

Clients & Friends Memo

Obama Administration's Financial Regulatory Reform Proposal Introduced

June 17, 2009

The Obama administration today released its white paper on its proposed overhaul to the system of regulation of the financial industry (the "Proposal")¹. The Proposal would:

- Expand the power of the Federal Reserve to regulate all financial firms that are found to pose a threat to our economy's financial stability based on their size, leverage and interconnectedness to the financial system and create a council of regulators to consult with the Federal Reserve, including the Secretary of Treasury, and the heads of the SEC and CFTC.
- Expand regulation of securitization, over-the-counter derivatives, and investment advisors to hedge funds and other private pools of capital.
- Establish a Consumer Protection Financial Agency to protect consumers of mortgages, credit cards and other financial products.
- Create a new regime to resolve systemically important nonbank financial institution failures.
- Seek to increase international coordination and cooperation regarding regulatory capital standards, oversight of global financial markets, supervision of internationally active financial firms and crisis prevention and management.

Many of the proposals will require action by Congress in order to be put into effect and some proposals are policy statements rather than concrete legislative proposals. It is possible (in fact, it is likely) that many components of the Proposal will undergo significant changes prior to going into effect and that some will never be instituted at all. However, those that are implemented will have a

¹ To view the white paper, see, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. To view the fact sheets on the Proposal see, http://www.financialstability.gov/docs/regulatoryreform/requiring_strong_supervision_reg_finirms.pdf; http://www.financialstability.gov/docs/regulatoryreform/strengthening_reg_core-markets_infrastructure.pdf; http://www.financialstability.gov/docs/regulatoryreform/strengthening_consumer_protection.pdf; http://www.financialstability.gov/docs/regulatoryreform/providing_govt_tools_manage_fin_crisis.pdf and http://www.financialstability.gov/docs/regulatoryreform/improving_internatl_reg_standards_co-op.pdf.

significant impact on the way that financial institutions are regulated and how the finance industry will do business going forward. Set forth below is a summary of the recommendations contained in the Proposal. Additional Clients and Friends Memoranda will follow that address specific issues raised in the Proposal in greater detail.

I. REQUIRING STRONG SUPERVISION AND REGULATION OF ALL FINANCIAL FIRMS

A. Increased Oversight Of Systemic Risk and Financial Regulation

Create a Financial Services Oversight Council:

- The plan will create a Financial Services Oversight Council chaired by Treasury, to help fill gaps in regulation, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities.
- The Financial Services Oversight Council will replace the President's Working Group on Financial Markets and will have a permanent, fulltime staff at Treasury. The Council will:
 - Have broad authority to gather information through the Chair from any financial firm to identify emerging risks to financial stability
 - Identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks
 - Recommend firms for identification as Tier 1 Financial Holding Companies (Tier 1 FHCs) that should be under consolidated supervision by the Federal Reserve
 - Provide consultation on material prudential standards for Tier 1 FHCs and systemically important payment, clearing and settlement systems
 - Provide a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies
 - Facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemaking, examinations, reporting requirements, and enforcement actions

- The Council will have eight members, one from each of the principal federal financial regulators: (i) the Secretary of the Treasury, who will serve as the Chair of the Council; (ii) the Chair of the Board of Governors of the Federal Reserve System; (iii) the Chair of the Commodity Futures Trading Commission (CFTC); (iv) the Director of the newly created Consumer Financial Protection Agency; (v) the Chair of the Federal Deposit Insurance Corporation (FDIC); (vi) the Director of the Federal Housing Finance Agency (FHFA); (vii) the Director of the newly created National Bank Supervisor (NBS); and (viii) the Chair of the Securities and Exchange Commission (SEC).

