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Financial Services and Products ADVISORY

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Regulatory Reform Proposal Released by Obama Administration

Yesterday, the Obama administration proposed sweeping reform of the federal regulatory structure for banking, insurance and securities firms (the "Proposal").[1] The Proposal is intended to achieve five objectives: (i) increase oversight of systemic risk and financial regulation; (ii) strengthen the regulation of core markets and market infrastructure; (iii) strengthen consumer protection; (iv) provide the government with tools to effectively manage financial crises; and (v) improve international regulatory standards and cooperation.

Nearly every financial institution would be affected by the Proposal; just how each institution will be affected depends on the nature of the organization and on the products that it offers. For any given institution, the objectives above will overlap and, for ease of reference, this advisory describes the Proposal as it would apply to different segments of the financial services industry—large institutions that present systemic risk, banking organizations (and other participants in the consumer credit market), securities firms (and other participants) and other institutions. This advisory also summarizes the proposed changes to the jurisdiction of existing regulatory agencies.

We anticipate immediate hearings on the Proposal by the House Financial Services Committee, as Chairman Barney Frank (D-MA) has stated his intention to have legislation ready prior to the August recess. Senate consideration is less clear, and likely to be delayed until later this year, given expected action on other major issues such as health care and energy. The content of the legislation will be influenced by several agency reports that the Proposal requires by the end of September, and intense lobbying is expected throughout the process as industry reacts to new regulatory requirements.

Systemic Risk Institutions

The Federal Reserve Board will have broad regulatory authority over "Tier 1 FHCs" (or "Tier 1 financial holding companies")—"firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness." Banking organizations will recognize FHC as a term of art covering certain bank holding companies,[2] but, in the Proposal, the label appears to apply to any institution whose failure poses systemic risk, regardless of whether there is a bank in the structure.

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[1] U.S. Treasury Department, Financial Regulatory Reform, *A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), accessible at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] Specifically, traditional FHCs are bank holding companies that are well capitalized, well managed and have elected to engage in an expanded list of permissible activities that are financial in nature.

- **Covered Institutions.** The universe of Tier 1 FHCs will be determined by the Federal Reserve and an interagency advisory council. While each of the 19 largest U.S. bank holding companies that participated in the recent Supervisory Capital Assessment Program stress test should regard itself as a Tier 1 FHC, the breadth of the definition may make it difficult for large financial organizations to determine for themselves whether they are Tier 1 FHCs. This group of institutions could include, for example, large insurance companies without a bank subsidiary that have not previously been subject to federal regulation.

- **Regulator.** Effectively, there will be two bodies to direct regulation. The Federal Reserve will be responsible for consolidated supervision and regulation, and subsidiaries will continue to be regulated by their current primary functional regulator (except where this regulator has changed as a result of the Proposal). Among the Federal Reserve's responsibilities will be the development of capital, liquidity and risk management standards. The Federal Reserve's work will be significantly informed by the Financial Services Oversight Council (FSOC). The FSOC will coordinate and share information on, identify risks associated with, and advise the Federal Reserve on firms to be classified as Tier 1 FHCs. The FSOC also will resolve jurisdictional disputes. The FSOC will include representatives from every bank regulatory agency and will have a full-time staff at Treasury with the power to request information from any financial firm. In regulating Tier 1 FHCs, the Federal Reserve and the FSOC are expected not only to supervise or monitor specific institutions, but also analyze the broad and systemic impact of these institutions.

- **Capital.** An interagency working group will assess regulatory capital requirements for Tier 1 FHCs and issue a report by December 31, 2009. New legislation would not be required for capital standards for bank holding companies that are Tier 1 FHCs, but legislation would be necessary for Tier 1 FHCs without a bank in their structure. The Proposal directs that the capital standards cover circumstances of "extreme stress," suggesting that the recent stress tests will be an ongoing feature of capital regulation for these institutions.[3] The new capital standards are to be "stricter and more conservative" than the requirements for other banking organizations. Tier 1 FHCs also will be subject to a prompt corrective action regime. This regime presumably would be modeled on the existing program for insured depository institutions, but calculations for non-bank assets will be challenging.

- **Failure and Receivership.** Treasury, with the support of either the FDIC or the SEC, as appropriate, and after consulting the President, may invoke a resolution procedure modeled on the resolution and receivership provisions of the Federal Deposit Insurance Act. The FDIC likely will act as receiver.

Banking Organizations and Related Entities

Insured Depository Institutions

Charters for both national and state banks remain unchanged. The charter for federal savings banks will be eliminated, and these thrift institutions will have the option of converting to a national or state bank charter. Charters for industrial banks, credit card banks, trust-only institutions and other specialty banking institutions at the state level will remain intact, but if these entities have federal deposit insurance, their holding companies will become bank holding companies.

