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Clients&FriendsMemo

The Obama Administration's Financial Regulatory Reform Proposal

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On June 17, the Obama Administration released its recommendations for reform of our financial regulatory system,[1] and the Firm sent its clients and friends a memorandum summarizing the proposal (the "Proposal").[2] This memorandum explains the impact the Proposal would have on the regulation of financial institutions, "Tier 1 FHCs," investment advisers, insurance companies, money market mutual funds and certain financial markets. It also discusses the Administration's proposals to protect consumers, manage financial crises and foster international cooperation. Note that two companion Firm memoranda also were issued today, one of which focuses on the manner in which the Proposal would impact the asset securitization market and the other of which focuses on the Proposal's impact on the over-the-counter derivatives markets.[3]

I. Supervision and Regulation

A. Enhanced Requirements for All Banks and BHCs

1. Reassessing Capital Requirements for All Banks and BHCs

The Proposal indicates that the capital requirements applicable to banks and bank holding companies ("BHCs") should be reassessed by December 31, 2009 by a group of federal financial regulators and outside experts led by Treasury. The Administration proposes that this review be comprehensive and include:

- changes to the capital rules to reduce procyclicality, e.g., by requiring all banks and BHCs to hold enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed times;

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1 To view the Obama Administration's white paper, see, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

2 See http://www.cadwalader.com/assets/client_friend/061709_FinancialRegulatoryReformProposal.pdf.

3 See http://www.cadwalader.com/assets/client_friend/062209RegulatoryReform_Securitization.pdf and http://www.cadwalader.com/assets/client_friend/062209RegulatoryReform_OTCDerivatives.pdf.

- analysis of the feasibility of satisfying regulatory capital requirements, at least in part, through the issuance of contingent capital instruments (such as debt securities that automatically convert into common equity in stressed economic circumstances) or through the purchase of tail insurance against macroeconomic risks;
- proposed increases in regulatory capital requirements on investments and exposures that the Proposal describes as posing high levels of risk under stressed market conditions, including: (i) trading positions; (ii) equity investments; (iii) credit exposures to low-credit-quality firms and persons; (iv) highly rated asset-backed securities and mortgage-backed securities; (v) explicit and implicit exposures to sponsored off-balance sheet vehicles; and (vi) OTC derivatives that are not centrally cleared; and
- consideration of adopting a simpler, more transparent measure of leverage to supplement the risk-based capital measures.

On a related front, the Proposal indicates that "financial holding company" ("FHC") status (and its attendant ability to engage in riskier financial activities) should turn on being "well-capitalized" and "well-managed" on a consolidated basis, rather than merely at the depository institution level.

What is initially striking about the capital aspect of the Proposal is its implicit acknowledgement that the Basel capital standards have not been as successful as hoped and need to be reassessed.

2. Reassessing Supervision of All Banks and BHCs

Under the Proposal, a working group similar to that described in Section A.1. above would be required to reassess by October 1, 2009, the manner in which banks and BHCs are supervised. This working group would review and analyze lessons learned about banking supervision from the recent financial crisis, including as to how to effectively conduct continuous, on-site supervision of large, complex banking firms.

3. Executive Compensation Standards and Guidelines for Banks and Others

The Administration proposes that Federal regulators, including the SEC, issue standards to better align the executive compensation practices of financial firms with long-term shareholder value and to prevent compensation from incenting conduct that threatens the safety and soundness of supervised institutions. The Administration believes these standards should be based on the following principles:

- Compensation plans should properly measure and reward performance.
- Compensation should be structured to account for the time horizon of risks.

- Compensation practices should be aligned with sound risk management.
- Golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executives and shareholders.
- Transparency and accountability should be promoted in the process of setting compensation (including through new SEC rules).

As previously announced, the Administration also supports "say on pay" legislation that will require all public companies to include in their proxies an annual non-binding shareholder vote on compensation packages for senior executives. It will propose, too, legislation giving the SEC the power to require that compensation committees be more independent (e.g., through the ability to hire their own compensation consultants and legal counsel).

Note that the bank regulators already have undertaken a little-publicized effort to devise standards to ensure that compensation does not incent undue risk, e.g., to assure that bonuses paid to managers for cost reductions are not attributable to laying off compliance or risk management personnel and that employees who generate loan business are not compensated on the basis of loan quantity, rather than loan quality.

4. Loan Loss Provisioning for All Banks and BHCs

The Proposal urges that FASB, IASB and the SEC review loan loss provisioning accounting standards to make them more "forward-looking" so that loan loss reserves better anticipate developments. The goal would be to maintain higher loan loss reserves earlier in the economic cycle to reduce procyclicality. Similarly, the Proposal urges that fair value accounting rules be reviewed to provide both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments. The Proposal expresses the view that the application of fair value standards during the financial crisis tended to amplify the effects of the unfavorable business cycle.

5. Strengthening Affiliate Transaction Firewalls for All Banks and BHCs

The Proposal suggests that the bank regulators tighten limits on affiliate transactions. In particular, it urges that regulators constrain the ability of banks to engage in OTC derivative transactions and securities financing transactions with affiliates. It also urges the regulators to tighten regulation of conflicts of interests arising from bank affiliations with hedge funds and proprietary trading units. Apparently speaking to Congress, the Proposal suggests that the Federal Reserve's discretion to provide exemptions from affiliate transaction restrictions be limited.