B. Robust, Accountable Regulation for Large, Interconnected Financial Firms

Consolidated Supervision and Regulation:

- All financial firms that are found to pose a threat to the economy's financial stability based on their size, leverage, and interconnectedness to the financial system will be subjected to strong consolidated supervision and regulation.
- These Tier 1 FHCs will be subject to consolidated supervision and regulation regardless of whether they own insured depository institutions and will be subject to the nonfinancial activities restrictions of the Bank Holding Company Act.
- Treasury will lead a working group, with participation by federal agencies and outside experts, that will conduct a fundamental reassessment of the supervision of banks and bank holding companies. The working group will issue a report with its conclusions by October 1, 2009.

Expanded Authority and Accountability for The Federal Reserve Board:

- The Federal Reserve currently regulates bank holding companies and the Proposal states that it is best suited to take on authority and accountability for consolidated supervision of all Tier 1 FHCs.

Establish Specific Criteria To Determine Which Firms are Subject to the Highest Regulatory Standards:

- Congress should establish criteria that the Federal Reserve must consider for identifying large and interconnected firms as Tier 1 FHCs.

Higher Prudential Standards for Large, Interconnected Firms:

- Tier 1 FHCs will be subjected to stricter and more conservative prudential standards than those that apply to other bank holding companies – including higher standards on capital, liquidity and risk management.

Authority to Federal Reserve Board To Assess Risk and Impose Requirements on Consolidated Activities of Large, Interconnected Financial Firms:

- The Federal Reserve will be authorized to assess risk and set higher standards at all levels (including regulated and unregulated subsidiaries) of a Tier 1 FHC to protect against excessive risk taking at any level.

C. Higher Standards For All Financial Firms**Higher Capital and Management Requirements for All Financial Holding Companies:**

- All financial holding companies – including Tier 1 FHCs – will be required to be “well capitalized” and “well managed” on a consolidated basis to engage in the broad set of financial activities permitted under the Gramm-Leach-Bliley Act.

Fundamental Reassessment of Design and Structure of Regulatory Capital Requirements:

- A working group led by Treasury will conduct a fundamental reassessment of the design and structure of the existing regulatory capital requirements for banks and bank holding companies (including Tier 1 FHCs).
- The working group will issue a report with its conclusions regarding how to strengthen regulatory capital requirements by December 31, 2009.

Executive Compensation Standards:

- Regulators will issue standards and guidelines that better align executive compensation practices with long-term shareholder value and that prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions.

- The SEC will have authority to require companies to allow shareholders to vote on executive-compensation packages to help ensure that compensation packages are closely aligned with the interests of shareholders.

Strengthen Firewalls Between Banks and Their Affiliates:

- Firewalls between banks and their affiliates will be strengthened to better protect the federal safety net that supports banks, to better prevent spread of the subsidy from the federal safety net to bank affiliates, and to better address conflicts of interest in banking organizations.

Review of Accounting Standards for Financial Firms:

- Accounting standards will be reviewed 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.
- Fair value accounting rules also will be reviewed, with the goal of identifying changes that could provide market participants with both fair value information and greater transparency regarding the cash flows management expects to receive from investments.

D. Providing a More Sensible, Efficient Regulatory System**Create New National Bank Supervisor:**

- A new National Bank Supervisor will conduct prudential supervision and regulation of federally chartered depository institutions and federal branches and agencies of foreign banks.

Eliminate Federal Thrift Charter:

- The Proposal states that the fragility of thrifts has become readily apparent during the financial crisis and that eliminating the thrift charter is one of the most important steps towards a more prudent, efficient financial regulatory system.

Eliminate Loopholes in the Bank Holding Company Act:

- All companies that control an insured depository institution will be subject to robust, consolidated supervision and regulation at the federal level by the Federal

Reserve and will be subject to the nonfinancial activity limits contained in the Bank Holding Company Act.

