

The Washington Letter is a regular update and commentary on national politics and policy affecting the AEGON companies.

DECEMBER 17, 2009

## **FEDERAL FINANCIAL REGULATORY REFORM LEGISLATION APPROVED BY HOUSE OF REPRESENTATIVES**

On December 11, 2009, the U. S. House of Representatives passed The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, by a vote of 223 to 202 with all Republicans and 27 Democrats voting against the bill. The House considered and voted on 36 of the more than 200 amendments filed by Members.

Commensurate legislation will be considered by the U.S. Senate most likely in early in 2010. Once the Senate acts, the House and Senate bills will have to be reconciled and passed a second time by each body before being sent to the President for signature

The House bill establishes a federal insurance office, a council of regulators to oversee systemically significant financial institutions, and resolution authority for failing nonbanking financial firms. It also creates a new Consumer Financial Protection Agency and a new fiduciary standard of care for broker dealers, as well as imposes new requirements for over-the-counter trading of derivatives.

## **FINANCIAL STABILITY IMPROVEMENT ACT**

Title I of the bill creates a Financial Services Oversight Council (the "Council") to monitor the financial services marketplace to identify potential systemic threats to the stability of the U.S. financial system. The Council will be chaired by the Secretary of the Treasury and includes as its voting members the Chairman of each of the major federal prudential regulators including the Federal Reserve Board ("FRB"), SEC, CFTC, FDIC and OCC. A state insurance regulator and state banking regulator, as well as the

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Director of the newly created Federal Insurance Office ("FIO"), will have nonvoting seats on the Council.

Among its duties, the Council will have the authority to identify companies that have become so large or interconnected that their failure could threaten the economy ("systemically significant firms"). In making a systemic risk determination regarding a company, the Council must consult with the company's federal prudential regulator or, in the case of an insurer, the FIO.

The FRB will act as the Council's agent and be charged with the enhanced supervision and regulation of systemically significant firms. The FRB will have the authority to establish stricter prudential regulatory standards on an institution by institution basis. These stricter standards relate to risk-based capital, leverage limits, liquidity and risk management. The FRB may also place limits on the size of the institution and the activities of a line of business or affiliate. The FRB may impose these standards directly on the institution if the institution's primary regulator fails to impose the stricter standards recommended by the FRB. The FRB will also have the authority, in consultation with the Treasury and the FDIC, to force a systemically significant institution into bankruptcy or the new resolution mechanism.

## FOREIGN FINANCIAL INSTITUTIONS

Special consideration is given to the application of the new regulatory regime to foreign owned companies. The Council may identify a U.S. subsidiary of non-U.S. company to be systemically significant. In identifying the U.S. subsidiary or operations to be systemically significant, as well as in determining whether to impose stricter prudential standards on the U.S. subsidiary, the Council must consider the extent to which the non-U.S. parent is both subject to prudential standards on a consolidated basis in its home country and is regulated by a comparable foreign authority. In addition, prior to imposing stricter prudential standards on the U.S. subsidiary, the FRB is required to give due regard to the principle of national treatment. The principle of national treatment requires treatment on par with U.S. institutions, and ensures that foreign institutions and U.S. institutions have equal competitive opportunity. Although the FRB may limit an institution's size or activities, it may not extend this authority to the non-U.S. parent or to activities that a non-U.S. parent company conducts solely outside the U.S., either directly or through another operating entity located outside the U.S. Finally, the FRB is required to coordinate with foreign regulators before requiring submission of reports from the non-U.S. parent.

## RESOLUTION AUTHORITY

The House bill establishes new mechanism for resolving failed systemically significant holding companies, including insurance holding companies, which is based on the Federal Deposit Insurance Act model used to resolve insolvent banks. FDIC authority would also extend to subsidiaries of the holding companies, although insurance holding company subsidiaries are specifically excluded from the FDIC authority. The FDIC will act as the agent of the Council in resolving such firms, and it will have the ability to sell off assets and liabilities and impose haircuts on creditors, among other powers.

