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Financial Regulatory Reform and the 111th Congress

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Summary

Financial regulatory reform is being discussed in the 111th Congress, in a policy debate that began before the September 2008 financial disruption. For example, Treasury issued a blueprint for financial reform in March 2008. In September 2008, after this blueprint was issued but before congressional action, the financial system suffered severe distress as Lehman Brothers and AIG failed. This financial panic accelerated the review of financial regulation and refocused some of the policy debate on areas that experienced the most distress.

Following the change of Administrations, the Treasury issued a new plan for reform in June 2009. House committees initially reviewed many related bills on an issue-by-issue basis. House Financial Services Committee Chairman Barney Frank then consolidated a number of proposals into a comprehensive bill, the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), which the House passed on December 11, 2009. H.R. 4173 as passed contains elements of H.R. 1728, H.R. 2571, H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996. Senate Banking, Housing, and Urban Affairs Committee Chairman Christopher Dodd has issued a committee print, the Restoring American Financial Stability Act of 2009.

One issue in financial reform is the potential reorganization of the financial system regulatory architecture. Currently, the United States has many regulators, some with overlapping jurisdictions, but with gaps in oversight of some issues. This structure evolved largely in reaction to past financial crises, with new agencies and rules created to address the perceived causes of the particular financial problems at that time. One option would be to consolidate agencies that appear to have similar missions. For example, the five regulators with bank examination authority could be merged or the two regulators with securities and derivatives oversight could be merged. Another option would be to remove regulatory authority on a particular topic from the multiple agencies that might address it within their area now, and establish a single agency to address that issue. For instance, a single consumer financial protection agency or a single systemic risk regulator could be created. Both the House and the Senate are considering the establishment of a single consumer financial protection agency and some consolidation of bank regulators, although details differ. Neither the House nor the Senate proposals would consolidate the securities and derivatives regulators or create a single systemic risk regulator.

Other issues of financial reform address a particular sector of the financial system or selected classes of market participants. For example, both the House and the Senate proposals would require more derivatives to be cleared through a regulated exchange and require additional reporting for derivatives that would remain in the over-the-counter market. There are several proposals to try to increase the amount of information available to regulators, investors, consumers, and financial institutions. For instance, hedge funds would have increased reporting and registration requirements. Credit rating agencies would have to disclose additional information concerning their methodologies and any potential conflicts of interest. A federal office would be created to collect insurance information. Institution-level regulatory agencies would have to share information about covered firms with systemic risk regulators. Proposed executive compensation and securitization reforms would try to reduce incentives to take excessive risks.

This report reviews issues related to financial regulation. It provides brief descriptions of comprehensive reform bills in the 111th Congress that address these issues. This report will be periodically updated to reflect congressional activity in financial regulatory reform.

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Introduction

Comprehensive Financial Reform Proposals

The 111th Congress is considering several proposals to reorganize financial regulators and to reform the regulation of financial markets and financial institutions. Following House committee markups on various bills addressing specific issues, House Financial Services Committee Chairman Barney Frank introduced the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) incorporating elements of numerous bills introduced earlier in the session.[1] After two days of floor consideration, the House passed H.R. 4173 as amended on December 11, 2009, by a 232-202 vote.

In the Senate, Chairman Christopher Dodd of the Senate Banking, Housing, and Urban Affairs Committee issued a single comprehensive committee print on November 16, 2009, the Restoring American Financial Stability Act of 2009 (the Dodd committee print).[2] Democratic and Republican members of Senator Dodd's committee are reportedly pairing up to revise the Dodd committee print in a bipartisan fashion.

In addition to Chairman Dodd's and Chairman Frank's bills, other proposals have been made but have not been scheduled for markup. For example, House Financial Services Committee Ranking Member Spencer Bachus introduced a comprehensive reform proposal, the Consumer Protection and Regulatory Enhancement Act (H.R. 3310) and offered a similar amendment (H.Amdt. 539) during House consideration of H.R. 4173.[3] The Treasury under previous Secretary Hank Paulson issued a "Blueprint for a Modernized Financial Regulatory Structure"[4] in March 2008, whereas the Obama Administration released "Financial Regulatory Reform: A New Foundation" in June 2009 and followed this white paper with specific legislative language.[5] This report will focus on H.R. 4173 and the Dodd Committee Print.

Understanding the fabric of financial reform proposals requires some analysis of the Panic of 2008, as well as understanding certain more enduring concerns about risks in the financial system. This report begins with that analysis.

The Panic of September 2008

Risks to the financial system as a whole are of heightened interest because of the financial disruptions during September 2008. As Treasury Secretary Timothy Geithner noted in written testimony delivered to the House Financial Services Committee on September 23, 2008, "The job

[1] Initially incorporated bills included H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996.

[2] The Restoring American Financial Stability Act of 2009 committee print is available at http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf.

[3] See http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=601&Itemid=42.

