WHAT'S COMING FOR FINANCIAL INSTITUTIONS, ISSUERS, AND MARKET PARTICIPANTS?

A LOOK AT THE AGENDA OF THE 111TH CONGRESS AND THE OBAMA ADMINISTRATION

With the kick-off of the 111th Congress and the arrival of the Obama Administration, financial institutions, issuers, and market participants of all types and sizes are in for a crowded Washington agenda.

In just over six weeks since the new Congress arrived, numerous bills and amendments have been introduced to address the financial crisis, mortgage foreclosures, executive compensation, hedge funds, over-the-counter derivatives, securities trading activity, criminal liability for financial crimes, and consumer protection. Oversight and legislative hearings have been held on a range of issues affecting financial market participants. Returning chairmen of congressional committees with primary legislative jurisdiction over financial services and securities regulation—House Financial Services Committee Chair Barney Frank (D-MA) and Senate Banking, Housing, and Urban Affairs Committee Chair Christopher Dodd (D-CT)—have announced broad agendas for their committees. And, in just over a month since President Obama's inauguration, the President and his economic team have moved forward with bold initiatives to bolster—and to regulate—the financial system and the broader economy. The actions of Congress, the President, and the financial regulators present a shifting landscape upon which financial institutions and market participants will need to manage their businesses and plan for the future, while monitoring and reacting to the activity in Washington.

Congress and the new Administration are implementing and conducting close oversight of the massive Federal expenditures dispensed under the Troubled Asset Relief Program (TARP) and related Federal programs. They also are considering a major restructuring of financial institution supervision and regulation, focusing on systemic risk mitigation, consumer protection, and regulatory "gap-plugging." We believe clients should anticipate proposed legislative and regulatory reforms targeting virtually all unregulated elements of the financial sector (such as unregistered hedge funds and over-the-counter derivatives), and a reconfiguration of the overall financial institutions regulatory structure to better oversee that sector. Numerous consumer protection measures will be proposed, and the Federal-state role in protecting consumers will be revisited. There will be proposals to eliminate or merge certain regulators (such as the OCC/OTS and the SEC/CFTC), as well as to create new ones (such as a Federal Systemic Risk Regulator and possibly a Federal Insurance Regulator). Significant new limitations and regulations will be proposed for regulated entities of all types, and Congress will arm and encourage the financial regulators and the US Department of Justice to beef up enforcement and criminal prosecutions.

This bulletin provides a look at the early activity, and it outlines what we believe will be the likely focus of major legislative and regulatory action affecting financial institutions, issuers, and market participants. As we publish this advisory for our clients, we caution that it is simply a snapshot of activity at the Federal level. Market developments, as well as the introduction of new legislation, new congressional oversight efforts, and new regulatory initiatives, will, on virtually a daily basis, change the status of much of what we discuss herein.

TARP/CPP/CAP PROGRAM IMPLEMENTATION/ OVERSIGHT

Organizations receiving funds through Treasury's capital purchase program (CPP), a preferred stock and warrant purchase program, and through the new capital assistance program (CAP) and related programs will face continuing and aggressive oversight of their compliance with the programs by Congress, the US Government Accountability Office (GAO), and US Department of the Treasury's Special Inspector General for the TARP. The initial US$350 billion allocation of TARP funds has been largely committed; the remaining US$350 billion requested by the outgoing Bush Administration survived efforts in Congress to disapprove its release, and new funds are being made available under the Administration's "Financial Stability Plan," announced February 10, 2009.

Many in Congress believe that the original US$350 billion was mismanaged. The House on January 21, 2009 passed legislation (H.R. 384) sponsored by House Financial Services Committee Chairman Barney Frank to impose additional restrictions and reporting requirements on recipients of TARP funds. Although Chairman Frank's legislation was not passed by the Senate, almost two dozen separate bills have been introduced to increase oversight of, or place conditions upon, organizations (and their executives) receiving funds under the TARP. The Administration has responded to congressional criticism with a number of program adjustments and conditions.

The Administration's new Financial Stability Plan represents an extension of certain of the programs initiated under the Bush Administration and depends heavily on investment by the private sector to help relieve the pressure of "toxic" assets currently weighing down the balance sheets of US financial institutions. It envisions formation of an aggregator vehicle to acquire and hold underperforming assets, expansion of the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF—a combination of Treasury funding and Federal Reserve lending) from US$200 billion to US$1 trillion, and further capital injections into ailing banks under the CAP program following a "stress test" to assess their strength. An additional US$75 billion will be devoted to mortgage modification and foreclosure relief (see next section).

