The Dodd Bill Redux: The Senate Takes Aim at Financial Regulatory Reform

After an initial effort to draft financial reform regulation was panned in late 2009, Senator Chris Dodd, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs (Banking Committee), proposed a revamped financial regulatory reform bill on Monday, March 15, 2010 (Dodd Bill). The release of the proposed bill follows weeks of intense negotiation with the goal of creating a bipartisan draft of the Dodd Bill that ultimately did not materialize. Senator Dodd has scheduled mark-ups for the Senate Banking Committee to begin on the Dodd Bill on Monday, March 22, 2010, with the stated hopes of bringing the bill to the Senate Floor at the end of April. The financial regulatory reform bill enacted by the House of Representatives in December 2009—The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173)—is similar in nature to the Dodd Bill. However, significant work remains to be done both with the Dodd Bill and with any ultimate reconciliation of such bill with H.R. 4173, before the full Congress will approve financial regulatory reform.

Set forth below is a high-level discussion of some of the important aspects of the Dodd Bill that could have an impact on our insurance company clients, including: Systemic Risk Regulation; the Office of National Insurance; the Bureau of Consumer Financial Protection; Broker-Dealer, Investment Adviser and Securities Law Issues; Enhanced Resolution Authority; Reinsurance; Corporate Governance; and Derivatives. We will continue to monitor the regulatory reform efforts with a focus on its impact on our insurance company clients in the coming months.

Systemic Risk Regulation

The Dodd Bill establishes a Financial Stability Oversight Council (Council) to oversee systemic risk. The Council would perform three key systemic risk functions: (1) identifying risks to the financial stability of the United States arising from the material financial distress or failure of large, interconnected bank holding companies *or* nonbank financial companies;[1] (2) promoting market discipline, by eliminating expectations that the U.S. government will protect shareholders, creditors, and counterparties from losses in the event of failure of a major institution; and (3) responding to emerging threats to the stability of U.S. financial markets. The Council would implement these functions by making recommendations to the member agencies[2] on general supervisory priorities and principles and to the Board of Governors of the Federal Reserve System (Board) on the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, capital, resolution plans, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies that are supervised by the Board. In addition, the Council, by at least a two-thirds majority vote, including an affirmative vote by the Chairperson, may determine that a U.S. or foreign nonbank financial company *must* be supervised by the Board, if the material financial distress of the company would pose a threat to the financial stability of the United States. The Dodd Bill also outlines considerations for the Council to take into account in conducting its analysis. We note that, like most of the predecessor proposals related to systemic risk

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[1] The definition of a “nonbank financial company” is broad and includes a U.S. or foreign company (other than a company treated as a bank holding company or a subsidiary thereof) that is substantially engaged in activities in the United States that are financial in nature (as defined in § 4(k) of the Bank Holding Company Act of 1956). Acting as a principal or agent with respect to insurance or annuities is deemed to be “financial in nature” under § 4(k) of the Bank Holding Company Act.

[2] Member agencies are agencies represented by members of the Council; Council membership is described below.

regulation, an insurance company complex, even if it owns no banking institutions, could be deemed subject to oversight by the Council and regulation by the member agency(ies).

The Council will also coordinate with and work through the Office of Financial Research, to be housed within the U.S. Department of the Treasury (Treasury), to identify and monitor potential risks to the financial system. Other duties of the Council include identifying gaps in regulation that could pose risks to the stability of the U.S. financial system and identifying systemically important financial market utilities and payment, clearing, and settlement activities, and requiring those utilities and activities to become subject to standards established by the Board.

Under the Dodd Bill, the Council will be composed of 9 voting members: the Secretary of the Treasury, who will also be the Chairman of the Council; the Chairman of the Federal Reserve Board; the Comptroller of the Currency (OCC); the Director of the Bureau of Consumer Financial Protection (the head of the "to be formed" consumer protection agency described below); the Chairman of the Securities and Exchange Commission (SEC); the Chairperson of the Federal Deposit Insurance Corporation (FDIC); the Chairman of the Commodity Futures Trading Commission (CFTC); the Director of the Federal Housing Finance Agency; and an independent member appointed by the President, with the advice and consent of the Senate, who has insurance expertise. Importantly, unlike some previous proposals, there appears to be a seat at the table for insurance expertise on the Council. The Council would also include one non-voting member, the Director of the Office of Financial Research.