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[3] Similarly, the Federal Reserve will develop liquidity standards to take into account the potential negative impact that (i) the financial distress, (ii) the rapid deleveraging or (iii) the disorderly failure of a Tier 1 FHC would systemically have.

- **Regulator.** National banks (including converted federal thrifts) will be regulated by the National Bank Supervisor (NBS), an agency that will replace both the OCC and the OTS.[4] State-chartered insured depository institutions will continue to be regulated by the Federal Reserve or the FDIC. Additionally, the proposed Consumer Financial Protection Agency (CFPA) will regulate consumer financial products offered by banks, including both credit and savings products. An interagency working group will evaluate bank supervision and provide a report by October 1, 2009, that should provide greater detail on the expected functions and operations of the NBS.

- **Powers.** Bank powers are largely unchanged, while specific thrift powers and limitations will be eliminated. The unrestricted interstate branching powers of federal thrifts will be available to all national banks, subject to compliance with existing deposit concentration and consumer protection limits. For thrifts converting to banks, the changes in powers may have importance in particular cases. For example, thrift operating subsidiaries have been regulated differently from national bank operating subsidiaries, and the agencies have had, in recent practice, different approaches to commercial credit concentrations.

- **Federal Preemption.** National banks no longer will enjoy federal preemption of state laws or regulations governing credit, savings, payment and other consumer financial products, including licensing requirements. The states will have corresponding enforcement authority over national banks as well.

- **Capital.** As with requirements for Tier 1 FHCs, an interagency working group will reassess capital requirements and issue a report by the end of this year. Again, we expect this review to result in higher requirements and in the abandonment of Basel II. One aspect of the reassessment may be the reduction or elimination of external ratings as the primary measurement of credit risk on debt obligations.

- **Affiliate Transactions.** Regulation W will be "strengthened." Specifically, there will be additional limitations on OTC derivatives and securities financing between a bank and an affiliate, higher collateralization requirements on loans to affiliates, greater restrictions on transactions between a bank and its sponsored or advised private investment vehicles, and tightened review of potential conflicts of interest.

- **Failed Banks.** The grounds for appointment of a receiver remain unchanged, as do the FDIC's powers as receiver.

Bank Holding Companies

The universe of bank holding companies will expand to include companies that control savings associations, industrial banks and other specialty-chartered depository institutions.

- **Regulator.** The Federal Reserve will continue to regulate all bank holding companies. The same working group as for banks will assess bank holding company supervision and produce a report by October 1, 2009.

- **Powers.** The non-banking powers of BHCs and presumably those of FHCs (as that term has been used historically) will remain the same. As a result, new BHCs that engage in non-conforming activities will be required to cease these activities. The Federal Reserve customarily has allowed a two-year transition

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[4] In part because the national bank charter will survive and the federal thrift charter will not, the NBS should be substantially similar to the OCC in its structure and operations.

period; however, the Proposal suggests that new entities required to comply with the activity restrictions of the Bank Holding Company Act will have five years in which to conform to those limits.

- **Financial Holding Companies.** Bank holding companies electing FHC status will have to meet capital and management requirements on a consolidated basis. Currently, these requirements apply only to subsidiary banks.

- **Capital.** These requirements will undergo the same interagency review process as for banks. New BHCs likely will have to raise capital or otherwise adjust their balance sheets in order to meet BHC standards.

- **Failed BHCs.** BHCs that are not Tier 1 FHCs will continue to be covered by the federal bankruptcy laws in the event of insolvency. The special resolution authority for Tier 1 FHCs does not appear to apply to other BHCs.

Institutions that Offer Consumer Financial Products

A new, independent agency, the CFPA, will have primary responsibility for regulating the sale of consumer financial products. These products include consumer loans, savings products and card products—traditional retail bank products. Retail securities products already regulated by the SEC or CFTC will remain subject to those agencies and outside the ken of the CFPA.

- **Regulated Entities.** In addition to insured depository institutions, the CFPA will have jurisdiction over other entities involved with consumer credit or card products, including all state-licensed consumer lenders. The Proposal does not rule insurers in or out.

- **Rules.** Among other things, the CFPA will take over the interpretation and enforcement of the various consumer protection regulations now under the jurisdiction of the Federal Reserve. Presumably, the transferred regulations will include Regulation DD (truth in savings), but the Proposal is not explicit.

- **Relationship with the FTC.** The Federal Trade Commission's authority over the consumer-facing practices of financial institutions will be transferred to the CFPA. The FTC will have back-up enforcement authority with respect to statutes currently within its jurisdiction. The FTC also will retain its privacy and data security jurisdiction.

