

Obama Administration White Paper on Financial Regulatory Reform: Executive Summary and Outline of Key Proposals

DAVIS POLK & WARDWELL

June 17, 2009

Introduction

This newsflash summarizes the key proposals in the Obama Administration's White Paper on Financial Regulatory Reform. We will post a full memorandum with analysis and commentary in the coming days, but, in the meantime, we hope readers will find this factual outline helpful.

* * * * *

Executive Summary

The five areas covered in the White Paper are:

1. Supervision and regulation of financial firms, including:

- creation of a Financial Services Oversight Council,
- identification of systemically important firms, which are called "Tier 1 FHCs,"
- enhanced standards for all banks and BHCs,
- BHC status for any firm owning a thrift, ILC, credit card bank, trust company, or other non-traditional bank,
- subjecting Tier 1 FHCs and firms owning non-traditional banks to non-financial activities restrictions in the BHC Act,
- merger of the OTS and OCC into a new National Bank Supervisor,
- registration and reporting requirements for most advisers of private pools of capital including hedge funds,
- establishment of an Office of National Insurance in Treasury, but no federal insurance charter, and
- stronger requirements for money market funds and government sponsored enterprises;

2. Regulation of financial markets, including:

- skin-in-the-game and compensation requirements for originators and sponsors of asset-backed securities,
- regulation of OTC derivatives and OTC derivatives dealers,
- proposal to harmonize futures and securities regulation, and
- enhanced oversight by the Federal Reserve over systemically important payment, clearing and settlement systems and activities of major participants;

3. Consumer and investor protection, including:

- creation of a Consumer Financial Protection Agency with rule making, supervisory and enforcement authority over credit products,
- creation of a Financial Consumer Coordinating Council to advise on gaps in consumer and investor protection and to promote best practices, and
- other initiatives to bolster the authority of the SEC, FTC and to address retirement security;

4. Resolution authority and Section 13(3) authority, including:

- giving Treasury resolution authority over BHCs and Tier 1 FHCs modeled on the FDIC's resolution authority over insured banks and thrifts, with the FDIC (or in the case of a group that is primarily a securities firm, the SEC) acting as receiver or conservator, and
- requiring the Federal Reserve to obtain prior approval from Treasury for all lending under Section 13(3); and

5. International regulatory standards and cooperation, including:

- support for existing G-20 and other initiatives, and
- rules for determining whether a foreign financial firm is a Tier 1 FHC.

Outline of the Proposals

I. Supervision and Regulation of Financial Firms

A. Council and Tier 1 FHCs

- *Council.* Creation of a Financial Services Oversight Council, chaired by the Treasury Secretary and with members from each federal financial regulatory agency. Would replace the President's Working Group on Financial Markets and have permanent staff.
- *Tier 1 FHCs.* Creation of a new category of systemically important firms called "Tier 1 FHCs." A firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed would be a Tier 1 FHC, regardless of whether the firm controls an insured depository institution. There is no express requirement that the firm be a *financial* firm. A Tier 1 FHC would be subject to consolidated supervision by the Federal Reserve, including *stricter* capital, risk management, liquidity, and prompt corrective action standards than BHCs.
 - *Information Gathering Authority from any U.S. Financial Firm.* The Council would have authority to require reports from any U.S. financial firm solely for the purposes of assessing threats to financial stability. As reasonably necessary to identify Tier 1 FHCs, the Federal Reserve would be authorized to collect reports from all U.S. financial firms over a specified size threshold and, if these reports prove insufficient, to conduct examinations.
 - *Prudential Standards for Tier 1 FHCs.* The Federal Reserve, in consultation with the Council, would set prudential standards, including capital requirements, liquidity standards, and overall risk management practices, for Tier 1 FHCs to maximize financial stability at the lowest cost to long-term financial and economic growth.
 - *Activities Restrictions on Tier 1 FHCs.* The activities restrictions in the BHC Act would be imposed on all Tier 1 FHCs, regardless of whether they controlled an insured depository institution, in order to reflect a renewed commitment to the wall between banking and commerce. Tier 1 FHCs that do not control an insured depository institution would be subject to the full range of prudential regulations and supervisory guidance applicable to BHCs.

