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IN-DEPTH ANALYSIS

Treasury Releases White Paper Proposing Significant Financial Regulatory Reform

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Introduction:

On June 17, 2009 the Treasury released a white paper entitled “*Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation*” (the “Proposal”) which outlined the Obama Administration’s ambitious plan to reform extensively the U.S. financial regulatory system. If adopted in its entirety, the Proposal will result in wide-ranging changes that will affect every corner of the financial markets and the financial regulatory landscape. For example, the Proposal would alter or eliminate several of the more significant recent legislative initiatives including the “functional regulation” regime of the Gramm-Leach-Bliley Act of 1999 (the “GLBA”) and the interstate branching approval process of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the “Riegle-Neal Act”). The Obama Administration hopes to sign legislation enacting the provisions of the Proposal by the end of 2009. Rep. Barney Frank, Chairman of the House Financial Services Committee, has set regulatory reform hearings for the next several weeks and has indicated that he wishes to pass legislation in the August congressional recess. Senator Chris Dodd, Chairman of the Senate Banking Committee, has indicated that he does not want to take up any legislation until the fall in order to prioritize health care legislation. Given this legislative timeline, the deadlines for many of the reports called for in the Proposal may be difficult to achieve.

This edition of the *Alert* examines each section of the Proposal in depth and discusses significant provisions that may not appear in more abbreviated summaries. Section I through IV also provide commentary on some of the initial reactions to the Proposal by members of Congress and the financial services industry.

I. Financial Regulatory Agency and Oversight Reform

Background. Currently, there are four federal bank regulatory agencies: OCC (national banks), FRB (bank holding companies (“BHCs”) and state member banks), OTS (thrifts) and FDIC (state nonmember banks and back-up regulator of insured banks). A few weeks ago, Treasury Secretary Geithner suggested that the Proposal might consolidate this federal bank regulatory oversight into a single new agency, and extend its reach into other significant nonbank financial services firms.

In part because of Congressional and other criticism, the Proposal does not go quite that far, but still arguably proposes the most significant change to the federal oversight of financial services firms since the Great Depression. To provide context to these proposed changes, the Proposal first describes the four principal shortcomings in the current regulatory regime that the Obama Administration believes were at the core of the financial crisis:

(1) regulators imposed insufficient capital and liquidity requirements, particularly as to off-balance sheet and trading assets; (2) in their oversight, regulators did not take into account the harm that the failure of a large, complex financial institution could have on the economy; (3) because of the division of supervision of large firms among many agencies and the number of bank charter types available, firms had fragmented, uncoordinated oversight and could “shop” for the ideal regulatory supervision; and (4) there was insufficient or no oversight over significant non-bank focused financial enterprises such as investment banks, money market funds, hedge funds and other private pools of capital. To address these perceived shortcomings, as described in more detail below, the Proposal would create a new umbrella oversight council, expand the FRB’s authority over banking firms and significant nonbank financial institutions, increase the capital and supervision of the largest financial firms, and eliminate the OTS.

A. Creation of Financial Services Oversight Council

To address the need for coordinated agency oversight and identification of emerging risks, the Proposal would create the Financial Services Oversight Council (the “Council”). The Secretary of Treasury would serve as the Council’s Chairman, and membership would also include representatives of a broad range of agencies, including the SEC, the CFTC, the FHFA, and the new federal banking and consumer protection agencies described in Sections I.D and III.A. below, respectively.

Role of the Council. The Council (with a broader membership than the FFIEC, which only includes bank and credit union regulators) is emblematic of the Administration’s focus on identifying and overseeing activities and interrelationships across the financial services industry. The Council’s mandate also reflects this mission, as it is intended to: (1) facilitate coordination of administrative actions and information sharing across agencies; (2) facilitate the evaluation of cross-industry products and trends; and (3) identify gaps in regulation and emerging risks in the economy. In addition, the Council will assist the FRB in connection with the FRB’s identification and prescription of regulations applicable to the most systemically important financial institutions (“Tier 1 FHCs”, as discussed further in Section I.B. below) and with the FRB’s identification of firms where resolution may be appropriate. The Council does not, however, have any enforcement powers or direct authority over financial institutions and other regulators.

Council Information Gathering Authority. To enable it to fulfill its role, the Proposal would provide the Council with broad information gathering authority. The Council would be permitted to require reports from any U.S. financial services firm, although the Proposal is careful to note that the Council would obtain information only to determine if a particular activity or market in which the firm participates poses a threat to financial stability.

B. Increased Supervision and Regulation of Large Financial Firms

The Proposal clearly places a lot of the blame for the current crisis around the sudden failures of large U.S. firms (*e.g.*, AIG) that “were large, highly leveraged, and had significant financial connections to the other major players in our financial system, yet ... they were ineffectively supervised and regulated.”

Tier 1 FHC Identification. To address this issue, the Proposal advocates sweeping new authority for the oversight (principally, via the FRB) and regulation of “any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed” (a so-called “Tier 1 Financial Holding Company” or “Tier 1 FHC”). Notably, by its terms the Proposal does not limit Tier 1 FHCs to institutions that own banking enterprises, or to domestic financial institutions (as discussed in Section V.B. below).

Although not detailing specific criteria, the Proposal states the following factors should be relevant to determining Tier 1 FHCs: (1) the impact the firm’s failure would have on the economy; (2) the firm’s size, leverage and reliance on short term funding; and (3) the firm’s importance as a source of credit for businesses, government and households, and as a source of liquidity for the financial system. However, unlike, for example, Basel II (which has defined criteria for “core banks”), the Proposal wants the FRB to have the discretionary power to designate firms as Tier 1 FHCs, so that an enterprise cannot avoid the designation

by adjusting its balance sheet or operations. The Proposal suggests that the FRB should conduct stress tests in analyzing whether a firm qualifies as a Tier 1 FHC.

Though the Council would have the ability to recommend that certain firms be designated as Tier 1 FHCs, the final determination rests solely with the FRB. As part of its responsibility to identify Tier 1 FHCs, the Proposal recommends that the FRB have the ability to conduct limited examinations of any U.S. financial firm that meets a certain minimum size threshold and cannot otherwise be determined to be a Tier 1 FHC.

Justification of the FRB Role. As discussed above, the Proposal provides the FRB with broad authority to identify and oversee Tier 1 FHCs. Recognizing that many in Congress, including Senator Dodd, have questioned the ability and/or desirability of having the FRB serve in that role rather than a council of regulators (such as the Council, described above), the Proposal devotes considerable attention to explaining why “ultimate responsibility for prudential standard-setting and supervision for Tier 1 FHCs must rest with a single regulator.” The FRB was selected because it “has by far the most experience and resources to handle consolidated supervision and regulation of Tier 1 FHCs.” Moreover, the Proposal likely creates, and provides a coordinating role to, the Council to assuage Congressional critics of an “FRB-only” approach.

The Proposal calls for the FRB to fundamentally adjust its current holding company supervisory framework in order to effectively regulate Tier 1 FHCs. The FRB would need to expand its focus and regulations beyond the safety and soundness of banking subsidiaries to address the activities of the organization as whole and the risks the organization presents to the financial system. The Proposal asks that the FRB, in consultation with the Treasury, propose recommendations by October 1, 2009, to align its structure and governance with the authority contemplated by the Proposal.

