(E)(ii).

coverage, or with coverage that is insufficiently rigorous to account for the risks they pose to the market and to the economy as a whole.

To remedy these problems, the Committee would strongly consider creating a new U.S. Financial Services Authority (USFSA) to be responsible for supervision of all financial institutions and other aspects of the financial system, including market structure, permissible activities, and safety and soundness.¹⁴² The USFSA would combine the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), FDIC, SEC, and CFTC. This would promote consistency and rapid reform, avoid adverse competitive consequences in financial regulation, and keep the Federal Reserve focused on monetary policy and regulation of systemic risk. While the Federal Reserve and the Treasury have argued for a supervisory role on the grounds that they need to supervise institutions to which they may have to lend,¹⁴³ the Federal Reserve and Treasury could be given the right to obtain all supervisory information obtained by the USFSA and the power to design examinations of large institutions to the extent required.

Although the initial Senate Banking bill released by Senator Dodd in November did not call for a consolidated financial regulator, it at least had the virtue of addressing fragmentation in a significant way by creating an independent consolidated banking supervisor. The consolidated banking supervisor would have taken over the powers of the Federal Reserve with respect to the supervision of bank holding companies and member banks, the OCC with respect to national banks, OTS with respect to federal thrifts, and the FDIC with respect to nonmember banks.¹⁴⁴

Unfortunately, the current Senate Banking bill does not even begin to address these issues. While the Senate Banking bill dissolves the OTS and transfers its responsibilities to the Federal Reserve, OCC, and FDIC, it retains almost all of the other agencies we had leading up to the crisis. The Senate Banking bill then adds several new regulators, including the CFPB, the Financial Stability Oversight Council, the Office of Credit Ratings, and the Office of National Insurance.¹⁴⁵ This will exacerbate the problem of fragmentation in what is already a highly fragmented regulatory structure.

B. Regulation of Systemic Risk

One of the chief innovations in the Senate Banking bill is the creation of a “Financial Stability Oversight Council” to play a key role in the regulation of systemic risk. While the Committee does not oppose the creation of the Financial Stability Oversight Council, particularly to monitor financial stability and sound early warnings of trouble (as long as it has no day-to-day operational role), the Committee is concerned that the Senate Banking bill would give too little

¹⁴² CCMR PLAN FOR REGULATORY REFORM, *supra* note 1, at 204. As previously noted, the Committee developed the USFSA proposal in the May Report. It may not reflect the views of Committee members who have joined since May 2009.

¹⁴³ *See, e.g.*, Brian F. Madigan, Dir., Div. of Monetary Affairs, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Kansas City’s Annual Economic Symposium: Bagehot’s Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis (Aug. 21, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm>.

¹⁴⁴ CHRISTOPHER DODD, S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2009 §§ 311, 322, 331 (2009).

¹⁴⁵ *See, e.g.*, Senate Banking bill, *supra* note 7, § 312.

authority to bank regulators in the general field of financial regulation. As previously noted, a 2/3 majority of the Financial Stability Oversight Council is required to veto CFPB actions that could undermine the safety and soundness of the banking system or threaten financial stability. Similarly, when the Federal Reserve determines that a bank holding company with \$50 billion or more in assets poses a “grave threat to the financial stability of the United States,” a 2/3 majority of the Council is required to approve a Federal Reserve decision to require that bank holding company to terminate certain activities or sell assets or off-balance sheet items.¹⁴⁶ Again, since this would allow the Council’s four members who are non-bank regulators to prevent the Council from acting on matters that mainly pertain to banks, the Committee would recommend revising the Senate Financial Stability Oversight Council to bring it closer to the House version.

