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OBAMA ADMINISTRATION'S PROPOSAL TO REFORM FINANCIAL REGULATION WILL AFFECT LARGE FIRMS, UNREGULATED MARKETS, AND RETAIL PRODUCTS

On June 17, 2009, the US Department of the Treasury unveiled details of the Obama Administration's proposal to reform financial regulation. The proposal recommends that Congress and regulatory agencies adopt a comprehensive series of changes to overhaul the US financial regulatory system. If adopted, it would increase the role of the federal government in virtually every aspect of the financial services industry. The proposal contemplates significant changes for banks, bank holding companies, securities firms, private investment funds, insurance companies, and virtually every other provider of financial services. Among many other significant changes, it would:

- Install the Board of Governors of the Federal Reserve (Federal Reserve) as an overarching regulator for any type of financial firm that it identifies as being systemically significant, giving it authority over certain entities that historically have been subjected to little or no oversight.
- Establish procedures to resolve or support failing significant financial institutions or bank holding companies.
- Impose heightened consolidated supervisory standards, including capital, liquidity, and prudential requirements, on all large interconnected financial firms, as well as tighter capital standards on banks and holding companies, in general.
- Drastically scale back the preemption powers of federally chartered financial institutions.
- Create several new federal agencies, offices, and councils, including a new Consumer Financial Protection Agency (CFPA), dedicated to policing consumer financial products and services.
- Regulate the markets for over-the-counter (OTC) derivatives and impose requirements on the securitization of debt.
- Require Securities and Exchange Commission (SEC) registration of advisers to hedge funds, venture capital funds, and other private investment funds.
- Require tighter regulation of money market mutual funds and require a study and proposal regarding whether money market mutual funds should continue to maintain a stable net asset value of US$1 per share.

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- Potentially ban mandatory arbitration clauses in retail financial services contracts.

I. FEDERAL RESERVE OVERSIGHT OF SYSTEMICALLY SIGNIFICANT FINANCIAL FIRMS

Under the proposal, the Federal Reserve would be charged with identifying and regulating any financial firm whose failure could pose a threat to financial stability due to its size, leverage, and interconnectedness. Such firms are referred to in the proposal as "Tier 1 Financial Holding Companies" (Tier 1 FHCs). Not only bank holding companies, but all types of financial entities, including hedge funds, insurance companies, and securities firms, could be deemed Tier 1 FHCs and become subject to regulation by the Federal Reserve.[1]

Moreover, the Federal Reserve would take more responsibility for the oversight of those payment, clearing, and settlement systems that it deems systemically important (although market regulators such as the US Commodity Futures Trading Commission (CFTC) and SEC would remain the primary regulators of such systems). In fact, it would be authorized to provide such systemically significant payment, clearing, and settlement systems with access to Reserve Bank accounts, financial services and the discount window. Perhaps even more importantly, the legislation would also provide the Federal Reserve with jurisdiction over the settlement *activities* of financial firms, and allow it to set reporting and conduct standards with respect to such activities.

To assist with the identification of Tier 1 FHCs, and to coordinate financial regulatory policy, in general, the Administration would create a "Financial Services Oversight Council" (FSOC) in place of the President's Working Group on Financial Markets. The Council would include the heads of the primary federal financial regulators,[2] be chaired by the Secretary of the Treasury, and have a full-time "permanent secretariat" of Treasury Department staff. In order to provide regulators with data as to entities that are not presently supervised at the federal level, advisers to hedge funds and other private investment companies would be required to register with the SEC, and a new Office of National Insurance (ONI) would be established within Treasury. The Council could also require reports from any US financial firm. Finally, the Federal Reserve would have authority to examine and require reports from financial firms that met certain unspecified size thresholds in order to determine if they should be deemed Tier 1 FHCs.

1 Since the Federal Reserve would become solely responsible for the consolidated supervision and oversight of such firms, the proposal would eliminate the ability of investment bank holding companies to seek consolidated supervision by the SEC under its Supervised Investment Bank Holding Company Program.