[4] "Blueprint for a Modernized Financial Regulatory Structure" U.S. Treasury, available at http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[5] Treasury has created websites to track financial intervention and financial reform. See http://ustreas.gov/initiatives/regulatoryreform/ and http://www.financialstability.gov.

of the financial system … is to efficiently allocate savings and risk. Last fall, our financial system failed to do its job, and became precariously close to failing altogether."[6] U.S. investment banks suffered heavy losses in 2007 and 2008 primarily because of declines in the value of mortgage-related assets. During the week of September 15, 2008, Merrill Lynch was sold in distress to Bank of America in a deal supported by the Federal Reserve (Fed) and Treasury, which has since become the subject of controversy. The Fed and Treasury failed to find a buyer for Lehman Brothers, which subsequently declared bankruptcy, disrupting financial markets. A money market mutual fund (The Reserve Fund) that held Lehman-related paper announced losses, triggering a run on other money market funds, and Treasury responded with a guarantee fund for money market funds. AIG, an insurance company with a division specializing in financial derivatives called credit default swaps, was unable to post collateral related to its derivatives and securities lending activities. The Fed intervened to prevent bankruptcy and to ensure full payment to AIG's counterparties.

Issues for Regulatory Reform

Several issues contained in financial reform proposals relate directly to the Panic of 2008. In regard to mortgage markets, one regulatory reform option would be to create an agency dedicated to regulating financial products offered to household consumers. Another option would be to extend mortgage regulation to non-bank lenders that were not covered by the underwriting guidances issued by bank regulators. In relation to Merrill Lynch and Lehman Brothers, one approach would be to supervise large interconnected financial institutions, regulate their assets, liabilities and counterparty concentrations, and provide more flexibility to an authority to unwind them outside of traditional bankruptcy proceedings. Regarding credit default swaps and other financial derivatives, one potential reform could be to mandate clearing and exchange trading of standardized derivative products and require greater transparency for non-standard derivatives traded over-the-counter. Another possible reform would be to establish a systemic regulator or council to monitor and regulate all concentrations of risk in the financial system.

Other issues within reform proposals relate to the fractured regulatory structure that has evolved historically in the United States, which has been characterized as a patchwork. The United States has a dual banking system where both the federal government and the state governments charter banks. There are multiple federal banking regulators plus the state regulators depending on whether the institution has a federal charter, has federally insured deposits, is a credit union, etc. Insurance regulation is primarily regulated at the state level. Securities markets and derivatives markets have separate regulators. Should the dual banking system of state chartered and federal chartered banks be continued? Should there be a single bank regulator with institutional examination authority? Should the monetary authority also have banking regulation powers or resolution authority for failing firms? Should the securities regulator be combined with the derivatives regulator? Should there be an option for a federal charter in insurance?

Some are concerned that a patchwork of regulators may leave regulatory gaps, or might allow firms to "shop" for regulators resulting in weaker regulatory standards. Whether due to the recent crisis or part of a more enduring issue, some have proposed comprehensive reform in part

[6] Treasury Secretary Timothy F. Geithner, Written Testimony House Financial Services Committee, Financial Regulatory Reform, September 23, 2009, available at http://www.ustreas.gov/press/releases/tg296.htm.

because of greater awareness that failures in one part of the financial sector can disrupt the system as a whole, as well as cause damage to the broader economy.

The next sections of this report provide greater detail on reform issues and proposals.

Systemic Risk

Policy Issues

Systemic risk is a term used frequently in the context of financial regulatory reform, but practitioners use the term to describe more than one kind of problem. In some contexts, systemic risk is defined as any risk that a person or firm cannot avoid through diversification. This definition could include risks arising from outside of the financial system. Another approach is to define systemic risk as contagion; liquidity and payment problems, for example, could disrupt a few financial institutions and the system could spread risks to market participants.[7] The recent financial crisis generated numerous episodes of perceived systemic risk, where the potential collapse of firms perceived as "too big (or too interconnected) to fail," such as Lehman Brothers and AIG, prompted large-scale government intervention in an effort to mitigate widespread economic instability.[8]

Legislation

H.R. 4173 proposes creating a Financial Services Oversight Council, which would be chaired by the Treasury Secretary, and would be authorized to identify systemically important firms, such as firms perceived to be too large or too interconnected. Under this proposal, the Fed would serve as the primary financial regulator for systemically important firms identified by the Council, subjecting them to stricter prudential oversight and regulation. In addition, H.R. 4173 stipulates objective standards for the Council to follow in determining whether a firm is systemically risky, and empowers it to take actions to rein in "too big to fail" firms. The systemic risk portions of H.R. 4173 originated in the Financial Stability Improvement Act of 2009 (H.R. 3996). H.R. 3996 provided for oversight of systemically important payment settlement and clearing systems and activities. In committee consideration of H.R. 4173, an amendment by Representatives Tom Price and Judy Biggert was adopted which eliminated this section.

