

COMMITTEE ON CAPITAL MARKETS REGULATION

June 14, 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 Barney Frank
Chairman
United States House of Representatives
Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

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 Spencer Bachus
Ranking Member
United States House of Representatives
Financial Services Committee
2246 Rayburn House Office Building
Washington, DC 20515

Re: House-Senate Finance Bill Reconciliation Process

Dear Chairman Dodd, Ranking Member Shelby, Chairman Frank and Ranking Member Bachus:

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 *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, on April 26, 2010, the Committee formulated a “Blueprint for Compromise” in a letter to the Chairman and Ranking Members of the Senate Banking Committee and Senate Agriculture Committee with respect to the then pending Senate Restoring Financial Stability Act of 2010.

In this letter we set forth our views as to the most desirable way to reconcile the Senate Restoring Financial Stability Act of 2010 (Senate bill) and the House Wall Street Reform and Consumer Protection Act of 2009 (House bill). We begin with a summary of our recommendations followed by a more detailed presentation.

The Committee wishes to emphasize six critical points for the reconciliation process:

1. **Volcker Rule Restrictions on Bank Activities.** While the Committee recognizes the importance of giving regulators flexibility to control bank activities that pose systemic

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

risk and that receive the benefit of taxpayer funded insurance, it is concerned about the provisions in the Senate Bill that provide for a blanket ban on proprietary trading and sponsoring hedge or private equity funds when such attempts appear to have little support in Continental Europe or Asia and were not responsible for the financial crisis. The Committee prefers the House bill approach, which vests the necessary discretion in regulators to curtail a broader set of bank activities on a case by case basis.

2. **Prudential Oversight.** The Committee would not require, as does the Collins Amendment to the Senate Bill, that bank capital requirements be applied to non-banks, because non-banks raise different types of risks. Also, the Committee favors eliminating the moral hazard and competitive distortions that will arise from branding banking organizations as systemically important. It thus favors the Senate approach of giving the Fed jurisdiction over banking institutions with \$50 billion or more in assets (there are currently 36) rather than the House approach of giving the Fed jurisdiction over systemically important banks. Moreover, the Committee supports the Senate approach of not tying the Fed's hands with regard to these designated financial institutions by requiring them to meet a fixed leverage ratio. The House bill's requirement that systemically important institutions maintain a debt to equity ratio below 15 to 1 is misguided and unnecessarily constrains the Fed's flexibility.
3. **Emergency Measures.** The Committee believes that both bills do a commendable job providing for necessary emergency protection measures against systemic risk in the financial system, and favors resolving differences between the bills on these points in ways that preserve regulatory discretion to act during periods of systemic stress without imposing procedural hurdles. Because the House bill's version of enhanced dissolution authority for systemically important nonbank financial institutions—which, unlike the Senate's version, does not require advance court approval for appointing the FDIC as receiver—preserves this regulatory ability to act quickly and decisively in an emergency, the Committee supports this provision. Additionally, the Committee opposes both bills' proposed modifications to the treatment of secured creditors during liquidation of systemically important financial firms, and reiterates its support for the Senate approach of funding dissolution of failed financial firms through ex post levies on financial institutions rather than the House approach of using an ex ante fund.
4. **Derivatives.** The Committee opposes the Lincoln Amendment to the Senate bill that would prohibit swaps entities from borrowing from the Federal Reserve or benefiting from FDIC guarantees during a crisis. The Amendment would effectively prohibit banks from hedging their risks through using derivatives, and is inconsistent with other parts of the Senate bill which sensibly allow swaps entities to benefit from access to the Fed window during periods of crisis.
5. **Credit Ratings Agencies (CRAs).** The Committee supports provisions in the House bill that would abolish the CRA exemption from Regulation FD and remove automatic government reliance on CRA ratings, both of which would allow the value of CRA-provided ratings to be determined by the market. The Committee believes CRAs should be subject to the same liability standards as other participants in the capital markets and

thus opposes the lower pleading standard in private actions against CRAs in the Senate bill and the stricter liability provisions of the House Bill. The Committee also opposes the Franken Amendment to the Senate Bill that would give a new Board the power to randomly assign issuers to ratings agencies.