Prudential Standards for Tier 1 FHCs. The Proposal demands heightened supervision and regulation of Tier 1 FHCs. The FRB would develop prudential standards for Tier 1 FHCs, in consultation with the Council. At a minimum, these standards would be equal to those necessary for a firm to maintain financial holding company status (which would be strengthened under the Proposal as discussed in Section I.C. below) and include heightened capital requirements, liquidity standards, risk management standards and public disclosures. Tier 1 FHCs that do not control a depository institution would be subject to all of the prudential regulations and guidance applicable to BHCs, including those requiring the separation from commercial activities. Those Tier 1 FHCs that were not previously subject to the Bank Holding Company Act of 1956, as amended (“BHC Act”), would have five years to conform to these activity restrictions. All Tier 1 FHCs would be subject to a prompt corrective action regime and would need to maintain a rapid resolution plan.

Consolidated Supervision. The Proposal would give the FRB the authority to supervise and examine a Tier 1 FHC and all of its subsidiaries, including those that have another primary regulator. The Proposal thus aims for a significant re-direction from the “functional regulation” at the heart of the GLBA. Under the Proposal, the supervision of Tier 1 FHCs would not focus solely on the safety and soundness of individual enterprises, but also on the impact of the failure of a Tier 1 FHC on the entire financial system. Accordingly, the Proposal would require each Tier 1 FHC to regularly report the nature and extent to which other major financial firms are exposed to it. The FRB would also be tasked with monitoring the concentration of risk with all Tier 1 FHCs as a group, even if no single institution appears to be at risk.

C. Strengthened Capital and Prudential Standards for Banks and Bank Holding Companies

Reviews of Current Regulatory Standards. The Proposal calls for the Treasury to establish a working group to review the capital requirements for banks and BHCs, including Tier 1 FHCs, and issue a report by December 31, 2009. This review would include changes to reduce procyclicality, a cost/benefit analysis of allowing banks and BHCs to issue contingent capital instruments to satisfy regulatory capital requirements (such as convertible debt triggered by economic circumstances), increases in regulatory capital requirements on investments and other high-risk exposures (including trading positions, equity investments, low-quality credit exposures, asset-backed securities, mortgage-backed securities, exposures to off-balance sheet exposures and OTC derivatives which are not centrally cleared), and more transparent measures of leverage. The Proposal does not discuss the affect of this proposal on the relatively recently completed Basel II capital rules (or proposed Basel IA). In addition to the working group that would review capital requirements, the Treasury would lead a separate working group that would conduct a fundamental reassessment of the supervision of banks and BHCs. This working group would issue a report by October 1, 2009 that would address key problems and gaps in the current regulatory framework.

Executive Compensation Reforms. The Administration has advocated executive compensation reforms and proposed new standards and guidelines intended to align executive compensation with long-term shareholder value and prohibit incentives for risk taking. For additional discussion of these executive compensation reforms, see the [June 16, 2009 Alert](#). The Proposal reiterates the call for such standards and also expresses support for “say on pay” legislation requiring non-binding shareholder resolutions on executive compensation.

Consolidated Capital and Management Requirements. Currently, subsidiary depository institutions of financial holding companies are required to be well-capitalized and well-managed in order for a holding company to maintain financial holding company status. The Proposal would extend these requirements to financial holding companies on a consolidated basis (current FRB regulations include the concept of a “well-capitalized” BHC, but do not mandate it for FHC status).

Review of Accounting Standards. The Proposal calls for the Financial Accounting Standards Board, International Accounting Standards Board and the SEC to review accounting standards and adopt more forward-looking loan loss provisioning practices. Such forward-looking practices would be designed to result in higher loan loss provisions earlier in the credit cycle and reduce procyclical tendencies. The Proposal also call for a review of fair value accounting rules to identify changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows that management expects to receive by holding investments.

Additional Affiliate Transaction Restrictions. The Proposal also would increase the existing affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act by placing more constraints on OTC derivatives and securities financing transactions with affiliates. Covered transactions would be required to be fully collateralized throughout the life of the transaction. Transactions between banks and private investment vehicles sponsored or advised by the banks would be considered covered transactions.

D. Creation of National Bank Supervisor, Elimination of the Thrift Charter and Bank Holding Company Act Revisions

Creation of the National Bank Supervisor. The Proposal also creates a new National Bank Supervisor (“NBS”). The NBS would have the sole authority with respect to federally chartered banks and would thereby assume the prudential supervision and regulation responsibilities currently held by the OCC and the OTS. The FRB and FDIC would retain their respective oversight of state member and non-member banks and the NCUA would continue to charter and supervise federal credit unions.

Elimination of the Thrift Charter. The Proposal eliminates the thrift charter. Citing the convergence of thrift and bank powers and changes in the markets for mortgage financing, the Proposal concludes that a strong rationale for the thrift charter no longer exists. Existing thrifts would be subject to “reasonable transition arrangements,” which could include conversion to a national or state bank charter.

The elimination of the thrift charter is also intended to reduce the risk of regulatory arbitrage. To this end, the Proposal calls for a reduction in the differences between the regulations applicable to federally- and state-chartered banks and for restrictions on the ability of a troubled bank to switch charters.

Interstate Branching. The Proposal disposes of the interstate branching framework of the Reigle-Neal Act by giving national and state-chartered banks the unrestricted ability to branch across state lines that is currently held only by federal thrifts. States would no longer be allowed to prevent *de novo* branching or impose a minimum age requirement for an in-state bank to be acquired by an out-of-state bank. The Proposal would, however, retain all consumer protection and deposit concentration caps related to interstate banking.

BHC Act Revisions. The BHC Act does not currently apply to companies which own certain types of depository institutions (thrifts, industrial loan companies, credit card banks, sole-purpose trust companies, and grandfathered “nonbank” banks). With the elimination of the thrift charter, all savings and loan holding companies would become BHCs subject to the BHC Act. The Proposal would amend the BHC Act to include holding companies of industrial loan companies, credit card banks, trust companies and grandfathered “nonbank” banks, thus effectively eliminating most of these institutions. However, when discussing trust companies the Proposal specifically refers to FDIC-insured depository institutions, which would suggest that holding companies of non-depository trust companies (at least state-chartered trust companies) would continue to fall outside the BHC Act.

E. Eliminate SEC’s Programs for Consolidated Supervision

The Proposal calls for the elimination of the SEC’s two supervision regimes for companies that own SEC-registered securities broker-dealers – the regime for consolidated supervised entities (“CSEs”) and the regime for supervised investment bank holding companies (“SIBHCs”). These regimes were established pursuant to a provision of the GLBA requiring consolidated supervision for investment bank holding companies. Most major stand-alone investment banks opted into either the CSE or SIBHC regime in order to demonstrate to European regulators that they were subject to consolidated supervision by a U.S. federal regulator (several large commercial banking organizations also opted in to either the CSE or SIBHC regime). The failure or acquisition of Bear Stearns, Lehman Brothers and Merrill Lynch last year, and the subsequent conversion of Goldman Sachs and

Morgan Stanley into BHCs, lead the SEC to abandon the voluntary CSE regime in the fall of 2008. Currently, only one entity is subject to supervision under the SIBHC regime. Accordingly, the Proposal recommends that the CSE and SIBHC regimes be eliminated and any investment banking firm seeking consolidated supervision by a U.S. regulator should be subject to comprehensive supervision and regulation by the FRB.