Despite the addition of the new Financial Stability Oversight Council, the Senate Banking bill envisions that the Federal Reserve would continue to play a key role in systemic risk regulation. In addition to including provisions that would give the Federal Reserve authority over various aspects of derivatives regulation, the Senate Banking bill provides that the Financial Stability Oversight Council could require the Federal Reserve to impose stricter prudential standards on nonbank financial firms the Financial Stability Oversight Council deems systemically significant as well as “large, interconnected bank holding companies.”¹⁴⁷ Stricter prudential standards to be imposed by the Federal Reserve include more rigorous capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, and concentration limits, as well as contingent capital requirements, enhanced public disclosure, and overall risk management requirements.¹⁴⁸

While the Committee has acknowledged that there are some advantages with giving the Federal Reserve authority over institutions designated “systemically important,”¹⁴⁹ there are also serious concerns about this approach. In addition to the fact that it would be difficult to determine *ex ante* which institutions are “systemically important,” the designation signals that there is a high probability that the government would act to prevent some institutions from failing, since their failure would threaten the financial system. When the government provides such a safety net, the government creates moral hazard: systemically important firms are encouraged to engage in imprudent risk-taking and ill-informed decision-making because they are insulated from the repercussions of bad decisions.¹⁵⁰

Second, designating systemically important firms will distort competition by giving those firms substantial competitive advantages. For example, creditors will lend to systemically important firms at lower interest rates based on the perception that the federal government will ensure they get paid back. The appearance of a federal backstop will also encourage participants in the derivatives market to trade with systemically important firms as a way of avoiding counterparty risk. Stratification of the financial services industry may result.¹⁵¹

¹⁴⁶ *Id.* § 121(a).

¹⁴⁷ *Id.* § 113.

¹⁴⁸ *Id.* § 115(b)(1).

¹⁴⁹ CCMR PLAN FOR REGULATORY REFORM, *supra* note 1, at 207.

¹⁵⁰ See Kevin Dowd, *The Case for Financial Laissez-Faire*, 106 *Econ. J.* 679 (1996).

¹⁵¹ CCMR PLAN FOR REGULATORY REFORM, *supra* note 1, at 207.

In light of the disadvantages associated with giving the Federal Reserve jurisdiction over “systemically important” nonbanks, the Committee recommends that Federal Reserve oversight be determined by an asset threshold that is set low enough to include some firms that are not intuitively systemically important. For example, a \$50 billion cut-off for life and health insurance companies would pick up 23 companies and 77% of sector assets, while a \$20 billion cut-off for property and casualty providers would cover 15 companies and 59% of sector assets. All such insurance companies operate in each of the 51 U.S. jurisdictions.¹⁵² For the hedge fund industry, a \$12 billion threshold would have included the top 21 advisors as of January 2010.¹⁵³ These data-points are only suggestive. Legislation should allow the Financial Stability Oversight Council, upon a recommendation by the Secretary of the Treasury, to set asset thresholds for different industries. Appropriate regulation of non-bank financial firms would be determined after a Federal Reserve study, though some on the Committee believe at least some additional regulation will be necessary. Using asset thresholds would avoid the implication that nonbanks supervised by the Federal Reserve can rely on bailouts. It would also harmonize with the Senate Banking bill’s treatment of banks, which fall under the jurisdiction of the Federal Reserve if they have more than \$50 billion in assets.¹⁵⁴ Since it is implausible to suppose that all 36 banks¹⁵⁵ above this threshold are systemically important, the Committee believes this aspect of the Senate Banking bill does a better job of avoiding the implication that firms supervised by the Federal Reserve can rely on bailouts.¹⁵⁶

Some have suggested that a significant disadvantage of using an asset threshold to determine which insurance companies, hedge funds, and other nonbanks will be subject to Federal Reserve supervision is that there could be a systemically important firm below the asset threshold. But while this is a possibility, as just noted, the Senate Banking bill already uses an asset threshold to determine which banks are subject to Federal Reserve supervision. It is unclear why the prospect of small-but-risky nonbank institutions presents a greater concern than that of small-but-risky banks.

Aside from whether it is better to rely on systemic risk designations or asset thresholds, some Committee members disagree with the idea of allowing the Federal Reserve to supervise nonbanks at all. These Committee members argue that the buy-side, e.g., mutual funds, is already well regulated by multiple supervisors (including the SEC and insurance regulators), and rather than introduce a new layer of supervision would support strengthening the role of current functional regulators. At a minimum, these Committee members recommend requiring the approval of the federal regulator with the greatest understanding of the risks posed by a given nonbank before the Federal Reserve subjects that nonbank to additional prudential supervision.

¹⁵² Nat’l Ass’n of Ins. Comm’rs, *Top 20 Property/Casualty Groups in Terms of Assets* (as calculated by the Ctr. for Risk Mgmt. & Ins. Research) (Dec. 30, 2008).

