Davis Polk

A NEW FOUNDATION FOR FINANCIAL REGULATION?

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The Obama Administration's White Paper on Financial Regulatory Reform is just the beginning of what is likely to be a legislative, regulatory and ideological marathon, despite the Administration's best efforts to achieve domestic political support before its publication. It is far less revolutionary than some either feared or hoped for and reflects an "art of the possible" approach to regulatory reform by the Obama Administration. Ultimately the White Paper reflects a compromise designed to avoid as much as possible the most difficult regulatory, state and congressional turf battles.

As a result, the plan is notable as much for what it does not do as for what it does. It is not a once-in-a-lifetime regulatory overhaul. It does not propose a CFTC-SEC merger, it does not propose an optional federal insurance charter and it does not streamline the alphabet soup of financial regulatory agencies. If anything, it adds more regulators than it eliminates. Its key innovations involve expanded power for the Federal Reserve as the sole systemic risk regulator, with the creation of a Financial Services Oversight Council to mollify those who are concerned about the aggregation of power in the Federal Reserve; the long anticipated registration of advisers to hedge funds, private equity funds and venture capital funds; the regulation of OTC derivatives; the merger of the OTS and the OCC; the creation of a Consumer Financial Protection Agency with vast new powers delineated in such a way that future jurisdictional turf wars are inevitable; and the creation of a resolution regime for bank holding companies and Tier 1 FHCs. While the White Paper is an incomplete framework, one possible benefit is that it creates the skeleton of a "twin peaks" structure, with a prudential and a business conduct regulator, into which other agencies could be merged in the future.

The Administration has set a goal of passing its reform package by the end of the year and promises that legislative text will soon be sent to the Hill. Naturally, the political reaction has already begun, with Republicans outlining their own plan and individual Senators and Congressmen proposing, or soon to propose, competing proposals and language.

Other stakeholders, both domestic and international, will also have a view and, in some cases, a voice. Indeed, the White Paper proposals are made at a time of parallel UK and European regulatory reform driven in part, as is the White Paper, by the G-20 proposals. The European Council of Ministers proposed its own plan this past week for which legislative text is expected in the fall, and the UK is expected to publish more details on its own version shortly. The era when financial regulation was purely a matter for domestic politics is over. More and more the domestic US financial regulatory agenda is being influenced by international fora, by an active EU regulatory structure which has created extraterritorial standards and imposed requirements of comparability and by the international and US domestic push for harmonization of standards across regulatory bodies.

The shifting dynamics of the regulatory reform proposals and the politics involved in any consolidation, reorganization or redistribution of regulatory responsibilities mean that it is too early to predict with certainty which proposals are likely to be enacted and in what form. In light of the many competing proposals and legislative texts, we believe that it is possible that some elements, such as the Consumer Financial Protection Agency, will be enacted separately and attached to other bills rather than as an omnibus package. Davis Polk is monitoring new developments and will issue newsflashes and memoranda from time to time.

Supervision and Regulation of Financial Firms

The White Paper attempts to strike a political compromise between those who would give systemic risk oversight to a college of regulators and those who would vest power in the Federal Reserve. The result is a proposal that is certain to be subject to substantial debate, change and negotiation in the coming months.

The Federal Reserve as Systemic Risk Regulator

The White Paper proposes fundamental changes to the powers and responsibilities of the Federal Reserve. At the heart of the Federal Reserve's expanded authority is the power to designate a new category of systemically important firms referred to as "Tier 1 FHCs." Any firm whose combination of size, leverage, and interconnectedness could pose a threat to the financial system if it failed would be a Tier 1 FHC. These firms would be subject to enhanced consolidated supervision and regulation by the Federal Reserve, regardless of whether the firm owns an insured depository institution.

The use of the acronym FHC is misleading. The Federal Reserve's power to tag a firm as a Tier 1 FHC is far broader and more sweeping than the current regulatory use of the term financial holding company, which is limited to bank holding companies ("**BHCs**") that meet certain well-managed and well-capitalized standards that entitle them to engage in a broader range of business activities. The precise definition of Tier 1 FHC in the legislative text is likely to be a topic of intense negotiation. Secretary Geithner has stated that "at this stage [the Tier 1 FHCs] would largely entail the major banks and investment banks in the country today."

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Many critics have questioned the wisdom of concentrating additional power in the Federal Reserve and have criticized its failure to curtail practices that arguably led to the current financial crisis. Some of these critics believe a committee of regulators would be more appropriate and less threatening than the Federal Reserve. The White Paper, however, challenges the notion that a committee of regulators could effectively undertake the task of regulating Tier 1 FHCs.

The House Financial Services Committee Republican Plan has suggested that increasing the Federal Reserve's regulatory powers creates an "incentive to prop up the economy through an accommodative monetary policy to prevent firms under its regulatory purview from failing." Democratic critics have also emerged, with Senator Mark Warner warning that

Report on the structure of the Federal Reserve

- The White Paper commissions a report from the Federal Reserve, Treasury and external experts due October 1, 2009
- The report should propose recommendations to better align the Federal Reserve structure and governance with its authorities and responsibilities
- Some commentators have questioned the continuing need for regional Federal Reserve Banks

concentrating power in the Federal Reserve risks "draw[ing] it more into the political process."

Financial Services Oversight Council

The White Paper proposes the creation of a Financial Services Oversight Council (the "**Council**"), chaired by the Treasury Secretary and with members from each federal financial regulatory agency. The Council's staff would be part of an office within Treasury. Combined with the Treasury Secretary's Chairmanship, this suggests that the proposal envisions Treasury as "first among equals" on the Council.

The Council's main responsibilities may be characterized as a monitoring and referral function, an administrative function and an advisory function.

- As an advisory group, the Council has no enforceable power and is not a check or balance against the Federal Reserve or any other regulator.
- In its monitoring and referral capacity, the Council is charged with identifying gaps in regulation and detecting emerging risks to the financial system. In furtherance of this role, the Council would have authority to require reports from any US financial firm solely for the purpose of assessing threats to financial stability posed by a financial activity or financial market in which the firm participates.
- Although the Council would be responsible for identifying gaps and detecting emerging risks, it would possess no power to take direct action. The White Paper proposes, instead, that the Council refer emerging risks to the attention of "regulators with the authority to respond." The White Paper also provides that the Council would prepare an annual report to Congress on market developments and potential emerging risks.
- The Council's advisory function is embodied in an ability to make recommendations to the Federal Reserve and a requirement that the Federal Reserve consult with the Council before taking specified actions.
- There is no suggestion that the Federal Reserve would be bound by recommendations generated by the Council or by the results of its consultations with the Council.

This proposed structure, in which the Federal Reserve may override the Council at will, has already produced strong criticism. It has been argued that the Council is "without teeth." Critics will likely view the establishment of the Council as an attempt to deflect attention from the breadth of the enhancement of the Federal Reserve's powers.

The Council's administrative function includes a responsibility to:

- Provide a forum for discussion of cross-cutting issues
- Facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding:
  - Policy development
  - Rulemaking
  - Examinations
  - Reporting requirements
  - Enforcement actions

In identifying Tier 1 FHCs, the Federal Reserve must consider:

- The impact the firm's failure would have on the financial system;
- The firm's combination of size, leverage, and degree of reliance on short-term funding; and
- The firm's criticality as a source of credit and liquidity.

Identifying Tier 1 FHCs

The White Paper proposes that Tier 1 FHCs would be identified by the Federal Reserve based on rules established in consultation with Treasury. This vests the Federal Reserve with a key power that some, particularly FDIC Chairman Sheila Bair, advocated for placing with the Council. In addition to the rules it establishes, the Federal Reserve would be bound to "consider" specific factors that would be incorporated into the legislation. These factors, set forth in the sidebar, would not, however, be exhaustive.