F. Require Registration of Advisers to, and Regulatory Reporting by, Private Pools of Capital Including Hedge Funds, Private Equity and Venture Capital Funds

Under the Proposal, all advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds (collectively, “private funds”), whose assets under management exceed “some modest threshold” would be required to register with the SEC under the Investment Advisers Act of 1940. “All investment funds advised by an SEC-registered investment adviser” would be subject to (a) recordkeeping requirements, (b) requirements regarding disclosures to investors, creditors and counterparties and (c) regulatory reporting requirements, with the SEC able to vary the particular requirements depending on the type of fund. Funds would be subject to regular, periodic examinations by the SEC to monitor compliance with these requirements. Regulatory reporting would be on a confidential basis and would encompass (1) assets under management, (2) borrowings, (3) off-balance sheet exposures, and (4) other information deemed necessary to assess whether a fund or group of related funds is so large, highly leveraged, or interconnected that it poses a threat to financial stability. The SEC would share fund regulatory reports with the Federal Reserve, which would determine whether a fund or fund group meets the Tier 1 FHC criteria, in which case it would be supervised and regulated as such (see Section I.B. above).

Separate from the Proposal, three bills already have been introduced in Congress to address the issue of hedge fund regulation – S. 344, which would effectively require any private fund with more than \$50 million to register with the SEC as an investment company; HR. 711, which like the Proposal seeks to register private fund advisers by eliminating the registration exemption for advisers that do not hold themselves out to the public as investment advisers and who have fewer than 15 clients (the “private adviser exemption”); and S.1276, which also seeks to register private fund advisers (by narrowing the private adviser exemption to apply only to non-U.S. advisers with less than \$25 million in assets) and enables the SEC to impose recordkeeping requirements on private funds similar to those contemplated by the Proposal. HR. 711 has received industry support from the Managed Funds Association and Alternative Investment Management Association. The Managed Funds Association has also expressed broad support for the Proposal and its private fund adviser registration and reporting component in particular, as has the Private Equity Council. The National Venture Capital Association has opposed the application of the private fund adviser registration and reporting element of the Proposal to venture capital firms because it believes they do not present significant risks to the financial system.

G. Money Market Fund Regulatory Reform

Citing the need to reduce the susceptibility of money market funds to “runs” by investors, the Proposal encourages the SEC to consider requiring all money market funds to: (a) maintain substantial liquidity buffers; (b) reduce the maximum weighted average maturity of their portfolios; (c) tighten their credit concentration limits; (d) improve their credit risk analysis and management of portfolio assets; and (e) empower their boards to suspend redemptions in extraordinary circumstances in order to protect the interests of fund

shareholders. The Proposal also asks the President's Working Group on Financial Markets to prepare a report by September 15, 2009 to consider changes that would more directly address the systemic risks posed by money market funds, such as whether money market funds should be (1) permitted to maintain a stable net asset value per share or (2) required to obtain access to reliable emergency liquidity facilities from private sources.

Most of those proposals generally are consistent with some of the recommendations made by the money market working group of the Investment Company Institute (the "ICI") (discussed in the [April 28, 2009 Alert](#)). The SEC's Chairman recently has hinted that the SEC staff is working on proposals similar to those put forth by the ICI. Neither the SEC nor the ICI, however, has proposed that money market funds no longer be permitted to maintain stable net asset values, a change likely to face stiff industry opposition.

The Proposal addresses unregulated unregistered and offshore funds that participate in the U.S. money markets in a very limited manner; it only directs the SEC to consider ways to mitigate the adverse effect of investor flight to unregulated or less regulated money market investment vehicles in response to increased registered money market fund regulation. Notably, the Proposal does not suggest, as the Group of 30 did in January 2009, that money market funds be required to reorganize as special purpose banks.

H. Creation of Office of National Insurance within Treasury

Significantly broadening the currently limited federal mandate with respect to insurance, the Proposal would establish the Office of National Insurance (the "ONI").

- The ONI would be responsible for monitoring all aspects of the insurance industry, in particular to identify emerging problems or gaps in regulation that could contribute to a future crisis and to identify to the Federal Reserve any insurance companies that should be considered for supervision as Tier 1 FHCs.
- The ONI would also carry out the federal government's current responsibilities under certain existing programs, such as the Terrorism Risk Insurance Act.
- On the international level, the ONI would be empowered to work with other nations and within the International Association of Insurance Supervisors (the "IAIS") to represent U.S. interests at the national level and would have the authority to enter into international agreements. The creation of the ONI would also address compliance with recent European Union legislation that will require a foreign insurance company operating in EU member states to be subject to supervision in the company's home country comparable to the supervision required in the EU.

Although the Proposal calls for increased national uniformity as one of its six principles of insurance regulation, it stops short of calling for an optional federal charter. Instead, the Proposal calls for increased uniformity through either "a federal charter or through effective action by the states." The Proposal notes that although some steps have been taken to increase uniformity, they have been insufficient.

Interested groups will continue to weigh in on the best way to achieve uniformity. For example, the American Council of Life Insurers issued a statement strongly supporting an optional federal charter as the only way to achieve the Treasury's objectives. The National

Association of Insurance Commissioners issued a statement commending the President and the Treasury for proposing a plan that preserves the role of states as regulators of insurance.

The Proposal identifies the following additional principles that would guide the Treasury's approach to insurance regulation:

- Effective regulation of the systemic risks posed to the financial system by the insurance industry
- Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies (including the management of liquidity and duration risk)
- Meaningful and consistent consumer protection for insurance products and practices (citing a wide variance in the protections currently provided by the states)
- Improvement in, and broadening of, the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business
- International coordination

I. Future of Government Sponsored Enterprises

The Proposal includes an initiative to develop recommendations on the future of Fannie Mae and Freddie Mac. The Treasury and the Department of Housing and Urban Development ("HUD") are called on to solicit input from other government agencies and the public on possible options. Options range from conducting business as usual to eliminating Fannie Mae and Freddie Mac altogether. Options specifically mentioned in the Proposal include: (1) returning both entities to their previous status of pursuing the paired interests of maximizing shareholder returns and promoting home ownership; (2) winding down the entities' operations and liquidating assets; (3) incorporating Fannie Mae's and Freddie Mac's functions into a federal agency; (4) transitioning their operating model to a "public utility model" where the government regulates the entities' profit margin and fee structure, and backs their commitments; or (5) splitting Fannie Mae and Freddie Mac into many smaller companies. The Treasury and HUD will report back to Congress on viable options at the time the President's 2011 budget is released.

J. Some Initial Reactions

Almost every element of Section I of the Proposal received both favorable and unfavorable reactions and comments. One aspect that raised a great deal of concern from Congressmen and others was the dramatically increased authority that would be granted to the FRB under the Proposal. Some stated that the performance of the FRB over the past few years did not warrant the grant of a broadened regulatory role. In addition, FDIC Chairman Sheila Bair stated that having the FRB handle monetary policy while regulating systemic risk could lead to situations in which there were significant conflicts of interest. In response, the FRB and others noted that, under the Proposal, the FRB would not only be gaining authority, it would be ceding its authority to regulate BHCs' and banks' consumer products and services. Moreover, some commentators argued that the Council should be able to do more than merely advise the FRB of its views. Others question whether the Proposal, and

specifically the increased role of Treasury, have the undesirable consequence of weakening the independence of the FRB.