¹⁵³ See Damian Alexander, *Global hedge fund assets rebound to just over \$1.8 trillion*, GLOBAL REV. 2010 (Mar. 2010), available at <http://www.hedgefundintelligence.com/Article/2455359/Issue/74948/Global-hedge-fund-assets-rebound-to-just-over-18-trillion.html?Task=ReportatData> from Pensions and Investments.

¹⁵⁴ Senate Banking bill, *supra* note 7, § 312(b)(1)(A).

¹⁵⁵ See Nat’l Info. Ctr., U.S. Fed. Reserve Sys., *Top 50 BHCs* (Mar. 31, 2010), available at <http://www.ffiec.gov/nicpubweb/nicweb/Top50form.aspx>.

¹⁵⁶ One drawback of this approach, however, is that it could encourage banks to manage their asset levels just below the \$50 billion threshold.

9. Volcker Rules and Related Size Limitations

On January 21, 2009, the Obama Administration proposed the adoption of the “Volcker Rules” and related limitations on bank size. The Volcker Rules would prohibit bank holding companies and their subsidiaries from engaging in proprietary trading, as well as from investing in or sponsoring hedge fund and private equity operations. The size limits would not require banks to divest existing operations or restrict organic growth, but would limit banks’ ability to gain market share in non-deposit liabilities through mergers and acquisitions.

The Senate Banking bill incorporates a modified version of these reforms. The Committee does not believe these reforms will meaningfully reduce systemic risk.

A. The Volcker Rules in the Senate Banking bill

The Senate Banking bill prohibits banks, bank holding companies, and subsidiaries of the foregoing from engaging in proprietary trading, sponsoring and investing in hedge funds and private equity funds, and from having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser.¹⁵⁷ In addition, nonbank financial companies supervised by the Federal Reserve that engage in proprietary trading, invest in, or sponsor hedge funds or private equity funds will be subject to new capital requirements and specific additional quantitative limits imposed by the Federal Reserve.¹⁵⁸

i. *Proprietary Trading*

Restrictions on proprietary trading focused solely on banks are unlikely to reduce systemic risk for several reasons. First, if “proprietary trading” is defined as trading activity carried out on internal trading desks purely for a bank’s own account, most banks engage in very little of it. For example, Wells Fargo and Bank of America, two of the largest deposit-funded banks, are estimated to earn less than 1% of revenues from proprietary trading in this sense.¹⁵⁹ Second, activities that threaten the financial system do not occur only in banks. In fact, none of the most prominent failures of the financial crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns, or Lehman—was a deposit-taking bank. And third, focusing on proprietary trading fails to address the real cause of the financial crisis: losses from lending and securitization accounted for approximately 80% of overall credit losses incurred by banks.¹⁶⁰

With regard to covering nonbanks supervised by the Federal Reserve, the Committee notes that the Senate Banking bill is even more restrictive than Chairman Volcker recommended. According to Chairman Volcker, it would be acceptable for an investment bank to drop its bank charter and continue to engage in proprietary trading.¹⁶¹ However, under the Senate Banking bill,

¹⁵⁷ Senate Banking bill, *supra* note 7, § 619(a)(2)(A).

¹⁵⁸ *Id.* § 619(f)(1).

¹⁵⁹ Brooke Masters, *Alert over proprietary trading clamp*, FIN. TIMES, Jan. 28, 2010.

¹⁶⁰ Goldman Sachs Group, Inc., Goldman Investment Research, *United States: Banks 6* (Nov. 30, 2009).

¹⁶¹ *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. (2010) (statement of Paul A. Volcker, Chairman,

a systemically important investment bank would continue to be supervised by the Federal Reserve and would therefore be subject to additional capital requirements and quantitative limits on proprietary trading. Since institutions that are systemically important are likely to be more thoroughly regulated than those that are not, this could encourage proprietary trading to shift to less carefully monitored firms, thereby increasing systemic risk if these firms become interconnected enough. If all firms engaged in large scale proprietary trading were considered to be systemically important, then the overall amount of proprietary trading could decrease, with adverse effects on the liquidity of markets which proprietary trading now supports.