Office of National Insurance

Similar to H.R. 4173 and the proposals that President Obama sent to Congress last July, Title V, Subtitle A of the Dodd Bill, titled "Office of National Insurance Act of 2010," would establish a new Office of National Insurance (ONI) in the Treasury. The ONI would be headed by a Director, who would be appointed by the Treasury Secretary, in a career reserved position that would not require Senate approval. Unlike H.R. 4173, the Director of the ONI would not be authorized to serve in an advisory capacity to the Council.

Similar to H.R. 4173 and the Obama proposal, the ONI would have the authority to:

- Monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
- Recommend to the Council that it designate an insurer, including its affiliates (defined as any person who controls, is controlled by, or is under common control with the insurer), as an entity subject to regulation as a nonbank financial company;
- Develop and coordinate Federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors (IAIS), and assisting the Treasury Secretary in negotiating international agreements on prudential matters in consultation with the U.S. Trade Representative (international insurance agreements);
- Determine whether State insurance measures are preempted by international insurance agreements under a process consistent with the Administrative Procedures Act; and
- Consult with the States on insurance matters of national importance and prudential insurance matters of international importance.

Like H.R. 4173 and the Obama proposal, the Dodd Bill would give the ONI broad authority to gather information from insurers and any affiliates; unlike H.R. 4173, it would grant the ONI subpoena power to require production of the data. Before collecting any data, the ONI must coordinate in advance with each relevant State insurance regulator (or other relevant Federal or State regulator). Considerable attention is paid in the Dodd Bill to keeping information privileged and confidential and to enabling information-sharing agreements between the ONI and State insurance regulators.

As required by previous proposals, the ONI has specific, but limited, authority to preempt State insurance measures. The ONI would determine whether a particular State insurance measure is preempted on the grounds that it results in less favorable treatment of a non-U.S. insurer than a U.S. insurer and is inconsistent with an international insurance agreement. The ONI could not preempt a State insurance measure that governs (1) any insurer's rates, premiums, underwriting or sales practices, or (2) the capital or solvency of an insurer, except to the extent that such State insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer. The Director of the ONI would be required to submit an annual report to the President and to Congress on the insurance industry and any preemptive actions taken by the ONI.

Finally, the Director of the ONI would be required to conduct a study and submit to Congress a report within 18 months on how to modernize and improve the system of insurance regulation in the United States. The study and report would be based on and be guided by such considerations as:

- Systemic risk regulation of insurance;
- Capital standards, including standards relating to liquidity and duration risk;
- Consumer protection, including gaps in State regulation;
- The degree of national uniformity of State insurance regulation;
- The regulation of insurance companies and affiliates on a consolidated basis; and
- International coordination of insurance regulation.

Under the Dodd Bill, the study moves beyond the topics covered under H.R. 4173 and also considers:

- The costs and benefits of potential Federal regulation of insurance across various lines of insurance;
- The feasibility of regulating only certain lines of insurance at the Federal level, while leaving other lines of insurance to be regulated at the State level;
- The ability of any potential Federal regulator(s) to eliminate or minimize regulatory arbitrage**;**
- The impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential Federal regulation of insurance;
- The ability of any potential Federal regulation or Federal regulators to provide robust consumer protection for policyholders; and
- The potential consequences of subjecting insurance companies to Federal resolution authority, including the effects of any Federal resolution authority on:
    - The operation of State insurance guaranty fund systems, including the loss of guaranty fund coverage if the insurance company is subject to a Federal resolution authority;
    - Policyholder protection, including the loss of priority status of policyholder claims over other unsecured general creditor claims;
    - The loss of special status of life insurance separate account assets and separate account liabilities; and
    - The international competitiveness of insurance companies.