If a failing company is an insurance company covered by a state insolvency law, the resolution of the company and its insurance subsidiaries is to be conducted as provided under state law, or if the appropriate action is not taken, by the FDIC directly.

The FDIC will also administer a resolution fund of \$150 billion which will be pre-funded by financial firms with more than \$50 billion in assets. Details such as who will

pay the assessment and what assets will be counted are not yet fully determined. AEGON USA and the insurance industry oppose the pre-funding requirement and continue to seek recognition of the adequacy of the State guaranty system to compensate policyholders in the event of a failed insurance company.

The resolution authority title also changes the way deposit insurance premiums are assessed, and it imposes new risk retention requirements on issuers of asset backed securities and other securitized lending.

## FEDERAL INSURANCE OFFICE

Title VI of the House bill establishes a new Federal Insurance Office ("FIO") within the Treasury Department. The FIO is to serve as an informational resource for Congress and federal policymakers on national and international insurance issues and to provide advice and counsel to the Administration and Congress on policy matters which affect the insurance industry. The FIO is also charged with identifying issues/gaps in the regulation of insurers that could pose systemic risks and recommending to the Council the designation of any insurer that should be subject to systemic regulatory oversight. The FIO does not, however, have any prudential regulatory authority over insurers.

The FIO will coordinate with the U.S. Trade Representative on "covered agreements" on behalf of the US. A "covered agreement" is defined as an international agreement on insurance matters between the U.S. and a foreign government that deals with prudential/regulatory matters. The FIO is also responsible for coordinating federal efforts and developing federal policy on international insurance matters, including representing the U.S. at the International Association of Insurance Supervisors (IAIS) and assisting in negotiation of certain international agreements.

However, the FIO will have limited authority to preempt state law that conflicts with the covered agreements or discriminates against foreign insurance firms. The FIO does not have authority to preempt state underwriting, sales practices or anti-trust laws, nor can it generally preempt state capital or solvency requirements. Notice of the proposed preemption must be published in the Federal Register and subject to public comment.

## **STUDIES ON INSURANCE MODERNIZATION AND GLOBAL REINSURANCE.**

The House bill requires the FIO to conduct a study on insurance modernization as well as a study on the role of the global reinsurance market in supporting insurance in the U.S.

The study on insurance modernization will examine how to “modernize and improve the system of insurance regulation in the United States.” It mandates the consideration of six criteria including “increased national uniformity through either a federal charter or effective action by the States.” While conducting the study, the Director will consult with State insurance commissioners, policyholders, representatives of the insurance industry and others as deemed appropriate. The Director is required to complete the study within one year of the enactment of the bill. AEGON USA supports the creation of the FIO as a good first step to the creation of a federal insurance charter.

## **REGULATION OF CREDIT FOR REINSURANCE**

The House bill incorporates pending legislation that prohibits a state from denying credit for reinsurance if the ceding insurer’s state of domicile recognizes such credit. The bill also reserves to the reinsurer’s state of domicile responsibility for regulating a reinsurer’s financial solvency and preempts state law applied to reinsurance agreements of ceding insurers outside the State.

## **CONSUMER FINANCIAL PROTECTION AGENCY ACT**

Title IV of the bill creates a new Consumer Financial Protection Agency (CFPA), one of the most controversial new agencies created as part of regulatory reform. The bill transfers to the CFPA all consumer financial protection functions of the federal banking agencies and the Federal Trade Commission (FTC). The bill would also give the CFPA authority to promulgate rules and enforce the consumer protection provisions of a number of federal consumer protection laws currently under the jurisdiction of existing agencies, including the Fair Credit Reporting Act (FCRA) and the privacy provisions of the Gramm-Leach-Bliley Act (GLBA). The CFPA will have authority to apply these rules to non-banks offering consumer financial products.