B. More Stringent Capital, Liquidity and Risk Management Requirements for the Largest and Most Interconnected Firms

1. Consolidated Supervision and Regulation by the Federal Reserve

The Administration proposes that the Federal Reserve supervise each financial firm, the "size, leverage, and interconnectedness" of which could pose a threat to financial stability if it failed. The Proposal refers to such entities as "Tier 1 FHCs." A firm could be designated as a Tier 1 FHC whether or not it owns an insured depository institution.

In identifying Tier 1 FHCs, the Federal Reserve is to analyze the systemic importance of a firm under stressed economic conditions and consider:

- the impact the firm's failure would have on the financial system and the economy;
- the firm's size, leverage and reliance on short-term funding; and
- how critical the firm is as a source of credit for consumers, businesses and state and local governments and as a source of liquidity for the financial system.

Although the Proposal expects that the Federal Reserve will establish rules to guide the identification of Tier 1 FHCs, it emphasizes that the Federal Reserve "should be allowed to consider other relevant factors and exercise discretion in applying the specified factors." To garner the necessary information to make these determinations, the Federal Reserve would be authorized to require periodic and other reports from, and even to examine, all U.S. financial firms above an unspecified size. The Federal Reserve would regularly review its classification of firms as Tier 1 FHCs.

The Federal Reserve's consolidated supervision would extend to parents and all subsidiaries. Although functional regulation of regulated subsidiaries would be maintained, the Federal Reserve would have the authority to require reports from, conduct examinations of and impose prudential restrictions on all subsidiaries, including subsidiaries that already have a functional regulator. This means, for example, that the Federal Reserve could exert regulatory authority over subsidiaries that are depository institutions, SEC-registered broker-dealers, SEC-registered investment advisers, CFTC-registered futures commission merchants or state-licensed insurance companies.

The Federal Reserve's supervision would be "macroprudential" in focus; it would not be focused primarily on "safety and soundness," as is currently the case with bank regulators. To help achieve this type of macroprudential supervision, a Tier 1 FHC would be required to regularly report the nature of, and extent to which, other major financial firms have financial exposure to the Tier 1 FHC.

Of course, the Federal Reserve already is quite powerful, witness its leadership in management of the current financial crisis. That power emanates from the Board's monetary policy and lender of last resort authorities, which are supplemented by its payment system and bank and bank holding company regulation authorities. Whether the powers of the Federal Reserve should be expanded in the manner proposed is likely to be the topic of some debate. It is unclear whether, if a firm is deemed to be a Tier 1 FHC, there will be some form of due process under which it might contest the finding, as such a finding obviously could have dramatic consequences for the entity's business.

2. More Stringent Capital, Liquidity and Risk Management Requirements

The Proposal urges that Tier 1 FHCs be subject to even stricter capital, liquidity and risk management standards than the increased standards proposed to be applicable to other financial institutions. However, to avoid setting standards so high as to constrain long-term economic growth, the Federal Reserve is to consult with the Financial Services Oversight Council (see section C. below) and set the standards "to maximize financial stability at the lowest cost to long-term financial and economic growth." The Proposal emphasizes that capital requirements should be strict enough to be effective under extremely stressful economic conditions and should be subject to rigorous liquidity risk requirements that recognize the potential negative impact that the financial distress of such a firm would have on the financial system.

Tier 1 FHCs would be required to identify and limit their firm-wide risk concentrations. Note that each such firm also would be required to prepare a credible plan for its own rapid resolution in the event of severe financial stress, thus potentially removing any implication that the firm is "too big to fail." To assure market discipline, such firms would be required to make enhanced public disclosures. Even if such a firm does not control a depository institution, it would be treated as if it did; for instance, its activities would be limited to those permissible for bank holding companies. It would have five years to conform its activities.

C. Council of Regulators with Coordinating Responsibility

The Administration proposes creation of a Financial Services Oversight Council chaired by Treasury to:

- facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemakings, examinations, reporting requirements, and enforcement actions;
- provide a forum for discussion of cross-cutting issues;

- identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks; and
- review executive compensation practices to monitor their impact on risk-taking.

This Council would consist of the heads of the principal federal financial regulators and have its own staff at Treasury. The Council would recommend firms that would be treated as Tier 1 FHCs by the Federal Reserve. The Federal Reserve would consult with the Council as to how Tier 1 FHCs should be identified and in setting prudential standards for them. The Council could gather information from any financial firm for the purpose of assessing the extent to which a financial activity or financial market poses a threat to financial stability and could refer emerging risks to the appropriate regulators. A subset of the Council would be responsible for determining whether to invoke resolution authority with respect to a Tier 1 FHC.

Note that certain precedents for a formalized effort to coordinate financial regulators already exist. In particular, the Federal Financial Institutions Examination Council ("FFIEC"), which was originally organized to conform examination practices of the banking agencies, has, over the years, expanded its scope to cover anti-money laundering, home mortgage disclosure, community reinvestment, insider lending reports and even disaster response. There also exists the President's Working Group on Financial Markets to coordinate financial institution policy. The Administration proposes to replace this Working Group with the Council.