6. **Consumer Financial Protection.** The Committee favors the structural approach of the House Bill which would establish an independent agency. This is preferable to the Senate approach of placing this function in the Fed, the only purpose of which is to give the Bureau a claim on Fed profits.

These are our most important recommendations for the key issues in reconciling the House and Senate bills; a more detailed discussion follows.

DISCUSSION

1. Regulation of Banks and Financial Institutions

A. Volcker Rule—Restrictions on Bank Activities

For federally insured, deposit-taking banks, the Senate bill incorporates the Volcker Rule prohibition on proprietary trading and on sponsoring or investing in hedge or private equity funds.² While this prohibition is subject to modification based on recommendations of the Financial Stability Oversight Council (FSOC) within six months of its passage, it does not appear that FSOC may actually significantly change the key provisions of the prohibition or undermine the “purposes” of this prohibition (preventing taxpayer-funded insurance or aid from reaching banks engaged in activities viewed as speculative).³ Nonetheless, we believe the permissible scope for FSOC action, if the Volcker rule is retained, should be clearer and broad.

By contrast, the House bill does not impose a Volcker Rule but instead empowers the FSOC to order banks to terminate certain activities it deems a “grave threat to the financial stability or economy of the United States.”⁴ The House bill also, through the Kanjorski Amendment, gives the FSOC a broad range of remedies to stop excessively risky activities of any kind, including the ability of banks to offer particular products.⁵

The Committee reiterates its position opposing the Volcker Rule since it is unlikely to reduce systemic risk and has the potential to cause significant disruption in financial activities.⁶ Proprietary trading is not a major portion of activities in many of the largest, systemically important financial institutions; moreover, proprietary trading had nothing to do with the

² Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 619(b) (2010) [hereinafter Senate Fin. Reform bill].

³ *Id.* § 619(g).

⁴ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1105(a) (2010) [hereinafter House Fin. Reform bill].

⁵ *Id.* § 1105(d).

⁶ Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking member, S. Comm. On Banking, Hous. & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Agric., Nutrition & Forestry 33 (Apr. 26, 2010) [hereinafter CCMR Apr. 26 Letter].

financial crisis, which was triggered by a traditional bank activity, lending.⁷ Further, implementation of the Volcker Rule, which has little support in Continental Europe or China, will put U.S. banks at a competitive disadvantage with customers seeking a wide range of services from their banks.

The Committee instead supports the House approach because it provides regulators with the flexibility to clamp down on any risky activity that may threaten the solvency of a bank on a case by case basis.

B. Collins Amendment—Capital Requirements for Nonbank Financial Institutions

Under the Collins Amendment to the Senate bill, nonbank financial institutions deemed systemically important by the FSOC⁸ are subject to the same Basel risk-based capital requirements and leverage ratios as banks.⁹ The House bill formulates no such requirement for nonbank financial institutions, requiring only that such institutions remain “well capitalized and well managed,”¹⁰ without giving more specific guidance.

The Committee supports an intermediate approach between the Senate and House proposals. The Senate proposal is overly broad; while it is important that certain nonbank financial institutions remain well capitalized, the current bank capital regulatory system (based on the Basel framework) is designed for banks. Imposing this regulatory system on nonbank financial institutions could lead to further increased regulatory arbitrage (and movement of activities to more lightly regulated entities not deemed to be systemically important), with an uncertain (and arguably negative) impact on financial stability.¹¹ More fundamentally, the one-size-fits-all approach of the Basel regime is ill-suited for the widely varying range of nonbank financial institutions.¹² At the same time, the House proposal, which leaves regulators wide discretion to enforce conditions ensuring banks are well-capitalized and well-managed, marks an insufficient change from the pre-crisis status quo, under which inadequate capital and leverage ratios for investment banks overseen by the SEC contributed to the crisis.