Products and services and firms regulated by the SEC and CFTC or State insurance regulators are exempted from CFPA jurisdiction. This would include broker-dealers and most investment and financial advisors, but only to the extent that they “act in a registered capacity”. The CFPA also excludes from its jurisdiction insurance products and any ERISA/employer sponsored retirement savings plan or compensation arrangement. The CFPA does not, however, exclude debt cancellation products.

This title makes federal law a floor and invites the states to adopt stricter consumer protection standards. It also permits state attorneys general to bring civil actions under the bill.

## **OVER-THE-COUNTER DERIVATIVES MARKETS ACT**

Title III regulates the swap markets by imposing a comprehensive system of regulation on the over-the-counter derivatives market and requiring the clearing and exchange trading of all standardized derivative contracts between dealers and other large market participants (“major swap participants”). The CFTC and SEC share jurisdiction over swaps. The SEC will oversee activity in swaps that are based on securities like equity and credit-default swaps. The CFTC will oversee all other swaps, including those based on interest rates and currencies. The title requires the registration and regulation of swap dealers and major swap participants. Capital requirements for swap dealers and major swap participants must be set at greater than zero, and the regulators are directed to set margin levels for counterparties in transactions that are not cleared, except when the counterparties is not a dealer or major swap participant. The bill imposes position limits and seeks to harmonize regulation of the swaps markets with similar markets overseas.

## **EXEMPTION FOR END USERS OF DERIVATIVES FOR RISK MANAGEMENT PURPOSES**

AEGON and other “end users” of derivatives for risk management purposes will generally be exempt from the central clearing and other requirements to which dealers and major swap participants are subject. A “major swap participant” is any non-dealer “who maintains a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk...” Definition of the term “commercial risk” will be left to the CFTC.

As derivatives legislation is considered by the Senate, we will work to have the Senate bill clarify that hedging to mitigate balance sheet risk is considered part of the commercial risk exclusion. In addition, we will work to ensure that any collateral requirements will recognize our use of corporate bonds as collateral in addition to cash and government securities.

## **DEFINITION OF SWAP TO INCLUDE ANNUITIES AND STABLE VALUE CONTRACTS, ETC.**

We remain concerned that many of our products, including stable value and annuities, are captured by the definition of swaps in that they provide for payments based on the value of one or more interest or other rates, etc. We will continue to try to clarify this point as the Senate considers its own derivatives legislation.

## **CAPITAL MARKETS (STANDARD OF CARE; HEDGE FUNDS AND CREDIT RATING AGENCIES)**

Title V imposes a new federal fiduciary duty for broker-dealers and investment advisers. It also instructs the SEC to study pre-dispute arbitration and authorizes it to modify or prohibit such arbitration clauses. Hedge funds must be registered and comply with numerous reporting requirements. The oversight and functioning of the credit rating agencies are reformed, and a new private right of action against credit rating agencies is established. The funding and organization of the SEC is changed: the SEC is given new enforcement powers; new remedies for violations of various securities laws are established; and federal preemption of state securities laws is preserved. Title V also amends the Securities Investor Protection Act and Sarbanes-Oxley, and requires the registration of municipal financial advisors.

### **NEW FIDUCIARY STANDARD OF CARE.**

The Investor Protection Act section of the House bill attempts to harmonize the standard of care to which broker dealers and registered investment advisers are subject by imposing a new fiduciary standard of care on broker dealers (including their registered representatives) and investment advisers when they provide personalized investment advice about securities to a retail customer. The broker dealer or financial advisor will only be held to a fiduciary standard while providing actual investment

advice. The broker dealer's fiduciary duty to the investor does not necessarily continue after personalized investment advice has been given. Unless a broker dealer and client establish that they have an ongoing advisory relationship at the start, the broker dealer can switch to a suitability standard when selling individual investment products.