D. New National Bank Supervisor for All Federally-Chartered Banks

The Proposal would create a new agency, the National Bank Supervisor, to supervise and regulate all federally-chartered depository institutions and all federal branches and agencies of foreign banks. This agency would become the successor to the Office of the Comptroller of the Currency ("OCC") (which currently regulates federally-chartered banks and federal branches and agencies of foreign banks) and would replace the Office of Thrift Supervision ("OTS") (which supervises federally-chartered thrifts and thrift holding companies).

The Administration proposes to eliminate the federal thrift charter; however, it proposes that both state and national banks be permitted to engage in unlimited interstate branching, just as federal thrifts presently can. The Administration also proposes to make thrift holding companies and the parents of industrial loan companies, credit card banks, trust companies and grandfathered "nonbank banks" subject to the provisions of the Bank Holding Company Act, just as the holding companies of FDIC-insured commercial banks typically are. Such firms would be given five years to conform their activities to those permissible for a bank holding company. The Proposal also would have Congress preempt state laws that attempt to support the value of local community banks by permitting banks to engage in interstate branching only by acquiring a pre-existing state bank.

Unfortunately, thrifts and thrift holding companies show up disproportionately in a list of major recently failed or nearly failed institutions: AIG (a thrift holding company), Countrywide (a thrift holding company), IndyMac, Washington Mutual, BankUnited and Lehman Brothers (a thrift holding company). For many years, every regulatory reform proposal has included merging the OTS and the OCC because of the efficiencies that might be gained by such a move. With the track record of the OTS in the current financial crisis, the inclusion of such a proposal in any regulatory reform package seemed inevitable.

The premise is that a "competition in laxity" among the regulators led to reduced regulation because firms that could easily change charters did so to escape regulation. For example, Countrywide was a bank holding company subject to Federal Reserve regulation and parent company capital requirements when it owned a national bank. However, when it converted the bank to a federal savings bank, the OTS became the bank's regulator and the parent holding company was relieved of regulatory capital requirements. Were this aspect of the proposal to become law, this type of regulatory arbitrage could no longer occur.

Note, however, that the thrift charter was established in 1933 to promote home ownership, and thrifts have been a source of home financing ever since. While thrifts may have expanded their activities in recent years, home finance remains their main mission. Query whether, in light of the shrinking of available sources of home finance, this is the most propitious time to eliminate a source of housing finance, especially when many believe a healthy housing market is central to economic recovery.

Initially it might appear that closing existing Bank Holding Company Act loopholes is not related to the financial crisis. However, it must be realized that, not only did many failing firms utilize those loopholes, but that, had they not been able to do so, they would have been subject to bank holding company capital requirements and supervision which arguably might have saved them.

E. Registration of Hedge Fund and Private Equity Fund Advisers

The Administration proposes that all advisers to hedge funds and "other private pools of capital" (including private equity funds and venture capital funds) be required to register under the Investment Advisers Act of 1940 (the "Advisers Act") if their assets under management exceed an unspecified "modest threshold."

The Administration further proposes that all investment funds advised by an SEC-registered investment adviser should be subject to requirements relating to: (1) recordkeeping; (2) disclosures to investors, creditors and counterparties; and (3) regulatory reporting with respect to the amount of assets under management, borrowings, off-balance sheet exposures and "other information necessary to assess whether the fund or fund family is so large, highly leveraged or interconnected that it poses a threat to financial stability." The Proposal indicates that the SEC should conduct regular, periodic examinations of such funds to monitor for compliance with the proposed requirements. Note that, if a fund or fund family meets the Tier 1 FHC criteria, the applicable funds would be regulated as Tier 1 FHCs.

The Proposal asserts that more expansive regulation is required to gather information to assess potential systemic implications of private pools of capital and to protect investors by filling perceived regulatory gaps.

If enacted in the manner proposed, many hedge fund managers, CDO managers, private equity fund managers and venture capital managers would be required to register with the SEC. However, the precise contours of the term "private pools of capital" remain unclear, as does the status of foreign advisers. Query, for example, whether advisers that manage funds that do not invest in securities (e.g., CLOs, commodity funds or infrastructure funds) would be required to register. The Proposal suggests that the applicable regulatory requirements may vary across the different types of private pools, and this type of tailoring would appear to be essential if "private pools of capital" is intended to have a broad sweep. The type of disclosure that would be made to creditors and counterparties also is unclear, as there is little or no precedent for government-mandated disclosure in a non-customer, non-investor context.

The Proposal appears to chart a different regulatory path than that proposed in the Hedge Fund Transparency Act (S. 344) introduced by Senators Grassley and Levin (which would utilize the Investment Company Act of 1940 as the framework for expanded regulation); however, it proposes to collect some of the same types of information. A bill introduced on June 16, 2009 by Senator Jack Reed (S. 1276) and captioned the Private Fund Transparency Act of 2009 appears to be a closer template.

Note that the process of registering under the Advisers Act and complying with the applicable regulatory requirements can significantly increase the cost of conducting an advisory business. Presently, SEC-registered advisers must, among other things: (1) file a Form ADV with the SEC to become registered and assure that the form remains current; (2) designate a Chief Compliance Officer and adopt appropriate compliance procedures; (3) establish a Code of Ethics (which, among other things, requires certain employees to report their personal securities positions); (4) maintain specified records; and (5) if applicable, comply with certain custody requirements (which the SEC recently proposed to make more stringent).