Regulators should retain some flexibility to deal with capital for nonbank financial institutions, but systemically important nonbank institutions that are already subject to capital requirements by their prudential regulator should be held to higher capital and leverage standards than they were before the crisis. Some members of the Committee would support an intermediate approach that calls for the development of risk-based capital requirements and leverage ratios for all nonbank financial institutions that exceed a specified minimum size.

⁷ *Id.*

⁸ Senate Fin. Reform bill, *supra* note 2, § 113(a)(1).

⁹ *Id.* § 171(b)(1)–(2).

¹⁰ House Fin. Reform bill, *supra* note 4, § 1304(3).

¹¹ CCMR PLAN FOR REGULATORY REFORM, *supra* note 1, at 91.

¹² *Id.*

C. Stricter Prudential Standards for Systemically Important Institutions

The Senate bill grants the Federal Reserve regulatory authority over banking organizations with assets of \$50 billion or more and over systemically important institutions as determined by the FSOC.¹³ This authority can be used to set higher capital or liquidity requirements, concentration limits, and other risk management regulations for these institutions.¹⁴

The House bill, on the other hand, grants the Federal Reserve a broad range of powers over any systemically important institution, as determined by the FSOC.¹⁵ Unlike the Senate bill, the House bill does not specify an asset threshold for banks, but rather leaves the FSOC to make this determination according to a series of criteria.¹⁶ These criteria include the extent of the company's leverage, off-balance sheet exposures, interconnectedness, importance to households and businesses as a source of credit, and several other factors.¹⁷ Also unlike the Senate bill, the House bill requires that institutions subject to stricter prudential standards maintain a debt to equity ratio of no more than 15 to 1.¹⁸

The Committee supports the Senate approach of not labeling systemically important banks. Not all of the 36 banks that have \$50 billion or more in assets are systemically important. The lack of branding in the Senate bill avoids the moral hazard associated with signaling that certain banks will be bailed out and also avoids the competitive advantage of a lower cost of funds that would come with the branding. Indeed, it would be preferable to use a similar asset threshold test for other financial institutions like insurance companies or hedge funds, as the Committee suggested in its letter of May 4, 2010.¹⁹

On the regulatory side, the Committee supports the Senate approach of granting the Federal Reserve the authority to set higher capital or liquidity requirements for designated institutions, according to its judgment. The Committee opposes the House approach of setting a predetermined, fixed leverage ratio for banks; bank regulators, not Congress, are in the best position to make such a decision. Additionally, the Committee also notes that the bank regulatory tools used by the Fed may be inappropriate for nonbank financial institutions (even large ones), and argues that existing functional regulators should have discretion to use regulatory tools most suitable for the businesses they oversee.

D. Emergency Federal Reserve Lending

The Senate bill provides that all Federal Reserve emergency lending to financial institutions be secured by collateral "sufficient to protect taxpayers from...losses."²⁰

¹³ Senate Fin. Reform bill, *supra* note 2, § 115(a)(2).

¹⁴ *Id.* § 115(b).

¹⁵ House Fin. Reform bill, *supra* note 4, § 1103(a).

¹⁶ *Id.* § 1103(b).

¹⁷ *Id.*

¹⁸ *Id.* § 1103(f)(3).

¹⁹ Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs 2 (May 4, 2010).

²⁰ Senate Fin. Reform bill, *supra* note 2, § 1151(a)(6).

Additionally, while the Senate would subject such lending to general procedures approved by the Secretary of the Treasury, it does not require his approval for any particular emergency lending facility.²¹ The House bill, by contrast, uses a different approach to collateral for such lending, requiring only that such lending be “secured to the satisfaction of the Federal Reserve Bank,” (specified to mean that the Federal Reserve and the Secretary of the Treasury both believe that “there is at least a 99 percent likelihood that all funds and interest risked in such actions” will be repaid).²² The House bill also provides that the Federal Reserve must obtain the consent of the Treasury Secretary before establishing such an emergency lending facility.²³ The Committee favors the approach of the Senate Bill.