As we previously have advised clients, under Section 5.3 of the mandatory CPP purchase agreement, institutions that already have received TARP funds are subject to statutory changes and new conditions. The ground continues to shift for these institutions, as the Administration and Congress respond to public anger over the bailout. Thus, although the Treasury on February 4, 2009 issued a new set of largely prospective guidelines on executive compensation and other limitations for institutions that receive government assistance, an amendment to the American Recovery and Reinvestment Act of 2009 (the Stimulus bill), P.L. 111-5, which became law February 17, 2009, imposes significant new restrictions on executive compensation, including bonuses, retention awards, incentive compensation, and golden parachutes. It also provides broad compensation "clawback" provisions, certification and corporate governance requirements, and other restrictions on dividends and share repurchases for institutions during the period they have an outstanding obligation to the Federal government under TARP. The Stimulus bill also requires Treasury to review and, where appropriate, reclaim compensation already paid to TARP recipient executives.

There is no assurance that enactment of the new restrictions will mark the end of congressional activity in this area. Indeed, we believe all recipients of Federal funds must be prepared for continued congressional oversight and the possibility of future directives or limitations with respect to their activity, both past and present.

MORTGAGE MODIFICATION/FORECLOSURE PREVENTION

By the time the new Congress and new President took office, a number of government-sponsored loan modification programs already had been created to address the mortgage foreclosure crisis, including: (1) the HOPE for Homeowners Program (H4H), which provides for the refinancing of distressed loans by providing FHA insurance for refinanced loans; (2) the Streamlined Modification Program (SMP), introduced by the Federal Housing Finance Agency, Fannie Mae, Freddie Mac, and the HOPE NOW Alliance (a coalition of mortgage servicers, investors, and counselors) in October 2007 with Treasury support to help homeowners avoid preventable foreclosures; and (3) the Federal Deposit Insurance Corporation's (FDIC's) Loan Modification Program (Mod in a Box), which was commenced at IndyMac Bank, FSB after it was placed into FDIC receivership in July 2008, and subsequently was publicized as an alternative to the H4H and SMP programs. These programs, in addition to various private efforts that loan servicers have implemented voluntarily, have been widely viewed as insufficient to address the alarming increase in the number of foreclosures.

Thus, in the six weeks after the 111th Congress convened, at least 14 separate bills designed to stem foreclosures and promote mortgage modification were introduced in the House and Senate. The range of proposals include bills designed to halt foreclosures for a period (H.R. 527, Rep. Matsui D-CA, and S. 241, Sen. Menendez (D-NJ)), to reduce mortgage interest rates available to certain borrowers (H.R. 230, Rep. Cardoza (D-CA)), or to establish mechanisms to promote mortgage modification (H.R. 37, Rep. Watters (D-CA); H.R. 472, Rep. Baca (D-CA); and S. 73, Sen. Feinstein (D-CA)). Other bills provide a safe harbor for mortgage servicers (H.R. 788, Rep. Kanjorski (D-PA)) or provide other incentives for mortgage modification (S. 376, Sen. Reed (D-RI)). Others would allow bankruptcy judges to modify a homeowner's existing loan (H.R. 200, Rep. Conyers (D-MI); H.R. 225, Rep. Miller (D-NC); and S. 61, Sen. Durbin (D-IL)). Several measures already have been reported by House committees; additional proposals were considered in the Senate debate on the Stimulus bill.

Legislation introduced by Chairman Frank and passed by the House January 21, H.R. 384, would have conditioned release of the second US$350 billion under TARP on funding foreclosure relief programs. Although that legislation did not become law, on February 18 President Obama announced a US$75 billion Homeowner Stability Initiative and other measures to promote mortgage modification. Among other things, the Obama plan would facilitate refinancings of conforming loans, provide US$75 billion to fund a program to supplement the cost of reducing monthly mortgage payments for certain borrowers and pay servicers for modifications, and increase Treasury's funding commitment to Fannie Mae and Freddie Mac.