If the existing regulatory framework is applied to all new registrants, query whether the expense of registration and ongoing compliance may make it difficult for firms to comply with investor requests for reduced fees, result in the consolidation of smaller managers, act as a deterrent to start-up operations or cause some managers to locate offshore.

F. Reduce Risk of Runs on Money Market Mutual Funds

The Proposal expresses the view that the SEC should continue its efforts to strengthen the regulatory framework applicable to money market mutual funds ("MMFs"). The Proposal indicates that the SEC should consider:

- requiring MMFs to maintain substantial liquidity buffers;
- reducing the maximum weighted average maturity of MMF assets;
- tightening the credit concentration limits applicable to MMFs;
- improving the credit risk analysis and management of MMFs; and
- empowering MMF boards of directors to suspend redemptions in extraordinary circumstances.

The Proposal also indicates that the President's Working Group on Financial Markets should report on whether more fundamental changes are necessary to reduce the industry's susceptibility to runs, such as eliminating the ability to use a stable net asset value and requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources. This report is to be completed by September 15, 2009. The Proposal indicates that the SEC and the Working Group should consider ways to mitigate any potential adverse effects of a stronger regulatory framework for MMFs, such as investor flight into less regulated money market vehicles or reductions in the terms of the money market liabilities of corporate issuers.

Given that the failure of the Reserve Fund was one of the primary events in the financial crisis and that this failure led to the issuance of numerous SEC exemptions allowing sponsors to support money market funds and to a federal guarantee of such funds, one would expect the regulation of these funds to be a very significant issue. In this regard, the Proposal notes that "The susceptibility of the entire prime MMF industry to a run. . . remains a significant source of systemic risk."

The suggestion that MMFs might be required to maintain "substantial liquidity buffers," including "reliable emergency liquidity facilities" and might be permitted to suspend redemptions and operate free of the need to maintain a $1 stable net asset value are particularly significant. Any of these measures could substantially change the nature of the MMF business and could be the subject of negative comments from the industry. Given, on the one hand, the popular acceptance of MMFs and, on the other hand, the systemic risk issues that such funds raise, addressing MMF issues is likely to be particularly challenging.

G. Establishment of Office of National Insurance

The Proposal includes a call for legislation that would establish, in the Department of Treasury, an Office of National Insurance ("ONI"). ONI's stated role would be to "gather information, develop expertise, negotiate international agreements and coordinate policy" in the insurance industry. ONI also would administer the Terrorism Risk Insurance Act and recommend to the Federal Reserve any insurance firms that should be supervised as Tier 1 FHCs. Additionally, ONI would be expected to identify the emergence of any problems or gaps in insurance regulation that could contribute to a future crisis.

Although the Proposal does not expressly call for the establishment of a federal insurance charter, it decries the consequences of the fact that the insurance industry is regulated primarily by the states, indicating that this has led to:

- a lack of uniformity;
- reduced competition both nationally and internationally;
- inefficiency;
- reduced product innovation;
- higher costs to consumers; and
- an inability to "speak with one voice" in the International Association of Insurance Supervisors.

The Proposal thus expresses a strong need to "develop a modern regulatory framework for insurance" and indicates that such a system should include certain core principles, including:

- strong capital standards and appropriate risk management, including the management of liquidity and duration risk;
- "meaningful and consistent" consumer protection;
- improved regulation, on a consolidated basis, of insurance companies and their subsidiaries;
- increased uniformity; and
- effective regulation of systemic risk.

The Proposal suggests that uniformity may be achievable either through a federal charter or through effective state action, thereby opening the door to the creation of a federal charter.

H. Consider Future Roles of Fannie Mae, Freddie Mac and the Federal Home Loan Banks

The Proposal indicates that Treasury and HUD, in consultation with other government agencies, will "engage in a wide-ranging initiative to develop recommendations on" the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. The Administration indicates that it will issue a public report at the time of the President's 2011 budget. The options reportedly under consideration include:

- returning them to their previous (i.e., pre-September 2008) status as GSEs, with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals;
- gradually winding-down their operations and liquidating their assets;
- incorporating their functions into a federal agency;
- adopting a public utility model where the government regulates their profit margins, sets guarantee fees and provides explicit backing for their commitments;
- converting them to entities that provide insurance for covered bonds; and
- dissolving Fannie Mae and Freddie Mac into many smaller companies.

II. Regulation of Financial Markets

A. Reduced Reliance on Credit Rating Agencies

The proposal calls for the SEC to continue its efforts to strengthen regulation of credit rating agencies, including with respect to the establishment of robust policies to disclose conflicts of interest. This topic is discussed at greater length in our Clients & Friends Memorandum relating to the impact of the Proposal on the securitization markets.[4]

The Proposal also calls upon regulators to reduce, wherever possible, their use of credit ratings in regulations and supervisory practices. The Proposal emphasizes, in particular, that risk-based regulatory capital requirements should "reflect the risk of structured credit products, including the concentrated systematic risk of senior tranches and re-securitizations and the risk of exposures held in highly leveraged off-balance sheet vehicles." We note that, while the bank regulators have informally criticized bank reliance on rating agencies, they have formally institutionalized a role for

[4] See http://www.cadwalader.com/assets/client_friend/062209RegulatoryReform_Securitization.pdf.

such agencies in the Basel II capital rules, which base bank risk ratings and capital requirements for certain investment securities on external and even inferred ratings.