E. Requiring Increased Transparency

Require Advisers to Hedge Funds and Other Private Pools of Capital To Register With The SEC:

- To protect investors, the Proposal requires all advisers to hedge funds - and other private pools of capital, including private equity funds and venture capital funds - whose assets under management exceed some modest threshold to register with the SEC under the Investment Advisers Act.
- Advisers will be required to report a sufficient amount of information on their managed funds that will allow for a proper assessment of whether any funds pose a threat to financial stability.

Improve the Regulation of Money Market Mutual Funds:

- The regulatory framework for money market mutual funds (MMFs) will be strengthened. The President's Working Group on Financial Markets will consider whether more fundamental changes are needed to make the MMF industry less vulnerable to runs.

F. Enhance Oversight of the Insurance Sector

Legislation will be proposed to establish the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with the principles outlined in the Proposal.

G. Determine the Future Role of the Government Sponsored Enterprises (GSEs)

Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. A report to the Congress and the American public will be made at the time of the President's 2011 Budget release.

II. **STRENGTHENING REGULATION OF CORE MARKETS AND MARKET INFRASTRUCTURE**

A. **Addressing the Critical Markets that Contributed to Today's Crisis**

Strengthen Supervision of Securitization Markets:

- Banking regulators will issue regulations that require the originator of a securitized loan, or the sponsor of a securitization to retain an economic interest in a material portion of the credit risk (generally 5%) of securitized exposures.
- Banking regulators will issue regulations to align compensation of market participants with longer term performance of underlying loans, including proposing changes to GAAP to eliminate immediate recognition of gain on sale by originators at inception of securitization and instead require recognition of income over time. In addition, changes will require 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.
- The SEC will continue its efforts to increase the transparency and standardization of securitization markets, and be given clear authority to require robust reporting by issuers of asset-backed securities.
- The SEC will continue its efforts to tighten the regulation of credit rating agencies, including measures to ensure that firms have robust policies and procedures that manage and disclose conflicts of interest and otherwise promote the integrity of the ratings process.
- Regulators will reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

Bring Comprehensive Regulation to the Markets for All Over-The-Counter Derivatives, Including Credit Default Swaps:

- Credit default swap markets and all other “over-the-counter” (OTC) derivatives markets will be subject to comprehensive regulation in order to:
 - Prevent activities in those markets from posing risk to the financial system
 - Promote transparency and efficiency of those markets
 - Prevent market manipulation, fraud, and other market abuses
 - Prevent OTC derivatives from being marketed inappropriately to unsophisticated parties
- These goals will be reached through comprehensive regulation that includes:
 - Requiring transparency for all OTC derivative trades and positions, through recordkeeping and reporting requirements
 - Empowering market regulators to take vigorous enforcement action against fraud, market manipulation, and other market abuses
 - Requiring conservative regulation of all OTC derivative dealers and all other major participants in the OTC derivatives markets
 - Requiring standardized OTC derivatives to be centrally cleared and executed on exchanges and other transparent trading venues
 - Requiring higher capital charges for customized OTC derivatives

Harmonize Futures and Securities Regulation:

- The CFTC and the SEC will make recommendations to Congress on how to eliminate differences in statutes and regulations with respect to similar types of financial instruments that are not essential to achieving investor protection, market integrity, or price transparency.
- The CFTC and SEC will complete a report by September 30, 2009 with their recommendations.

- If the CFTC and SEC cannot reach agreement by the above date, their differences will be sent to the Financial Services Oversight Council, which will be required to make recommendations to resolve the differences within 6 months of its formation.

B. Broad New Authority To Monitor Threats to Financial Stability from Activities in Financial Markets

- A new Financial Services Oversight Council will have broad authority, through a permanent staff in Treasury, to require reports from any U.S. financial firm for the purpose of assessing whether activity in a financial market poses a threat to financial stability.
- The Council would be responsible for referring emerging risks to the attention of U.S. regulators with the authority to respond.