The House is now poised to consider H.R. 1106, the Helping Families Save Their Homes Act, which combines three bills passed by the Financial Services Committee on February 4, 2009 (H.R. 786, 787, and 788) with a bill passed by the Judiciary Committee on January 27 (H.R. 200). The combined package would: (1) allow bankruptcy judges in Chapter 13 proceedings to modify the principal, interest, and term of a homeowner's mortgage loan under specified conditions; (2) revise the H4H program to loosen certain criteria for modifications under the program and make it more attractive to lenders; (3) provide a safe harbor for loan modifications under the program; and (4) make permanent the increase in the deposit insurance limit to US$250,000 and increase the FDIC's and National Credit Union Administration's (NCUI's) borrowing authority. The bankruptcy "cram down" provisions are highly controversial. Although they were modified to include several provisions negotiated with Citigroup Inc. and to include other provisions to moderate the impact on certain holders of mortgage-backed securities, they continue to be opposed by the financial services industry. Senator Durbin also has introduced a bankruptcy bill, S. 61, which he hopes to add to other legislation that may be taken up by the full Senate. Efforts by members of the financial services industry to modify these proposals are continuing.

REGULATORY RESTRUCTURING

President Obama, Chairman Frank, and Chairman Dodd have separately announced their intention to put forward major financial regulatory reform proposals. The current level of interest in regulatory reform is in sharp contrast with the lukewarm interest shown by Congress in March 2008, when the Treasury issued its "blueprint" for restructuring financial regulation. Circumstances have changed, and elements of that blueprint, such as the need for some overall "systemic risk" regulator, have gained support.

While Congressional hearings and legislation introduced thus far have focused largely on oversight of the TARP program and the foreclosure crisis, some hearings have begun examination of broader issues. Some elements of potential restructuring proposals are emerging, particularly with the January 2009 release of the Group of Thirty report, "Financial Reform, a Framework for Financial Stability," which was developed under the leadership of former Federal Reserve Chair and current Obama adviser Paul Volcker. Of course, the Obama Administration and Chairmen Frank and Dodd will develop their own proposals, which may differ from many of those in the Group of Thirty report. President Obama recently announced his "core principles" for regulatory reform, which include providing government oversight of financial institutions that pose systemic risk, streamlining regulation to assure that markets can withstand stress, strengthening supervision of consumer financial products, closing regulatory gaps, promoting transparency, pushing for accountability (tough penalties for those who violate public trust), and recognizing the global nature of the markets. Some of the specific issues we believe may be considered are noted below.

Systemic Risk Regulator—Enhanced Role for the Federal Reserve? There is broad support for creating a Federal capacity to monitor and address risk throughout the financial system. Chairmen Frank and Dodd have endorsed the idea and have suggested that this issue should be addressed prior to broader regulatory reform. Such a regulator might well usurp functions of other regulators, such as establishing standards for capital and leverage for institutions that are systemically significant. Although the Federal Reserve is a candidate for this role, Chairman Dodd and others have expressed concerns that such a role could interfere with the Fed's other responsibilities.

Possible Consolidation of Financial Regulators; Office of Thrift Supervision/Office of Comptroller of the Currency. The failure of IndyMac and Washington Mutual, two of the largest Federal savings banks regulated by the OTS, and the near-collapse of AIG, which controlled a Federal savings bank and was regulated at the holding company level by the OTS, have led to predictions that the OTS will not survive as an independent regulator and may be combined with the OCC, as suggested by the 2008 Treasury blueprint. The reduced number of sizeable institutions now regulated by the OTS make its continued existence as a viable and effective regulator more difficult, since its operations are funded entirely by assessments from its supervised institutions. If the agency is downsized, moved, or eliminated altogether, Congress will need to address, among other issues, the role of "grandfathered" thrift holding companies.

Creation of a Federal Insurance Charter. The near-collapse of AIG starkly brought to the forefront the need for more government oversight of the insurance industry. Although some Members of Congress have advocated a complete federalization of the interstate insurance industry, a less extreme proposal that has gained support is the Optional Federal Charter (OFC), premised on the idea of creating a dual Federal-state system of regulation. OFC legislation was first introduced in the 107th Congress, followed by similar proposals in both the 109th and 110th Congresses. Among issues that would have to be addressed are how "optional" Federal regulation should be, what types of insurance should be covered, whether Federal regulation should be mandatory for institutions that are systemically significant, what aspects of state regulation should continue to exist, and how a new Federal regulator would be structured.