B. Harmonize Regulation of Futures and Securities

While merging the CFTC and the SEC might be quite logical, it is politically difficult in light of the committee structure in Congress giving the Agricultural Committees authority over the CFTC and the Commerce and Banking Committees jurisdiction over the SEC. Accordingly, instead of advocating a politically untenable merger, the Administration has proposed the "harmonization" of SEC and CFTC regulations. In particular, the Proposal recommends that the CFTC and SEC complete a report to Congress by September 30, 2009 that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either: (1) explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity and price transparency; or (2) recommends changes to eliminate the differences. To increase the incentive for the agencies to concur, the Proposal suggests that, if no agreement is reached by that date, the new Financial Services Oversight Council should be required to address the differences and report its recommendations to Congress.

C. Safeguarding Payment and Settlement Systems

1. Systemically Important Systems

The Proposal urges that the Federal Reserve be given authority to oversee systemically important payment, clearing and settlement systems. The concern is that weaknesses in settlement arrangements can cause the spread of financial problems.

The Administration has indicated that it will propose legislation that broadly defines the characteristics of a systemically important payment, clearance and settlement system (each, a "Covered System"). Such legislation would direct the Federal Reserve, in consultation with the new Financial Services Oversight Council, to identify Covered Systems and establish risk management standards for their operation. The Proposal indicates that a system should be a Covered System if its failure or disruption could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system.

The Federal Reserve would not displace any primary regulator of any system; rather, it would work with such regulator. The Federal Reserve nonetheless would impose standards for ensuring timely settlement under a range of extreme market scenarios, participate in periodic safety and soundness examinations, provide prior review of both rule changes and operational changes and have the authority to impose reporting requirements.

2. Systemically Important Activities

As an adjunct to the identification of Covered Systems, the Proposal calls for the identification of systemically important payment, clearing and settlement activities of financial firms ("Covered Activities") and for the establishment of related risk management standards. Covered Activities would be identified in essentially the same manner as would Covered Systems. The Federal Reserve would have the authority to collect information from financial firms with respect to activities that may be Covered Activities. It also would have the authority to examine such firms with respect to compliance with the applicable standards and to require such firms to submit reports with respect to their conduct of Covered Activities.

3. Access to Federal Reserve Bank Services

The Proposal recommends that Congress permit the Federal Reserve to provide Covered Systems with access to Reserve Bank accounts, financial services and the discount window.

III. Consumer and Investor Protection

A. Consumer Protection

1. Creation of New Agency

The Administration proposes the creation of a new federal agency, the Consumer Financial Protection Agency ("CFPA"), which would be dedicated to protecting the consumers of financial products and services (other than consumers of products and services already regulated by the SEC or CFTC). Among other things, the CFPA would have authority to regulate unfair, deceptive or abusive acts or practices for "all credit, savings and payment products." The CFPA accordingly would have supervisory, examination and enforcement authority over a wide range of providers of consumer financial products and services, including banks and their unregulated affiliates, mortgage brokers, mortgage originators, debt collectors, debt counselors and mortgage modification firms.

It also would have sole authority to promulgate and interpret regulations under a plethora of existing consumer financial services statutes – including the Truth in Lending Act, the Home Ownership and Equity Protection Act ("HOEPA"), the Real Estate Settlement and Procedures Act ("RESPA"), the Home Mortgage Disclosure Act ("HMDA"), the Equal Credit Opportunity Act and the Fair Debt Collection Practices Act – as well as under any newly-enacted consumer protection laws.

Additionally, the CFPA would administer the S.A.F.E. Act mortgage loan originator registration requirements, have the ability thereunder to impose higher minimum net worth requirements for originators and have sole authority to evaluate financial institutions under the Community Reinvestment Act ("CRA"). It could be funded in part by fees levied on providers of financial services.

Note that the Proposal that an agency like the Consumer Products Safety Commission be established for financial services is favored by Senate Banking Committee Chair Christopher Dodd. However, some assert that the regulators already have enormous consumer protection authority and that any gaps could be closed by expanding the powers of existing regulators.

2. Relationship to States and Existing Federal Agencies

The regulations issued by the CFPA would not preempt stricter state laws, regardless of whether a bank is federally-chartered or state-chartered. States would possess concurrent jurisdiction to enforce CFPA regulations while the CFPA would play a coordinating role among the states and possess the right to intervene in any state action. Moreover, the Administration proposes to subject federally-chartered banks to "nondiscriminatory state consumer protection and civil rights laws to the same extent as other financial institutions," thereby eliminating federal preemption in this context. It also proposes that states should be able to enforce these laws, as well as regulations of the CFPA, with respect to federally-chartered institutions. An important unheralded element of this aspect of the Proposal thus may be an attack on national bank preemption. Consumer activists have long decried the fact that national banks are not subject to many state consumer protection laws and that even state enforcement agencies may not enforce such laws against national banks. In the past, however, national banks have repeatedly won court battles over preemption.