2 I.e., the Federal Reserve, SEC, CFTC, Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), the to-be-created National Bank Supervisor (NBS), and Consumer Financial Protection Agency (CFPA).

OVERSIGHT OF TIER 1 FHCS AND BANK HOLDING COMPANIES

Under the supervision of the Federal Reserve, Tier 1 FHCs would be subject to supervision on a consolidated basis extending to parent companies and through all subsidiaries, regulated and unregulated, US and foreign. They would also be subject to enhanced capital, liquidity, and risk management standards. Moreover, a Tier 1 FHC would become subject to the restrictions on nonfinancial activities imposed by the Bank Holding Company Act, even if it did not control an insured depository institution (such companies would be given five years to comply). Finally, Tier 1 FHCs would have to adopt plans for their rapid resolution in the event of severe financial distress.

As to banks and bank holding companies, the Administration's proposal contemplates enhancing current capitalization standards. Notably, it calls for all FHCs to meet capital and management requirements on a consolidated basis, not just at a depository institution level. Further, it calls for regulations to strengthen the restrictions that are in place between banks and their affiliates through Sections 23A and 23B of the Federal Reserve Act.

INSTITUTION OF SYSTEMS TO RESOLVE OR SUPPORT FAILING BHCS, INCLUDING TIER 1 FHCS

The Administration also proposes a mechanism to wind down or "stabilize" failing BHCs, including Tier 1 FHCs, where a failure might threaten the financial system. Under the proposal, Treasury should have the power to decide whether to appoint a receiver or conservator, which would be the FDIC (or SEC if the firm were a broker-dealer), and/or to support a failing firm with loans, guarantees, equity investments, or asset purchases. In order to improve accountability in such situations, the Administration intends to propose legislation to require prior written approval of the Secretary of the Treasury for any emergency extensions of credit by the Federal Reserve.

Treasury could only employ the special resolution regime after consulting with the President and obtaining approval from two-thirds of the members of the Federal Reserve and (depending on the firm's largest subsidiary) either two-thirds of the FDIC Board or two-thirds of the SEC commissioners. The newly-created ONI would be consulted if the failing firm included an insurance company.

II. STREAMLINED FEDERAL BANKING REGULATION

As expected, the Reform Proposal calls for the elimination of the Office of Thrift Supervision (OTS). Surprisingly, however, it also calls for elimination of the thrift charter itself. Supervision of all federally chartered depository institutions and federal branches, and agencies of foreign banks would fall under a new agency within Treasury: the National Bank Supervisor (NBS). It is not clear from the proposal whether the new NBS would be a continuation of the Office of the Comptroller of the Currency (OCC) or would be an entirely new agency with a new staff and leadership. While the OTS would be gone, its relatively permissive interstate branching rules would be extended to state and national banks. There would be no changes in the role of the Federal Reserve, FDIC, or the National Credit Union Administration in their regulation of state banks and credit unions.

Moreover, companies controlling industrial loan companies, trust companies, credit card banks, and "nonbank" banks would be required to become BHCs and would be subject to regulation by the Federal Reserve. Such companies would be given five years to conform to BHC activity restrictions.

At the same time, the proposal calls for the Financial Accounting Standards Board, the International Accounting Standards Board, and SEC to "review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information" and otherwise review potential revisions to fair value accounting rules.

III. CONSUMER FINANCIAL PROTECTION

The proposed new CFPA would be dedicated to policing consumer financial products and services. It would have authority to promulgate and interpret rules, as well as enforce current federal consumer financial services and fair lending statutes within its jurisdiction, which is proposed to extend to bank affiliates not currently supervised by a federal regulator.