In the Senate, the Dodd committee print would establish an Agency for Financial Stability, to be led by an independent chairman appointed by the President with the advice and consent of Congress. This agency would be authorized to collect and analyze data on emerging risks to the financial system and be empowered to set strict prudential standards for firms identified as systemically important. Under H.R. 4173, the Financial Services Oversight Council would serve in a similar role. Further, provisions for oversight of systemically important payment and clearing systems are included in the Dodd committee print.

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[7] Several definitions for systemic risk are available in CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

[8] For issues concerning systemic risk related to the Federal Reserve, see CRS Report R40877, *Financial Regulatory Reform: Systemic Risk and the Federal Reserve*, by Marc Labonte

Federal Reserve Emergency Authority and Congressional Oversight

Policy Issues

During the recent financial turmoil, the Fed engaged in unprecedented levels of emergency lending to non-bank financial firms through its authority under Section 13(3) of the Federal Reserve Act. This law states that "*in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank ... to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange*," provided that the targeted borrower is unable to obtain the needed credit through other banking institutions.[9] In addition to the level of lending, the form of the lending has been novel, particularly the creation of three limited liability corporations controlled by the Fed, to which the Fed lent a total of $72.6 billion to purchase assets from Bear Stearns and AIG. The Fed's recent actions under Section 13(3) have generated debate in Congress about whether measures are needed to amend the institution's emergency lending powers.

Legislation

H.R. 4173 includes several provisions related to Federal Reserve authority. In particular, this legislation stipulates that while the Fed can authorize a Federal Reserve Bank to discount notes, drafts, or bills of exchange as part of broadly available credit, it would not be permitted to assist specific individuals, partnerships, or corporations. In addition, H.R. 4173 would remove existing Government Accountability Office (GAO) auditing restrictions over the Fed. This bill would also require the approval of the Treasury Secretary for emergency lending under the Federal Reserve Act.

Similar to H.R. 4173, Chairman Dodd's proposal includes an amendment to Section 13(3) authorizing the Fed to lend only to "*financial utilities or payment, clearing or settlement activities that the Agency for Financial Stability determines are, or are likely to become, systemically important, or any program or facility with broad-based participation*." In addition, the Dodd committee print proposes granting GAO audit authority of existing Federal Reserve actions initiated under Section 13(3), and proposes changes to the procedures currently followed for selecting the Boards of Directors of Federal Reserve Banks.

Resolution Regime for Failing Firms

Policy Issues

The United States provides a general bankruptcy code for most failing firms but depository banks have a separate resolution regime.[10] General bankruptcies are handled in the courts with no additional public resources available to support the process, but the Federal Deposit Insurance

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[9] For a discussion of the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte

[10] CRS Report R40530, *Insolvency of Systemically Significant Financial Companies: Bankruptcy vs. Conservatorship/Receivership*, by David H. Carpenter.

Corporation (FDIC) resolves failing depositories administratively and can use the deposit insurance fund to minimize any potential systemic impact. Some believe that the speed and discretion available in the FDIC's conservatorship/receivership regime for insured depositories is a useful model for resolving systemically important firms. The collapse of Lehman Brothers (and the near collapse of AIG, Bear Stearns, and others) during the recent financial crisis has now focused congressional attention on policy options for addressing the resolution of systemically significant non-depository financial institutions.[11]

Legislation

In the 111th Congress, legislative proposals in both the House and the Senate have outlined new processes for mitigating financial system instability posed by the potential failure of systemically important firms.

H.R. 4173 would establish new dissolution authority for the Treasury and FDIC with respect to bank holding companies, systemically important financial firms, and insurance companies. To provide financing for this new FDIC authority, H.R. 4173 would create a Systemic Dissolution Fund pre-funded by FDIC assessments on large companies, and limited to a maximum size of $150 billion.

Chairman Dodd's committee print would require large and interconnected companies to submit plans for their own shutdown should they become financially insolvent, which is a provision also included in H.R. 4173. Dodd's legislation is also similar to H.R. 4173 in that the FDIC would serve as the receiver of a failing firm, consulting with the primary financial regulatory agency to unwind the company. Financing for firm shutdown would be made available through a Systemic Resolution Fund capitalized by systemically significant institutions' issuance of hybrid debt securities.

Securitization and Shadow Banking

Policy Issues

Shadow banking refers to financial activity conducted either by non-banks or sponsored by banks off of their balance sheets.[12] Securitization supports the shadow banking system. Securitization is the process of turning mortgages, credit card loans, and other debt into marketable securities. Securitizers acquire and pool many loans from primary lenders and then issue new securities based on the flow of payments through the pool. Securitization can allow banks to reduce the risk of their retained portfolio. Securitization also finances non-bank lenders specializing in mortgage loans, credit cards, and other loan products. If the risks of securitized products are accurately rated, then securitization can contribute to financial stability by shifting financial risk to those willing and able to bear it.

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[11] This overview of resolution regimes is adapted from CRS Report R40928, *Lehman Brothers and IndyMac: Comparing Resolution Regimes*, by David H. Carpenter.