The White Paper proposes that the Federal Reserve be permitted to exercise discretion in the application of factors to individual firms—a process in which Treasury would play no explicit role. In the identification process, the Federal Reserve is instructed to include an analysis of the firm's systemic importance under stressed economic conditions. Before regulating a Tier 1 FHC, the Federal Reserve would be required to consult with the prudential regulator of the firm's regulated subsidiaries, if any. The proposal asserts that the flexibility provided to the Federal Reserve in identifying Tier 1 FHCs "is essential to minimizing the risk that an 'AIG-like' firm could grow outside the regulated system."

The White Paper is silent on whether a firm would have the right to challenge any determination or presumption that it is a Tier 1 FHC, or enjoy any transition period for newly anointed Tier 1 FHCs, or whether the rules would be clear enough to permit firms to run their businesses in such a way as to avoid a Tier 1 FHC designation.

Information Collection and Examination

To aid in the identification process, the Federal Reserve would be granted authority to collect reports from all US financial firms meeting a certain unspecified size threshold. [1] Where the Federal Reserve is unable to make a determination based on these reports and other available information, it would be permitted to examine any US financial firm exceeding a certain unspecified size threshold. In both circumstances, the Federal Reserve would have access to information from other regulators.

The lack of fixed identification criteria and clear size thresholds subjects the identification process to the criticism that the Federal Reserve could arbitrarily determine which institutions are systemically important and "too big to fail." Moreover, many entities not currently regulated by the Federal Reserve will not be prepared for pervasive Federal Reserve oversight and examination. Given the consequences to a financial firm that suddenly finds

[1] Although the White Paper indicates that the Federal Reserve's "authority to require reports should be limited to information that cannot be obtained from reports to other regulators," there remains a risk of duplicative requests for information from the Council, the Federal Reserve and other regulators.

itself tagged as a Tier 1 FHC, the Federal Reserve should consider whether a transition period would be appropriate for any firm so anointed.

Although it is not explicitly stated in the White Paper, we assume that the identification of a firm as a Tier 1 FHC would become a matter of public record. Critics have already pointed out that such firms might benefit from a subsidy in capital-raising given the implicit state guarantee (from being "too big to fail"). Given the greater regulation to which such firms would be subject, however, others might view Tier 1 FHC status as a signal to spin off divisions or otherwise maintain a size level just below that which would require that they become Tier 1 FHCs.

Identifying Foreign Firms as Tier 1 FHCs

Foreign Financial Firms

The Federal Reserve to develop rules for when a foreign financial firm will be a Tier 1 FHC, which may be based on:

- The firm's US operations;
- The firm's global operations; or
- How the firm's global operations affect US financial markets.

Treasury to be involved in drafting rules, but not in identifying specific firms.

The White Paper also recommends that the Federal Reserve, in consultation with Treasury, develop rules for determining when a foreign financial firm will be a Tier 1 FHC. The White Paper calls for the Federal Reserve to give due regard to the principle of national treatment and equality of competitive opportunity between foreign firms operating in the US and domestic firms.

The White Paper recommends that the Financial Stability Board and national authorities implement the G-20 agreement to support and develop supervisory colleges for the thirty most significant global financial firms and establish additional colleges for other significant firms. Without such international coordination, overlapping regulation could result in liquidity traps that impair firms' ability to manage their cross-border capital needs.

Prudential Standards for Tier 1 FHCs

The White Paper proposes that the full range of prudential regulations and supervisory guidance applicable to BHCs would apply to all Tier 1 FHCs, even those that do not control insured depositary institutions. Moreover, the White Paper calls for "stricter and more conservative" prudential standards for Tier 1 FHCs than for other institutions. The Federal Reserve's assessment of a Tier 1 FHC's capital strength should include assessments of capital adequacy under severe stress scenarios, making stress-testing a permanent feature of supervision. In addition to a proposal for enhanced public disclosure and the establishment of a resolution plan subject to review by the Federal Reserve, the White Paper presents the following prudential standards as areas of focus:

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- ***Capital Requirements*** that reflect the negative externalities associated with the financial distress, rapid deleveraging, or disorderly failure of the firm and are therefore strict enough to be effective under extremely stressful economic and financial conditions. The requirements should provide for a sufficient increase in high-quality capital during good economic times to remain above prudential minimum levels during stressed economic times;

- ***Prompt Corrective Action Regimes*** that require action as the firm's regulatory capital levels decline, similar to the regime established under the Federal Deposit Insurance Corporation Improvement Act for insured depositary institutions;

- ***Liquidity Standards*** that recognize the potential negative impact on the financial system of financial distress, rapid deleveraging or disorderly failure and that are stress tested across a variety of stress scenarios. The Federal Reserve should continuously monitor liquidity risk profiles and promote full integration of liquidity risk management into the overall risk management of Tier 1 FHCs; and

- ***Overall Risk Management*** that is in proportion to the risk, complexity and scope of a Tier 1 FHC's operations with appropriate limits and controls around firm-wide risk concentrations.

These enhanced capital, liquidity and other requirements have the potential to make US Tier 1 FHCs uncompetitive with foreign firms if similar standards are not placed on other important global financial firms. In particular, capital standards have, since 1988, been coordinated at an international level by the Basel Committee, and the US representatives on that Committee are likely to recommend that enhanced liquidity, prompt corrective action and risk management principles be part of the Basel Committee purview, as well.

The increased focus on risk management implies, we believe, an enhanced role for Chief Risk Officers, an increase in board-level risk committees and, as risk management is now also seen as linked to corporate governance, an implicitly increased role of the Federal Reserve and perhaps the Council in the corporate governance of Tier 1 FHCs.

Activities Restrictions on Tier 1 FHCs

The White Paper reaffirms the traditional US commitment to the separation between banking and commerce. Historically, the separation of banking from commerce in the US has had a multitude of meanings, so the exact contours of what is intended here will have to await clarification from the text of the proposed legislation. Under the proposal, each Tier 1 FHC would be required to comply with the nonfinancial activity restrictions of the BHC Act, regardless of whether that firm controls an insured depository institution.

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Regulation of Subsidiaries

The Federal Reserve would be given authority to require reports from and to conduct examinations of a Tier 1 FHC and all of its subsidiaries. In introducing these proposals, the White Paper notes that aspects of the Gramm-Leach-Bliley Act have made it "difficult to take a truly firm-wide perspective" and have forced the Federal Reserve to rely solely on other supervisors for information. After consultation with a subsidiary's primary regulator and Treasury, the Federal Reserve would be authorized to impose and enforce more stringent prudential requirements on subsidiaries of a Tier 1 FHC. The authority granted to the Federal Reserve under the proposal would extend to the Tier 1 FHC and all of its subsidiaries, regulated and unregulated, US and foreign.

This proposal potentially has broad implications for Tier 1 FHCs with broker-dealer or insurance subsidiaries, as well as the regulators of those entities. The Federal Reserve will essentially have the authority to override the judgments of the functional regulators and impose stricter or different requirements, such as capital or liquidity requirements, on regulated subsidiaries of Tier 1 FHCs. This is a substantial change from the Gramm-Leach-Bliley Act's regulatory framework, which permits the Federal Reserve to examine subsidiaries, foreign and domestic, but requires it to rely on any functional regulator's examinations in the first instance.

Macroprudential Focus

In addressing systemic risk, Federal Reserve Chairman Bernanke has called for "a more explicitly macroprudential approach to financial regulation and supervision . . . focus[ing] on risks to the financial system as a whole." The White Paper takes up this call with an explicit exhortation that in regulating and supervising Tier 1 FHCs, the Federal Reserve should maintain a macroprudential focus, continuously analyzing the connections among the major financial firms and the dependence of the major financial markets on such firms. In particular, the White Paper calls on the Federal

Reserve to constantly monitor the build-up of concentrations of risk across all Tier 1 FHCs that may collectively threaten financial stability. This task is to be supported by a requirement that Tier 1 FHCs regularly report to the Federal Reserve the nature and extent to which other major financial firms are exposed to them.