At a minimum, if restrictions on bank proprietary trading must be put in place, “proprietary trading” should be narrowly defined as trading activities set up with segregated capital and separate teams who do not interact with customer businesses and deposits.

ii. Private Equity

As of September 30, 2009, investments in private equity accounted for less than 3% of the aggregate reported trading and/or “other” assets of the six largest U.S. banks.¹⁶² As a percentage of *total* bank assets, private equity investments accounted for less than 1% of the total consolidated balance sheet of Bank of America, JP Morgan, Wells Fargo, and Citigroup, and less than 2% of the total balance sheet assets of Goldman Sachs and Morgan Stanley.¹⁶³ There is also no apparent evidence that losses associated with private equity were a material portion of total losses during the financial crisis.

In fact, preventing banks from participating in private equity may just make it more difficult for banks to reduce exposure to risk. Suppose a bank wants to acquire a 20% ownership stake in a commercial company. If the bank cannot invest through a private equity fund in which it has a 20% stake, it may achieve the same result by buying the commercial company outright (through merchant banking) and then syndicating 80% of the equity. But this approach requires the bank to line up a new set of co-investors for each investment. The bank will ultimately wind up with the same risk profile, but will be forced to achieve it in a less efficient manner.

While preventing banks from becoming involved in private equity will not make banks safer, banks and investment banks account for \$115 billion, or 12%, of investment by limited partners (including co-investments) in private equity funds involved in corporate finance and buyouts.¹⁶⁴ Historically, banks have also represented an important source of direct proprietary

President’s Econ. Recovery Advisory Bd.) (“The basic point is that there has been, and remains, a strong public interest in providing a “safety net”—in particular, deposit insurance and the provision of liquidity in emergencies for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.”).

¹⁶² Private Equity Council, *Private Equity and Banks* 1, Jan. 22, 2010.

¹⁶³ *Id.* at 1-8.

¹⁶⁴ *Id.* at 1; see also Press Release, Preqin, Effects of Obama’s Proposal on Alternatives Industry Significant (Jan. 22, 2010),

http://www.preqin.com/docs/press/Preqin_PR_Potential_effects_of_Obamas_proposals_on_alternatives.pdf.

involvement in private equity as general partners.¹⁶⁵ Mandating the exit of banks from involvement in these activities could force the withdrawal of a substantial fraction of the private equity industry's available investment capital. At a moment when private equity is starting to rebound, rules that would force a withdrawal or reconfiguration of significant capital in the industry could chill investment in U.S. industry.

iii. Hedge Funds

Although the Committee has not been able to gather much data regarding bank exposure to the hedge fund industry, the information we have suggests that eliminating these activities will not significantly reduce bank risk profiles either. Analysis by Preqin shows that banks directly invest only \$10 billion (or 0.9%) of the total capital invested by U.S. investors in hedge funds.¹⁶⁶

B. Size Limitations in the Senate Banking bill

The Senate Banking bill subjects insured depository institutions, bank holding companies, savings and loan companies, companies controlling insured depository institutions, and non-bank financial institutions supervised by the Federal Reserve to restrictions prohibiting any such institution from merging or consolidating with, or acquiring all assets or control of, another company, if the total consolidated liabilities of the acquiring institution following the transaction would exceed 10% of the aggregate consolidated liabilities of all financial companies. These restrictions, however, are subject to recommendations from the Financial Stability Oversight Council.¹⁶⁷

As with the Volcker Rules, the Committee does not believe that size limitations will reduce systemic risk. An institution does not pose systemic risk because of its absolute size, but rather because of its debt, its derivatives positions, and the scope and complexity of its other financial relationships. Because the problem is not size but interconnectedness, reform should focus on reducing the interconnections so that firms can fail safely. Furthermore, even if size were the right issue, the Senate Banking bill would not require any existing bank to shrink; it would only prevent further growth by consolidation or acquisition. Assuming size is the source of systemic risk, we should presumably be concerned about it whether it is the result of acquisition or organic growth.

10. Corporate Governance

The Senate Banking bill contains measures related to corporate governance, including a provision granting the SEC authority to issue rules allowing shareholders to put nominees on the company proxy.¹⁶⁸ Without taking a view on the merits of proxy access, the Committee recommends limiting the scope of pending legislation to matters relevant to the financial system. Since proxy access does not fall into this category, most Committee members believe it should not be covered in this legislation.