- *Regulation of Subsidiaries.* The Federal Reserve would have expanded authority to require reports from and conduct examinations of a Tier 1 FHC and all of its subsidiaries. Instead of the single Gramm-Leach-Bliley functional regulator of a subsidiary, the Federal Reserve, after consultation with a subsidiary's primary regulator and Treasury, would be allowed to impose and enforce more stringent prudential requirements on subsidiaries of a Tier 1 FHC.
 - *Restructuring of the Federal Reserve.* The Federal Reserve, in consultation with Treasury and external experts, would propose recommendations by October 1, 2009, to better align its structure and governance with its authorities and responsibilities.
- B. Capital and Other Prudential Standards for All Banks and BHCs
- *Review of Capital Requirements.* Treasury, in consultation with federal financial regulatory agencies and external experts, would conduct a fundamental reassessment of existing capital requirements for banks and BHCs to be done by December 31, 2009, including a review of proposed changes to reduce procyclicality and the use of contingent capital instruments.
 - *Review of Supervision and Regulation.* Treasury, in consultation with federal financial regulatory agencies and external experts, would conduct a fundamental reassessment of the supervision and regulation of banks and BHCs to be finished by October 1, 2009, including how to effectively conduct continuous supervision.
 - *Standards and Guidelines for Executive Compensation.* Federal regulators would issue standards and guidelines to align executive compensation practices of financial firms with long-term shareholder value and to prevent undue risk-taking through five main principles. Compensation would be further restrained by increased SEC disclosure requirements, proposed "say on pay" legislation and legislation that would empower the SEC to require compensation committees to be more independent.
 - *Consolidated Capital and Supervisory Requirements.* In order to qualify as an FHC under the BHC Act, a BHC would be required to satisfy well-capitalized and well-managed tests at both the consolidated and subsidiary depository institution levels.
 - *Review of Accounting Standards.* Accounting standard setters would be required to review certain accounting standards to make them less procyclical (e.g., standards applicable to loan loss provisioning and fair market accounting).
 - *Restrictions on Transactions with Affiliates.* Strengthen firewalls between banks and their affiliates under Sections 23A and 23B of the Federal Reserve Act and limit the Federal Reserve's discretion to provide exemptions from the bank/affiliate firewalls.
- C. Merger of OTS and OCC into a new National Bank Supervisor
- *National Bank Supervisor.* The OCC and the OTS would be merged into a new federal governmental agency, the National Bank Supervisor within Treasury, to conduct prudential supervision and regulation of all federally chartered depository institutions and all federal branches and agencies of foreign banks. Federal Reserve and FDIC supervision and regulation of state-chartered banks and the National Credit Union Administration authorities would remain the same.

- *Elimination of the Federal Thrift Charter, but Expansion of Interstate Branching Powers.* The federal thrift charter would be eliminated, but its interstate branching rules would be preserved and extended to all state and national banks.
- *Eliminate the Ability to have a Non-Traditional Bank Subsidiary without being Regulated as a BHC.* The exceptions from the BHC Act for companies that control thrifts, ILCs, credit card banks, trust companies or other non-traditional banks would be eliminated, including possibly for grand-fathered institutions.
- *Eliminate the SEC's Consolidated Supervision Programs.* Investment banking firms seeking consolidated supervision by a U.S. regulator would be subject to the Federal Reserve's supervision and regulation. The SEC would not be permitted to be a consolidated supervisor.

D. Register Private Pools of Capital

- *Register Investment Advisers.* Investment advisers to hedge funds and other private pools of capital would be required to register with the SEC under the Investment Advisers Act if their assets under management exceed a modest threshold.
- *Recordkeeping Requirements.* All funds advised by an SEC-registered investment adviser would be subject to recordkeeping requirements; enhanced disclosure requirements; and regulatory reporting requirements, including assets under management and counterparty exposures. These disclosures would allow determination of whether any fund or fund family meets the Tier 1 FHC criteria.
- *Tier 1 FHC Status.* Reports to the SEC will be shared with the Federal Reserve, which will supervise and regulate funds that meet the Tier 1 FHC criteria.

E. SEC Plans to Strengthen Money Market Funds to Proceed. The SEC should proceed with plans to strengthen the regulatory framework around money market funds. By September 15, 2009, the President's Working Group on Financial Markets should prepare an assessment of potential fundamental changes to directly address systemic risk (e.g., elimination of the use of stable net asset value).

F. Office of National Insurance

- *Establish an Office of National Insurance.* An Office of National Insurance to be created within Treasury would monitor all aspects of the insurance industry, gather information, identify emerging problems or gaps in regulation, and recommend to the Federal Reserve insurance companies that should be monitored as Tier 1 FHCs. The Office of National Insurance would interface internationally and have the authority to negotiate and enter into international agreements.
- *No Federal Insurance Charter.* The White Paper articulated principles for insurance regulation that do not mandate a federal insurance charter, but include "increased national uniformity through either a federal charter or effective state action."

G. Government Sponsored Enterprises. Treasury and HUD to explore options and develop recommendations for the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and to report to Congress at the time of the President's 2011 budget release.