[12] CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

Securitization may have contributed to the housing bubble and financial turmoil in a variety of ways. Lenders planning to sell their loans have a reduced stake in the borrower's long-term capacity to repay the loan. Bank underwriting standards are subject to guidances issued by bank regulators because loans to risky borrowers might be unsafe and unsound for the banks themselves. These guidances, however, do not apply to non-bank mortgage lenders that are funded through securitization. Securitization was especially prevalent in the subprime mortgage market and the non-conforming California mortgage market, where loan defaults have been particularly severe.

Opaqueness in the shadow banking system may also have caused problems. When defaults rose among home buyers, the complexity of mortgage-backed securities (MBS) made it more difficult to identify which firms would suffer the largest losses. Furthermore, a drop in the rating of an MBS could require some holders to sell even though the MBS was still performing. In addition to holding the securities of non-bank subprime lenders, some banks also sponsored their own mortgage funding facilities off of their balance sheets in special purpose vehicles. When the liquidity of MBS declined, some of these sponsoring banks had to pull the assets of such special purpose vehicles back on to their balance sheets and recognize more losses. Potential reforms include regulation of securitization both at the level of the original loan and in the way the products are constructed and offered to investors.

There are numerous proposals to realign incentives in the shadow banking system. One approach is to require loan securitizers to retain a portion of the long-term default risk. The retained risk is typically not allowed to be hedged. One possible advantage of this approach is that it may help preserve underwriting standards among lenders funded by securitization. Another possible advantage is that securitizers would share in the risks faced by many of the investors to whom they market their securities. A possible disadvantage is that if each step of the securitization chain must retain a portion of risk, then relatively little risk may ultimately be shifted out of the financial sector to investors. To the extent that securitization is used as a device to shift risk to those more willing and able to bear it, concentration of risk in the financial sector may be self-defeating.

Other approaches to reforming securitization include changes to accounting standards and to the liability of the secondary market participants. Accounting changes could require banks to report securitized loans on their balance sheets if the sponsoring bank retains a contingent liability to support the assets. To the extent that changes in financial reporting would affect bank capital requirements, such reforms could dampen any recovery of securitization because banks would have to keep more capital for a given volume of lending. Another approach would be to make secondary market purchasers liable for the acts of primary lenders.

Legislation

H.R. 4173 would require that securitizers retain 5% of the risk (and not hedge it), but allow regulators to adjust this percentage under some circumstances. In May 2009, the House passed the Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728), which would make secondary market purchasers liable for the acts of primary lenders under certain conditions. Elements of H.R. 1728 were incorporated into H.R. 4173 as passed by the House.

The Dodd committee print would require that securitizers retain 10% of the risk (and not hedge it), but it allows regulators to adjust this percentage under some circumstances. It does not include provisions for some secondary market liability for securitized loans.

Consolidation of Bank Supervision

Policy Issues

Commercial banks and similar institutions are subject to regulatory examination for safety and soundness.[13] Depending on their charter, commercial banks, thrifts and credit unions may be examined by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve, the National Credit Union Administration (NCUA), or a state authority. State bank examiners often coordinate through the Conference of State Bank Supervisors (CSBS). Federal bank examiners often conduct joint rulemaking, and coordinate through the Federal Financial Institutions Examinations Council (FFIEC).

The current system of multiple bank regulators may have problems, some of which could be mitigated by regulatory consolidation. Multiple regulators may find it challenging to implement consistent enforcement even if they employ joint rulemaking. To the extent that regulations are applied inconsistently, institutions may be able to choose the regulator that they feel will be the weakest or least intrusive. If so, then competition among the regulators for covered institutions (regulatory arbitrage) could lead to less effective financial supervision. Among the arguments against consolidation are that regulatory consolidation could change the traditional U.S. dual banking system in ways that put smaller banks at a disadvantage. Another potential argument for maintaining the current system is that competition among regulators could encourage the regulators to monitor each other, and alert policymakers if one regulator lowers standards.

A narrower point also could apply to the Fed, which both regulates bank holding companies and conducts monetary policy. Some argue that the Fed should concentrate on monetary policy and have fewer regulatory responsibilities, especially if the institution's independence is to be preserved. In contrast, the Fed argues that its bank regulation responsibilities provide it with helpful information for the conduct of monetary policy. The Fed also argues that its monetary policy role makes it uniquely positioned to respond to systemic events in the banking system.

Legislation

H.R. 4173 as passed by the House would eliminate OTS and transfer most of its regulatory powers to a newly created Division of Thrift Supervision within the OCC. Additionally, under this legislation the Federal Reserve and the FDIC would assume OTS regulatory responsibilities over savings and loan holding companies, and state thrifts, respectively. However, H.R. 4173 preserves the current bank regulatory authority of the Fed and other agencies. The Dodd committee print would consolidate all of the bank regulatory responsibilities into a new single agency, the Financial Institutions Regulatory Administration.

[13] CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision*, by Mark Jickling and Edward V. Murphy.