The study and report must contain legislative, administrative and regulatory recommendations, as the Director deems appropriate, to carry out and effectuate the report's findings. In conducting the study, ONI's Director must consult with the National Association of Insurance Commissioners (NAIC), consumer organizations, representatives of the insurance industry and policyholders, and other organizations and experts, as appropriate.

Bureau of Consumer Financial Protection

Title X of the Dodd Bill would create a new "Bureau of Consumer Financial Protection" (Bureau), much like the Consumer Financial Protection Agency (CFPA), under H.R. 4173. Whereas the CFPA would be an independent agency, the Bureau would be housed within the Federal Reserve but is described as "independent," as it would have an independent director (appointed by the President and confirmed by the Senate) and a dedicated budget paid by the Board.

The Bureau generally would have jurisdiction over "consumer financial products and services" such as loans and other financial products from credit card companies, mortgage companies, brokers, banks and others. Title X of the Dodd Bill seems designed to generally exclude annuities themselves (both fixed and variable) from the Bureau's jurisdiction, but there are some uncertainties as to annuity and insurance-related activities (such as investment or financial planning). In addition, other more technical or nuanced areas, such as life settlements and premium financing, do not seem to be addressed at all.

Exclusion for Business of Insurance. Section 1002 (13) of the Dodd Bill defines "financial product or service" broadly to include many enumerated products or services, including certain "other financial product[s] or service[s]" as the Bureau may define by regulation, but provides that the term "does not include the business of insurance." Under Section 1002(3) of the Dodd Bill, the term "business of insurance" is defined broadly to mean "the writing of insurance" (or reinsuring of risks) "including all acts necessary to such writing" (or reinsuring), by persons who act as, or are, officers, agents, employees or other persons authorized to act on behalf of such persons. These provisions do not specifically mention annuities, but there is no indication that annuities are intended to be within the Bureau's jurisdiction.

Section 1027 of the Dodd Bill also provides that "the Bureau may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance" *except* with respect to certain identified insurance activities described in Section 1002. That exception is puzzling and may be a drafting error, since the current draft of Section 1002 does not describe insurance activities (other than the definition of and exclusion for the business of insurance noted above), but an earlier draft of the bill did include a definition of credit insurance as a financial activity in Section 1002 of that draft.

Persons Regulated by a State Insurance Regulator. Title X of the Dodd Bill also includes a limited exclusion for persons regulated by a State insurance regulator (defined in Section 1002(20), limited to activities subject to such regulation). This exclusion provides that Title X does not alter or amend any State insurance regulator's rulemaking, enforcement, or other authority over such persons. This exclusion under Section 1027(f) also provides that the Bureau shall have no enforcement authority with respect to such persons, *except* to the extent that such persons are engaged in the offering of any consumer financial product or service (or is otherwise subject to a Federal consumer financial law).

Persons Regulated by the SEC. Section 1002(19) of the Dodd Bill also includes an exclusion for persons regulated by the SEC, including broker/dealers, investment advisers, and investment companies, and employees, agents and contractors thereof, but only to the extent that such persons, agents, or contractors act in a regulated capacity. This exclusion provides that Title X does not alter or amend the

SEC's rulemaking, enforcement, or other authority over such persons. This exclusion also provides that the Bureau shall have no authority to enforce Title X with respect to such persons (however, unlike the exclusion noted just above for persons subject to State insurance regulation, this provision does *not* contain an exception for offering consumer financial products or services).

Broker-Dealer, Investment Adviser and Securities Law Issues

Title IX of the Dodd Bill is called "Investor Protections and Improvements to the Regulation of Securities." It focuses on a number of areas including broker-dealer and investment adviser harmonization, pre-dispute customer arbitration and certain disclosure issues.