C. Strengthening Oversight of Systemically Important Payment, Clearing, and Settlement Systems

- The Federal Reserve will be given stronger statutory authority to oversee systemically important payment, clearing, and settlement systems.
- The Federal Reserve will be required to consult with the Financial Services Oversight Council to identify systemically important systems and in setting standards for those systems.
- In the case of clearing and settlement systems for regulated markets, the Federal Reserve will be required to coordinate its oversight with the CFTC or the SEC, which will remain the primary regulators of such systems.

III. STRENGTHENING CONSUMER PROTECTION**A. A Strong, Independent Agency with Full Authority To Protect Consumers****Create a Consumer Financial Protection Agency:**

The new agency will have broad authority to protect consumers of credit, savings, payment and other consumer financial products and services, and to regulate all providers of such products and services. The agency will be responsible for:

- promoting concise and clear information for consumers and protecting consumers from unfair and deceptive practices
- promoting fair, efficient, and innovative financial services markets for consumers
- improving access to financial services

Give Consumer Financial Protection Agency Full Authority To Enforce Proper Protections:

The agency will be structured to be independent and accountable; with an empirical approach to regulation and a stable source of funding. The agency will have authority to:

- write rules across bank and nonbank firms for a level playing field and higher standards
- supervise and examine institutions for compliance
- enforce compliance through orders, fines, and penalties
- write rules that serve as a floor, not a ceiling with respect to state laws, and states will be empowered to enforce these strong rules

B. Key Principles for Action**Transparency:**

- Mandate a new proactive approach to disclosure.
- 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.
- Consumers should have clear disclosure regarding the consequences of their financial decisions.

Simplicity:

- Define standards for “plain vanilla” products that are simple and have straightforward pricing.
- Require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.
- Alternative products will be subject to more scrutiny and violations with respect to alternative products will carry higher penalties.
- In some cases, the agency would have authority to mandate consumers to “opt out” of standard products before they could be offered other alternatives.

Fairness:

- Ban unfair terms and practices or place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs.
- Impose heightened duties of care on financial intermediaries that reflect reasonable consumer expectations.
- Help ensure that compensation practices do not create conflicts of interest between intermediaries and consumers.

Accountability:

- Provide the agency with accountability as the primary federal financial consumer protection supervisor.

Access:

- Enforce fair lending laws and the Community Reinvestment Act.
- Seek to ensure that underserved consumers and communities have access to prudent financial services, lending, and investment.

C. For Example, the Agency Would Have Authority To Reform Mortgage Laws**Require Transparency:**

- Ensure that consumers receive a single, simple, integrated federal mortgage disclosure.
- Require communications with consumers to adequately present risks and benefits of mortgage products.
- Require timely collection and publication of data on how loans perform, so the agency can quickly learn what steps to take to protect consumers.

Promote Simple Products To Make Consumer Choices Easier:

- Require firms to offer a “plain vanilla” mortgage product with straightforward terms, while preserving consumer freedom of choice to opt-out for other products, subject to stringent protections.

Demand Fairness:

- Require mortgage brokers to owe a duty of best execution among available mortgage loans to avoid conflicts of interest between themselves and the homeowners, as well as a duty to determine the mortgages they sell are affordable to borrowers.
- Ban unfair practices such as “yield spread premiums” – side payments from lenders that encourage mortgage brokers to push consumers into higher priced

loans than they qualify for – and require brokers to be paid over time based on continued loan performance rather than in a lump-sum at closing.

- Restrict or ban prepayment penalties, which can lock borrowers into bad loans.
- Require loan originators or sponsors of securitizations – where loans are bundled and sold to investors – to retain an economic interest in a material portion of the credit risk (generally 5%) in order to keep skin in the game.

Require Accountability:

- Ensure that banks, nonbanks, and independent mortgage brokers all play by the same rules, and no lender or broker falls between the cracks of supervision or enforcement.

Increase Access:

- Strongly enforce the Community Reinvestment Act and fair lending laws.
- Ensure that underserved consumers and communities have access to prudent financial services, lending and investment.