There will be enormous challenges to getting such a system up and running, which include building the computer and technological systems to monitor activity, as well as adding the expert staff to analyze vast quantities of data. To the extent the Federal Reserve's information is limited solely to information generated by the domestic Tier 1 FHCs that it regulates, it will have a limited view of the global picture. As a result, the actual effectiveness of the macroprudential approach will be dependent on both technological implementation and international cooperation. In addition, the line between macroprudential regulation and functional regulation is unclear enough that there is a significant risk of regulatory duplication and overlap.

Capital and Other Prudential Standards for Banks and BHCs

The White Paper proposes numerous initiatives to strengthen capital and other prudential standards governing banks and BHCs. The White Paper acknowledges that "[m]ost banks that failed during the crisis were considered well-capitalized just prior to their failure."

Review of Capital Requirements

The White Paper states that Treasury will lead a working group to conduct a fundamental reassessment of existing regulatory capital requirements for banks, BHCs and Tier 1 FHCs.

The working group, which will include external experts and representatives from the federal financial regulatory agencies, is supposed to issue a report by December 31, 2009 that will address all elements of the regulatory capital framework. Specific items for review are set forth in the sidebar. The timing of this working group's report may be designed to influence the Basel Committee on Banking Supervision, which is set to begin its review of regulatory minimum capital levels in 2010.

Recent history demonstrates the challenges this process will face, especially with large, diversified financial institutions. For example, in May of 2008, AIG estimated that its excess economic capital, as of March 31, 2008, was in the range of \$2.5 billion to \$7.5 billion, compared to total shareholders' equity of \$79.7 billion. In August 2008, one month before it entered into a \$85 billion revolving credit agreement with the Federal Reserve Bank of New York, AIG indicated that, as of June 30, 2008, its economic capital model confirmed its ability to meet its consolidated obligations at a 99.95% confidence level.

The Working Group on Capital Requirements should:

- Review proposed changes to the capital rules to reduce procyclicality;
- Analyze the costs, benefits, and feasibility of allowing banks and BHCs to satisfy a portion of their regulatory capital requirements through the issuance of contingent capital instruments or through the purchase of tail insurance against macroeconomic risks;
- Review proposed increases in regulatory capital requirements on investments and exposures that pose high levels of risk under stressed market conditions; and
- Recognize the importance of a simpler, more transparent measure of leverage for banks and BHCs to supplement risk-based capital measures.

Basel Committee on Capital Standards

As the US is a member of the Basel Committee, it is highly unlikely that the US alone will be setting capital standards, so the results and recommendations of this working group will most likely form the core of US proposals for change at the Basel Committee level.

Consistent with G-20 commitments, the White Paper calls for the Basel Committee to address weaknesses in the Basel II capital adequacy framework that have been highlighted by the financial crisis by:

- Improving the regulatory capital framework for trading book and securitization exposures;
- Strengthening the definition of regulatory capital to improve the quantity, quality and international consistency of capital;
- Developing a simple, transparent, non-model-based measure of leverage; and
- Implementing the G-20's April 2 recommendations to mitigate procyclicality, including a requirement that banks build capital buffers in good times that they can draw down in bad times.

The White Paper recommends that the Basel Committee and national authorities develop a global framework for promoting stronger liquidity buffers at financial institutions by 2010. In September 2008, the Basel Committee on Banking Supervision published Principles for Sound Liquidity Risk Management and Supervision, which sets out principles to strengthen the measurement and management of liquidity risk. The principles highlight "the importance of establishing a robust liquidity risk management framework that is well integrated" into broader risk management process. The White Paper also recommends that the Financial Stability Board work with the Bank for International Settlements and international standard setters to develop macroprudential tools and provide a report to the G-20 by autumn 2009.

Review of Supervision and Regulation

The White Paper also calls for a working group to conduct a fundamental reassessment of the supervision of banks and BHCs. The working group, which is supposed to issue a report with its conclusions by October 1, 2009, would address some of the key problems of the pre-crisis framework that resulted in gaps in supervision and regulatory arbitrage. Similar to the working group on capital requirements, this working group would also be headed by Treasury and include outside experts and representatives of the federal financial regulatory agencies as participants.

The Working Group on Bank and BHC Supervision should review:

- How to effectively conduct continuous, on-site supervision of large, complex banking firms;
- What information supervisors should require from regulated firms;
- How functional and bank supervisors should interact with consolidated holding company supervisors;
- How to coordinate domestic and foreign supervision of multi-national banking firms;
- How to tailor supervision for smaller, simpler firms and larger, more complex firms;
- How to fund and structure supervisory agencies, while avoiding regulatory competition and regulatory capture; and
- The costs and benefits of having supervisory agencies that are responsible for other governmental functions, such as monetary policy.

Consolidated Capital and Supervisory Requirements

The White Paper provides that a BHC wishing to qualify as an FHC would be required to satisfy well-capitalized and well-managed tests at both the consolidated holding company and subsidiary depository institution levels, as opposed to the current legal framework, under which the well-capitalized and well-managed tests, by their terms, apply only to depository institutions. The particular capital standards for FHCs are to be determined in line with the results of the proposed working group's findings.

The White Paper calls for the Federal Reserve to apply the well-capitalized and well-managed tests to foreign financial firms in a manner comparable to their application to US firms, while taking into account any difference in legal form (*e.g.*, if the financial firm operates in the US through branches, rather than subsidiaries).

Review of Accounting Standards

The White Paper proposes that accounting standard setters –- meaning the Financial Accounting Standards Board, the International Accounting Standards Board and the SEC –- should adopt more robust, less procyclical standards for loan loss provisioning and fair value accounting. The White Paper specifically recommends more forward-looking loan loss provisioning standards that would result in higher provisions earlier in the credit cycle. This is an implicit recommendation of Spanish-style "dynamic provisioning" which had, before the financial crisis, been long disapproved of by the SEC accounting staff as creating "cookie jar" reserves. On fair value accounting, the White Paper recommends, without offering further detail, that the applicable rules should be changed to require disclosure of both fair value information and more information about the cash flows that management expects to receive by holding financial instruments.

As with the capital standards, international cooperation between Financial Accounting Standards Board and the International Accounting Standards Board will be critical to making any real progress here. The White Paper expresses support for the G-20 commitments to improve accounting standards, as described in the sidebar.

G-20 Accounting Goals:

- Substantial progress toward a single set of global accounting standards by the end of 2009;
- Simpler, clearer and more consistent fair value standards, including those related to the impairment of financial instruments; and
- More forward-looking accounting standards for loan loss provisioning.

Restrictions on Transactions with Affiliates

Noting that the financial crisis highlighted the value of the federal subsidy associated with a banking charter, the White Paper proposes to broaden and strengthen the restrictions on transactions between banks and their affiliates contained in Sections 23A and 23B of the Federal Reserve Act. The White Paper proposes four measures that either eliminate exemptions in the statutory and related regulatory restrictions or expand the restrictions to newly identified transactions, as set forth in the sidebar.

The White Paper proposes to place the following new restrictions on bank affiliate transactions:

- Place more effective constraints on the ability of banks to engage in OTC derivatives and securities financing transactions with affiliates;
- Require covered transactions between banks and their affiliates to be fully collateralized through the life of the transaction;
- Apply existing federal restrictions on affiliate transactions to transactions between a bank and all private investment vehicles sponsored or advised by the bank; and
- Limit the Federal Reserve's discretion to provide exemptions from the restrictions on affiliate transactions.

The definition of "covered transaction" would be expanded to include derivatives and securities financing transactions, thereby subjecting these transactions to quantitative limits and collateral requirements. The definition of "affiliate" would be expanded to include investment vehicles sponsored or advised by the relevant insured depository institution, thereby subjecting transactions with such affiliates to both the quantitative limits and collateral requirements and the requirement that these transactions be performed on market terms. In addition, supervision and regulation would be tightened to reduce the potential conflicts of interest arising out of the affiliation of banks with non-bank affiliates, such as proprietary trading units and hedge funds.