A number of Congressmen and others stated that even if the OTS is mingled into another regulatory agency, there may be merit in preserving the thrift charter. In addition, there was a mixed reaction to the Proposal's failure to reduce the total number of federal banking agencies. Furthermore, there appeared to be a general recognition that the Proposal's increased capital requirements and heightened level of regulation would tend to reduce profitability in the banking industry.

II. Comprehensive Regulation of Financial Markets

A. Securitization Market Reforms

Risk retention by loan originators/ABS sponsors. In order to provide sufficient incentives for lenders and sponsors of asset backed securities ("ABS") to consider the performance of the underlying loans after ABS are issued, the Proposal calls on federal banking agencies to promulgate regulations that would require loan originators or sponsors of ABS to retain 5% of the credit risk of the underlying instruments and prohibit originators from directly or indirectly hedging or otherwise transferring the required risk retention. The federal banking agencies should have the ability to specify the permissible forms of required risk retention (e.g., first loss position or pro rata vertical slice) and the minimum duration of the required risk retention, as well as the ability to grant exceptions or adjustments to those requirements.

Aligning compensation of ABS market participants with underlying loans' longer term performance. The Proposal urges measures to link the compensation of market participants to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products. Appropriate measures cited in the proposal include:

- Accounting changes already under consideration that would require originators to recognize income over time in lieu of an immediate recognition of gain at the inception of a securitization transaction, which would also have the effect of requiring many securitizations to be consolidated on the originator's balance sheet and their asset performance to be reflected in the originator's consolidated financial statements.
- Requiring that the fees and commissions received by loan brokers and loan officers be disbursed over time and reduced in the event of underwriting or asset quality problems.
- Requiring sponsors of securitizations to make standardized representations and warranties regarding the risk associated with the origination and underwriting practices for the securitized loans underlying ABS.

Increased transparency and standardization of ABS markets and more robust reporting by ABS issuers. Under the Proposal, the SEC would increase the reporting requirements applicable to ABS issuers to expand the availability to investors and credit rating agencies of information that would enable them to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of ABS. Specifically, the Proposal would require disclosure of loan-level data (broken down by loan broker or originator) and the nature and extent of broker, originator and sponsor

compensation and risk retention for each securitization. The Proposal also urges standardization of legal documentation for securitization transactions, which should include uniform rules for servicers to modify home mortgage loans under appropriate circumstances, if such modifications would benefit the securitization trust as a whole. Trade reporting for ABS should be added to FINRA's TRACE reporting system for corporate bond transactions.

Additional regulation of credit rating agencies. The Proposal urges the SEC to adopt additional regulations applicable to credit rating agencies to require (1)(a) better management and disclosure of conflicts of interest, (b) better differentiation of ratings applied to structured debt from those applied to unstructured debt, (c) disclosure of credit rating performance measures and the types of risk credit ratings they are designed to assess, and (d) disclosure of methodologies used to assign ratings to structured debt, and (2) reporting by credit rating agencies of any unpublished rating agency data and methodologies to the SEC. The SEC has already undertaken rulemaking initiatives with respect to credit rating agencies that address some of the Proposal's recommendations in this area (as discussed in the [December 9, 2008 Alert](#)).

Reducing reliance on credit ratings in regulations and supervisory practices. Consistent with its recommendations with respect to other aspects of aspects of the securitized products markets, the Proposal would have regulators modify regulations and supervisory practices to better recognize the potential differences in performance between structured and unstructured credit products with the same credit rating, particularly in risk-based regulatory capital requirements. In this regard, the Proposal urges attention to the concentrated systematic risk of senior tranches and re-securitizations and the risk of exposures held in highly leveraged off-balance sheet vehicles, and calls for regulatory capital requirements to minimize opportunities for firms to use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk.

B. Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (CDS)

The Proposal advocates comprehensive regulation of the OTC derivatives markets, including CDS markets, to achieve the following four objectives: (1) containing the systemic risk posed by those markets; (2) promoting their efficiency and transparency; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Containing systemic risk. Under the Proposal, the Commodities Exchange Act (the "CEA") and the securities laws would be amended to require clearing of all standardized OTC derivatives through regulated central counterparties ("CCPs"). CCPs would be required to impose robust margin requirements and other risk controls. Mechanisms would be implemented to ensure that customized OTC derivatives cannot be used solely as a means to avoid using a CCP, for example, by creating a presumption that an OTC derivative accepted for clearing by one or more fully regulated CCPs is a standardized contract that must be cleared. OTC derivatives dealers and other firms whose activities in the OTC derivatives markets create large exposures to counterparties should be subject to conservative capital requirements (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, conservative requirements relating to initial margins on counterparty credit exposures and prohibitions addressing unacceptable counterparty risks associated with

customized bilateral OTC derivatives transactions. As noted elsewhere in the Proposal, part of this regulatory regime would include increasing regulatory capital requirements for all banks and BHCs on OTC derivatives that are not centrally cleared.

Transparency and efficiency. The Proposal would increase the transparency of the OTC derivatives markets by amending the CEA and the securities laws to authorize the CFTC and the SEC to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Proposed changes would also include public reporting of aggregate data on open positions and trading volumes and the availability of data on any individual counterparty's trades and positions on a confidential basis to the CFTC, SEC and the institution's primary regulators. The trading of standardized OTC derivatives would be moved onto regulated exchanges where they would be subject to regulated transparent electronic trade execution systems and timely reporting of trades and prompt dissemination of prices and other trade information. Regulated financial institutions would be encouraged to make greater use of regulated exchange-traded derivatives.

Market integrity. Under the Proposal, the CEA and the securities laws would be amended to ensure that the CFTC and the SEC, consistent with their respective missions, have clear, unimpeded authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives. The CFTC would also have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

Protecting unsophisticated parties. Upon completion of reviews currently being conducted by the CFTC and SEC regarding participation limits, the Proposal recommends that the CEA and the securities laws be amended to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties such as small municipalities.

C. Harmonization of Futures and Securities Regulation

The Proposal focuses principally on achieving consistent regulatory treatment of economically equivalent instruments regardless of whether they are subject to SEC, CFTC or combined jurisdiction. Unlike many prior recommendations for regulatory reform, the Proposal does not call for the consolidation of the SEC and the CFTC. The proposed harmonization instead would include an agreement by the SEC and the CFTC on precise core principles of regulation. Consistent procedures would be developed for reviewing and approving proposals for new products and rulemaking proposals by self-regulatory organizations.

The Proposal recommends that the SEC and CFTC complete a report to Congress, by September 30, 2009, that (1) identifies all existing conflicts in statutes and regulations related to similar types of financial instruments and (2) provides either proposed changes to reconcile the differences or explanations justifying them. If the SEC and CFTC do not reach agreement by September 30, 2009, the Proposal calls for the Council (described in Section I.A., above) to address the differences and make recommendations within six months of its formation.