- **Permissible Products.** The CFPA's rules will focus on disclosures, information and similar consumer protection measures, but the agency will have authority to tailor or prohibit products that it deems unfair or abusive.

Securities Firms and Other Participants in the Capital Markets

Hedge Funds and Other Private Investment Pools

Advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds, with assets in excess of a modest but unspecified threshold, will be required to register with the SEC under the Investment Advisers Act. The funds themselves will be subject to reporting, disclosure and recordkeeping requirements promulgated by the SEC, and the SEC will have authority to conduct examinations of the funds to assess compliance with these requirements. The reporting requirements will require funds to report, on a confidential basis, the amount of assets under management, borrowings, off-balance sheet exposures and other information necessary to assess whether the fund or fund family is so large, highly leveraged or interconnected that it poses a threat to financial stability. These reports will be shared with the Federal Reserve so that the Federal Reserve can determine whether any fund or fund family meets the criteria for being supervised and regulated as a Tier 1 FHC.

Money-Market Mutual Funds

The SEC will be required to develop regulations to strengthen the regulatory framework around money market mutual funds (MMFs) to, among other things, reduce the credit and liquidity risk of individual MMFs and otherwise insulate MMFs from runs. In doing so, the SEC is to consider (i) requiring MMFs to maintain substantial liquidity buffers; (ii) reducing the maximum weighted average maturity of MMF assets; (iii) tightening the credit concentration limits applicable to MMFs; (iv) improving the credit risk analysis and management of MMFs; and (v) empowering MMF boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders. The President's Working Group on Financial Markets will prepare a report on whether more fundamental changes are necessary to reduce susceptibility to runs, such as eliminating the ability of MMFs to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources. This report is due September 15, 2009.

Broker-Dealers and Investment Advisers

- **Harmonization.** Regulations governing broker-dealers and investment advisers will be harmonized. Specifically, broker-dealers that provide investment advice about securities to investors will have the same fiduciary obligations as investment advisers. Both will be required to make simple and clear disclosures to investors about their relationships with investment professionals. The Proposal will also prohibit certain conflicts of interest and sales practices deemed contrary to the interests of investors.

- **Mandatory Arbitration.** The SEC will study and have the authority to prohibit mandatory arbitration clauses.

Issuers of Securities and/or Futures

- **Disclosures.** The SEC will receive additional authority to improve the timing and quality of disclosures to investors, including the delivery of disclosures at or before the point of sale. The SEC also may field test disclosures to determine their effectiveness. The SEC also will require that shareholders have non-binding votes on executive pay.

- **Harmonization.** The CFTC and the SEC should make recommendations to Congress for changes to statutes and regulations to harmonize the regulation of futures and securities.

Institutions Engaged in Derivatives Trading

The Proposal will subject all over-the-counter (OTC) derivatives markets, including credit default swaps (CDS) markets, to comprehensive regulation designed to achieve four policy objectives: minimizing the systemic risk posed by OTC derivatives; promoting efficiency and transparency of OTC derivatives markets; preventing market manipulation, fraud and other market abuses; and protecting unsophisticated participants in the OTC derivatives markets. Congressional proposals seem to favor the CFTC as the principal federal regulator of the OTC derivatives markets, but the Proposal largely leaves it to the CFTC and the SEC to make recommendations on appropriate jurisdictional lines.

- **Systemic Risk.** All standardized OTC derivatives must be cleared through regulated central counterparties (CCPs) with strong margin requirements and risk controls.
- **Counterparty Risk.** All OTC derivatives dealers will be subject to strong capital requirements, business conduct standards, reporting requirements, margin requirements and other supervisory and regulatory requirements.
- **Transparency.** The appropriate agency will impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. CCPs and trade repositories must make aggregate data on open positions and trading volumes available to the public, and information on individual trades and positions available to regulators.
- **Market Efficiency and Price Transparency.** The appropriate agency also will require (i) central clearing of standardized products, (ii) standardized portions of the OTC markets to be traded or moved onto regulated exchanges and regulated electronic trade execution systems, and (iii) timely trade reporting and prompt dissemination of trade and pricing information.
- **Market Integrity.** Both the CFTC and SEC will be granted enhanced authority to police and prevent fraud, market manipulation and other market abuses. The CFTC will be authorized to set position limits on OTC derivatives that perform a significant price discovery function with respect to regulated products.
- **Consumer Protection.** Minimum standards for participation in OTC products will be raised or additional disclosures will be required for marketing to less sophisticated parties.