Merging or Restructuring of the Securities and Exchange Commission and Commodity Futures Trading Commission Authority. Proposals to merge the SEC and the CFTC have been offered in Congress since the mid-1980s. As others have in the past, the Treasury Department argued for merger of the agencies in its March 2008 "blueprint." The GAO has stated concerns that the split in authority between the two agencies "could result in uncertainty about jurisdiction over some types of derivative products and possibly encourage companies to structure new products and activities to avoid oversight." President Obama, in announcing his selection of Mary Schapiro, a past Chairman of the CFTC and a former SEC Commissioner, as his nominee for Chair of the SEC, referred to "the need to potentially consolidate some of the regulatory agencies that are there, to streamline them, to make clear who [has] got what mission so that things aren't falling through the cracks." Ultimately, Congress would have to approve such a merger, and it is not at all clear that a merger is politically feasible, since the CFTC is under the jurisdiction of the House and Senate Committees on Agriculture, while the SEC is under the jurisdiction of the House Financial Services Committee and Senate Banking Committee.

Establishing a Financial Product Safety Commission. Recent events have led to calls for more regulation of the financial services industry, particularly with regard to consumer credit. One proposal that has gained attention is the creation of a new Federal agency modeled on the Consumer Product Safety Commission to regulate the "consumer safety" of financial products. As it has been discussed, an FPSC would review mortgages, credit cards, car loans, and other financial products, such as life insurance and annuities. It would have authority to establish consumer disclosure standards, review financial products for consumer safety, ban products it deems to be dangerous, and penalize violators. A number of Members of Congress have indicated support for such an idea, including Chairmen Dodd and Frank. The TARP Oversight Board also has recommended beefed-up Federal regulation and oversight of consumer credit products.

Other Issues. At this early date, it is difficult to predict the exact form a regulatory reform effort will take and whether wide-ranging legislation will in fact be enacted during in the first session of this Congress. Of the many issues to be addressed, we believe, at a minimum, both the President and Congress will want to assure that they have addressed unregulated elements of the financial sector that could pose risks to the financial system. In this regard, regulation of over-the-counter derivatives and private investment funds (both discussed in more detail elsewhere in this bulletin) may be addressed and may well be higher on the agenda. Other issues that may be considered could include Federal regulation of mortgage brokers and other issues that have arisen as a result of the market disruptions during the last year, such as an examination of the regulation of money market mutual funds.

REGULATION OF OTC DERIVATIVES

Whether or not legislation merging the SEC and CFTC is enacted, both Congress and the Administration will take steps to encourage the centralized clearing of credit default swaps and other over-the-counter derivatives and to increase oversight of these markets by one or more Federal financial regulators. In addition, some in Congress also may continue to push for a requirement for exchange trading of most derivatives. The effort to regulate in this area is a sharp reversal of position by Congress, which only a few years ago acted to expressly exclude or exempt OTC derivatives from direct regulation. Although it is clear that more regulation is in store for this market, it is not yet clear which regulator will be charged with making it happen. After years of hands-off regulation, three different agencies—the SEC, the CFTC, and the Federal Reserve—now vie for oversight of these instruments.

Two significant bills have been introduced, and one already has been passed by a House Committee. H.R. 977, the Derivatives Markets Transparency and Accountability Act of 2009, was introduced by House Committee on Agriculture Chairman Peterson (D-MN) and was voted on by the committee February 12, 2008. Because at least two other House committees share jurisdiction over the bill, it will not be taken up by the full House any time soon. Among other provisions (including provisions relating to CFTC actions with respect to physical commodities), the bill would require that OTC derivatives be settled and cleared through a CFTC-regulated designated clearing organization, with narrow exceptions. The bill also provides that the CFTC may permit OTC transactions relating to an excluded commodity (most financial derivatives) to be settled and cleared through an SEC-regulated clearing agency. The second bill, S. 272, the Derivatives Trading Integrity Act of 2009, was introduced by Senator Tom Harkin (D-IA), Chairman of the Senate Agriculture Committee, and would require derivatives, including credit default swaps, to be traded on designated contract markets or derivatives transaction execution facilities. The bill treats virtually all OTC derivatives, including credit default swaps, as futures, and authorizes the CFTC to regulate them. In his recent confirmation hearing before the Senate Agriculture Committee, CFTC Chair Designate Gary Gensler endorsed the concept of central clearing and also endorsed the concept of requiring exchange trading to the extent possible, as well as comprehensive regulation of all derivatives dealers.