D. Oversight and Functioning of Systemically Important Payment, Clearing, and Settlement Systems and Activities

The Proposal identifies the strength of the systems for settling payment obligations and financial transactions among institutions as a key determinant of the risks posed by the interconnectedness of financial institutions. According to the Proposal, where such systems are weak, they can spread financial contagion. For this reason, the Proposal seeks to strengthen oversight of systematically important payment, clearing, and settlement systems (“covered systems”) and systematically important payment, clearing, and settlement activities of financial firms (“covered activities”).

The Proposal would give the FRB authority to identify covered systems and covered activities and to establish risk-management standards for their operations. The FRB also would possess authority to collect information from any payment, clearing, or settlement system or financial firm engaged in payment, clearing, or settlement activity for the purpose of assessing their systematic importance.

Systematically important systems would be subject to “rigorous on-site safety and soundness” examinations and prior reviews of changes to their rules and operations. Such reviews would be conducted by a principal market regulator (*e.g.*, the CFTC or SEC), if one exists, but the FRB would have the right to participate in the exams. The FRB also would have enforcement authority and the right to receive reports from systematically important systems. In instances where there is a principal market regulator, the FRB’s enforcement authority and power to require reports would be shared with that regulator, but the FRB would have the reserve authority to take actions if it disagrees with the positions of the principal market regulator.

The FRB would be granted similar authority over covered activities at financial firms. Compliance with standards for covered activities would be enforced by the firm’s primary federal regulator (if applicable) with the FRB having back-up examination and enforcement authority. The FRB would be able to require reports on the conduct of covered activities from firms engaging in such activities.

E. Settlement Capabilities and Liquidity Resources of Systemically Important Payment, Clearing, and Settlement Systems

In addition to the enhanced oversight of covered systems discussed in Section II.D. above, the Proposal would grant covered systems access to the discount window and FRB accounts and financial services. Access to the discount window would be reserved for emergency purposes, to prevent liquidity crises.

F. Some Initial Reactions

Both Congressmen and other commentators have been supportive of the Proposal’s focus on increased regulation of derivatives transactions; however, a number of commentators have stressed that it is the “customized” derivatives and not the plain vanilla derivatives that damaged the financial system and that, under the Proposal, it will be only the plain vanilla derivatives that will be required to be traded on an exchange.

III. Consumer Protection

The Proposal calls for a comprehensive reform of the consumer protection supervisory framework for financial products. Citing the fragmented structure of multiple supervisory agencies, the Proposal asserts that the current consumer protection framework has significant gaps and weaknesses. These gaps and weaknesses are blamed for allowing companies outside of the purview of bank regulation to create overly complicated products, such as certain types of subprime and non-traditional mortgages, unsuited to consumers' needs. This created a competitive environment where banks and thrifts followed suit in offering non-traditional consumer financial products, leading to the widespread availability of abusive products. The Proposal claims that the mission of federal and state bank regulators to promote safety and soundness potentially conflicts with consumer protection goals. In response, the Proposal calls for the creation of a single regulatory agency focused on consumer protection in the market for financial products and services, the Consumer Financial Protection Agency ("CFPA"). It also proposes legislative, regulatory and administrative reforms to promote transparency, simplicity, fairness, accountability and access in the market for consumer financial products and services. The Proposal further asserts that those agencies dedicated to consumer protection had limited jurisdiction or tools to address abuses in consumer financial products. To address this, the Proposal calls for new authorities and resources for the Federal Trade Commission ("FTC") and the SEC.

A. Creation of the Consumer Financial Protection Agency

The Proposal would create the CFPA, which would have consolidated authority over consumer financial products and services and the providers of such products and services. Investment products and services would continue to be regulated by the SEC or the CFTC.

CFPA Structure. The Proposal envisions the CFPA as an independent agency with a Director and a Board. The five-member CFPA Board would include a diverse set of members, including at least one seat reserved for the head of a prudential regulator. The Proposal anticipates combining the consumer compliance staff from each of the federal banking agencies to create the CFPA. Funding for the CFPA could come in part from fees assessed on transactions and entities, including banks and other providers of covered products and services.

CFPA Jurisdiction and Mission. The proposed jurisdiction of the CFPA would cover consumer financial products and services, such as credit, savings and payment products and services. The proposed jurisdiction would also cover all institutions that provide such products or services, including entities that provide services to providers of consumer financial products. In certain circumstances the Proposal refers to the CFPA having jurisdiction over federally supervised institutions. It is important to note that if Congress enacts the Proposal in its current form, all providers of consumer financial products subject to the CFPA's regulations would be federally supervised.

The Proposal states that the mission of the CFPA would be to ensure that:

- Consumers have the information they need to make responsible financial decisions;
- Consumers are protected from abusive, discriminatory or unfair and deceptive acts or practices;

- Consumer financial services markets operate fairly and efficiently with ample room for sustainable growth and innovation; and
- Traditionally underserved consumers and communities have access to lending, investment and financial services.

Under the Proposal, the relationship between the CFPA and the institutions it regulates would be more adversarial than the current relationship between financial institutions and their regulators. Furthermore, it appears that the CFPA could adopt a relatively adversarial posture toward the prudential regulators.

CFPA Rulemaking Authority. The Proposal would give the CFPA sole rulemaking authority under existing consumer financial protection statutes, such as the Truth in Lending Act (“TILA”), Home Ownership and Equity Protection Act, Real Estate Settlement and Procedures Act, Community Reinvestment Act (“CRA”), Equal Credit Opportunity Act, Home Mortgage Disclosure Act (“HMDA”) and the Fair Debt Collection Practices Act. Under the Proposal, the CFPA would also have rulemaking authority under any future consumer protection law addressing consumer credit, savings, collection or payment products and services, along with the authority to adopt its own rules to address abusive or unfair and deceptive acts or practices.

The Proposal would require the CFPA to consult with other federal regulators when proposing rules and to consider the cost of such rules, including any reduction in consumers’ access to financial services. The Proposal contemplates that the CFPA would not limit private rights of action and that in some cases the Administration could seek legislation to increase statutory damages. The Proposal calls for the CFPA to complete a regulatory study of each newly-adopted regulation at least every three years after its effective date.

CFPA Supervisory and Enforcement Authority. The Proposal calls for the CFPA to have supervisory, examination and enforcement authority over all entities subject to its regulations, including regulations implementing consumer protection, fair lending and community reinvestment laws, as well as to entities subject to selected statutes for which existing rulemaking authority does not exist or is limited (such as the Fair Housing Act to the extent it covers mortgages, the Credit Repair Organization Act, the Fair Debt Collection Practices Act and provisions of the Fair Credit Reporting Act). The CFPA would assume from the federal banking agencies all responsibility for supervising banking organizations for compliance with consumer regulation. This would include both federally- and state-chartered institutions and bank affiliates that are not currently supervised by the federal banking agencies. The Proposal would require the CFPA to notify prudential regulators of major matters and to share confidential examination reports with them. The Proposal also would require the federal banking agencies to refer potential compliance matters to the CFPA. The federal banking agencies and state supervisors of state-chartered institutions would still be authorized to take action if the CFPA fails to act. The Proposal recommends that the CFPA maintain a special group of examiners to evaluate CRA compliance.