II. Regulation of Financial Markets

A. Securitization Markets

- *Retention of Risk.* Loan originators and asset-backed securities sponsors would generally be required to retain 5% of credit risk of securitized exposures, and be generally prohibited from hedging that risk.
- *Compensation Incentives.* The compensation of originators and sponsors would be linked to the longer-term performance of the securitized loans. Sponsors would provide representations and warranties regarding the securitizations. Originators would not recognize gain on sale, but income over time.
- *Reporting and Disclosure Requirements.* The SEC would increase the transparency and standardization of securitization markets. Disclosure requirements for asset backed securities issuers, and legal documentation to be standardized. SEC and FINRA to expand TRACE trade reporting for corporate bonds to include asset backed securities.
- *Credit Rating Agencies.* Credit rating agencies should disclose conflicts of interest, distinguish structured and non-structured ratings and use comparable rating systems, and highlight the risks addressed by the ratings. Regulators should avoid using ratings in regulations.

B. OTC Derivatives Regulation

- *All Standardized OTC Derivatives to be Cleared through central counterparties.* All standardized OTC derivatives would be cleared through central counterparties which impose margin requirements and other risk controls.
- *OTC Derivative Dealers Subject to Prudential Supervision.* All OTC derivative dealers would be subject to prudential supervision, including capital requirements, conduct of business standards, requirements of initial margins on counterparty credit exposure and reporting requirements. Capital requirements would be more conservative than the existing bank regulatory capital requirements for OTC derivatives.
- *Recordkeeping and Reporting Requirements.* The CFTC and the SEC would impose recordkeeping and reporting requirements on all OTC derivatives. Central counterparties and trade repositories would be required to make public aggregate data on open positions and trading volumes. Standard derivative contracts would be cleared on regulated exchanges and electronic trading platforms. Regulated financial institutions would be encouraged to use exchange-traded derivatives.
- *Market Protection Authority.* The CFTC and the SEC would have unimpeded authority to police market abuses involving OTC derivatives, and the CFTC would have the authority to set position limits on OTC derivatives. Current laws would be amended by more stringently limiting the types of counterparties that can participate or imposing disclosure requirements or standards of care with respect to marketing.

- C. SEC and CFTC Report on Harmonization of Futures and Securities Regulation. The SEC and CFTC would seek to harmonize futures and securities laws for economically equivalent instruments through intermediate approaches where the two agencies differ. The SEC and the CFTC to complete a report by September 30, 2009 to justify conflicts in statutes and regulations with respect to similar financial instruments or recommend changes to eliminate the differences. If they fail to do so, the Financial Services Oversight Council will make its recommendations to Congress.

- D. Expanded Federal Reserve Authority Over Systemically Important Payment, Clearing and Settlement Systems and Major Participants. The Federal Reserve would have enhanced oversight authority over risk management systems of systemically important payment, clearing and settlement systems, and with the primary regulator (the SEC or the CFTC), could obtain reports, examine and enforce standards for these systems or for financial firms participating in these systems. The Federal Reserve would seek to obtain reports first through the primary regulator and would have back-up examination and enforcement authority with respect to risk management standards.
- E. Central Bank Money and Discount Window Access for Payment, Clearing and Settlement Systems. Federal Reserve to have the authority to give systemically important payment, clearing and settlement systems access to central bank money (instead of being limited to commercial bank money) to settle transactions, as well as financial services and the discount window. Discount window access would be for emergency purposes.

III. Consumer and Investor Protection

A. Consumer Financial Protection Agency

- *CFPA.* A single primary federal consumer protection supervisor, the Consumer Financial Protection Agency (“CFPA”), would be given broad jurisdiction to protect consumers of credit, savings, payment, and other consumer financial products and services, except for investment products and services already regulated by the SEC or the CFTC, and to regulate bank and nonbank providers of such products and services.
 - *Funding and Rule Making.* The CFPA will be an independent agency, funded in part from fees on entities such as bank and nonbank providers of covered products and services, and from transactions across the financial sector, and will have sole rule-making authority for consumer financial protection statutes, along with the ability to fill gaps through rule-making.
 - *Floor, Not Ceiling.* The states will have the ability to adopt and enforce stricter laws for institutions of all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter.
 - *Supervisory and Enforcement Authority.* The CFPA will have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes it implements, including insured depositories and the range of other firms not previously subject to comprehensive federal supervision, and will be able to work with the DOJ to enforce compliance in federal court.
 - *Stricter Regulations.* The CFPA will implement stricter regulations to improve transparency, fairness, accountability, access, and appropriateness of consumer and investor products and services. It will focus on making all disclosure mandates and communications to consumers clear and reasonable; promoting “plain vanilla” products; placing tailored restrictions on product terms and provider practices; imposing duties of care on financial intermediaries; and enforcing fair lending laws and the Community Reinvestment Act.
- B. FTC to Have Concurrent Authority with the CFPA. The FTC will retain concurrent authority with the CFPA for dealing with fraud in the financial marketplace, including the sale of services like advance fee loans, credit repair, debt negotiation, and foreclosure rescue/loan modification fraud. The FTC will be authorized to conduct rulemakings and obtain civil penalties for unfair and deceptive practices in areas remaining under its authority.