The Committee commends both the House and Senate bills’ attention to collateralization as a general matter.²⁴ The Committee has noted in the past that the Federal Reserve’s assumption of too much credit risk by lending against insufficient collateral may ultimately compromise its independence by exposing it to undue risk.²⁵

The Committee thinks the approach of the Senate bill to collateralization is preferable; what is needed is adequate collateral, as judged by the Federal Reserve. The 99 percent test is perhaps too stringent and will be difficult to operationalize.²⁶

On the issue of prior Treasury approval, the Committee favors the Senate approach of not requiring Treasury approval for all new facilities.²⁷ The House approach imposes unnecessary procedural hurdles on the Federal Reserve, potentially hampering its ability to act decisively in a crisis.

E. FDIC Debt Guarantee Program

Both the Senate and House bills grant authority to the FDIC to guarantee the debt of solvent financial institutions, as it did in the financial crisis. However, under the Senate bill, Congressional approval is required before the FDIC exercises this authority,²⁸ while in the House bill such approval is not required.²⁹

While the Committee commends the Senate bill for recognizing that guarantees should only be used to combat systemic risk—not to prop up insolvent institutions³⁰—the Committee supports the House version of the bill because of its concern that requiring advance congressional approval could unnecessarily tie the hands of the FDIC in the event of an emergency. Effort should be made to clarify, though, that these guarantees should only be used on a temporary and exceptional basis to combat systemic risk in crisis situations.

²¹ *Id.*

²² House Fin. Reform bill, *supra* note 4, § 1701.

²³ *Id.*

²⁴ CCMR Apr. 26 Letter, *supra* note 6, at 20.

²⁵ *Id.* at 20–21.

²⁶ *Id.* at 20.

²⁷ *Id.*

²⁸ Senate Fin. Reform bill, *supra* note 2, § 1155.

²⁹ House Fin. Reform bill, *supra* note 4, § 1109.

³⁰ CCMR Apr. 26 Letter, *supra* note 6, at 19.

F. Orderly Liquidation Authority

Under the House bill, if the Secretary of the Treasury makes a determination that a systemically important financial institution is in danger of default, he is required to appoint the FDIC as receiver for the company; the FDIC then engages in expedited resolution procedures.³¹ The financial institution can appeal this appointment to a district court, but this appeal only occurs after the appointment of the FDIC as receiver.³² The Senate bill makes a similar provision that the FDIC serve as receiver for failing systemically important financial institutions, but requires the Treasury Secretary to petition the U.S. District Court for the District of Columbia for an order appointing the FDIC as receiver.³³ Both bills provide for expedited appellate review of the district court's determination that the financial institution in question is both in danger of default and systemically important.³⁴

Although both the House and Senate bills provide the FDIC with resolution authority over systemically important institutions, the Committee supports the House version of the expedited resolution process to the extent that it makes appointment of the FDIC a default rule, rather than requiring the Treasury Secretary to seek court approval for appointing a receiver in each case. As currently conceived, the Senate process appears overly cumbersome, at a time when speedy resolution is essential.

G. Creditor Rights in Liquidation

Both the House and Senate bills propose changes to the rules of the liquidation process. The Miller-Moore amendment to the House bill provides that the FDIC may treat secured creditors' claims as up to 10% unsecured if necessary to satisfy any amounts owed to the United States.³⁵ The Senate version makes somewhat different changes to creditor rights during liquidation of systemically important institutions, including providing for potentially different treatment of similarly situated creditors, subject to the broad discretion of the FDIC.³⁶ Finally, the Senate bill also proposes a three-day stay on "qualified financial contracts" (i.e., repos) during resolution.³⁷

The Committee opposes each of these modifications to the traditional liquidation process. Both the "haircut" provision in the House bill and the increased FDIC discretion to treat different classes of creditors differently in the Senate bill could discourage investors from investing in the debt of arguably systemically important institutions, thus exacerbating these institutions' private financing challenges in an emergency situation. The proposed Senate rule on repos could negatively impact money market funds' ability to invest in repos, which would impact the availability of funding for governments and other entities. Overall, the Committee opposes these

³¹ House Fin. Reform bill, *supra* note 4, § 1604(a)(1).