The proposal would significantly scale back the preemption powers of federally chartered financial institutions. States would have the ability to adopt laws more stringent than the federal laws administered by the CFPA. Additionally, the proposal would provide the states examination and enforcement authority over federally chartered institutions with respect to state and federal consumer protection laws. The expressed intent of these proposals is to create a level playing field between state and federally chartered institutions. This proposed expanded authority of the states, however, if enacted as proposed, may undermine the ability to provide uniform financial products and services on a multistate basis, reducing the attractiveness of a federal banking charter.

The CFPA would exercise a broad range of consumer protection powers. For example, it could:

- Oblige providers of financial products and intermediaries to ensure that disclosures are "reasonable" and not just compliant (e.g., disclosures that identify the most significant risks of a product, as opposed to only listing risks).
- Set standards for relatively simple, "plain vanilla" products, and require providers and intermediaries to offer them along with other products.

- Enforce fair lending and other laws to ensure that underserved consumers have access to financial services.

The Federal Trade Commission would retain backup authority for statutes over which it has jurisdiction (such as in matters concerning the sale of services like advance fee loans, credit repair, and debt negotiation). It would also be permitted to obtain civil penalties and allowed to conduct rulemakings dealing with unfair and deceptive practices on an accelerated basis.

IV. SECURITIES AND SECURITIES MARKET REFORMS

The Administration advances several other proposals that impose more stringent regulation on securities markets, intermediaries, and issuers. These include, among other things:

- *SEC registration for advisers to hedge funds, private equity funds, venture capital funds, and other private investment pools.* Registration under the Investment Advisers Act will subject such advisers and the funds that they manage to a host of recordkeeping and reporting requirements, as well as to potential regulation by the Federal Reserve as Tier 1 FHCs.
- *Regulation of OTC derivative markets, including those for credit default swaps.* The proposal suggests legislation to reverse the exemption from regulation provided for such instruments by the Commodity Futures Modernization Act of 2000. New laws would mandate that standardized OTC derivatives, including credit default swaps, be executed on regulated markets and cleared through regulated central counterparties with "robust" margin requirements that are subject to prudential supervision. CFTC and SEC would be authorized to require records and reports as to trading in such instruments, and CFTC allowed to set position limits with respect to those that have a significant price discovery function.[3]
- *Bank rules to require loan originators and securitization sponsors to retain five percent of the credit risk of securitized loans and other exposures.* Requiring lenders and sponsors to retain exposure to securitized debt is meant to yield more careful review of the performance of loans underlying asset-backed securities.
- *Harmonization of futures and securities regulation.* SEC and CFTC are to jointly recommend legislation to harmonize the regulation of futures and securities. If the two agencies cannot agree, the task will fall to the new FSOC.
- *Subjecting broker-dealers who give investment advice to the same fiduciary duties as registered investment advisers.*
- *Legislation authorizing SEC to require greater independence for compensation committees.* The proposal also supports requiring issuers to implement non-binding shareholder votes on executive compensation and the authorization of SEC "say on pay" rules.

V. FUTURE ACTIONS AND UNDERTAKINGS

While acknowledging their importance to the financial system, the Administration's proposal essentially pledges consideration and later action on a number of issues. Thus it:

- Describes future options for Fannie Mae and Freddie Mac, ranging from dissolution to continued operation, and pledges to report on alternatives at the time of the President's 2011 Budget.
- Expresses support for enhanced disclosures by credit rating agencies, less regulatory reliance on ratings, and further SEC efforts to improve their regulation.
- Outlines the Administration's intent to coordinate with international authorities to promote reforms that complement US initiatives, such as a stronger Basel II capital framework, enhanced oversight of OTC derivative markets, better fair value accounting standards, and improved regulation to address systemic risk.

3 Reforms proposed for the OTC derivative markets are more fully described in our prior advisory: http://www.arnoldporter.com/resources/documents/Advisory_MajorRegulationProposedForOverTheCounterDerivatives_060909.pdf)

We hope that you have found this advisory useful. We will be following the proposal closely during the coming months as the Administration seeks to implement it through regulation and legislation. If you have questions about the proposal or its implementation, please contact your Arnold & Porter attorney, or:

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