Standards and Guidelines for Executive Compensation

Five principles that were articulated by Secretary Geithner on June 10, 2009:

- Compensation plans should properly measure and reward performance.
- Compensation should be structured to account for the time horizon of risks.
- Compensation should be aligned with sound risk management.
- Golden parachutes and supplemental retirement packages should be reexamined to determine whether they align with the interests of executives and shareholders.
- Transparency and accountability in setting compensation should be encouraged.

For those firms that hoped that, by repaying TARP money, they would escape regulation of their executive compensation, the White Paper makes it clear that the Obama Administration does not intend to let go of the issue so readily. As restrictions on executive compensation are widely supported by the public, both in the US and internationally, and as major players in the financial industry are on record as stating that the executive compensation system needs to be reconsidered, this initiative should not be a surprise.

The Treasury regulations require the Special Master to consider risk and performance and take into account competitiveness of the employer, the value that the employee has to the employer and comparability with other financial institutions

The White Paper proposes that federal regulators issue standards that would be integrated into the supervisory process, with the intent to align executive compensation practices of financial firms with long-term shareholder value and financial stability. The five principles are identical to those articulated by Secretary Timothy Geithner on June 10 and would apply to all financial firms, not just those participating in the TARP. These five principles are also similar, although not identical, to the principles required to be applied by the Special Master established by Treasury's recent regulations governing compensation for TARP participants. We anticipate that the compensation experience built up by Treasury in the TARP context will be leveraged in fleshing out the principles. In addition, the President's Working Group, and if formed, the Council, will review compensation practices to monitor their impact on risk-taking.

We believe that Treasury assumes that the UK and the EU will develop similar standards because, otherwise, the US financial sector would be placed at a significant competitive disadvantage. The White Paper calls for the adoption by national authorities of guidelines that align compensation at banks and BHCs with long-term shareholder interests and discourage excessive risk-taking. Similarly, the White Paper recommends that the Basel Committee on Banking Supervision integrate the Financial Stability Board compensation principles into its risk management guidance by the end of 2009. Although there has yet to be significant international movement in this regard, the UK's Financial Services Authority has issued a draft code on remuneration practices applicable to "the larger banks and broker dealers." The draft code includes performance considerations in presenting principles to implement the general requirement that "[r]emuneration policies must be consistent with effective risk management."

The compensation standards would be supplemented by increased SEC disclosure, proposed "say on pay" legislation, which would allow shareholders a non-binding vote on executive compensation packages, and proposed legislation to empower the SEC to require that compensation committees be more independent.

We observe that it appears that at least three different federal agencies will have input over compensation: the SEC, as noted above; the Treasury, supporting federal regulators; and the Federal Reserve, as part of risk management.

For more information on the Treasury's guidelines for TARP recipients, see Davis Polk memorandum entitled Treasury Regulations Governing Compensation for TARP Participants dated June 17, 2009.

The National Bank Supervisor

As expected, and in light of the heavy criticism recently showered on the OTS from almost all quarters, the Administration would fold the responsibilities and powers of the OCC and OTS into a new federal government agency, the National Bank Supervisor. Not expected was the proposal to eliminate the thrift charter, which is likely to be highly contentious. The proposals would also expand the reach of the BHC Act by requiring that all holding companies of insured depository institutions become BHCs. We discuss the consequences of each proposal below.

The National Bank Supervisor will:

- Inherit the responsibilities and authorities of the OTS and OCC.
- Have a separate agency status within Treasury and be led by a single executive.
- 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.

National Bank Supervisor

Through the creation of the National Bank Supervisor, all federally chartered insured depository institutions and all federal branches and agencies of foreign banks would be supervised and regulated by a single federal governmental agency, as described in the sidebar. These entities are currently regulated by one or more of the OCC, OTS and the Federal Reserve. Therefore, the creation of the National Bank Supervisor would slightly simplify the bank regulatory system at the federal level by reducing the number of bank regulators. However, the proposal stops short of achieving full supervisory integration at the federal level because the roles of the Federal Reserve and FDIC in the supervision and regulation of state-chartered banks and the National Credit Union Administration authority over credit unions would remain the same.

The proposal to eliminate the thrift charter is in line with the Blueprint published by the Paulson Treasury on March 31, 2008, which called for converting thrifts into national banks. As a risk matter, the qualified thrift lender test forces thrifts to have concentrated exposure to real estate assets. In the recent crisis, this proved to be to the detriment of thrifts.

The elimination of the thrift charter would also eliminate the separate regime of supervision and regulation of thrift holding companies, instead subjecting such companies to the Federal Reserve's regulation and supervision of BHCs, thereby reducing opportunities for arbitrage.

In recognizing that separate federal regulators would continue to exist for national banks, state member banks and state nonmember banks, the White Paper proposes to minimize arbitrage opportunities by restricting the ability of troubled banks to switch charters and supervisors and proposing to reduce the differences in the substantive regulations and supervisory policies governing banks. Taken together with the proposals for CFTC-SEC regulation alignment and reconciliation of EU-US standards, the proposal to make banking regulations and policies more uniform indicates that we are likely to enter into a phase of attempted harmonization efforts.

Although the proposals call for the elimination of the federal thrift charter, they would also preserve and expand one of its key benefits by applying its interstate branching rules to national and state banks and eliminating state-level restrictions on interstate branching. Under the White Paper's terms, states would not be allowed to prevent *de novo* branching into their states, or to impose a minimum age requirement on in-state banks that can be acquired by an out-of-state banking firm.

State regulators are likely to view this change as eliminating an important check on excessive expansion and the development of even more "too big to fail" banks. Historically, the ability of states to reject interstate *de novo* branching and require out-of-state banks to enter their states by acquisition or merger has been one of the remaining checks on nationwide banking. In addition, interstate branching law for federal thrifts generally requires such thrifts to meet certain asset concentration requirements on a state-by-state basis, but there is no obvious analogy in the case of a national or state bank. The proposal endorses the view of banking regulators that geographic diversification reduces risk in the face of local economic shocks.

Institutions that would become subject to BHC regulation

Companies that own one of the following would be required to submit to Federal Reserve supervision and would have five years to conform to the existing BHC Act activity restrictions:

- Thrift
- Industrial loan company
- Credit card bank
- Trust company
- Grandfathered nonbank bank

Eliminating Traditional Exemptions in the BHC Act

The White Paper proposes that all companies that control an insured depository institution become BHCs, meaning that they would be required to submit to the supervision and regulation of the Federal Reserve and to comply with the restrictions on commercial activities. Affected companies are described in the sidebar. The biggest challenge to becoming a BHC for many holding companies currently not regulated under the BHC Act would be compliance with the separation of banking and commerce. This part of the proposal is likely to be viewed by some as a jurisdictional grab by the Federal Reserve and will be highly contentious. GE has already announced its opposition, as has Senator Robert Bennett of Utah, the state with the greatest number of industrial loan companies. This proposal has been criticized on the basis that industrial loan companies were not a major part of the problem leading to the crisis. The proposals would also capture a number of major retail companies, including Nordstrom and Target, that hold industrial loan companies and are not currently regulated as BHCs.

Eliminating the SEC's Consolidated Supervision Programs

The White Paper, in a largely symbolic act, would eliminate the SEC's Supervised Investment Bank Holding Company program, which currently provides consolidated supervision for one investment bank holding company, with the admonition that investment bank supervisors seeking consolidated supervision should look to the Federal Reserve.

Registering Private Pools of Capital

Registration Requirement

The White Paper proposes that all advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds be required to register with the SEC if their assets under management exceed an unspecified "modest" threshold. Currently, some advisers to private funds voluntarily register with the SEC, and others that trade commodity derivatives are required to register with the CFTC, but the proposal aims to require nearly all funds' advisers to register with the SEC under the Investment Advisers Act of 1940 ("**Advisers Act**").