³² *Id.* § 1605.

³³ Senate Fin. Reform bill, *supra* note 2, § 202(a)(1)(A)(i).

³⁴ House Fin. Reform bill, *supra* note 4, § 1605; Senate Fin. Reform bill, *supra* note 2, § 202(a)(2).

³⁵ House Fin. Reform bill, *supra* note 4, § 1609(a)(4)(D)(iv).

³⁶ Senate Fin. Reform bill, *supra* note 2, § 210(b)(4).

³⁷ *Id.* § 210 (c)(10)(A)(ii).

modifications to creditor rights that are likely to increase uncertainty for investors and covered institutions.

H. Resolution Financing

The House bill creates within the Treasury a “Systemic Dissolution Fund” of up to \$150 billion, to be formed through assessments on financial companies with \$50 billion or more in assets.³⁸ The purpose of this fund is to provide for the orderly dissolution of failed financial companies that pose a systemic threat to financial markets.³⁹ The Senate bill creates a similar “Orderly Liquidation Fund (OLF)”⁴⁰ administered by the FDIC, but finances it quite differently. The FDIC can fund the OLF by borrowing from the Treasury,⁴¹ and then repay this borrowing through ex post assessments on systemically important institutions.⁴² These Senate bill assessments are first levied on the recipients of this FDIC bailout funding, and if these assessment amounts are insufficient, then additional assessments are levied on systemically important non-bank financial institutions regulated by the Federal Reserve and banking organizations with \$50 billion or more of assets.⁴³

The Committee favors the Senate approach. As we have previously noted, the size of the needed fund cannot be known in advance. Further, a standing fund creates the temptation to use fund money for other purposes, various safeguards against this possibility notwithstanding.⁴⁴ More importantly, the standing fund makes it more likely that unnecessary bailouts will occur because the funding is already in hand.

2. Derivatives

A. Clearing House Oversight

The House bill provides for OTC derivatives (swaps) clearing houses to be supervised by the CFTC, with an exception for clearing institutions already subject to oversight by the SEC.⁴⁵ By contrast, the Senate bill delegates broad authority to the Fed to regulate swaps clearing houses and other systemically important financial market utilities, subject to input from the other overseeing agencies.⁴⁶

The Committee has previously expressed its view that the Federal Reserve should have broad authority over derivatives clearing houses given its central role in monitoring and responding to systemic risk.⁴⁷ While the Senate bill requires that the Federal Reserve prescribe risk management standards for clearing houses and other financial market utilities in consultation

³⁸ House Fin. Reform bill, *supra* note 4, § 1609(n).

³⁹ *Id.*

⁴⁰ Senate Fin. Reform bill, *supra* note 2, § 210(n)(1).

⁴¹ *Id.* § 210(n)(5).

⁴² *Id.* § 210(o).

⁴³ *Id.* § 210(o)(1)(D)(i)–(ii).

⁴⁴ CCMR Apr. 26 Letter, *supra* note 6, at 28.

⁴⁵ House Fin. Reform bill, *supra* note 4, § 3103(b)(1).

⁴⁶ Senate Fin. Reform bill, *supra* note 2, § 805.

⁴⁷ CCMR Apr. 26 Letter, *supra* note 6, at 14.

with other regulatory agencies, it ultimately gives the Federal Reserve final say in promulgating these standards, which the Committee commends.

B. Exchange Trading

The Senate bill provides that swaps required to be cleared must also be traded on an exchange or the equivalent or a swap execution facility.⁴⁸ The House bill, by contrast, encourages exchange trading of swaps but does not mandate it.⁴⁹ The Committee prefers the House approach, although there is some disagreement among Committee members on this point.⁵⁰ While the Committee generally recognizes that exchange trading offers a number of important benefits, including enhanced price discovery, real-time dissemination of transaction price and quote data, and increased liquidity, many on the Committee are concerned that exchange-trading will not be feasible for all derivatives products even if they are standardized and liquid.