Consumer Financial Protection Agency (CFPA)[14]

Policy Issues

In the United States, depository institutions—banks, thrifts, and credit unions—are subject to comprehensive supervision, examination, and enforcement by a number of federal bank regulators. These regulators monitor the institutions that they supervise for both safety and soundness and for compliance with other federal laws, including the various federal consumer protections laws. Most non-depository financial companies, on the other hand, do not have a primary federal regulator. Non-depositories, such as payday lenders and non-bank mortgage lenders, generally are regulated at the state level and often are not supervised or examined for consumer protection compliance on an ongoing basis. However, the financial products that these non-depositories offer may still be subject to federal consumer protection laws, such as the Truth in Lending Act (TILA).[15] The Federal Reserve largely is charged with promulgating the regulations to implement the TILA and most other federal consumer protection laws, and the Federal Trade Commission (FTC) primarily is responsible for enforcing these laws against financial institutions that do not have a primary federal regulator.

Proposals to establish a CFPA raise a number of policy questions. One is how best to balance safety and soundness regulation with compliance. Although a loan that cannot be repaid is typically bad for both the borrower and the lender, there are some areas in which there can be a conflict between safety and soundness regulation and consumer protection. When a banking activity is profitable, safety and soundness regulators tend to look upon it favorably, since it enables the bank to meet capital requirements and withstand financial shocks. A consumer protection regulator, however, may look at such activity less favorably, especially if the profit is gained at the expense of consumers. Removing compliance authority from the federal bank regulators might arguably weaken the safety and soundness regulation of banks if, for example, the separation results in a less complete picture of bank operations for the prudential regulator. The Fed has argued that its role in consumer protection aids its other authorities, including bank supervision and systemic risk. On the other hand, some, including the Obama Administration, have argued that professional bank examiners are trained "to see the world through the lenses of institutions and markets, not consumers,"[16] and separating compliance and safety and soundness into different agencies is the best way to protect both consumers and financial institutions. Depending on exactly what rules and regulations a new agency might implement, the cost and availability of credit could be affected.

Legislation

The Dodd Committee print and H.R. 4173 have similar general approaches to consumer protection for financial products. Both would establish a new executive agency, the Consumer Financial Protection Agency, to be the primary federal supervisor, examiner, and enforcer of many consumer financial products and activities. Both would transfer existing consumer

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[14] CRS Report R40696, *Financial Regulatory Reform: Analysis of the Consumer Financial Protection Agency (CFPA) as Proposed by the Obama Administration and H.R. 3126*, by David H. Carpenter and Mark Jickling.

[15] 15 USC 1601 *et seq.*

[16] U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, June 2009, pg. 56, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

protection authority and personnel from the FTC and the federal bank regulators to the new CFPA. Both would continue to vest safety and soundness powers with the bank regulators. Both would apply consumer protection regulation to non-depository financial institutions by granting the CFPA the authority to supervise and examine these entities on an ongoing basis. Both would grant the CFPA rulemaking authority over an array of consumer financial products and activities, while also becoming the primary rulemaking body for the existing federal consumer protection laws.

There are some differences between H.R. 4173 and the Dodd Committee Print regarding consumer protection. Although both proposals would allow the CFPA to assess fees for funding, the details differ. For example, H.R. 4173 includes a provision that 10% of the Federal Reserve System's total expenses be transferred to the CFPA to implement the authorities provided by the bill. This percentage roughly accounts for the compliance and supervisory costs of implementing the authorities transferred from the Federal Reserve to the CFPA. The Dodd Committee Print does not include this 10% transfer. Although both proposals would ultimately have the CFPA governed by a board structure, the details differ. For example, H.R. 4173 has the CFPA run by a single director/appointee during an interim period lasting at least two years, but the Dodd approach establishes a board immediately. Also, the board under the Dodd proposal would include a bank regulator as an ex officio member in addition to the four advice and consent board members, while the board established by H.R. 4173 would be comprised of five advice and consent appointed members.

Derivatives

Policy Issues

Derivatives refer to investment contracts that are based on another underlying product or contract.[17] Examples include swaps, options, and futures. Derivatives regulation has historically been associated with agriculture because contracts for future delivery of farm products have been traded for thousands of years. Derivatives can be traded on an organized exchange with a central clearinghouse, in which case the clearinghouse itself has the incentive to make sure that market participants can honor their obligations. Derivatives can also be traded bilaterally in the over-the-counter market, in which case any collateral and margin requirements are set by individual contract. The Commodity Futures Trading Commission (CFTC) regulates commodity derivatives, but the Commodity Futures Modernization Act of 2000 (CFMA)[18] exempted some financial derivatives from regulation. Disruptions in markets for financial derivatives during the recent crisis have led some to call for reform of derivatives regulation.

Financial regulators encourage banks to manage their risks with financial derivatives, especially since the savings and loan crisis of the late 1980s. During the recent housing boom, innovative financial derivatives such as credit default swaps were developed and used to support the securitization of mortgages. AIG was a major issuer of credit default swaps. During the week of September 15, 2008, AIG was unable to cover an increase in its collateral requirements for credit default swaps traded over-the-counter. If AIG had been forced to clear credit default swaps on an exchange, the firm might have had to post the higher collateral and margin earlier, and thus the

[17] CRS Report R40965, *Key Issues in Derivatives Reform*, by Rena S. Miller.