¹⁶⁵ Private Equity Council, *2009 Year End Update* 5-6, Jan. 4, 2010.

¹⁶⁶ See Press Release, Preqin, Effects of Obama's Proposal on Alternatives Industry Significant (Jan. 22, 2010).

¹⁶⁷ Senate Banking bill, *supra* note 7, § 620(a)-(b).

¹⁶⁸ *Id.* § 972.

11. Total Costs and U.S. Competitiveness

The debate over financial reform is occurring in a rapidly changing policy context. On January 14, 2010, President Obama proposed a “Financial Crisis Responsibility Fee” to recoup costs incurred by the U.S. government in connection with TARP.¹⁶⁹ The Fee would be levied on the debts of financial institutions with more than \$50 billion in assets, and would raise up to \$117 billion.¹⁷⁰ According to the White House, over 60% of the revenues would be paid by the 10 largest financial institutions.¹⁷¹ Others have estimated that the annual cost of the tax would be more than \$1 billion for Citigroup (\$2.2 billion per year), JP Morgan (\$2.0 billion per year), and Bank of America (\$1.7 billion per year).¹⁷²

Against this backdrop, the Committee is concerned that the significant additional costs the Senate Banking bill would impose on financial institutions may begin to erode the dynamism of the financial sector and hinder overall economic growth. While acknowledging that some of increased costs associated with regulatory reforms may be appropriate, it is important to weigh all costs in evaluating the net effects of the proposed measures. Costs fall into several categories:

- **Costs from Levies Imposed to Capitalize a Liquidation Fund.** As discussed, the Senate Banking bill proposes funding a \$50 billion Orderly Liquidation Fund through levies on large banks and nonbank financial companies that are supervised by the Federal Reserve.¹⁷³ If the Fund’s cash levels fall below its target size, additional risk-based assessments can be made on financial companies with more than \$50 billion in assets. The FDIC may continuously replenish the Fund, and there is no limit on the amount that it can raise in response to a systemic event.
- **Costs from Restrictions on Profitable Lines of Business.** According to a recent study by Oliver Wyman and Morgan Stanley, large banks’ revenues from credit and securitization divisions are estimated to decline by 40% in 2010, in significant part because of proposed regulatory changes to these key lines of business. The Volcker Rules would also restrict banks’ involvement in proprietary trading, private equity, and hedge funds. The restrictions on private equity may be particularly significant, given that investments by banks represent over 10% of private equity assets under management.
- **Costs from stricter “Prudential Standards.”** There are likely to be significant costs associated with the new risk-based capital requirements, leverage limits, liquidity requirements, and concentration limits imposed by the Federal Reserve on systemically significant nonbanks and large bank holding companies.
- **Higher Borrowing Costs.** The proposed Orderly Liquidation procedures, which allow the FDIC substantial discretion in deciding which assets and liabilities are transferred to bridge

¹⁶⁹ Press Release, The White House, President Obama Proposes Financial Crisis Responsibility Fee to Recoup Every Last Penny for American Taxpayers (Jan. 14, 2010).

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² Jackie Calmes, *Taxing Banks for the Bailout*, N.Y. TIMES, Jan. 14, 2010.

¹⁷³ Senate Banking bill, *supra* note 7, § 210(n).

banks, would increase risk to creditors and result in higher funding costs. Further, giving the Federal Reserve regulatory jurisdiction over “systemically important firms” may raise borrowing costs for small financial companies, who will be seen not to enjoy the same government guarantees as larger competitors.

Finally, the Committee is worried about negative effects on U.S. competitiveness if regulation is not coordinated on a global level. Unilateral regulation threatens to drive capital offshore and could weaken the position of institutions headquartered in the U.S. in the international capital markets.

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Conclusion

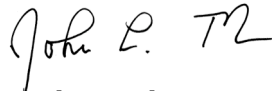
We must address the major regulatory issues raised by the crisis now and do so on a bipartisan basis, rather than preserving the ability to make partisan attacks in upcoming elections. The future well-being of the financial system is crucial to our economy and the prosperity of our people. Action will require compromise and we urge both parties to work hard to achieve this goal.

Respectfully submitted,



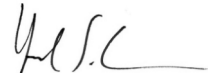
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