C. Foreign Currency Derivatives Clearing Exemption

While both bills exempt foreign currency options from mandatory central clearing,⁵¹ they take somewhat different approaches to foreign currency swaps and forwards. Under the House bill, foreign currency swaps and forwards are covered under the new swaps rules, including those requiring mandatory central clearing, only if the SEC and Treasury Secretary determine that they should be regulated as swaps, thus providing a default exemption.⁵² Under the Senate bill, there is a presumption that foreign currency swaps and forwards will be subject to new regulations, again including mandatory central clearing, unless the Secretary makes a written determination that either should not be regulated as swaps.⁵³

The Committee supports the House version. At least for short-term contracts, the House's default exemption is preferable because of the limited risks in these shorter-term contracts.⁵⁴ The Committee notes that such short-term foreign exchange swaps and forwards comprise the bulk of the foreign exchange forward and swap market.

D. Clearinghouse Access to Discount Window

The Senate bill authorizes the Federal Reserve to provide clearing houses and other financial market utilities access to the same discount and borrowing privileges the Fed provides to depository institutions.⁵⁵ The House bill, by contrast, makes no such provision. The

⁴⁸ Senate Fin. Reform bill, *supra* note 2, § 723(a)(2).

⁴⁹ House Fin. Reform bill, *supra* note 4, § 3103(a)(4).

⁵⁰ 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. 25–26 (Mar. 4, 2010) [hereinafter CCMR Derivatives Letter]; CCMR Apr. 26 Letter, *supra* note 6, at 18.

⁵¹ Senate Fin. Reform bill, *supra* note 2, § 721(a)(21); House Financial Reform bill, *supra* note 4, § 3101(a)(3).

⁵² House Fin. Reform bill, *supra* note 4, § 3101(a)(3).

⁵³ Senate Fin. Reform bill, *supra* note 2, § 721(a)(21).

⁵⁴ CCMR Derivatives Letter, *supra* note 50, at 11.

⁵⁵ Senate Fin. Reform bill, *supra* note 2, § 806.

Committee supports clearinghouse access to the discount window during financial emergencies. Additionally, it is unclear exactly how the extension of discount window access to clearinghouses in the Senate bill squares with the prohibition on federal assistance to swaps entities, discussed just below.

E. Lincoln Amendment—Federal Assistance for Swaps Entities

The Lincoln Amendment in the Senate bill would prohibit the use of “federal assistance”—defined broadly as any funds, including Federal Reserve credit facilities, FDIC insurance, or federal guarantees—by any “swaps entity.” This would practically require banks, which need to have access to federal assistance, to spin off their swaps desks into separate non-bank affiliated entities not subject to federal assistance.⁵⁶ The House bill has no such broad requirement; it merely imposes heightened regulation of swap dealers and participants, and prohibits federal assistance only to clearinghouses.⁵⁷ The Committee opposes the Lincoln Amendment.

The Committee emphasizes its position (expressed in its March Derivatives letter and April Blueprint for Compromise) that federal regulators need to retain the ability to support swaps entities in the event of a crisis on a temporary basis, since they are at the center of the interconnectedness problem in the financial system.⁵⁸ Banks need the ability to hedge their interest rate or credit risks through the use of derivatives, hedging that could not be easily achieved through affiliated derivative activity. Hiving off banks’ swaps desks could ultimately prove harmful to consumers as banks with more exposure to interest rate movements may be forced to pass these increased credit costs along to consumers.⁵⁹ Finally, the Lincoln Amendment is not consistent with the Senate bill provision giving swaps entities access to the Fed discount window, at least during emergencies. This inconsistency, combined with the importance of letting regulators help swaps entities, further suggests that the Lincoln Amendment should be excluded from the final version of the bill.

F. Mandated Fiduciary Duty for Swaps Dealers in Connection with Certain Counterparties

Another provision of the Senate bill imposes a fiduciary duty on any swaps dealer that enters into a derivative transaction with certain counterparties—specifically, any governmental entity or pension plan, endowment, or retirement plan.⁶⁰ We are concerned that such a duty, and the potential liability it entails, could deter swaps dealers from entering into derivatives contracts with these counterparties, thus depriving them of important hedging tools. We, therefore, would oppose this provision, which is only in the Senate bill.