The CFPA would also have full supervisory and enforcement power over nonbanking institutions, including the ability to intervene in an action by a state enforcement agency for a violation of a CFPA regulation. The Proposal envisions that the CFPA would work closely with the Department of Justice, which would have independent authority to enforce violations of the statutes administered by the CFPA.

CFPA Coordination with State Laws and Enforcement. The Proposal would retain the ability of states to adopt stricter consumer protection and fair lending laws, as long as they do not conflict with federal law. Rules promulgated by the CFPA would override weaker state laws. The Proposal calls for the CFPA to coordinate state supervisory and enforcement efforts to provide for greater consistency.

Preemption. In a radical departure from the current framework of federal bank charter preemption of state laws, the Proposal recommends that federally-chartered institutions be subject to nondiscriminatory state consumer protection and civil rights laws to the same extent as other financial institutions. States would have the ability to enforce these state laws against federally-chartered institutions as well as state-chartered institutions. Furthermore, states would have the ability to enforce the regulations of the CFPA against federally-chartered institutions. These proposals would create many enforcers for the CFPA's regulations and subject all institutions to a potential patchwork of more restrictive state laws and enforcement regimes.

Consumer Advisory Council. The Proposal recommends the establishment of a Consumer Advisory Council, similar to the FRB's Consumer Advisory Council, to promote the CFPA's accountability and provide information on emerging industry practices. The CFPA would work with other regulatory agencies through the Consumer Advisory Council to coordinate consistent treatment of similar financial products.

CFPA Registration and Licensing Authority. The Proposal calls for the CFPA to administer the SAFE Act, under which any institution that originates residential mortgage must register with a national database. The Proposal also states that the CFPA should be specifically authorized to set higher minimum net worth requirements for mortgage originators. The Proposal further states that the CFPA should be authorized to establish or facilitate the registration and licensing of financial service providers and intermediaries such as debt collectors, debt counselors or mortgage modification organizations.

Other CFPA Functions. Under the Proposal, the CFPA would have the authority to collect information through the supervisory process and through specific data collection statutes, such as HMDA. The CFPA would also be responsible for collecting and tracking complaints about consumer financial services and would facilitate compliant resolution for banking institutions. The other federal supervisory agencies would be required to refer complaints on consumer issues to the CFPA. The Proposal suggests that the CFPA should play a leading role in financial education and community affairs.

Mandatory Arbitration Clauses. The Proposal calls for the CFPA to study mandatory arbitration clauses in consumer financial products and services to determine whether such clauses are fair to the consumer. If the CFPA determines they are not, it would be required to establish conditions for fair arbitration or ban mandatory arbitration clauses in certain contexts, such as mortgage loans.

The CFPA's Relationship with the FTC. While the FTC's primary authority for financial product and services protection would be transferred to the CFPA, the Proposal would allow the FTC to retain backup authority for the statutes as to which it currently has jurisdiction. The Proposal also recommends that the FTC retain its authority to deal with fraud in the financial marketplace, which it would share with the CFPA. The Proposal further states that the FTC should remain the lead federal consumer protection agency for data security, but that "front-end" privacy protection on financial issues should be under the

jurisdiction of the CFPA. Though not defined in the Proposal, presumably the “front-end” privacy protection under the jurisdiction of the CFPA would be consumer-facing privacy protections, such as regulating privacy policy disclosures. The proposed retention of significant consumer protection authority by the FTC is seemingly inconsistent with one of the major goals of the Proposal: to create “a single regulatory agency.”

B. Consumer Protection Reforms

The Proposal contains a series of recommendations for legislation, regulations and administrative measures by the CFPA to reform consumer protection based on principles of transparency, simplicity, fairness, accountability and access.

Disclosure Standards. Under the Proposal, the CFPA would be authorized to require that all disclosures and other communications with consumers be reasonable, balanced in their presentation of benefits and clear and conspicuous in their identification of costs, penalties and risks. The Proposal calls for all mandatory disclosure forms to be clear, simple and concise. The CFPA would make judgments about which risks and costs should be highlighted. The Proposal recommends that the CFPA establish standards and procedures for testing disclosures (including immunity from liability) for providers of consumer financial products and services. The Proposal suggests that the CFPA might consider imposing a duty on consumer financial product providers and intermediaries to have reasonable communications with consumers. Under the Proposal, a reasonable communication would balance the presentation of risks and benefits and have a clear and conspicuous description of significant product costs and risks. This standard would apply to communications with customers, marketing materials and mandatory disclosures. The CFPA would be authorized to implement a process under which a provider of consumer financial products and services could obtain the equivalent of a “no-action” letter for disclosures and other communications regarding new products. The Proposal suggests that consumer financial product providers and intermediaries be subject only to administrative action, rather than civil liability, for violations of this duty. Finally, the Proposal recommends utilizing technology to improve disclosures, such as requiring internet calculators to compare the overall cost of a mortgage and a warning at ATMs and point-of-sale terminals that informs customers that the transaction will result in an overdraft.

Simplicity - “plain vanilla products”. The Proposal recommends that the CFPA be authorized to define standards for “plain vanilla” products, such as standardized fixed term mortgages without prepayment penalties, and require financial institutions to offer such plain vanilla products alongside the institution’s other products. The Proposal further recommends that the CFPA assume responsibility for the FRB regulations that impose extra protections and higher penalties on alternative or higher cost loans. The CFPA would be authorized to add other mortgage types to the class of products that receive additional scrutiny, leaving only products which meet the plain vanilla standards in the less scrutinized class. The Proposal suggests that the CFPA could impose a strong warning label on alternative products, require applicants to fill out a financial experience questionnaire or require providers to obtain a written opt out to plain vanilla products. Originators and purchasers of plain vanilla products would enjoy a strong presumption that the products were suitable and affordable for the borrower.

Fairness. As discussed above, the CFPA would have the authority to regulate unfair and deceptive acts or practices for all credit, savings, and payment products. The Proposal also calls for the CFPA to have the authority to address overly complex financial contracts.

Under this authority, the CFPA could determine to ban certain practices such as prepayment penalties for certain types of contracts or side payments to mortgage originators, including yield spread premiums, if disclosures were found to be an inadequate protection. The CFPA could also adopt a “life of loan” approach to requirement consumer protections through the servicing and loss mitigation stages of the loan. Additionally, the Proposal suggests that the CFPA could consider requiring that mortgage originators receive a portion of their compensation over time, contingent on loan performance, rather than in a lump sum at the time of origination. The Proposal further recommends granting the CFPA the authority to impose duties of care on financial intermediaries. Examples of such duties in the Proposal include imposing a duty of best execution on mortgage brokers with respect to available mortgage loans. The Proposal also calls for the CFPA to apply consistent regulation to similar products, taking into consideration consumer perceptions of such products. As an example, the Proposal states that the CFPA would be authorized to regulate overdraft protection more like a credit product, including requiring TILA disclosures, an opt-in to the plan or affirmative consent to overdraft fees at the point-of-sale terminal or ATM.