Originators and Issuers of Asset-Backed Securities

- **Regulation.** The SEC will be given clear authority to require robust disclosure and ongoing reporting by issuers of asset-backed securities. The reports should include loan-level data. Issuers also should be required to disclose the nature and extent of compensation for and risk retention by originators and others.
- **Risk Retention.** The originating or sponsoring bank must retain five percent of the loss on a securitized asset pool. Moreover, the appropriate federal bank regulator will prohibit the originating or sponsoring bank from hedging or transferring the risk associated with the retained interest.

- **Capital.** The regulatory capital requirements for banking organizations will be increased for investments and exposures, such as ABS, that pose high levels of risk under stressed market conditions.

- **Secondary Market Reporting.** ABS will be eligible for TRACE reporting.

Participants in the Futures and Securities Markets

To address the gaps and inconsistencies in the regulation of financial products, the Proposal directs the CFTC and SEC to report to Congress by September 30, 2009, on current conflicts in statutes and regulations regarding similar types of financial instruments under their jurisdiction, with recommendations for changes to eliminate any conflicts. Any differences between the two agencies will be referred to the FSOP. The agencies are expected to develop principles of market regulation that are sufficiently clear to identify violations and expedite enforcement, yet that are sufficiently flexible to permit market innovation. The Proposal also requires the agencies to develop consistent procedures for review and approval of proposals for new products and rules by self-regulatory organizations.

Other Financial Institutions

Insurance Companies

Existing state-by-state regulation remains intact. A new Office of National Insurance will have indirect effects on insurance companies through its ability to coordinate policy in the insurance sector, through the following:

Rating Agencies

- Having rating agencies maintain robust policies and procedures for the management and reporting of conflicts of interest;

- Having structured finance ratings differentiated from the ratings on other products and companies by, for example, the use of different or supplemental letter designations or symbols (this proposal has been strongly opposed by the securitization industry—being derisively characterized as "scarlet letters");

- The agencies will be required to promote the integrity of the ratings process and reduce the incentives for over-reliance on credit ratings by, for example, explaining which risks are and are not captured by ratings, describing how structured finance risks differ from those of corporate debt and disclosing the methodologies and data upon which the ratings are based;

- Generally, the Proposal encourages regulators to reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

Foreign Institutions

- **U.S. Branches and Agencies.** The NBS will be the exclusive regulator of federal branches and agencies of foreign banks; the Federal Reserve no longer will have jurisdiction.

- **Global Regulatory Reform.** Although foreign institutions without a U.S. presence will not, of course, be regulated by any U.S. department or agency, the Proposal calls for substantial efforts to align U.S. regulatory initiatives with those of other countries, particularly members of the G-20. A particular subject of interest will be credit derivatives and other OTC derivative products.

Government-Sponsored Enterprises

Treasury and HUD will develop recommendations on the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. A report will be issued at the time of the President's 2011 budget release. The GSEs already have been the subject of significant reform legislation in the Housing and Economic Recovery Act of 2008.

Changes in Regulatory Jurisdiction

- **Treasury.** New oversight of Tier 1 FHCs.

- **Federal Reserve.** Consolidated supervision of Tier 1 FHCs. Loss to CFPA of authority over consumer protection regulations. Emergency lending authority under section 13(3) of the Federal Reserve Act will be modified to require Treasury clearance.

- **National Bank Supervisor.** This agency appears to be the OCC by another name, and will oversee regulation, supervision and examination of national banks and former federal savings banks. Also, the agency will have exclusive jurisdiction over federal branches and agencies of foreign banks.

- **Office of the Comptroller of the Currency.** This agency will be folded into the NBS, but NBS will likely reflect or contain all operations, policies and staff of the OCC.

- **Office of Thrift Supervision.** This agency will be "dismantled," according to the Obama administration, but may technically be folded into the NBS. Because the federal thrift charter will not survive, few if any policies or operations appear unlikely to be part of NBS.

- **FDIC.** The agency likely will act as receiver to have the wind down Tier 1 FHCs.

- **SEC.** The SEC will have new, but limited, authority over hedge funds, private equity funds and venture capital funds. The Supervised Investment Bank Holding Company program will be eliminated. The SEC could take this action without new legislation. The agency will have expanded enforcement powers, as well as possible jurisdiction over elements of the derivatives markets.

- **CFTC.** The agency will have new authority to regulate the OTC derivatives market. The SEC may participate in some regulation here as well.

- **Consumer Financial Products Agency.** This new agency will assume jurisdiction over and enforcement responsibility for consumer protection regulations now under the aegis of the Federal Reserve.

- **Office of National Insurance.** This office within Treasury will monitor the insurance industry, but will have no regulatory or enforcement authority. The Proposal does not include a federal insurance charter.

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