⁵⁶ *Id.* § 716(a).

⁵⁷ House Fin. Reform bill, *supra* note 4, §§ 3107; 3304.

⁵⁸ CCMR Derivatives Letter, *supra* note 50, at 8; CCMR Apr. 26 Letter, *supra* note 6, at 14.

⁵⁹ See Marshall Eckblad, *Why Big Banks Fear Senate bill’s Lincoln Amendment*, WALL ST. J., May 21, 2010, http://online.wsj.com/article/BT-CO-20100521-710383.html?mod=WSJ_latestheadlines&mg=com-wsj.

⁶⁰ Senate Fin. Reform bill, *supra* note 2, § 731.

3. Credit Rating Agencies

A. Private Rights of Action

While both the House and Senate bills provide for private rights of action against credit rating agencies (CRAs), there are several key differences between the approach in each bill.

First, the Senate bill makes CRAs subject to lower pleading requirements in private causes of action than is presently the case for all other potential defendants under the Private Securities Litigation Reform Act (PSLRA).⁶¹ Under the Senate bill, a plaintiff need only 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 while the PSLRA would require pleadings to state “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,”⁶² which is “knowingly” or “recklessly” for a 10b-5 claim.⁶³ The House bill, by contrast, does not alter the PSLRA pleading standard just for credit ratings agencies.⁶⁴ Pleading standards are an important bulwark against unmeritorious class actions that seek settlement leverage.

On the other hand, the House bill lowers the normal 10b-5 liability standard of knowing or reckless just for CRAs, allowing plaintiffs to recover damages from CRAs if the “process of determining the credit rating was a substantial factor in the economic loss suffered by the investor.”⁶⁵ The Senate bill, by contrast, imposes no such lower liability standard (though it does empower the SEC to make rules governing such private causes of action).⁶⁶

Although the Committee does not generally believe in the creation of new private rights of action, it sees no reason to alter pleading and liability standards just for CRAs; thus it supports the House position on pleading standards and the Senate position on liability standards.⁶⁷ Credit ratings agencies should be on the same footing as other financial “gatekeepers.”

B. Franken Amendment—Credit Rating Agency Board

To reduce conflicts of interest in the “issuer-pays” CRA business model, the Senate bill, through the Franken Amendment, creates a new entity, the Credit Rating Agency Board, which registers all CRAs and assigns issuers that need ratings to the CRAs which provide them.⁶⁸ The Senate bill does not specify how CRAs will be matched to particular issuers, but suggests that the allocation process may take place through a “lottery” or “rotating assignment system.”⁶⁹

⁶¹ Senate Fin. Reform bill, *supra* note 2, § 933(b)(2); 15 U.S.C. § 78u-4(b)(2).

⁶² 15 U.S.C. § 78u-4(b)(2).

⁶³ 17 C.F.R. § 240.10b-5 (1996). See CCMR Apr. 26 Letter, *supra* note 6, at 12 n.27 for a description of the circuit split on the scienter standard for 10b-5 claims.

⁶⁴ House Fin. Reform bill, *supra* note 4, § 6003(b).

⁶⁵ *Id.* § 6003(c).

⁶⁶ Senate Fin. Reform bill, *supra* note 2, § 933(a)–(b).

⁶⁷ CCMR Apr. 26 Letter, *supra* note 6, at 12–13.

⁶⁸ Senate Fin. Reform bill, *supra* note 2, § 939D.