As Congress works to address these issues, the financial regulators also are grappling with ways to improve the functioning of these markets and reduce the risks associated with the trillions of dollars of outstanding derivatives contracts. The SEC, CFTC, and Federal Reserve are working to issue regulatory approvals and/or exemptions to various clearing organizations in order to foster the development of central counterparties for OTC transactions. Up to this point, the actions sought from market participants largely have been voluntary. In addition, because the CFTC and SEC have limited authority over "swap agreements," legislation may be necessary to apply their efforts to a substantial portion of the market.

HEDGE FUNDS, PRIVATE EQUITY, OTHER POOLED INVESTMENT VEHICLES

Two bills have been introduced to regulate private investment pools, including hedge funds. One bill, H.R. 711, the Hedge Fund Adviser Registration Act of 2009, was introduced by Representatives Michael Capuano (D-MA) and Michael Castle (R-DE); the other, S. 344, the Hedge Fund Transparency Act, was introduced by Senators Chuck Grassley (R-IA) and Carl Levin (D-MI).

The bills take two different approaches. The Capuano-Castle bill would remove the "private adviser" exemption from the requirement for investment advisers to register under the Investment Advisers Act of 1940 with the SEC. The bill is a response to a decision by the District of Columbia Circuit in 2006, which struck down an SEC rule that would have required most hedge fund managers to register under that act.

The Grassley-Levin bill is broader and moves beyond hedge fund adviser regulation to require registration of the funds themselves. The bill requires SEC registration of private funds with more than US$50 million in assets under management, requires the filing of specified information with the SEC, authorizes the SEC to request additional information, and subjects the manager and its funds to uniform record-keeping and anti-money laundering requirements. Neither the Capuano-Castle bill nor the Grassley-Levin bill makes exceptions for private equity funds or venture funds. Senator Levin, in his introductory remarks accompanying S. 344, acknowledged that such other funds would be covered by the bill's provisions and made it clear that he intended no exceptions for such entities. However, neither he nor Senator Grassley sits on the Senate Banking Committee, which has jurisdiction over the bill.

Chairman Dodd and Chairman Frank—the two key players on this issue—have not announced hedge fund legislation or scheduled hearings on the subject, but it is possible that they may consider legislation going beyond the proposals introduced to date. For example, the Group of Thirty Report issued in January of this year recommends that, for funds of a size deemed to be "systemically significant," the prudential regulator should have authority to establish appropriate standards for capital, liquidity, and risk management. The report recommends that for other funds that employ substantial borrowed funds, registration should be required (with minimum size and venture capital exceptions) and that the prudential regulator should have authority to require reports and periodic disclosure.

As Congress focuses on private funds, it also may return to issues raised in the last Congress. For example, there may be renewed interest in limiting the discretion of pension-fund managers to invest plan assets in hedge funds. Rep. Castle (R-DE) has introduced a bill, H.R. 712, to amend the Employee Retirement Income Security Act (ERISA) to require defined benefit plans to provide annual disclosure of investments in hedge funds. Another area to be revisited is possible changes in the taxation of investment partnerships, as proposed in the budget by President Obama for future years. Private funds also will be impacted by any changes in the regulation of market participants, such as reporting or disclosure requirements relating to trading activity (e.g., short sales), and any regulation of swaps and other currently unregulated financial instruments.

SECURITIES MARKET REGULATION AND TRADING RULES

Congressional outrage at the SEC's failure to detect and put a stop to the massive Madoff fraud prompted oversight hearings by the House Financial Services Committee and Senate Committee on Banking, Housing, and Urban Affairs and may lead to legislative proposals to address specified areas of weakness. The scandal already has resulted in personnel and procedural changes at the SEC. Senate Securities Subcommittee Chair Jack Reed (D-RI) has announced that he will conduct a top-to-bottom review of the SEC.

As a result of other events in the financial markets over the past year, Congress may legislate, or push the SEC to regulate, in a number of areas. One area involves the SEC's regulation of short sale activity. During the market turmoil in the summer and fall of 2008, the SEC issued a series of emergency orders designed to limit or stop short selling of the equity securities of financial institutions. The SEC also adopted "interim final temporary rules" to address potential short sale abuses and required investment managers to report short sale data to the SEC staff. SEC actions banning short sales (with limited exceptions) in all financial stocks led to furious debate over whether regulators were attempting to address real abuses or to prop up share prices of financial companies, and ultimately led to statements by then-Chairman Cox and another commissioner that the short sale ban, in retrospect, resulted in inefficiencies and market dislocations and disruptions. The SEC's temporary rules are set to expire in mid and late 2009, and the battle over short-sale regulation has come to what may be a temporary cease-fire. As of this date, the only legislation introduced on this subject is H.R. 302, by Rep. Ackerman (D-NY), a senior member of the House Financial Services Committee, and six other members, to require the SEC to reinstate a price test for short sales. The so-called "uptick" rule, until it was eliminated by the SEC in 2007, provided that, with some exceptions, a security could be sold short only at a price above that of the immediately prior sale (a plus tick) or at the last sale price if that price was higher than the last different price (a zero-plus tick). SEC Chair Schapiro has committed to reexamine whether to reinstate the rule. Alternatively, it is possible that the SEC or the exchanges might seek to implement a "circuit breaker" rule that would limit short sales in the event of a significant decline in the price of an issuer's shares. The SEC also may extend or permanently adopt its interim final temporary rule requiring reporting of short positions.