The CFPA would have the option to request action on the part of the Department of Justice, such as to enforce the CFPA's subpoena authority. The Proposal would eliminate the consumer protection responsibilities of the federal prudential bank regulators, but allow the CFPA to share information gleaned from its own investigations with those regulators, as well as with the Department of Justice. The plan calls for the FTC to retain "backup" jurisdiction with respect to the product areas transferred to the CFPA, but concurrent authority in matters of financial services fraud. The Proposal calls for increased funding for the FTC with respect to the areas that would remain under its jurisdiction. The Proposal includes no expansion of existing private rights of action, but indicates that legislation may be sought to increase statutory damages.

3. Mandatory Arbitration Clauses

The Proposal indicates that the CFPA should be directed to gather information regarding mandatory arbitration clauses in consumer financial services and products. If the CFPA determines that such clauses do not "promote fair adjudication and effective redress," it would be required to either: (1) establish conditions for fair arbitration; or (2) if necessary, ban mandatory arbitration clauses in particular contexts, such as mortgage loans.

4. Mandatory Disclosures

The Proposal calls for a dual system of detailed consumer product disclosure rules, on the one hand, and a requirement of "reasonable" disclosure, on the other. Providers of financial services would be required to ensure that their disclosures are not only non-deceptive and compliant with the CFPA's specific prescriptions but also "reasonable" in terms of both balanced presentation of risks and benefits and clarity and conspicuousness of significant costs and risks. Excessive disclosure of costs and risks deemed less important could serve as a basis for enforcement action if it obscures costs and risks deemed more important. The requirement would apply to mass marketing materials as well as to formal agreements. Violation of the "reasonable" disclosure requirement would be a basis for administrative action only; not civil liability. The CFPA would weigh disclosure requirements on the basis of a cost-benefit analysis that takes into account the potential downside of reduced availability of consumer credit. The guiding principle is to be a clear, balanced presentation of risks and benefits, with the most significant risks, costs and penalties made most conspicuous.

The CFPA would be directed to establish standards and procedures for field testing various forms of disclosure. Providers of financial services carrying out an authorized field testing program would be immune from liability for claims asserting that the form of disclosure was misleading. The potential pitfalls created by the "reasonableness" requirement would be ameliorated by the CFPA's authority to issue communications analogous to SEC "no-action" letters with respect to disclosures relating to a new product. If the CFPA failed to respond within a prescribed time, the service provider could proceed without fear of enforcement action relating to the proposed disclosures. The waiting period could potentially be shortened if the requestor submitted empirical evidence that its materials adequately disclosed relevant risks.

The CFPA also would have authority to require point-of-sale disclosures, such as the issuance of a debit card warning before an overdraft occurred. The agency could mandate the expansion of "calculator" disclosures of the type required under the recently enacted Credit CARD Act of 2009 and widely available on the internet if the benefits of providing such disclosures justify the added cost.

5. Contract Terms and "Opt-Ins"

The Proposal also would give the CFPA broad authority to regulate – and even to ban – certain contract terms if it concludes that the relevant disclosure inadequately protects consumers. In particular, the Proposal indicates that the CFPA should be authorized to define "plain vanilla" products and to require firms to offer such products prominently, alongside "other lawful" products offered by the firm. The CFPA would assume responsibility for recently issued Federal Reserve regulations, to take effect in October, that favor "plain vanilla" mortgage loans by subjecting alternative loans to additional scrutiny and higher penalties for violations. As with disclosure requirements, determinations as to which types of loans should be deemed "plain vanilla" are to be based in part on empirical data regarding consumer ability to grasp the risks and costs. The CFPA would be authorized to help ensure that non-plain vanilla mortgages were obtained only by consumers who could understand and manage the related risks. The Proposal indicates, for example, that such products could include warning labels and financial experience questionnaires or that providers could be required to obtain an applicant's written "opt-in" to such a product.

If the CFPA deems a contract term (e.g., a prepayment penalty) to be too complex, it would have the authority to ban its use for some or even all types of products. The Proposal also notes that if the CFPA concludes that disclosure is not an adequate remedy, it could be authorized to ban side payments to mortgage originators – so-called yield spread premiums or overages – that are tied to the borrower receiving worse terms than those for which he or she qualifies. The Proposal also suggests that the CFPA could consider requiring that originators receive a portion of their compensation over time, contingent upon loan performance, rather than in a lump sum at origination, and could adopt a "life of loan" approach to regulating mortgages.

6. Imposition of Duty of Care

The Proposal suggests that the CFPA should have the authority to impose new duties of care on financial intermediaries, such as mortgage brokers, to counter perceived conflicts of interest or to align an intermediary's conduct with consumer expectations. It indicates, for example, that the CFPA could impose a duty of "best execution," which would require disclosure of the best available mortgage loan terms, and a duty to determine "suitability" and "affordability" for borrowers. The Proposal also indicates that mortgage originators and purchasers could be subject to similar duties. In this regard, the Proposal asserts that the originators and purchasers of "plain vanilla" mortgages would have the benefit of a strong presumption of suitability. By contrast, the Proposal indicates that originators and purchasers of non-plain vanilla mortgages should not enjoy any presumption that the products are "suitable" for the borrower and that such originators and purchasers should be subject to "significantly higher" penalties for rule violations.