- C. SEC Authorities and Investor Protection. The SEC would be given expanded authority to promote transparency in investor disclosures and new tools to increase fairness for investors, including the authority to require certain disclosures, such as a summary prospectus, to be delivered at or before the point of sale, to establish the same fiduciary duty for broker-dealers providing investment advice about securities to retail investors as for registered investment advisors. The SEC would also be given authority to prohibit mandatory arbitration clauses. Before using such authority, the SEC would need to conduct a study on the use of mandatory arbitration clauses to determine whether investors are harmed, as well as whether changes to arbitration are appropriate.
- D. Financial Consumer Coordinating Council. A Financial Consumer Coordinating Council would advise on gaps in consumer and investor protection and promote best practices across different markets. The new Council will be under the leadership of the Financial Services Oversight Council and will consist of the heads of the SEC, FTC, the Department of Justice, the CFPB, and other federal and state agencies.
- E. Promoting retirement security. Legislation would create the “Automatic IRA” plan and a strengthened saver’s credit, apply consumer and investor protection principles to employee-directed workplace retirement plans, such as 401(k)s, and “Automatic IRA” plans, and encourage measures to restore more lifetime income throughout the retirement system.

IV. Resolution Authority and Section 13(3) Authority

- *Resolution Authority.* A resolution authority would be created for BHCs and Tier 1 FHCs. The proposal is structurally similar to Treasury’s proposed legislation to create a resolution authority. The resolution authority would supplement, but not displace, bankruptcy and FDIC regimes.
- *Change the “Rules of the Game” on the Eve of Bankruptcy.* As currently proposed, the resolution authority would fundamentally change the “rules of the game” that determine the rights of creditors, customers, and other stakeholders on the eve of bankruptcy.
- *FDIC or SEC as conservator or receiver.* Treasury would determine whether to resolve a failing firm, and how to do so. Treasury would generally appoint the FDIC to act as conservator or receiver, but could appoint the SEC if the firm’s largest subsidiary is a broker-dealer or securities firm.
- *FDIC’s Powers.* The FDIC would be able to obtain any examination report prepared by the Federal Reserve for any BHC and have back-up examination authority over all BHCs.
- *Section 13(3) Powers.* The Administration will propose legislation requiring the Federal Reserve to obtain prior approval from Treasury for all lending under Section 13(3) to ensure accountability.

V. International Regulatory Standards and Cooperation

- *G-20 Initiatives.* Generally, the proposals do not recommend new international initiatives, but instead support existing G-20 and other initiatives. Topic areas include capital requirements, increased regulation of credit rating agencies, convergence of regulations, OTC derivatives markets, cross-border supervisory colleges, and cross-boarder resolution mechanisms for global financial firms.
- *Foreign Financial Firms as Tier 1 FHCs.* The Federal Reserve, in consultation with Treasury, should (1) develop rules that base a determination of whether a foreign financial firm is a Tier 1 FHC on the firm’s U.S. operations

Obama Administration White Paper on Financial Regulatory Reform: Executive Summary and Outline of Key Proposals

June 17, 2009

and (2) apply newly proposed tests for FHC status to foreign financial firms in a manner comparable to their application to U.S. firms.

This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

* * * * *

If you have any questions regarding this newsflash, please contact any of the lawyers listed below or your Davis Polk contact.

Annette L. Nazareth, Partner*
202-962-7075 | annette.nazareth@dpw.com

Luigi L. De Ghenghi, Partner
212-450-4296 | luigi.deghenghi@dpw.com

Arthur S. Long, Partner
212-450-4742 | arthur.long@dpw.com

Margaret E. Tahyar, Partner
212-450-4379 | margaret.tahyar@dpw.com
33 1 56 59 36 70

Robert Colby, Counsel
202-962-7121 | robert.colby@dpw.com

Reena Agrawal Sahni, Counsel
212-450-4801 | reena.sahni@dpw.com

Randall D. Guynn, Partner
212-450-4239 | randall.guynn@dpw.com

Ethan T. James, Partner
212-450-4244 | ethan.james@dpw.com

Lanny A. Schwartz, Partner
212-450-4174 | lanny.schwartz@dpw.com

Gerard Citera, Counsel
212-450-4881 | gerard.citera@dpw.com

Courtenay Myers, Counsel
212-450-4943 | courtenay.myers@dpw.com

* Admission pending in DC; practicing in DC under the supervision of partners of the firm.