[18] P.L. 106-554.

magnitude of its collapse might arguably have been diminished, potentially reducing the bubble in housing finance. On the other hand, credit default swaps may not be standard enough to be traded effectively on an exchange, and it could be argued that overconfidence led to the housing bubble, rather than over-the-counter trading.

Legislation

In general, agriculture, banking, and financial services committees have had congressional jurisdiction over derivatives and their use in risk management. Common elements of the major bills include requiring more trading through derivatives clearing organizations, removing exemptions in the CFMA, and granting greater authority for the CFTC and SEC to standardize derivatives products. The coverage and effectiveness of legislation may hinge on the definitions of a few key terms. Generally, reform proposals require major or significant market participants to register and post collateral and margin, but there is an exemption for end users that are hedging. Depending on the definitions of "major participant," "end user," and "hedge," bills that appear similar might have very different effects.

H.R. 4173 and the Dodd committee print have similar overall approaches, but differ in details. Both bills have a general requirement for clearing of standard derivatives products, and similarly require regulators to monitor the capital adequacy and operations of derivative clearing organizations. In addition, H.R. 4173 and the Dodd committee print both designate the CFTC as the primary regulator for commodity-based derivatives, and the SEC for security-based derivatives. Both bills also require any derivatives that might be continued to be traded over-the-counter to report to regulators trade information that might be useful for monitoring systemic risk. The bills differ in terms of their definitions of key elements. For example, the definitions within the Dodd committee print make it more difficult for firms to gain an end user exemption because there is a narrower definition of a hedge.

Credit Rating Agencies

Policy Issues

Credit rating agencies provide investors with what many presume to be an informed perspective on the creditworthiness of bonds issued by a wide spectrum of entities, including corporations, sovereign nations, and municipalities.[19] The grading of the creditworthiness is typically displayed in a letter hierarchical format: AAA commonly being the safest, with lower grades representing a greater level of risk. Credit rating agencies are typically paid by the issuers of the securities that are being rated by the agencies, which could be seen as a conflict of interest. In an exchange for adhering to various reporting requirements, the SEC provides interested credit rating agencies with a Nationally Recognized Statistical Rating Organization (NRSRO) designation. The designation is important because a variety of state and federal laws and regulations reference NRSROs.[20]

[19] CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

[20] For example, see CRS Report RS22519, *Credit Rating Agency Reform Act of 2006*, by Michael V. Seitzinger.

In recent years, credit rating agencies have come under increased public scrutiny following several alleged performance failures. For instance, during the recent housing boom cycle the three dominant agencies (Fitch, Moody's and S&P) initially rated many mortgage-backed securities as AAA before sharply down-grading the securities as the sub-prime mortgage market collapsed, resulting in heavy losses for investors that relied on these ratings.[21] The perceived agency failings have led to a public policy focus on strengthening the accountability of credit rating agencies and reducing potential conflicts of interest that may compromise the integrity of their ratings.

Legislation

H.R. 4173 and the Dodd committee print would both enhance the SEC's oversight over NRSROs. H.R. 4173 also would also require NRSROs to adopt rating symbols that differentiate between ratings for structured products and other products, remove references to credit ratings in a number of federal laws, require financial regulatory agencies to review and remove certain credit ratings references, and mandate SEC registration for all issuer-pays rating agencies (rating agencies that are compensated by the issuers or arrangers of the securities that they rate). In addition, H.R. 4173 clarifies that NRSROs can be sued under private rights of action and establishes gross negligence as the standard for private securities actions against them for money damages.

The Dodd committee print provides that investors can bring private rights of action against NRSROs for a knowing or reckless failure to investigate or to obtain analysis from an independent source. The Dodd committee print would authorize the SEC to temporarily suspend or revoke NRSRO registration with respect to a particular class of security if it finds that the NRSRO lacks adequate financial and management resources to provide ratings with integrity.

Neither H.R. 4173 nor the Dodd committee print specifically directly addresses the issuer-pays business model used by the three dominant rating agencies.

Policy Issues

For many observers, including the SEC's Inspector General, the multi-billion dollar Madoff scandal raised concerns over the effectiveness of the SEC's efforts to protect investors. Mr. Madoff's operation was a registered broker-dealer subject to both SEC and Financial Industry Regulatory Authority (FINRA, the self regulatory organization for broker-dealers) oversight, as well as a registered investment adviser subject to SEC oversight. Various reform initiatives are seeking to address concerns over the SEC's perceived ineffectiveness by providing it with more funding, and by making modifications to the disparate obligations and regulatory treatment of broker-dealers and investment advisers, and other similar agents.