⁶⁹ *Id.*

The Committee opposes the Franken Amendment for several reasons. First, despite imposing a fundamental change on the way the ratings business is conducted, it does not address the fundamental conflict of interest in the issuer-agency relationship where the agency is paid by the issuer, despite the fact that the agency must render an impartial rating. Second, given a guarantee of business, one would expect a rush to become a CRA, with a possible dilution of the unsatisfactory level of competence that has existed in the past. Further, there is little reason to trust government when it comes to picking a CRA, even leaving aside the conflict of interest that would exist when government debt was rated. Finally, while the details of how the Franken Amendment would be implemented are unclear, there is a substantial risk that its implementation could unnecessarily delay the initial credit rating process for structure finance products, potentially precluding investors from investing in them. The House bill contains no such provision for the selection of CRAs, although it would generally subject CRAs to heightened regulation.⁷⁰ The Committee favors the House approach.

C. Use of Ratings by the Government and the Regulation FD Exemption

While both the House and Senate bills provide for the elimination of references to specific CRA-determined ratings across a range of federal statutes,⁷¹ the House bill goes much further than the Senate bill toward eliminating ratings language in the broader regulatory framework. Specifically, the House bill requires that every agency review any of its rules that rely on CRA-determined credit ratings, and replace this language with "such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."⁷² The Senate bill requires no such broad regulatory review of ratings.

Second, CRAs are currently exempt from Regulation FD,⁷³ allowing them access to material nonpublic information for their ratings research, thus providing a privileged and competitive advantage over other market analysts. The House bill eliminates the CRA exemption from Regulation FD, while the Senate bill has no such provision.⁷⁴ One important virtue of the Regulation FD exemption is it permits the issuer to furnish information to a CRA, for purpose of formulating a rating, without releasing this information to the public unless and until the rated securities are actually issued. But Regulation FD could provide that any analyst, not just a CRA, could get information, under the same conditions. Indeed, one could build on another exemption in Regulation FD that permits analysts to obtain material non-public information under a confidentiality agreement. The Committee's objective is to enable a wide range of professionals, analysts as well as CRAs, to evaluate securities issued to the market.

The Committee also supports the broader review of reliance on CRA ratings under the House bill because there is no reason why reliance on privately determined CRA ratings should be hard-wired into federal regulations. The government should not support a private oligopoly in the credit rating industry, particularly where reliance on such ratings has proved extremely harmful in the recent past.

⁷⁰ House Fin. Reform bill, *supra* note 4, § 6001–6013.

⁷¹ Senate Fin. Reform bill, *supra* note 2, § 939(a)–(f); House Fin. Reform bill, *supra* note 4, § 6009(a)–(f).

⁷² House Fin. Reform bill, *supra* note 4, § 6010.

⁷³ 17 C.F.R. § 243.100–103 (2005).

⁷⁴ House Fin. Reform bill, *supra* note 4, § 6007.

4. Consumer Financial Protection Agency

The Senate bill establishes the Consumer Financial Protection Bureau (CFPB) as a completely autonomous office within the Federal Reserve.⁷⁵ The only purpose of housing the CFPB in the Federal Reserve is to allow the CFPB to fund itself out of Fed profits; the Fed would have absolutely no say over the agency's operations.⁷⁶ On the other hand, the House bill proposes a new Consumer Financial Protection Agency (CFPA) with very similar powers to the CFPB proposed by the Senate bill, but existing as a freestanding independent agency, not as part of the Federal Reserve.⁷⁷

The Committee favors the freestanding agency approach in the House bill.⁷⁸ Despite the CFPB's formal independence from the Federal Reserve under the Senate proposal, there is still a significant reputational risk for the Federal Reserve from the actions of the CFPB, which could be avoided if the CFPB were truly independent.⁷⁹ Additionally, the CFPB funding process proposed by the Senate bill—through a claim on Fed profits rather than the normal appropriations process or industry fees—establishes an unwelcome precedent of earmarking Fed profits and thus avoiding accountability.⁸⁰

⁷⁵ Senate Fin. Reform bill, *supra* note 2, § 1011; 1012(c).

⁷⁶ *Id.* § 1017(a).

⁷⁷ House Fin. Reform bill, *supra* note 4, § 4101.

⁷⁸ CCMR Apr. 26 Letter, *supra* note 6, at 22.

⁷⁹ *Id.*

⁸⁰ *Id.* at 23.