Broker-Dealer and Investment Adviser Harmonization. Much of the fanfare related to financial services regulatory reform has been focused on the proposal to impose equal standards of care on investment advisers and broker-dealer serving investors. Section 913 of the Dodd Bill takes the approach of requiring the SEC to conduct a very detailed study of broker-dealer and investment adviser regulation and to submit the report to the House Committee on Financial Services and the Senate Banking Committee within one year of the enactment of the Dodd Bill.[3] The SEC is required to seek and consider public comments in order to create the report. The Dodd Bill study must evaluate:

- The effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers; and
- Whether there are legal or regulatory gaps, or overlap, in the protection of retail investors related to the standards of care for broker-dealers and investment advisers.

In addition, the Dodd Bill sets forth 12 "considerations" related to the regulation of broker-dealers and investment advisers that must be considered in the report, including but not limited to the following:

- The regulatory, examination and enforcement resources devoted by the SEC and the Financial Industry Regulatory Authority, Inc. to broker-dealer and investment adviser standards of care;
- The substantive differences, compared in detail, in the regulation of broker-dealers and investment advisers providing advice to customers, including the differences in resources;
- Specific instances in which customers of a broker-dealer receive greater protections than an investment adviser, and vice versa;
- The potential impact on retail customers to the range of products and services offered by broker-dealers if the fiduciary duty standard of care is applied to broker-dealers;
- The potential impact of the SEC designating a self-regulatory organization to assist the SEC in overseeing investment advisers;
- The ability of investors to understand the differences in regulatory oversight of broker-dealers and investment advisers;
- The varying level of services provided by broker-dealers and investment advisers and the varying terms of customer relationships.

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[3] Note that this is a markedly different approach from what appears under H.R. 4173. Under H.R. 4173, some of the changes to the regulatory regime for broker-dealers and investment advisers include: broker-dealers would generally be subject to a fiduciary standard of care; the SEC would be granted rulemaking authority to prohibit compensation schemes, conflicts of interest or sales practices that are deemed contrary to investor protection; and certain disclosures related to conflicts of interest or proprietary product sales would be required as applicable.

If the study identifies any gaps or overlaps related to the standard of care, the SEC shall, within two years after the Dodd Bill's enactment, begin a rulemaking to address those gaps or overlaps taking into consideration the findings in the study.

Mandatory Pre-Dispute Arbitration Clauses. As has been the case in most iterations of proposed regulatory reform since the Treasury's proposed language last summer, including H.R. 4173, the Dodd Bill expressly addresses mandatory pre-dispute arbitration clauses. Section 921 of the Dodd Bill indicates that the SEC may conduct a rulemaking to reaffirm or prohibit, or impose conditions or limitations on the use of mandatory arbitration provisions for broker-dealer customers upon a finding that such rulemaking is in the public interest and for the protection of investors. Section 922 of the Dodd Bill contains a similar charge with respect to arbitration clauses used by investment advisers.

Disclosure Requirements. Section 918 of the Dodd Bill provides the SEC with rulemaking authority to identify documents or information that must be provided by a broker-dealer to a retail investor *before* the purchase of an "investment product or service." This provision is very similar to a provision in H.R. 4173.

Enhanced Resolution Authority

A key focal point of the proposed regulatory reform under the Obama proposal and under H.R. 4173 has been the "orderly liquidation" of institutions. Sections 202 and 203 of the Dodd Bill also set forth a three-part procedure for an "Orderly Liquidation." The first two parts of the process are similar to H.R. 4173, but the third part differs from H.R. 4173 and provides for a judicial check on the actions of the Federal regulators.

Orderly Liquidation Procedure. First, the Board or the FDIC alone, or at the request of the Treasury Secretary, must determine that the financial company (defined below) is in default or in danger of default such that the Secretary should appoint the FDIC as receiver. The recommendation must be made with not less than a two-thirds majority vote of each of the Board and the board of directors of the FDIC. If the financial company is a broker-dealer—or if the largest U.S. subsidiary of the financial company is a broker-dealer—the determination of default or danger of default must be made by the Board and the SEC. In either case the recommendation must contain, among other findings, a description of the effect of a default on financial stability in the United States, a recommendation of actions to be taken, and an evaluation of why a case under the Bankruptcy Code is not appropriate.