Reform of nationally recognized statistical rating agencies (NRSROs) also will be on the congressional and SEC agenda. Senator Reed has identified it as an area of potential legislation, and, although the SEC just completed a rulemaking in this area, Chairman Schapiro has said she will reexamine this area as well. A key focus of reform in this area will be an effort to move away from the current model in which issuers select an NRSRO and pay for the rating.

CREDIT CARD AND CONSUMER LENDING LEGISLATION

Chairmen Dodd and Frank each have vowed to move credit card legislation in this Congress. Although the Senate failed to act on credit card legislation passed by the House in the last Congress, Chairman Dodd moved quickly this year when he and 15 other Democratic Senators on February 11, 2009 introduced S. 414, the "Credit Card Accountability, Responsibility, and Disclosure Act (CARD Act), which amends the Consumer Credit Protection Act to prohibit a number of "abusive" practices and to provide additional disclosures to credit card holders. The Committee held a hearing on the legislation February 12, 2009. Among other things, the Dodd bill would prohibit so called "universal default" provisions by prohibiting credit card issuers from increasing interest rates on cardholders in good standing for reasons unrelated to the cardholder's behavior with respect to that card, prohibit the retroactive application of interest rate changes; prohibit charging interest on fees, restrict certain fees, require enhanced disclosures (including requiring issuers to provide individual consumer account information and disclose the period of time and total interest to pay off a card balance if only minimum monthly payments are made); prohibit issuers from unilaterally changing the terms of a credit card agreement for the length of the agreement; prohibit double billing cycles and certain billing allocation practices, and restrict the marketing of credit cards to teenagers and college students. The vast majority of these restrictions and requirements are already imposed by new rules issued late last year by the Federal Reserve, the OTS, and the National Credit Union Administration. Nevertheless, it is likely Congress will enact legislation in this area, in part because the effective date for the regulatory rules is not until July 2010 and in part because legislating in favor of these consumer protections is popular with the public and consumer advocates.

Thus, in addition to the Dodd bill, eight other bills have been introduced to address what their sponsors view as abusive practices by credit card issuers. The Credit Cardholders' Bill of Rights, H.R. 627, was introduced by Rep. Maloney (D-NY) and is similar to the bill that passed the House last year. Bills also have been introduced by Senators Feinstein (D-CA), S. 131; Kohl (D-WI), S. 165; Schumer (D-NY), S. 235; Whitehouse (D-RI), S. 255 and S. 257 (one of his bills would empower states to set maximum annual percentage rates; another would disallow claims in bankruptcy from high cost credit debts); Menendez (D-NJ), S. 392; and Tester (D-MT), S. 399.

Senator Durbin (D-IL) has introduced legislation targeting payday lenders and other consumer lenders. His bill, S. 500, the Protecting Consumers from Unreasonable Credit Rates Act, would set a Federal 36% annualized interest rate on consumer lending, including open-end credit plans. Rep. Gutierrez (D-IL) also has introduced a payday lending bill, H.R. 1214, which would cap fees and interest rates, require extended repayment plans and require certain disclosures.

PREDATORY LENDING LEGISLATION

The House in 2007 passed legislation entitled the Mortgage Reform and Anti-Predatory Lending Act, which was designed to impose a number of restrictions on mortgage lending, particularly for higher priced loans. Parts of that bill addressing the licensing and regulation of mortgage brokers were enacted in 2008, but the broader bill was not taken up by the Senate. Chairman Frank has said that he intends to move a predatory lending bill this year, with tougher provisions than the 2007 legislation. Although he has not yet introduced legislation, Chairman Frank has said that, among other things, the bill will address securitization practices and will restrict yield spread premiums.