The SEC is authorized to issue rules regarding the application of the new standard, including required disclosures, as well as to ban certain sales practices, conflicts of interests and forms of compensation that it deems "contrary to the public interest." The bill specifically provides that neither the receipt of commission compensation nor the offering of proprietary products or a limited range of products "in and of itself" constitutes a violation of the fiduciary standard. However, the broker dealer is required to provide notice to its customer and obtain the customer's consent or acknowledgement. Ultimately, however, the degree to which broker commissions and the offer of proprietary/limited range of products is preserved will depend heavily on the SEC regulation.

The bill also directs the SEC to conduct a six month study on the merits of creating an Self-Regulatory Organization ("SRO") for the registered investment advisor/financial planning sector. If the SEC decides to subject retail investment advisors to an SRO, AEGON will seek to have all retail investment advisors subject to the same SRO (as opposed to requiring broker-dealer affiliate investment advisors reporting to FINRA and all other retail investment advisors reporting to another SRO).

The bill shifts greater regulatory responsibility for investment advisers onto the states by raising the asset minimum for those registered investment advisers falling under the SEC's jurisdiction to \$100 million from \$25 million. This would give the states jurisdiction over an additional 4,000 firms. This provision could subject our smaller, retail, broker-dealer affiliate investment advisors who do business nationwide to the filing requirements and inconsistent regulation of 50 different states, absent some other exemption that relates to investment advisors affiliated with broker-dealers.

### **SENIOR SUITABILITY**

The Investor Protection Act provisions of the bill also address the so-called "senior designations" issue. These provisions address Congressional concerns that seniors

are allegedly being targeted by salespersons who use misleading certifications and designations that imply a level of knowledge or training that the adviser does not in fact possess.

The bill establishes a program by which states can apply for and receive grants of up to \$500,000 annually to investigate and prosecute misleading and fraudulent marketing practices (including senior designations) aimed at seniors. To qualify for the grants, the State must either have adopted the NAIC Suitability in Annuity Transactions Model Regulation, the NAIC Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities, or, with respect to the sale of securities products, rules on the appropriate use of designations in the offer or sale of investment advice that meet or exceed the minimum requirements of the NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations or of FINR rules on suitability.

## **NEXT STEPS: THE SENATE BANKING COMMITTEE**

The Senate Banking Committee has pending before it a regulatory reform bill drafted by the Committee chairman, Senator Dodd (D-CT). The Committee has held opening statements on the bill which was met with strong opposition from the senior Republican on the panel, Senator Shelby (R-AL). As opposed to a normal “mark-up” process for considering amendments to the bill before reporting it to the full Senate, Chairman Dodd and Senator Shelby agreed to have an eight member working group focus on key elements of the bill. In addition, the Senate Agriculture Committee is considering offering its own derivatives bill or amendment to the Dodd bill. It is unlikely that there will be committee action in the Senate before the end of the year.

The Dodd bill takes a different approach on many key issues as compared to the House passed bill including: fiduciary standard of care; systemic risk regulator; regulatory consolidation; and derivatives. The Dodd bill would create a new systemic risk regulatory council, establish a mechanism for resolving systemically important financial firms and eliminating the too big to fail problems in our current system, create a new consumer financial protection agency focused on bank consumer products and services, create a new federal office of insurance and create a new financial institutions regulatory agency to assume the bank and holding company safety and soundness jurisdiction of the federal banking agencies, including the FRB, the FDIC, the OCC and the OTS. Like the House legislation the Senate legislation would significantly change the regulation and oversight of the derivatives markets, the operation of the credit rating agencies, investor protection standards and practices and the provision of advice by private fund investment advisers. Unlike the House bills, the Senate bill would stripe the FRB of most of its supervisory and regulatory functions and leave the Federal Reserve focused on monetary policy.

## **MORE INFORMATION**

If you have any questions or would like additional information about this report, please contact either Jeanne de Cervens or Byron Anderson. Both are listed in the AEGON global directory.