Access – CRA administration. The Proposal states that a critical part of the CFPA’s mission would be to promote access to financial services, especially households and communities that traditionally have had limited access. Accordingly, a core function of the CFPA would be administering the CRA, and the Proposal recommends that the CFPA should have sole authority to evaluate financial institutions for CRA compliance. This includes allowing the CFPA to determine whether a financial institution had a record of meeting the lending, investment and services needs of its community under the CRA in connection with the approval of a merger application by the institution’s prudential supervisor. The Proposal calls for the CFPA to maintain a fair lending unit with primary enforcement power over federally-supervised institutions and concurrent authority with the states over other institutions. The Proposal also calls for the CFPA to have the authority to collect data on mortgage and small business lending, including expanding the required data to be reported under HMDA.

C. Strengthen Investor Protection

The Proposal contains several measures intended to strengthen the investor protection framework by focusing on transparency, fairness and accountability. The Proposal also calls for “say on pay” rules, the establishment of a Financial Consumer Coordinating Council, and strengthening employment-based and private retirement plans.

Transparency – point of sale disclosure. The Proposal recommends that the SEC be authorized to require that certain disclosures, including the recently adopted mutual fund summary prospectus, be provided to investors at or before the point of sale, if the SEC finds that such disclosures would improve investor understanding of the financial product. The Proposal calls for the SEC to require adequate information be given to investors without slowing the pace of transactions. The Proposal also calls for the SEC to receive budgetary support to engage in consumer testing of investor disclosures.

Fairness – investor relationships with investment professionals. The Proposal has several initiatives for the SEC to increase fairness for investors. It proposes establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers. The Proposal recommends that the standard of care for broker-dealers offering investment advice to retail investors should be the same

fiduciary standard that applies to registered investment advisers. It further recommends that investors should be provided with simple and clear disclosures detailing the terms of their relationships with investment professionals. The Proposal calls for the SEC to examine and ban certain conflicts of interest and sales practices that are contrary to the interest of investors, such as forms of compensation that encourage intermediaries to sell investors products that are profitable for the intermediary but are not in the investor's best interest. Finally, the Proposal recommends that the SEC be given the authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. Prior to exercising that authority, the SEC would have to conduct a study on whether mandatory arbitration negatively affects the resolution of legitimate investor grievances and whether arbitration should be modified.

Accountability – whistleblowers, collateral bars and single primary liability standard. The Proposal recommends that the SEC establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. The Proposal also calls for expanded SEC authority to impose collateral bars against regulated persons across all aspects of the securities industry. The Proposal supports the SEC's efforts to have the federal securities laws amended to provide a single explicit standard for primary liability in lieu of the various standards that have been created by the federal courts of appeal.

Say on Pay. The Proposal recommends that all public companies should be required to implement non-binding shareholder votes on executive compensation.

Financial Consumer Coordinating Council. The Proposal suggests establishing a Financial Consumer Coordinating Council under the leadership of the Financial Services Oversight Council. The Financial Consumer Coordinating Council would consist of the heads of the SEC, FTC, Department of Justice, CFPB and other state and federal agencies. It would meet quarterly to identify gaps in consumer protection across financial products and facilitate coordination of consumer protection efforts.

SEC Investor Advisory Committee. The Proposal recommends that the recently created Investor Advisory Committee, which advises the SEC on investor perspectives regarding the securities markets and regulatory issues, should be made permanent by statute.

Employment-Based and Private Retirement Plans. The Proposal notes that the 2010 budget contains two proposals to encourage retirement savings: (i) introducing the "Automatic IRA" for employees whose employers do not offer a retirement plan and (ii) making the saver's credit refundable for families earning less than \$65,000. Under the Automatic IRA plan, employers in business for at least two years that have 10 or more employees would be required to offer an automatic IRA option (with opt out), under which regular payroll-deduction contributions would be made to an IRA. Employers would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. The modified saver's credit for families earning less than \$65,000 would be fully refundable and deposited automatically in the individual's qualified retirement plan account or IRA. The Proposal also states that employee-directed workplace retirement plans (such as 401(k)s) and Automatic IRAs should be governed by the principles of transparency, simplicity, fairness and accessibility.

D. Some Initial Reactions

Part III of the Proposal has prompted comments concerning the costs to banks and the impact on their operation of being subject to examination by yet another regulatory agency, the CFPB. Some commentators felt it is potentially troubling to separate the regulation of the bank as an entity from the regulation of the bank's products. Another topic that generated significant comment was the impact of the Proposal on preemption. Some argued that the Proposal's suggestion that states be allowed to enforce state statutes that go beyond a federal standard could cause financial institutions to be subject to differing standards on some issues in each of the 50 states.

IV. Resolution Authority

A. "Too Big to Fail" and Related Issues

The Proposal cites gaps in the legal framework governing insolvency of financial institutions and the absence of authority for the federal government to provide assistance to failing nonbank firms as a source of risk to the financial system, and it cites the bankruptcy of Lehman Brothers and its aftermath as an example of the consequences to the financial system and broader economy of disorderly failure. To mitigate this risk, the Proposal recommends creation of a resolution regime that would apply to failure of a bank holding company that would present a risk to financial stability and any financial firm (whether or not a bank holding company) whose size, leverage and interconnectedness to other firms and the broader economy would present a threat to financial stability if it were to fail, a Tier 1 FHC as discussed in Section I above. However, the Proposal is careful to point out that this regime would not replace bankruptcy procedures in the normal course of business and that bankruptcy would remain the dominant tool for resolving a failed bank holding company. The special resolution regime described in the Proposal closely follows the proposal outlined in draft legislation that the Treasury released in March 2009.

The proposed resolution regime for BHCs would be modeled on the "systemic risk exception" set forth at section 13(c)(4)(G) of the Federal Deposit Insurance Act, pursuant to which the FDIC may avoid resolving a failed depository institution in the manner that is least costly to the deposit insurance fund if it determines that compliance with this requirement would have serious adverse effects on economic conditions or financial stability and that FDIC action would avoid or mitigate such adverse effects.

Under the Proposal, the resolution regime for BHCs and Tier 1 FHCs that pose a systemic risk would only be invoked in extraordinary circumstances and would be subject to a number of checks and balances. Specifically, the authority to decide whether to invoke this regime would be vested in the Treasury, which could utilize the regime only after consulting with the President and only upon the recommendation of two-thirds of the members of the FRB and two-thirds of the members of the FDIC board of directors. If the largest subsidiary of the failing firm is a broker-dealer, then FDIC approval would not be required, but approval of two-thirds of the SEC Commissioners would be required instead. Similarly, if the failing firm operates an insurance company, the proposed Office of National Insurance (discussed in Section I.H. above) to be created within the Treasury would be consulted. To invoke the resolution regime, the Proposal suggests that the Treasury would need to determine that (1) a firm is in default or in danger of defaulting; (2) the failure of the firm and its resolution under otherwise applicable law would have

serious adverse effects on the financial system or economy; and (3) use by the government of the special resolution regime would avoid or mitigate these adverse effects.