EXECUTIVE COMPENSATION/CORPORATE GOVERNANCE LEGISLATION

If enactment of the Sarbanes-Oxley Act of 2002 left any doubt about Congress's willingness to wade into corporate governance regulation, the governance and executive pay provisions of the Emergency Economic Stabilization Act (EESA) last fall, the recent executive compensation restrictions enacted as part of the Stimulus bill, and statements made by Chairman Frank that he wants to "build on these measures and apply them more broadly," suggests that issuers of all types should anticipate proposals to regulate or provide shareholder input on executive pay and other governance matters.

The provisions on executive compensation enacted as part of the Stimulus package apply to all TARP participants during the period in which a participant has an outstanding obligation to the Federal government under TARP. They include restrictions on bonuses, retention awards, incentive compensation, and golden parachutes, as well as compensation "clawback" provisions, certification and corporate governance requirements, and other restrictions on dividends and share repurchases. Some of the restrictions in the case of institutions receiving over US$500 million apply to the 25 highest paid employees; they apply to smaller numbers of employees for institutions receiving lesser amounts. The Stimulus package also included a "say-on-pay" provision—a requirement that during the period of a TARP obligation, the company must permit a non-binding shareholder vote to approve the compensation of certain executives.

Congress may be willing to consider corporate governance regulation beyond TARP participants. Chairman Frank, as well as then-Senator Obama, sponsored legislation in the last Congress to provide a shareholder advisory vote on the compensation of certain executives and on golden parachutes, a position endorsed by the Democratic platform in August 2008. The Frank legislation passed the House in April 2007 on a 269-134 vote and undoubtedly would pass again, if it is offered in this Congress. Additional proposals, such as shareholder access to the proxy (for nomination of directors), possible compensation committee reforms (e.g., evaluating executive pay in terms of excessive risk incentives), and expanding the current "clawback" provisions that apply under Sarbanes-Oxley may be in store for all issuers—and not just companies that are TARP recipients. Some of these proposals could be implemented by SEC rule, and Chairman Schapiro and other SEC commissioners have expressed support for say-on-pay and expanded shareholder access proposals. Chairman Schapiro noted at her nomination hearing that about 40 of the largest markets outside of the United States permit investors or shareholders of some size and of some duration access to the proxy, and "it's time for the United States to step into that club." Chairman Schapiro also has announced that the SEC will examine the role of the boards of financial institutions and their oversight of management and risk assessment.

MARK-TO-MARKET AND OTHER ACCOUNTING ISSUES

Massive write-downs at financial institutions last year led to heated debate over fair value accounting. Critics argue that "mark-to-market" requirements have exacerbated the crisis by forcing financial institutions to take massive write-downs of investments that do not properly reflect their economic value due to illiquid or frozen markets. Others emphasize that suspending fair value accounting would weaken transparency and investor confidence in financial statements, resulting in further market instability.

On September 30, 2008, more than 60 Members of the House wrote to the SEC, urging it to suspend mark-to-market requirements. EESA included a provision that specifically affirmed the SEC's authority to suspend mark-to-market accounting and directed the SEC to conduct a study on mark-to-market accounting and the guidance issued by the Financial Accounting Standards Board (FASB) under Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*.

On December 30, 2008, the SEC staff issued a report to Congress that recommended against suspending fair value and mark-to-market accounting requirements, but recommended that additional measures be taken to improve existing practices, including the development of additional guidance for determining fair value when relevant market information is not available in illiquid or inactive markets, the enhancement of existing disclosure and presentation requirements related to the effect of fair value in financial statements, and a reassessment of the accounting for financial asset impairments (i.e., the write-down of devalued assets).

Although Members of Congress are under a great deal of pressure from the financial industry to provide relief from fair value accounting, it is possible that Congress will be willing to give new SEC Chair Schapiro time to review the issue. Only one bill in this area has been introduced to date, H.R. 607, which directs the SEC to provide guidance on fair value accounting. The House Financial Services Committee has included this issue in its oversight agenda.

Congress also may conduct oversight on the shift from US Generally Accepted Accounting Principles (GAAP) to international financial reporting standards (IFRS), an issue identified by Senate Securities Subcommittee Chairman Reed.