Second, the Treasury Secretary, after consultation with the President, must reach a number of conclusions, including that (1) the financial company is in default or in danger of default, (2) the financial company's failure and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States, (3) no viable private sector alternative is available to prevent default, and (4) any action taken under the resolution authority would avoid or mitigate those adverse effects.

Third, upon such determinations by the Treasury Secretary, the Treasury Secretary, with notice to the FDIC and to the financial company, will file a petition with the Orderly Liquidation Authority Panel—three judges from the U.S. Bankruptcy Court for the District of Delaware appointed by the Chief Judge for such Court and District. If the Panel agrees with the determination, it will issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver. If the Panel disagrees with the Treasury Secretary, the Treasury Secretary has a right to refile. In either case, the Panel's decision must be made within 24 hours of receipt of the original filing. Section 202 of the Dodd Bill sets forth a limited right of appeal.

Financial Company. Section 201(11) of the Dodd Bill defines a financial company as a company that is incorporated or organized under any provision of State or Federal law and is: (i) a bank holding company as defined under the Bank Holding Company Act, including certain entities usually excluded as bank holding companies, e.g., companies holding bank stock as fiduciaries and companies owning or controlling bank stock as a result of a debt previously contracted; (ii) a nonbank financial company supervised by the Board under the applicable title of the Federal statutes (and described above); (iii) any company that is predominately engaged in activities that the Board has determined are financial in nature or incidental thereto for purposes of § 4(k) of the Bank Holding Company Act, which by its terms would include among other companies, insurance companies, insurance agencies, broker-dealers, and investment advisers; and (iv) any subsidiary of such named companies (other than a subsidiary that is an insurance company or an insured depository institution).

An insurance company is defined as an entity that is: (i) engaged in the business of insurance; (ii) subject to regulation by a State insurance regulator; and (iii) covered by a State law designed specifically to address liquidation, insolvency or rehabilitation of an insurance company. Importantly, under the Dodd Bill, insurance companies, but not their non-insurance company affiliates or subsidiaries, are excepted from the Bill's resolution provisions and instead, rehabilitation, or liquidation of an insurance company, will be conducted under applicable State law.

Impact on Complex Insurance Entities. The Dodd Bill allocates resolution authority along financial and nonfinancial business lines. That is, in a complex entity that includes broker-dealers, State licensed insurance companies, and banking institutions, three separate agencies in four different roles may be involved:

- Example One: the FDIC as receiver for the "financial company"; a holding company that is not also an insurance company, and its non-regulated subsidiaries; Securities Investor Protection Corporation (SIPC) for a failing broker-dealer subsidiary; the FDIC as receiver of a failing insured depository institution subsidiary; and a State insurance regulator for a failing insurance company subsidiary.
- Example Two: The State insurance regulator for a failing financial company that is an insurance company; SIPC for its failing broker-dealer subsidiary; the FDIC as receiver for its failing depository institution subsidiary, and the FDIC as receiver of its failing non-regulated subsidiaries.

Complicating matters further, § 203(e) provides that if the applicable Federal authority does not file the appropriate judicial action in a State court to place an insurance company into an orderly liquidation under the laws of the State, then the FDIC has back-up authority to file the action.

As a general matter, the resolution provisions of the Dodd Bill are substantially similar, or identical, to H.R. 4173.