Under the Proposal, the Treasury would have authority to decide how to resolve a failing firm, and the Proposal describes the tools that the Treasury would have at its disposal. These tools include the ability to appoint a conservator or receiver, the ability to provide loans to the failing firm or purchase assets from the failing firm, the power to guarantee liabilities of the firm and to make equity investments in the firm. The Proposal indicates that the Treasury should generally appoint the FDIC as receiver or conservator for a failing firm, presumably because of the FDIC's historic expertise in managing resolutions of depository institutions. The Proposal suggests that a receiver or conservator should have at its disposal certain powers similar to the so-called "super powers" that the FDIC currently possesses in its role as receiver or conservator for a failed depository institution, including authority to transfer derivatives contracts (and thereby avoid termination of such contracts by counterparties notwithstanding any contractual termination rights), power to sell or transfer any part of the assets of the failing firm to a bridge institution or other entity, and the ability to repudiate or renegotiate contracts, including contracts with employees. The entity acting as conservator or receiver should be authorized to borrow from the Treasury when necessary to finance the exercise of its authority. Presumably, these authorities are meant in part to respond to assertions by government officials following the bankruptcy of Lehman Brothers that the government lacked legal authority to save Lehman Brothers, confusion among counterparties of Lehman Brothers following the bankruptcy and the need for the government to provide assistance to large counterparties of Lehman Brothers and AIG to avoid further failures, and the furor surrounding the payment of bonuses earlier this year to certain employees of AIG.

B. Amend the FRB's Emergency Lending Authority

Section 13(3) of the Federal Reserve Act ("Section 13(3)") provides that in "unusual and exigent circumstances" the FRB, upon a vote of five or more members, may authorize a Federal Reserve Bank to lend to any individual, partnership or corporation. The only constraints on such lending are that any such loans must be guaranteed or secured to the satisfaction of the Reserve Bank making the loan and that the Reserve Bank obtain evidence that the borrower is unable to obtain "adequate credit accommodations" from banks. The FRB has used its lending powers under Section 13(3) on more than one occasion in the face of the financial crisis, including to establish the TALF and other liquidity facilities and to provide support to AIG. The Proposal states that the Administration will propose legislation requiring the FRB to obtain the prior written approval of the Treasury Secretary for any lending under Section 13(3).

C. Some Initial Reactions

Much of the focus of public comment on Section IV of the Proposal has been on the fact that the Proposal does not propose to eliminate the concept that certain financial institutions are too large or too central to our economy to allow them to fail. Rather, the Proposal seeks to address the issue by identifying institutions that are "too big to fail" and enhancing regulatory oversight of such companies. Some commentators have urged that the Administration create a system in which financial institutions would be prevented from growing to the size or complexity where their size would pose a threat to the financial system.

V. International Regulatory Standards and Cooperation

One of the five principal objectives of Treasury's Proposal is to improve international regulatory standards and cooperation. This focus on international coordination is entirely consistent with past pronouncements – not only by the Administration, but also by many foreign and international bodies – on the need for a globally consistent supervisory and regulatory framework. We covered this development at length in the [April 7, 2009 Alert](#). The Proposal suggests that international consistency is necessary to avoid a “race to the bottom,” in which financial industry participants move activities to where they will face the lowest regulatory requirements, and to address adequately systemic risks that are cross-border in scope.

A. Four “Core” Issues

The Proposal states that, to achieve its international coordination objectives, the United States should focus on four “core” issues: (i) regulatory capital standards; (ii) oversight of global financial markets; (iii) supervision of internationally active financial firms; and (iv) crisis prevention and management. Neither the four issue areas that the Proposal identifies, nor the topics discussed within each issue, breaks new ground. The Proposal suggests no new international approaches but, instead, generally supports initiatives already announced elsewhere, such as the London G-20 Leaders' Summit.

As to capital, the Proposal recommends revisions to the Basel II capital framework and supports efforts already being undertaken by the Basel Committee to strengthen capital standards. Among other things, the Proposal supports ongoing efforts to improve the quality, quantity, and international consistency of capital. The Proposal also recommends that the Basel Committee adopt a simple, transparent, non-risk based, leverage test, and urges implementation of capital and accounting standards that mitigate pro-cyclicality issues.

The Proposal also urges improved oversight of OTC derivatives markets through, among other things, the use of central counterparties. As discussed in Section II.B., the Proposal recommends comprehensive regulation of U.S. OTC derivatives markets, including increased transparency, reporting, and recordkeeping; the Proposal suggests that the United States should work with international counterparts to raise standards worldwide.

With respect to internationally active firms, the Proposal suggests nothing more than strengthening arrangements for international cooperation, such as through a “college of supervisors” approach. To this end, the Proposal notes with approval that, following the April 2009 London G-20 Leaders' Summit, supervisory colleges have been established for the 30 most significant global financial institutions and that each of those colleges has met once.

Regarding the final “core” issue, the Proposal echoes past calls for the development of international mechanisms for the cross-border resolution of global financial firms. More specifically, the Proposal calls on creating flexible powers for resolution authorities (so that systemically significant functions may continue even in a case of insolvency), furthering cross-border information sharing, and increasing the effectiveness of crisis management and resolutions in cases of cross-border failures.

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B. Expanding Other Regulatory Frameworks

Beyond the four “core” issues, the Proposal proposes various stricter regimes for supervision and regulation of various types of internationally based entities. The Proposal recommends that the Financial Stability Board complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009. Additionally, the Proposal seeks to promote stronger international standards in a number of areas, such as liquidity risk management, executive compensation, anti-money laundering controls, accounting and the oversight of credit rating agencies.

To begin with, the Proposal calls on the FRB, in consultation with the Treasury, to adopt rules for determining whether a foreign financial institution should be considered a Tier 1 FHC. According to the Proposal, the FRB’s evaluation would be similar to what it uses for U.S. firms. The FRB also would have discretion to make the necessary determination based on the potential threat to financial stability posed by the U.S. operations of the foreign financial institution and/or its world-wide operations. The proposal does not call on the FRB to consult with foreign authorities in its determination, which perhaps is at odds with the Proposal’s “core” goal of strengthening international cooperation. As a practical matter, however, the FRB could confer with foreign regulatory authorities as part of its evaluation process.

The Proposal also calls on national authorities to regulate hedge funds and their managers. More specifically, such funds and managers would be required to register and submit information to regulators. Information disclosures would be focused on assessing systemic risks posed by individual funds and by hedge funds collectively.

The Proposal further seeks enhancements in regulatory standards that govern such topics as money laundering/terrorist financing and tax-information exchange. In addition, the Proposal recommends various changes to international accounting standards, such as those that govern loan loss provisioning and fair value accounting standards. Finally, the Proposal reiterates calls to develop a single set of high-quality globally applied accounting standards.

In sum, the international elements of the Proposal are expansive in scope but not groundbreaking. Many of these international elements already are being pursued by other bodies and in other fora; some of the proposed changes will require U.S. legislation, and the full contours of these revisions will only be known after a careful review of legislative language.

Conclusion:

In his testimony before the Senate Banking Committee on June 18, 2009, Treasury Secretary Geithner stated that “[o]ur core challenge is to design a system that has a proper balance between innovation and efficiency on the one hand, and stability and protection on the other. We did not get that balance right. That requires reform.” The Administration’s response, the Proposal, outlines a myriad of proposed reforms, not all of which may strike the Administration’s objective of achieving a proper balance. Many of these individual proposals may not be adopted, or may not be adopted in their current form, but if even a portion of the Proposal passes in some form, the financial services regulatory landscape is likely to be altered significantly.