ANTI-PREEMPTION LEGISLATION

Congress has over time kept a close watch on the Federal banking agencies' actions involving preemption. Two years ago, the Supreme Court's 2007 decision in *Watters* v. *Wachovia Bank, N.A.* 127 S. Ct. 1559 (2007), which held that preemption under the National Bank Act (NBA) extends not only to national banks, but also to "operating subsidiaries" of such banks, brought new focus on the issue. Chairman Frank criticized the decision at the time, stating that the OCC "succeeded in reducing and eliminating a lot of state consumer laws without putting anything in their place." Earlier this year, Chairman Frank pointedly criticized the Bush administration's exercise of Federal preemptive powers, saying that preemption was used "to cancel virtually all state regulation in the consumer area." Frank said it was a "mistake" and said the Financial Services Committee would reexamine the Federal-state balance.

To date, Congress has not moved forward on any serious steps to retract Federal banking law preemption, but the states remain eager to lessen the blow rendered by the *Watters* decision on their authority in the bank regulatory arena. One proposed approach suggested by Chairman Frank in the past would be to enhance the enforcement powers of the states over activities of federally chartered financial institutions. Another proposed approach would be to enact changes such as those advocated by Congressman Luis Gutierrez (D-IL), who, after *Watters* was decided, introduced legislation to invalidate the OCC's preemption rules, narrow the scope of the NBA with respect to regulation of national bank activities, and limit the ability of the OTS to preempt state laws that purport to govern Federal thrift activities and powers. These types of changes could expose national banks and Federal thrifts to significant state-specific compliance obligations in their banking activities. The Gutierrez bill also would have given state attorneys general the right to enforce any state or Federal law, directly or on behalf of their citizens, against national banks and Federal savings banks. The bill also provided that private actions could be brought under the bill or under the deceptive trade practices provisions of the Federal Trade Commission Act.

With a consumer protection-oriented administration now in place, proposals to restore state powers to protect consumers may gain more momentum. Any number of legislative vehicles could be used as anti-preemption mechanisms, so this area requires careful monitoring and early action to ensure the proper balance is struck between Federal and state authority.

NEW CRIMINAL LAW AND FRAUD ENFORCEMENT INITIATIVES

It should come as no surprise that the financial crisis has spurred Congress to draft legislation to enhance the criminal law in the areas of mortgage lending, underwriting of mortgage-backed securities, swaps, and other financial market activities that Congress views as root causes of the crisis. It also has prompted legislation to beef up agency resources and to push the relevant agencies to focus greater efforts on detecting and prosecuting fraud in the financial markets. These efforts, and the increased activity of agency inspectors general in second-guessing financial regulators and pursuing contractor fraud, promise vigorous investigative and enforcement activity, as well as criminal prosecutions, in both the near term and future years.

One bill in this area, S. 386, the Fraud Enforcement and Recovery Act (FERA), was introduced February 5, 2008 by Senate Judiciary Committee Chairman Leahy (D-VT) and was the subject of a hearing before the committee February 11, 2009. The bill authorizes more funding for the FBI to bring on special agents and other professionals and analysts, and increases funding for other DOJ programs (including additional funding for the criminal, civil, and tax divisions) for purposes of investigations, prosecutions, and civil proceedings involving Federal assistance programs and financial institutions. It also increases funding for the HUD Inspector General and US Postal Inspection Service (USPS) for such purposes. The bill also makes a number of changes to Federal fraud statutes to target mortgage lending businesses not directly regulated or insured by the Federal government and to cover funds expended under the TARP and Stimulus package. The bill also includes amendments to the Federal securities laws to cover fraud schemes involving commodities futures and options, including derivatives involving mortgage-backed securities. It also amends the money laundering statute and False Claims Act. Chairman Leahy's sponsorship and interest in the legislation suggests that the bill, in some form, has a good chance of becoming law.

Other bills targeting financial fraud and/or increasing funding for civil or criminal enforcement have been introduced, including: Stop Mortgage Fraud Act, H.R. 78, Biggert (R-IL); Nationwide Mortgage Fraud Task Force Act, H.R. 529, Meek (D-FL); Taxpayer Protection Act, S. 195, Dorgan (D-ND); Supplemental Anti-Fraud Enforcement for our Market Act, S. 331, Schumer (D-NY); the Nationwide Mortgage Fraud Task Force Act, S. 365, Nelson (D-FL); and S. 481, Snowe (R-ME).

We hope this overview of the legislative and regulatory outlook is helpful in planning for proposals from the new Administration and Congress. If you have additional questions, please contact your Arnold & Porter attorney or:

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Market Volatility and the Changing Regulatory Landscape

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