Legislation

Under current law, broker-dealers must make recommendations that are "suitable" to their customers, while investment advisers have a fiduciary duty to act in the customers' best interests, without regard to their own compensation, and with an affirmative duty to disclose any potential conflicts of interest. The services provided by broker-dealers and investment advisers, however,

[21] This overview of credit rating agencies is adapted from CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

often overlap. For example, both can provide investment advice and there are some concerns that customers may falsely assume that the person advising them is committed to acting in their best interests.

H.R. 4173 requires the SEC to adopt rules specifying that the standard of conduct for broker-dealers shall be the same as the standard of conduct for investment advisers when providing personalized investment advice to a retail customer about securities. It would require the SEC to write regulations defining that investment advisor fiduciary standard of conduct. The Dodd committee print would also harmonize the standards of conduct for broker-dealer and investment advisers by eliminating the so-called "broker-dealer exemption" from the Investment Advisers Act of 1940, which exempts broker-dealers from registering as investment advisers if the advice they provide to clients is "solely incidental" to selling products. H.R. 4173 would also give the SEC discretion to write regulations that define the fiduciary standards for broker-dealers and contains a controversial provision that says that "nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care ... after providing personalized investment advice about securities." By contrast, the Dodd committee draft would basically leave the Investment Advisers Act intact.

H.R. 4173 would expand the states' regulatory authority to investment advisers with assets of less than $100 million, compared to the current $25 million standard, reducing the number of regulated advisers under SEC jurisdiction.

The SEC currently collects fees from sellers of corporate stock, issuers of stocks and bonds, and participants in tender offers. The fees go to an account available to congressional appropriators. Historically, however, the SEC's budget tends to be much less than total annual fee collections. H.R. 4173 would double SEC appropriations through FY2015 to $2.25 billion. Alternatively, the Dodd committee print would provide the SEC with a budget based on self-funding from its fee collections similar to other financial regulators like the FDIC.

Currently, small corporations with a market value of generally less than $75 million enjoy a temporary exemption from Section 404 of the Sarbanes-Oxley Act of 2002, which requires publicly traded companies to report on their internal controls (a process aimed at ensuring the reliability of a firm's financial reporting).[22] While small businesses claim the requirement would impose disproportionate financial burdens on them, others say that removing the exemption would enhance investor confidence in the markets. The SEC has adopted rules to remove the small business exemption from such reporting. A provision in H.R. 4173, however, would undo the SEC rulemaking, making the small business exemption permanent.

[22] See CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

Hedge Funds

Policy Issues

Hedge funds are not explicitly defined in federal securities law.[23] They are generally described as privately organized, pooled investment vehicles administered by professional investment managers and not widely available to the public. Hedge funds whose primary investors are wealthy individuals or institutions are also distinguishable from investments such as mutual funds by their pronounced use of leverage and their use of trading strategies based on short selling. The funds have a significant capital market presence. According to some estimates, they have been responsible for about one-fifth of the daily trading on the New York Stock Exchange and by some estimates have over a trillion dollars in assets.[24]

Hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency and by reallocating financial risk. Some potential risks inherent in the funds' large capital market footprint were revealed in 1998 when the hedge fund Long Term Capital Markets teetered on the brink of collapse following failure of its computer models to anticipate global market turmoil. Concerns over the systemic implications of the large hedge fund's collapse resulted in the New York Fed engineering a multi-billion dollar rescue of the fund by 13 financial institutions. Hedge funds have generally not been identified as contributors to the recent financial crisis. Because of concerns over possible systemic risks they may pose, some observers advocate more sweeping hedge fund regulation akin to the safety and soundness regulatory oversight of banks.

Under a current "private adviser" exemption, hedge fund managers, who do not hold themselves to be investment advisers and who have less than fifteen clients, are exempted from registering with the SEC as investment advisers under the Investment Advisers Act.[25] Although some hedge fund managers currently register voluntarily, there are concerns that the absence of comprehensive hedge fund data that would accompany mandatory fund registration deprives regulators of potentially critical information on the size and nature of the funds that could help them better understand the risks that they may pose to the economy.

Legislation

H.R. 4173 and the Dodd committee print would basically eliminate the "private adviser" exemption from registration as investment advisers, though they differ slightly as to the nature of the exemptions. H.R. 4173 would exempt venture funds, small business investment companies, and funds with less than $150 million in assets. The Dodd committee print would exempt venture capital funds, private equity fund, funds with less than $100 million in assets, and home offices. Both H.R. 4173 and the Dodd committee print would also authorize the SEC to share the records of registered investment advisers for the purpose of evaluating systemic risk.

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[23] CRS Report R40783, *Hedge Funds: Legal Status and Proposals for Regulation*, by Kathleen Ann Ruane and Michael V. Seitzinger.

[24] For a more extensive treatment of this issue, see CRS Report 94-511, *Hedge Funds: Should They Be Regulated?*, by Mark Jickling and CRS Report R40783, *Hedge Funds: Legal Status and Proposals for Regulation*, by Kathleen Ann Ruane and Michael V. Seitzinger.