A requirement for hedge funds or their advisers to register with the SEC has been on the legislative horizon for some time and was widely expected. It would likely be accomplished by eliminating the so-called "private adviser exemption" from registration under the Advisers Act, which is currently relied on by many investment advisers to private funds. The SEC's prior attempt to eliminate this exemption through rulemaking was overturned by the D.C. Circuit. A House bill that would eliminate this exemption is pending.

More controversial, however, is the proposal to extend the registration requirement to advisers to private equity and venture capital funds. The financial stability rationale cited for the regulation of hedge fund advisers does not clearly support mandatory registration of advisers to private equity and venture capital funds as such funds do not generally engage in the kind of market activity that the White Paper cites as potentially posing systemic risk.

While the assets under management threshold is not specified in the White Paper, its description as "modest" indicates an impulse to require almost all funds to be subject to SEC oversight. As state securities regulators appear eager to increase regulation of advisers to private funds as well, there will likely be few, if any, gaps between state and federal registration requirements.

Proposed Private Fund Regulation

- Mandatory registration with the SEC for advisers to private funds with assets under management over a "modest" threshold
- Confidential disclosure to SEC to permit assessment of whether a fund should be regulated for financial stability purposes
- SEC would share information with the Federal Reserve
- Registered adviser requirements to include recordkeeping and disclosures to investors, creditors and counterparties

With respect to hedge funds, the US proposals are less onerous than those that have been proposed by the EU. Under legislation put forward on April 29, 2009, European hedge fund managers with €100 million euros or more under management would have to report regularly to the competent national authorities on their main investments, performance and risks, and would be subject to rules on minimum capital, risk management and auditing.

The White Paper expresses support for the G-20 commitment that, by the end of 2009, national authorities will require hedge funds or their managers, subject to minimum size thresholds, to register and disclose appropriate information on an ongoing basis to allow supervisors to assess the systemic risk they pose individually or collectively.

Regulatory Reporting Requirements

SEC-registered advisers to private funds would be required to report to the SEC, on a confidential basis, the amount of their assets under management, borrowings, off-balance sheet exposures and other information relevant to the determination of whether the fund or fund family might pose a threat to financial stability. The SEC would share such reports with the Federal Reserve, which would determine whether a fund or fund family's size, leverage or interconnectedness to the financial system warrants its being regulated as a Tier 1 FHC.

Additional Requirements

The White Paper proposes that all funds advised by an SEC-registered investment adviser be subject to recordkeeping requirements and to requirements regarding disclosures to investors, creditors and counterparties. It notes that some of these requirements may vary for different types of private funds. It further states that the SEC should perform regular examinations of registered advisers to monitor compliance with the requirements.

The White Paper does not specify what recordkeeping requirements may be introduced, and as the Advisers Act already imposes substantial recordkeeping requirements on registered investment advisers, it is unclear what more is envisioned. Likewise, there is no detail as to the nature of disclosures to investors, creditors and counterparties that may be required. Currently, registered investment advisers are required to make specified disclosures on Form ADV. In addition, the Advisers Act imposes on all investment advisers, both registered and unregistered, a fiduciary duty to their investors that includes a duty of full and fair disclosure. Disclosure to fund creditors and counterparties of funds, on the other hand, is not currently regulated, as such arrangements are made pursuant to private contracts, and any regulation in this arena would be novel.

The President's Working Group report on Money Market Mutual Funds, due September 15, 2009, should consider the advisability of:

- A move away from a stable net asset value; and
- A requirement that money market funds obtain access to emergency liquidity facilities from private sources designed to avoid disadvantaging remaining money market fund shareholders if drawn upon.

Money Market Mutual Funds

The White Paper calls for the SEC to continue with plans to strengthen the regulatory framework for money market mutual funds. The White Paper refers to the breaking of the buck by the Reserve Primary Fund in the wake of the Lehman Brothers collapse, which caused a run on money market funds and in turn triggered a collapse in the commercial paper market. The White Paper asserts that "the vulnerability of [money market funds] to breaking the buck and susceptibility of the entire prime [money market fund] industry to a run in such circumstances remains a significant source of systemic risk." SEC Chairman Mary Schapiro has announced that the SEC will consider measures to improve the standards applicable to money market funds as early as this week.

The White Paper also proposes that the President's Working Group consider fundamental changes that might address more directly the systemic risk associated with money market funds. Examples of items the President's Working Group might consider are set forth in the sidebar on the previous page. Both the SEC and the President's Working Group are tasked with considering how to mitigate any potential adverse effects of an enhanced regulatory framework for money market funds, including the potential flight of capital to less regulated investment vehicles.

Six general principles for future insurance regulation:

- Effective systemic risk regulation, including an openness to additional insurance-specific regulation;
- Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies;
- Meaningful and consistent consumer protection for insurance products and practices;
- Increased national uniformity through either a federal charter or effective action by the states to reduce the "tremendous differences in regulatory adequacy and consumer protection among the states";
- Improved and broadened the regulation of insurance companies on a consolidated basis, including affiliates outside of the traditional insurance business; and
- International coordination with improvements to the US system that will satisfy existing international frameworks and enhance the international competitiveness of the industry.

Office of National Insurance

Among the major issues that the Administration has decided to sidestep is the heated question of an optional federal insurance charter. This issue has divided the insurance industry and raises major turf wars with the state insurance commissioners. See Davis Polk's memorandum entitled The Debate Over Federal Insurance Regulation dated April 14, 2009. We believe it is likely that many in Congress will still explore the creation of an optional federal insurance charter. However, the White Paper proposes only the establishment of an Office of National Insurance within Treasury, with limited powers. Legislation to create an Office of National Insurance has already been introduced in the House.

As proposed, the Office of National Insurance would be responsible for monitoring and gathering information on the insurance industry, identifying problems or gaps in regulation that could contribute to a future crisis and recommending to the Federal Reserve any insurance company that it believes should be supervised as a Tier 1 FHC.

In perhaps its only real power, the Office of National Insurance would be given authority to work with other nations and within the International Association of Insurance Supervisors to represent American interests, enter into international agreements and increase cooperation on insurance regulation. Creating such an office would respond to persistent EU complaints with respect to the difficulty of resolving insurance-related disputes and harmonizing regulatory standards when no one voice speaks

The White Paper lists several options for the future of the GSEs:

- Return them to their previous status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals;
- Unwind their operations and liquidate their assets gradually;
- Incorporate the GSEs' functions into a federal agency;
- Build them on a public utility model in which the government regulates the GSEs' profit margin, sets guarantee fees, and provides explicit backing for GSE commitments;
- Convert GSEs to provide insurance for covered bonds; and
- Dissolve Fannie Mae and Freddie Mac into many smaller companies.

for the US on insurance matters. The power to enter into international agreements may have teeth, however; treaties have the power of laws, and international agreements may be found to be binding.

The specific responsibilities and authority of the Office of National Insurance remain to be determined. While the proposals could result in certain identified insurers being supervised by the Federal Reserve if found to be a Tier 1 FHC, the Office of National Insurance is not independently represented on the Council, and the proposal for the Council does not explicitly include any member with insurance expertise. Furthermore, without strong preemptive authority over the states, an office of insurance information would have limited ability to enact nationwide policies or to effectively represent the US insurance market. In contrast, the EU's recent Solvency II initiative will harmonize certain regulatory requirements for insurance companies and provide more comparability for insurance buyers.

Government Sponsored Enterprises

The White Paper indicates that Treasury, the Department of Housing and Urban Development and other government agencies will explore options and develop recommendations for the future of Fannie Mae, Freddie Mac and the Federal Home Loan Bank system and will report to Congress at the time of the President's 2011 budget release. The breadth of possibilities for GSEs suggests that such analysis will play an important role in determining the future of the GSEs.