7. Vigorous Application of the CRA and Fair Lending

The Proposal asserts that rigorous application of the Community Reinvestment Act should be a core function of the CFPA and that the CFPA should vigorously enforce fair lending laws. To achieve the latter goal, the CFPA would maintain a fair lending unit with attorneys, compliance specialists, economists and statisticians. The Proposal calls for "critical new fields" to be added to HMDA data, such as: (1) a universal loan identifier that permits tying HMDA data to property databases and proprietary loan performance databases; (2) a flag for loans originated by mortgage brokers; (3) information about the type of interest rate (e.g., fixed vs. variable); and (4) other fields that "the mortgage crisis has shown to be of critical importance."

B. Investor Protection

1. Expanded SEC Authority

The Proposal suggests that the SEC should be given expanded authority to require that disclosures, such as a summary prospectus, be delivered at or before the time of sale for certain financial products, such as mutual funds. It also suggests that the SEC should be better enabled to engage in field testing of investor disclosures.

The Administration also suggests that new legislation should be enacted to:

- require that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as do registered investment advisers;
- require that simple and clear disclosure be made to investors regarding the scope of the terms of their relationships with investment professionals;
- prohibit unspecified conflict of interests and sales practices that are contrary to the interests of investors (such as compensation that encourages brokers to put investors into products that are profitable for the broker, but not in the investors' best interest); and
- give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment adviser agreements with retail customers, provided that the SEC has first conducted a study to determine whether investors are harmed by such clauses.

The legislation also would expand the SEC's authority to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards and would give the SEC expanded authority to bar persons subject to enforcement actions from all aspects of the securities industry, rather than from only a specific segment.

2. Establishment of Financial Consumer Coordinating Council

The Administration proposes to create a Coordinating Council comprised of the heads of the SEC, FTC, Department of Justice and the CFPA, as well as representatives from other unspecified state and federal agencies. The Coordinating Council's mission would be to identify gaps in consumer protection across financial products and facilitate coordination of consumer protection efforts.

IV. Managing Financial Crises

A. Resolution of Systemically Important Financial Holding Companies

The Administration proposes the establishment of a new authority, modeled on the existing authority of the FDIC, to resolve failures of systemically important bank holding companies and nonbank financial firms, including Tier 1 FHCs. The regime would supplement (rather than replace), and be modeled on, the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act. Whether the special resolution regime would apply would be determined under a formal process that could be initiated by Treasury, the Federal Reserve, the FDIC or the SEC (if the largest subsidiary of a failing firm is a securities firm). The decision to apply the special resolution regime would be made by Treasury after consulting with the President and upon written recommendation of two-thirds of the Federal Reserve Board and two-thirds of the FDIC's board of directors (or two-thirds of the SEC commissioners if the largest subsidiary is a broker-dealer).

Treasury generally would appoint the FDIC as conservator or receiver; however, the SEC could be appointed if the largest subsidiary is a broker-dealer. The conservator or receiver would have broad powers to take action with respect to the financial firm. For example, the Proposal indicates that it should have the authority to: (1) take control of the operations of the failing firm or to sell or transfer all or any part of the assets of the firm, including derivatives contracts, to a bridge institution or other entity; and (2) renegotiate or repudiate the firm's contracts, including contracts with its employees. The conservator or receiver would be authorized to borrow from Treasury when necessary to finance exercise of the authorities under the resolution regime, and Treasury would be authorized to issue public debt to finance any such loans. The costs of any such loans would be paid from the proceeds of assessments on BHCs. In light of the FDIC's role in the proposed special resolution regime, it would be given "back-up examination authority" over BHCs.

One of the biggest issues raised by this proposal is the identity of the agency that should be given systemic resolution authority. In this regard, some have proposed that a new bankruptcy court category be established for institutions posing systemic risk, rather than relying upon the FDIC (or SEC) to serve as conservator or receiver.

B. Federal Reserve Emergency Lending

In the midst of the financial crisis, the Federal Reserve lent to investment banks and other non-depository firms under its emergency lending authority. The Administration proposes that the

Federal Reserve be precluded from doing so in the future without the prior written approval of Treasury. To achieve this, Section 13(3) of the Federal Reserve Act would have to be amended.

V. Raise International Standards and Improve International Cooperation

A. Four Core International Issues

The Proposal's international strategy focuses on four "core issues": (1) strengthening capital standards; (2) improving the oversight of global financial markets, particularly for OTC derivatives; (3) enhancing supervision of complex global financial firms; and (4) improving cross-border crisis prevention and resolution procedures.

1. Capital Standards

The Proposal recommends that the Basel Committee on Banking Supervision ("BCBS") improve Basel II risk weights applicable to trading book assets and securitized products. The Proposal also recommends that the BCBS develop a "simple, transparent, non-model based measure of leverage" and liquidity risk management standards. Further, the Proposal recommends adoption of the G-20's recommendations to mitigate procyclicality, including a requirement for banks to build up capital buffers during favorable economic conditions for use in deteriorating economic environments.

2. Oversight of Global Markets

The Proposal urges international cooperation to raise global standards for OTC derivatives markets, further integrate market infrastructures and avoid measures that may result in market fragmentation. In particular, it calls for standardization and improved oversight of credit derivatives and other OTC derivatives through the use of central counterparties, along the lines of the G-20 commitment.

3. Supervisory Colleges

The Proposal mentions that "supervisory colleges for the thirty most significant global financial institutions" have been established. Such supervisory colleges provide a forum for cross-border information sharing and collaboration. The Proposal recommends the establishment and continued operational development of such colleges.