[25] 15 U.S.C. 80b-1 *et seq.*

Executive Compensation

Policy Issues

The financial crisis has led to policy concerns over a possible link between excessive financial firm risk taking and executive compensation practices.[26] In 2008, the Troubled Asset Relief Program (TARP) subjected recipients to various executive pay restrictions and corporate governance requirements. In fall of 2009, as part of its safety and soundness regulatory oversight of banks, the Fed proposed to review bank pay structures to identify any compensation arrangements that provide employees incentives to take excessive risks that could threaten the banks' safety and soundness.[27] Such initiatives are significantly premised on the widely held belief that large financial firm pay structures contributed to excessive risk taking. However, at least one major academic study has raised some significant questions concerning this premise.[28]

Legislation

In July 2009, the House passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269), which contained provisions on executive compensation. Both the Dodd committee print and H.R. 4173 contain sections similar to parts of this bill. Other sections of H.R. 4173 pertaining to executive compensation were parts of H.R. 3817.

H.R. 4173 incorporates provisions in H.R. 3269 to require financial firms above a certain size to disclose incentive-based pay arrangements to federal financial regulators for the purpose of determining whether these are aligned with sound risk management. H.R. 4173 would also authorize federal financial regulators to prohibit incentive structures that encourage inappropriate risk-taking. H.R. 4173 includes a provision from H.R. 3269 that would give shareholders a nonbinding vote on executive pay and golden parachute packages (known as say on pay). H.R. 4173 would provide the SEC with authority to implement rules for proxy access, the right of investors to use a company's proxy to nominate their own directors.

The Dodd committee print would create a Financial Institution Regulatory Agency with duties including writing standards that proscribe bank holding companies from having compensation plans that provide executives, employees, directors, and principal shareholders with excessive compensation or benefits, or could lead to a material financial loss to the bank holding company. The draft would also require the appropriate federal banking agencies to prohibit a depository institution holding company from paying excessive executive compensation or compensation that could lead to a material financial loss to any institution controlled by the holding company.[29] The Dodd committee print contains a say on pay provision similar to H.R. 4173. With regard to proxy access, the Dodd committee print would specifically direct the SEC to issue a rule granting this access.

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[26] CRS Report R40762, *"Say on Pay" and Other Corporate Governance Reform Initiatives*, by Gary Shorter.

[27] See CRS Report R40540, *Executive Compensation Limits in Selected Federal Laws*, by Michael V. Seitzinger and Carol A. Pettit.

[28] Rudiger Fahlenbrach, Rene Stulz, and Rene M. Bank, "CEO Incentives and the Credit Crisis," *Charles A. Dice Center Working Paper No. 2009-13*, July 27, 2009, available at SSRN: http://ssrn.com/abstract=1439859.

[29] For an overview of these areas, see CRS Report R40762, *"Say on Pay" and Other Corporate Governance Reform Initiatives*, by Gary Shorter.

Insurance

Policy Issues

Under the McCarran-Ferguson Act of 1945,[30] insurance regulation is generally left to the individual states. For several years prior to the financial crisis, some Members of Congress have introduced legislation to federalize insurance regulation along the lines of the dual regulation of the banking sector, although none of this legislation has reached the committee markup stage.[31]

The financial crisis, particularly the involvement of insurance giant AIG and the smaller monoline bond insurers, changed the tenor of the debate around insurance regulation, with increased emphasis on the systemic importance of insurance companies. Although it could be argued that insurer involvement in the financial crisis demonstrates the need for full-scale federal regulation of insurance, to date the broad financial regulatory reform proposals have not included language implementing such a system. Instead, broad reform proposals have tended to include the creation of a somewhat narrower federal office focusing on gathering information on insurance and setting policy on international insurance issues. The broad reform proposals may also affect insurance through consumer protection or systemic risk provisions, though insurance is largely exempted from these aspects of the legislation as well.

Legislation

The legislation proposed by the Administration, House Financial Services Subcommittee Chairman Kanjorski (H.R. 2609), and Chairman Dodd, all contain slightly differing versions of a federal insurance office, which would be a newly created entity. H.R. 4173 includes the language of H.R. 2609 as amended. H.R. 4173 would also completely exempt insurance from the Consumer Financial Protection Agency's oversight, a change from the original bill (H.R. 3126), which included title, credit, and mortgage insurance under the agency's oversight. Under both H.R. 4173 and the Dodd committee print, systemically significant insurers could be subject to regulation by the systemic risk regulator and to federal resolution authority. Ranking Member Bachus' bill (H.R. 3310) does not address insurance, nor subject insurers to any of its provisions, although his floor amendment (H.Amdt. 539) did include a federal insurance office. In addition, both H.R. 4173 and the Dodd committee print contain language from previous bills (H.R. 2571/S. 1363) addressing surplus lines and reinsurance.[32]

[30] 15 U.S.C. 1011 *et seq*.

[31] See CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111th Congress*, by Baird Webel.

[32] See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation*, by Baird Webel.

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