Regulation of Financial Markets

The White Paper proposes "skin-in-the-game" requirements for asset-backed securities to raise accountability for originators and sponsors, as well as improvements to transparency rules. It proposes a strengthening of credit rating agency regulation, and it proposes to replace the statutory "duty free zone" for OTC derivatives with pervasive regulation of OTC derivatives markets and participants. The White Paper also proposes to authorize the Federal Reserve to govern risk management in-payment, settlement and clearing systems. Finally, the White Paper proposes harmonization of regulations for futures and securities.

Securitization Markets

The core of the White Paper's proposal to revamp securitization markets consists of requiring originators or sponsors to retain a financial interest in securitized loans, imposing new disclosure requirements to increase market transparency and strengthening regulation of credit rating agencies.

The proposal incorporates some measures that have already been proposed or implemented by lawmakers or regulators. For example, requiring lenders to have "skin in the game" has been advocated by, among

Strengthen Supervision and Regulation of Securitization Markets:

- Retention of risk: Originators or sponsors should retain 5 percent of the credit risk of securitized exposures.
- Compensation Incentives: The compensation of originators and others involved should be linked to the longer-term performance of the securitized loans.
- Increasing Transparency: Investors and credit rating agencies should have access to loan-level data. Disclosure requirements for asset-backed securities issuers and legal documentation for securitization should be standardized.
- Strengthening Regulation of Credit Rating Agencies: Credit rating agencies should disclose conflicts of interest and highlight how the risks of structured products differ from those of corporate debt.

others, House Financial Services Committee Chairman Barney Frank. Some disclosure requirements imposed on credit rating agencies have been implemented by the SEC.

Changing Incentives

Under the proposal, originators or sponsors would have to retain 5 percent of the credit risk of securitized exposures and would be prohibited from hedging such risk. Without “skin in the game,” lenders may have little interest in how the loans perform after they sell them off to banks who bundle them into securities, and banks may have the same problem after they sell securities to investors.

Under the proposal, originators or sponsors would have to retain 5 percent of the credit risk of securitized exposures and would be prohibited from hedging such risk

The European Parliament has adopted a similar rule requiring banks to retain at least 5 percent of securitized products they originate and sell, which may lessen some people’s concern that the asset-backed securities market will shift to a less regulated market.

The purpose of changing incentives is probably better served if federal banking agencies require risk retention across the structure (*e.g.*, pro rata vertical slice) rather than on a first-loss basis. The financial industry has voiced concern that the 5 percent retention may tie up too much capital, increase financing cost and discourage securitization. Some question whether the no-hedging rule is feasible because some banks hedge a pool of risks all at once. Perhaps to appease these concerns, the proposal allows regulators to provide exemptions or adjustments, including to the no-hedging rule.

Other measures aimed at changing incentives include having originators recognize income over time instead of booking gains upon the sale of loans at the inception of securitization and paying loan brokers’ fees and commissions over time that will be reduced if underlying loans perform poorly. The proposal also requires many securitizations to be consolidated on the originator’s balance sheet. One important purpose of securitization is to move assets off the originator’s balance sheet and transfer risks to investors. Requiring the originator to consolidate securitization on its balance sheet may defeat the purpose.

There are incentive problems on the investors’ side as well. Many banks purchase securitized products and put them on their trading books, which have lower capital requirements than loan books. This may have led banks to build up their holdings in asset-backed securities. The White Paper recommends that the Basel Committee on Banking Supervision refine the risk weights applicable to the trading book and securitized products. The

White Paper's call for reform of capital requirements will probably be one of the items on the Federal Reserve's agenda.

Increasing Transparency

The White Paper gives the SEC authority to require ongoing reporting by asset-backed securities issuers. To help investors assess the risk, the White Paper would give investors and credit rating agencies access to necessary information, especially loan-level data. The Administration is not alone in thinking heightened disclosure on asset-backed securities, especially at the loan level, will help increase confidence and revive the asset-backed securities market. The European Central Bank has proposed a similar measure.

The White Paper also urges the industry to standardize the legal documentation for securitization so that it will be easier for investors to compare risks and make informed decisions. For residential mortgage-backed securities, the White Paper states that the standards should include uniform and clear rules for servicers to modify home mortgage loans.

The White Paper also requires the SEC and the Financial Industry Regulatory Authority to expand the trade reporting system for corporate bonds to include asset-backed securities. This would increase price transparency in the US asset-backed securities market.

Strengthening Regulation of Credit Rating Agencies

Credit rating agencies have been blamed for contributing to the crisis by assigning high ratings to complex financial products that turned out to be much riskier than the ratings suggested.

In 2006, Congress authorized the SEC to regulate credit rating agencies. The SEC has exercised this authority and has both adopted final rules and proposed additional rules to reform the credit rating industry. The White Paper does not make many new suggestions on this subject. Rather, the proposal includes reforms that are already under consideration by the SEC and that would not require any additional authority for the SEC to implement. The proposal calls for credit rating agencies to implement policies to manage and disclose conflicts of interest, differentiate ratings issued for structured products and provide enhanced disclosure of the methodologies employed in rating structured finance products. Echoing the Republican plan and SEC proposals, the White Paper urges regulators to reduce the use of ratings in regulations "wherever possible" and suggests that regulatory capital requirements should reflect the risk of structured credit products.

In 2006, Congress authorized the SEC to regulate credit rating agencies

The White Paper's relative restraint toward credit rating agencies may reflect a desire to maintain a regulatory focus on this area, while indicating deference to the SEC's current reforms. One key question that remains unanswered is whether the proposal extends to all credit rating agencies or is limited to the more narrow class of SEC-registered Nationally Recognized Statistical Rating Organizations.

The SEC requires credit rating agencies that are registered as Nationally Recognized Statistical Rating Organizations to disclose, as opposed to ban, certain conflicts of interest as long as the agency maintains an effective policy for the management of that conflict. Although recent debate has focused attention on the potential conflict of interest created by the use of an issuer-pays business model by Nationally Recognized Statistical Rating Organizations, the White Paper does not address this issue, and may indicate that the SEC is unlikely to prescribe particular payment schemes. Instead, the White Paper emphasizes other, less controversial measures.

The White Paper expresses support for the G-20 commitments to enhance oversight of credit rating agencies, which includes agreements that:

- All credit rating agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and is consistent with the International Organization of Securities Commissions Code of Conduct Fundamentals, and
- National authorities will enforce compliance and require any necessary changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the transparency and quality of the ratings process, including differentiating ratings for structured products and providing full disclosure of ratings track records and methodologies.

The White Paper also states that the Administration will continue to seek greater consistency of national oversight and information sharing with respect to credit rating agencies.

The EU passed comprehensive regulation on credit rating agencies in April 2009. It has some similar provisions, such as differentiating the ratings for structured products. Other provisions, such as the requirement that credit rating analysts rotate periodically, are not found in the White Paper. Under the European regulation, ratings used for "regulatory purposes" in Europe must be issued by EU-registered credit rating agencies, a third-country credit rating agency endorsed by an EU-registered credit rating agency or a third-country credit rating agency that passes an equivalence determination. This requirement may have an impact on the marketability of US-rated securities in Europe. The future of credit rating agency regulation probably lies in global cooperation.

Credit Default Swaps and Other OTC Derivatives

Treasury's March roadmap for regulatory reform called for the government to regulate credit default swaps and other OTC derivatives for the first time. These instruments, and the lack of transparency in their markets, have popularly been seen as a cause of the current economic crisis. For example, credit default swaps are largely blamed for the failure of AIG Financial Products. The regulatory framework for credit default swaps and other OTC derivatives in the White Paper is almost identical to the plan laid out by Secretary Geithner in his May 13 letter to Congress on the subject.

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The White Paper's Four Pillars of OTC Derivatives Regulation

Like Secretary Geithner's May 13 Letter, the White Paper identifies four objectives of OTC derivative regulation: (1) preventing activities in those markets from posing risk to the financial system, (2) promoting OTC derivative markets' efficiency and transparency, (3) preventing market manipulation, fraud and other market abuses and (4) ensuring OTC derivatives are not marketed inappropriately to unsophisticated parties.