4. Cross-Border Resolutions

The Proposal expresses a degree of frustration with the absence of a clear regime for the cross border resolution of failing financial firms. The Proposal suggests that the lack of international consistency with respect to netting rules and the "ring-fencing" of assets within each country compound the difficulty of resolving large cross-border failures. The Proposal identifies four specific improvements that must be made to the cross-border resolution regime: (1) creating flexible powers for resolution agencies to provide for continuity of systemically significant functions (such as the transfer of assets and contracts to other firms or a bridge institution); (2) enhancing information-sharing among agencies responsible for resolution and heightened understanding of the manner in which the various resolution regimes interact with each other; (3) improving capacity for resolution agencies to address the failure of an institution operating as a "separate entity" in separate jurisdictions; and (4) enhancing the effectiveness of existing clearance and settlement rules for cross border financial contracts and large value payments transactions, including by providing options for the maintenance of contractual relationships (e.g., through a bridge institution).

B. Additional Areas of Reform in the International Context

1. Tier 1 FHCs

The Proposal also would require certain non-U.S. financial firms to be subject to regulation as "Tier 1 FHCs." The Proposal calls on the Federal Reserve to develop standards for evaluating whether to designate a non-U.S. firm as a Tier 1 FHC. In evaluating whether a foreign firm should be so designated, the Proposal calls on the Federal Reserve to give due regard to the principle of national treatment and equality of competitive opportunity. The Federal Reserve also would consider how the proposed new FHC requirements with respect to being "well-capitalized" and "well-managed" should apply to foreign banks that seek FHC status.

2. Hedge Funds

The Proposal reiterates the importance of requiring hedge funds or their managers to register and to disclose information necessary to assess whether they pose systemic risk individually or collectively.

3. Compensation Practices

The Proposal indicates that the BCBS should integrate principles on appropriate compensation practices into its risk management guidance. The Proposal indicates that such practices should be designed to align compensation structures with a firm's long-term goals and with prudent risk taking.

4. Prudential Supervision, Anti-Money Laundering and Tax Information Exchange

The Proposal urges international standard setters to raise international standards with respect to prudential supervision, anti-money laundering laws and tax information exchange.

5. Accounting Standards

The Proposal recommends that international accounting standard setters clarify fair value accounting standards and the standards for loan loss provisioning. In addition, the Proposal urges standard setters to continue their progress in converging Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS"). The Proposal notes that such convergence has been set by the SEC as a precondition to the adoption in the U.S. of IFRS for all U.S. issuers.

6. Credit Rating Agencies

The Proposal urges all national authorities to enhance oversight of credit rating agencies, consistent with international standards and the G-20 Leaders' recommendations. The Proposal notes, in particular, that national authorities should register and oversee all credit rating agencies whose ratings are used for regulatory purposes and that such an oversight regime should establish rules for minimizing conflicts of interests in the credit ratings process. It also notes that the G-20 Leaders called for ratings for structured products to be differentiated.

VI. SEC and CFTC Addendum

A. The SEC

Although the SEC has come under a fair bit of criticism over the last year, the Proposal treats the agency generally well. In particular, the SEC is praised for its renewed attention to enforcement and for making enforcement actions easier to bring. Under the Proposal, the SEC would be: (1) given greater power to impose broad sanctions; (2) told to regulate credit rating agencies more strictly; (3) given some undefined power over OTC derivatives that are not "securities" under current law; (4) authorized to require the registration of virtually all investment advisers of any size; and (5) granted greater powers over executive compensation at public companies and accounting procedures, particularly those used by financial firms. Most significantly, the SEC would not lose any of its turf to the CFPA. Although the SEC would lose its authority over the holding companies of large broker-dealers subject to consolidated supervision, this would be just a formality as this authority has already been lost in practice. That said, it is clear that the Proposal was heavily influenced by the banking regulators.

B. Broker-Dealers

It is implicit in the Proposal that broker-dealers, and their holding companies, would be subject to stricter capital regulations.

There are a number of statements in the proposal that would risk subjecting broker-dealers to very open-ended enforcement risk. For example, the Proposal indicates that "Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers." In practice, does this mean that a broker-dealer could not recommend a security to a client without extensive background on the client's personal status? And, would the broker-dealer have an ongoing duty to update any recommendation?

In addition, the SEC would be "empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest." This seems to be a very open-ended provision that could operate as an invitation to litigation. Moreover, in light of the comments in the Proposal that all financial product providers should be made subject to a level playing field, one wonders if this standard also could be applied to banks, FCMs or (down the road) insurance companies.

C. CFTC

The CFTC is not only preserved, its authority is likely expanded into the OTC markets. The CFTC is directed that its current "principles-based approach" to exchange/clearing corporation regulation must be made "more precise" so that violations may be readily detected.

D. Commodity Funds

The Proposal notes that the CFTC regulates over 1,300 operators of commodity pools, including many of the largest hedge funds. The Proposal goes on to state that "it will be important that the CFTC be able to maintain its enforcement authority over these entities as the SEC takes on important new responsibilities in this area." Query: if the CFTC is supposed to harmonize its regulations with the SEC, and if the SEC is going to register virtually every adviser having control over private pools of capital, will the CFTC likewise expand its registration requirements for pool operators and advisors?

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