IV. PROVIDING THE GOVERNMENT WITH TOOLS TO EFFECTIVELY MANAGE FINANCIAL CRISES

A. Reducing the Likelihood and Impact of Failures

Impose More Stringent Capital, Activities, and Liquidity Requirements On Large, Interconnected Firms (Tier 1 FHCs):

- In view of the risks such firms introduce into the financial system, Tier 1 FHCs will be subject to more stringent capital, activities, and liquidity standards, and more exacting prudential supervision.

Require Prompt Corrective Action from Large, Interconnected Firms Should Their Capital Levels Decline:

- Tier 1 FHCs will be subject to a prompt corrective action regime that would require the firm and its supervisor to take corrective actions as the firm's regulatory capital levels decline.

- This regime will mirror the prompt corrective action regime for insured depository institutions established under the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

B. Planning in Advance for Orderly Resolution

Require Rapid Resolution Plans from All Large, Interconnected Firms:

- The Federal Reserve will require each Tier 1 FHC to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress.

C. Providing a Regulatory Regime that Can Adequately Respond to a Financial Crisis

Provide the Government with Emergency Authority To Resolve Any Large, Interconnected Firm in an Orderly Manner:

- Give the federal government the authority necessary to avoid the disorderly resolution of large, interconnected firms when the stability of the financial system is threatened.
- The proposed resolution authority would supplement (rather than replace) and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act.
- Treasury can invoke the resolution authority only after consulting with the President and upon the written recommendation of two-thirds of the members of the Federal Reserve Board, and the FDIC or SEC as appropriate.
- To invoke this authority, Treasury must make the following determinations:
 - That the firm is in default or in danger of defaulting
 - That the failure of the firm would have serious adverse effects on the financial system
 - That the use of the special resolution authority would avoid or mitigate these adverse effects

- The resolution authority will give Treasury the ability to appoint a receiver or conservator for the failing firm. In general, that role will be played by the FDIC (though the SEC may be appointed in certain cases).
- The conservator or receiver of the firm will have a broad set of powers including authority to take control of the operations of the firm, sell or transfer all or any parts of the firm's assets. The resolution authority will also include the ability to provide loans, assume liabilities, or inject capital.

V. IMPROVING INTERNATIONAL REGULATORY STANDARDS AND COOPERATION

A. Leveling the Playing Field

Subject Foreign Financial Firms Operating Within the U.S. to the Same Standards as U.S. Firms:

- Foreign firms whose US operations pose risks to the US financial system will be subject to the same robust prudential regulation and oversight as U.S. firms that pose risks to the U.S. financial system.

B. Promoting Higher International Standards

Strengthen the International Capital Framework:

- The Proposal calls on the Basel Committee on Banking Supervision (BCBS) to develop a simple, non-risk based capital measure to limit the amount of leverage built up in the international financial system.
- The Proposal calls on the BCBS to improve Basel II by requiring more capital to offset riskier assets, such as trading book instruments, securitized products, and off-balance sheet items.
- The Proposal calls on the BCBS to complete an in-depth review of the Basel II framework to mitigate its pro-cyclical impact on the global economy.
- The Proposal calls on the BCBS to strengthen the definition of "regulatory capital" to improve the quality, quantity, and consistency of capital held by financial firms.

Improve the Oversight of Global Financial Markets:

- The Proposal urges national authorities to promote the standardization and improved oversight of credit derivatives and other OTC derivative markets – in line with G-20 commitments.

Reform Crisis Prevention and Management Authorities and Procedures:

- The Proposal recommends that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009 to help ensure that countries have powers and tools necessary to quickly resolve a failing financial firm.

Enhance Supervision of Internationally Active Financial Firms:

- The Proposal recommends that the Financial Stability Board strengthen international cooperation on the supervision of global financial firms through supervisory colleges.

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If you have any questions regarding the contents of this memo, please do not hesitate to contact any of the following attorneys:

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