To contain systemic risk, the proposal would:

- Require all standardized OTC derivatives to be cleared through central counterparties that impose margin requirements and other risk controls;
- Subject all OTC derivative dealers and other entities with large counterparty exposures in OTC derivatives to prudential supervision through capital requirements, business conduct standards, requirements of initial margins on counterparty credit exposure and reporting requirements; and
- Impose capital requirements that are more conservative than the existing bank regulatory capital requirements for OTC derivatives.

To promote transparency and efficiency, the proposal would:

- Authorize the CFTC and the SEC to impose recordkeeping and reporting requirements on all OTC derivatives;
- Require central counterparties and trade repositories to make public aggregate data on open positions and trading volumes;

To achieve the four objectives of OTC derivatives regulation, the White Paper:

- Requires mandatory clearing of all standardized OTC derivatives through regulated central counterparties;
- Authorizes the CFTC and the SEC to impose recordkeeping and reporting requirements and to require the movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems;
- Grants the CFTC and the SEC "clear, unimpeded authority" to police fraud, market manipulation and other market abuses involving all OTC derivatives; and
- Seeks to tighten limits and impose additional disclosure requirements with respect to marketing of derivatives to less sophisticated counterparties.

See also Davis Polk's newsflash entitled Obama Administration Proposes Regulatory Reform for OTC Derivatives dated May 14, 2009.

- Require standardized derivatives contracts to be transacted on regulated exchanges and electronic trading platforms; and
- Encourage regulated financial institutions to use exchange-traded derivatives.

To protect market integrity, the proposal would:

- Give the CFTC and the SEC unimpeded authority to police market abuses involving OTC derivatives;
- Give the CFTC authority to set position limits on OTC derivatives; and
- Require market participants to keep the CFTC, the SEC and other primary regulators informed of their activity.

To protect unsophisticated parties, the proposal would amend current laws by more stringently limiting the types of counterparties that can participate or by imposing disclosure requirements or standards of care with respect to marketing.

The White Paper emphasizes that the capital requirements on OTC derivatives that are not centrally cleared will be increased for derivatives dealers as well as for banks and BHCs.

Standardization

The White Paper proposes what is likely to be a highly controversial answer to the crucial question currently being debated in the OTC derivatives industry: what is a standardized OTC derivative? The White Paper delegates to the central counterparties the responsibility for determining what is "standardized" by letting them choose what to clear. The White Paper states that "[i]f an OTC derivative is accepted for clearing by one or more fully regulated CCPs [central counterparties], it should create a presumption that it is a standardized contract." The market dynamics engendered by this approach are difficult to predict and will require negotiation between market participants as to what elements of OTC derivatives contracts need to be standardized and who the gatekeepers of standardization norms will be. Industry groups such as the Managed Funds Association, which generally represents the hedge fund industry, have suggested that the push for "standardization" should require that OTC derivatives have common product terms, definitions published by ISDA and common specifications for terms such as pricing. OTC derivatives dealers and their counterparties may have incentives to maintain maximum flexibility for customized transactions and therefore be opposed to a regime that will leave uncertainty in what constitutes a "standardized" transaction. In addition, exchanges and central counterparties have warned that pushing complex and tailored derivatives onto central counterparties may increase risk.

Exchange Trading and Central Clearing

The White Paper, like Secretary Geithner's May 13 letter, does not mandate exchange trading, but encourages financial institutions to use exchange-traded products. The UK's Financial Services Authority has indicated that it is unlikely that OTC derivatives will move to exchanges in the UK anytime soon. Because the bulk of OTC derivatives are traded in London and New York, making US regulation more stringent than that in the UK may encourage market participants to shift OTC derivatives activity from New York to London, a shift Treasury presumably wants to avoid.

The White Paper, like Secretary Geithner's May 13 letter, does not mandate exchange trading, but encourages financial institutions to use exchange-traded products

Futures and Securities Regulation

Despite some support for merging the SEC and the CFTC, the White Paper does not propose a merger of the two agencies, reflecting the Administration's understanding of the political reality. Rather, it requires the SEC and the CFTC to harmonize futures and securities regulation to avoid subjecting related instruments to inconsistent regulation.

One often-cited obstacle to harmonizing these two regulatory regimes is their different philosophies, primarily in how to oversee exchanges. The statutes governing the CFTC give exchanges far greater freedom to change their rules without review or delay than do the statutes governing the SEC. In fact, the differences in regulation, such as the prohibition of insider trading in the securities markets, derive from the original purposes of these markets: the primarily institutional nature of the futures market and the greater retail participation in the securities markets. Nonetheless, the White Paper offers little guidance to the agencies and merely proposes that the SEC and the CFTC agree on new principles that are both precise and flexible and develop consistent procedures for reviewing and approving exchange rules. The harmonization is intended to permit competition among exchanges for trading derivatives and to avoid regulatory arbitrage between them.

The White Paper does not specify which OTC derivatives will be regulated by the SEC and which by the CFTC, leaving it up to these agencies and the Congressional committees with oversight authority over these agencies to determine an appropriate split. The White Paper recommends that the SEC and the CFTC complete a report by September 30, 2009 on how to achieve harmonization. If they fail to do so, as they have failed to do repeatedly in the past, the Council (dominated by bank regulators) will make its own recommendations to Congress.

Traditional rivalries between the Financial Services Committee and the Agricultural Committee in the House, and the Banking Committee and the

Agricultural Committee in the Senate, as well as between the SEC and the CFTC themselves, may frustrate efforts to reach a harmonious allocation of responsibility and authority between the SEC and the CFTC. Thus, notwithstanding the White Paper's encouragement that regulators work together, sorting out the division of labor between the SEC and the CFTC may be contentious.

Systemically Important Payment, Clearing and Settlement Systems and Major Participants

The White Paper would extend the Federal Reserve's aegis from Fedwire and the Depository Trust Company to all systemically important payment, clearing and settlement systems, as well as their major participants.

Systemic Importance

Under the White Paper, payment, clearing and settlement systems and activities would be systemically important if their failure or disruption could cause liquidity or credit problems to spread among financial institutions and threaten the stability of financial system. All of the major payment systems, as well as clearance systems such as DTCC, the Options Clearing Corporation and the Chicago Mercantile Clearing Corporation, would likely be deemed to be systemically important ("**covered systems**"). Transactions in customized OTC derivatives would be captured by the definition of systemically important payment, clearing, and settlement activities of financial firms ("**covered activities**") if financial firms engaging in them face or create a significant counterparty risk.

Federal Reserve's Power

Under the proposal, the Federal Reserve would:

- Identify covered systems, in consultation with the Council. The Federal Reserve would have access to information to facilitate its assessment;
- Impose risk management standards on covered systems to ensure timely payments in extreme but plausible scenarios;
- Have authority to compel enforcement actions if a covered system fails to meet risk management standards. If the primary regulator and the Federal Reserve could not agree on the need for such action, the Federal Reserve would still be able to enforce such action after consultation with the Council; and
- Have authority to request reports from a covered system or a financial firm engaged in a covered activity, although its authority would be limited to information that could not be obtained from reports to the primary regulator.

The White Paper provides that the primary regulator (the SEC or the CFTC) of a covered system or financial firm engaging in covered activities would lead examinations and be the primary source of information, but the Federal Reserve would oversee systemic risk and be able to override its decisions.

Strengthen Settlement Capabilities and Liquidity Resources of Covered Systems:

- The Federal Reserve should have authority to give covered systems access to Reserve Bank accounts, financial services and the discount window
- But discount window access should be for emergency purposes only

Central Bank Money and Discount Window Access

The White Paper recommends that the Federal Reserve be given the authority to give covered systems access to central bank money through Reserve Bank accounts, as well as financial services and the discount window. This would enable the Federal Reserve to react immediately to liquidity crises encountered by central counterparties and would provide valuable backups to these entities.