Reinsurance

Sections 531 to 533 of the Dodd Bill address certain issues related to reinsurance. The Dodd Bill effectively prevents any State from refusing credit for reinsurance ceded to a reinsurer domiciled in the

United States.[4] As a practical result, U.S. domiciled reinsurers will not need to post letters of credit, establish and fund credit for reinsurance trusts, enter into fund withheld arrangements, or become “accredited reinsurers” in order for their cedents to take credit for reinsurance ceded to them. This may give U.S. reinsurers a significant advantage over non-U.S. reinsurers, which will continue to need to post collateral equal to 100% of reserve credit taken by their U.S. cedents, unless other proposals are enacted (e.g., NAIC’s Reinsurance Regulatory Modernization Framework). The Dodd Bill also pre-empts any State’s efforts to require the applicable reinsurance agreement to be governed by a law of any State other than the cedent’s domicile, or otherwise apply the laws of any other State to the reinsurance agreement. Further, non-domiciliary States may not require financial information of reinsurers in addition to that required by their domiciliary State, but may require the filing of a copy of the financial statements filed in the domiciliary State. Reinsurers, for purposes of the Dodd Bill, are defined as insurers principally engaged in reinsurance, and that do not conduct significant amounts of direct insurance or solicit direct insurance on an ongoing basis. The Bill appears to apply to branches of foreign reinsurers licensed in the United States.

Corporate Governance

Under Section 971 of the Dodd Bill, the SEC is required to prohibit the listing of any security, the issuer of which does not comply with the following corporate governance provisions: In an uncontested election for a board of directors seat, if the director does not receive a majority of the votes cast, then the director must resign unless the board of directors votes unanimously to reject the director’s resignation. Whether the board of directors accepts or rejects the resignation, within 30 days it must make a public disclosure discussing the analysis used to come to its decision.

Under Section 972 of the Dodd Bill, the SEC is authorized to issue rules (i) requiring proxies to include one nominee submitted by a shareholder and setting out the procedure, and (ii) permitting shareholders to use proxy materials supplied by the issue to nominate individuals for the board. Section 973 of the Dodd Bill also directs the SEC to issue a rule requiring issuers to disclose the reason for its decision to have a single person serve as Chairman of the Board of Directors and CEO or to have two different people serve in those positions.

Derivatives

The Dodd Bill continues the debate over various legislative proposals aimed at reforming the financial system that could dramatically change the way the over-the-counter (OTC) derivatives industry operates. These proposals, if enacted, will initiate a new regulatory regime to govern previously lightly regulated OTC transactions. Notably, each of the proposals contemplates new registration, capital, disclosure and reporting requirements for OTC dealers; a new category of regulated entity “Major Swap Participants” subject to regulation akin to that to be imposed on OTC dealers; required clearing, including margin requirements for most OTC transactions; and the imposition of new position limits on both exchange-traded and certain OTC swaps. The most viable legislative proposals, including Senator Dodd’s prior bill, the Restoring American Financial Stability Act of 2009 (Prior Dodd Bill) and H.R. 4173 were summarized and compared by us in our January 7, 2010, Legal Alert.

[4] It can be refused if the cedent’s home State is not NAIC accredited and does not have financial solvency requirements substantially similar to NAIC accreditation, but currently all 50 states and the District of Columbia are NAIC accredited.

The Dodd Bill only slightly revises the Prior Dodd Bill and is not likely to curtail the debate. Attached is a chart that includes a comparison of the derivatives provisions in the Dodd Bill to those in the Prior Dodd Bill. http://www.sutherland.com/files/upload/8717973_6.pdf Senators Jack Reed and Judd Gregg have already announced that they will propose significant amendments to the Dodd Bill's derivatives provisions. More significantly, it is expected that Senator Blanche Lincoln, Chairman of the Senate Committee on Agriculture, Nutrition and Forestry (the Senate Committee that has had primary responsibility for legislation regarding the OTC markets and the CFTC), will submit a draft bill addressing derivatives regulation in the near future. The prospect of a new bill proposed by Senator Lincoln, coupled with the announced negotiation of a revised Dodd Bill by Senate Banking Committee Democrats and Republicans, make it likely that significant changes will be made to the Dodd Bill in the final legislation.

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We will continue to monitor developments related to the regulatory reform initiatives impacting our insurance company clients. If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorneys with whom you regularly work.

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