To avoid abuse and moral hazard, the discount window would be for emergency purposes only and the Federal Reserve would impose risk management standards on covered systems. Such standards would include a requirement to maintain sufficient liquidity to make timely payments, notwithstanding a default by the participant to which a covered system has the largest exposure under extreme but plausible market conditions.

Consumer and Investor Protection

Consumer Financial Protection Agency

The CFPA is designed to have the authority and responsibility to:

- Ensure that consumer protection regulations are written fairly and enforced vigorously;
- Reduce gaps in federal supervision;
- Improve coordination among the states;
- Set higher standards for financial intermediaries;
- Address concerns about mandatory arbitration harmful to consumers; and
- Ensure consistent regulation of similar products.

Among the various reforms proposed by the Administration in its White Paper, the creation of a single federal regulator in the form of the Consumer Financial Protection Agency ("**CFPA**") to protect consumers in the financial products and services markets is one of the boldest and likely one of the most controversial pieces.

The Congressional Oversight Panel, chaired by Professor Elizabeth Warren, recommended the creation of such a regulator in its January 2009 report, and bills have already been introduced in both houses of Congress proposing the creation of a similar Financial Product Safety Commission. Nevertheless, the proposal to create the CFPA is likely to spark a massive debate on Capitol Hill. Proponents argue that the Federal Reserve and other agencies have failed to protect consumers. Industry groups and agency officials acknowledge failures in recent years but argue that the existing model remains a better way to protect consumers since the existing agencies can better scrutinize firms for problems.

The CFPA would add yet another regulator to the multiple, existing functional regulators, and opponents warn that a new agency could create competing frameworks between existing regulators and the new entity. Some opponents fear that the CFPA could go too far, limiting access of consumers to loans and other products and effectively raising the cost of a range of financial products, such as mortgages and credit cards. Furthermore, a CFPA with the power to determine which products are eligible for regulation would be likely to seek to expand the list of products it regulates over time, potentially creating conflicting or overlapping regulatory missions.

Even if all sides of the debate agree that an agency should regulate the products in question, some believe that the SEC, with 75 years of experience in investor protection issues, may be a more appropriate choice than the CFPA. Given the close link between investor protection issues and disclosure, accounting standards, intermediary regulation, and market oversight, some argue that it is difficult to foresee a new federal regulator in a better position to carry out the consumer and investor protection mission than the SEC.

The CFPA would:

- Be structured as an independent agency;
- Be funded in part from fees assessed on entities and transactions across the financial sector, including from bank and non-bank institutions and other providers of covered products and services;
- Have a Director and a Board, with at least one seat on the Board reserved for the head of a prudential regulator; and
- Be required to consult with other federal regulators to promote consistency with prudential, market, and systemic objectives.

Scope of CFPA Authority

Jurisdiction

The White Paper proposes that the CFPA have 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. This differentiation between investment and non-investment products will likely take some of the intensity out of the regulatory turf war related to the creation of a new consumer protection agency. SEC Chairman Mary Schapiro and Commissioner Luis Aguilar have strongly resisted the idea of creating an agency to serve as a consumer protection watchdog if it were to regulate all financial products and strip the SEC of some of its powers.

Sole Rulemaking Authority for Consumer Financial Protection Statutes

CFPA would have sole authority to promulgate and interpret regulations under statutes such as:

- Truth in Lending Act;
- Home Ownership and Equity Protection Act;
- Real Estate Settlement and Procedures Act;
- Community Reinvestment Act;
- Equal Credit Opportunity Act;
- Fair Debt Collection Practices Act; and
- Home Mortgage Disclosure Act.

The White Paper proposes that the CFPA have sole authority to promulgate and interpret regulations under existing consumer financial services and fair lending statutes, and that it should be given similar rulemaking authority under any future consumer protection laws addressing the consumer credit, savings, collection or payment markets. The Administration proposes to vest in the CFPA broad authority to adopt tailored protections against unfairness, abuse and deception, such as disclosures and restrictions on contract terms and sales practices. These protections would apply to any entity that engages in providing a covered financial product or service, including intermediaries such as mortgage brokers and entities that provide services related to consumer debt, such as debt collectors and debt buyers. The CFPA would have authority to grant appropriate exemptions from its regulations.

Preemption: "Floor, Not Ceiling"

The states would have the ability to adopt and enforce consumer protection laws that are stricter than the federal rules promulgated by the CFPA for institutions of all types, regardless of charter. The Administration's proposal represents a significant shift from the current system, and would require national banks to comply with consumer protection laws in all 50 states, along with facing additional examinations from local authorities. This will likely be a major point of opposition for the banking industry. The American Bankers Association has already expressed concern over this issue.

The White Paper, however, would also permit rules promulgated by the CFPA to preempt state regulations to the extent that the latter are less protective of consumers.

The issue of whether a state law is more or less protective of consumers than a rule promulgated by the CFPA could become mired in litigation.

Supervisory Authority, Enforcement and Compliance Coordination

The CFPA would have supervisory and enforcement authority over all entities covered by the statutes it implements, including entities not previously subject to comprehensive federal supervision. The CFPA would assume from the federal prudential regulators all responsibilities for supervising banking institutions for compliance with consumer regulations, whether federally chartered or state chartered and supervised by a federal banking regulator, including bank affiliates that are not currently supervised by a federal regulator. The CFPA would also have supervisory and enforcement authority over nonbanking institutions, although the states would be the primary enforcers.

Under the Administration's proposal, the CFPA would coordinate compliance and enforcement efforts with the states and would assume responsibility for federal efforts to help the states unify and strengthen standards for registering and improving the quality of providers and intermediaries.

For example, the CFPA would:

- Administer the SAFE Act, under which it would set standards for registering and licensing any type of institution that originates mortgages;
- Be authorized to set higher minimum net worth requirements for originators; and
- Be authorized to establish or facilitate registration and licensing regimes for other financial service providers and intermediaries, such as debt collectors, debt counselors or mortgage modification outfits.

The CFPA would be required to notify prudential regulators of significant issues and share confidential examination reports with them. These agencies, in turn, would be required to refer potential compliance matters to the CFPA and be authorized to take action if the CFPA fails to act; the same would be required of state supervisors of state-chartered institutions.

The White Paper proposes a series of measures to make the CFPA accountable, including regulatory studies and an outside advisory council. The CFPA would also be authorized to collect data and would be responsible for financial education and tracking and resolving complaints.

Regulatory Measures to be Implemented by CFPA

The White Paper also proposes a series of legislative and regulatory measures to be implemented by the CFPA to improve transparency, fairness, accountability, access and appropriateness of consumer and investor products and services.

Potential Ban on Mandatory Arbitration Clauses

The CFPA would be authorized to gather information and study mandatory arbitration clauses in consumer financial services and products contracts. If the CFPA determines that mandatory arbitration fails to achieve fair adjudication and effective redress, the CFPA would be required to establish conditions for fair arbitration clauses or, if necessary, ban mandatory arbitration clauses in particular contexts, such as mortgage loans.

Imposing a Duty of Reasonableness in Disclosures

The White Paper proposes a principles-based approach to disclosure for consumer credit and other financial products. The CFPA would be authorized to impose a duty of reasonableness on providers and intermediaries to ensure that mandatory disclosures and communications with or to the consumer, including marketing materials and solicitations, are reasonable, in addition to technically compliant and non-deceptive.

- Reasonableness would include balance in the presentation of risks and benefits, as well as clarity and conspicuousness in the description of significant product risks, costs and penalties.
- A provider or intermediary would be subject to administrative action, but not civil liability, if its communications violated this duty.

Applying the duty of reasonableness to mandatory disclosures would shift the burden to the provider to update mandatory disclosures when introducing new products. The White Paper proposes that the CFPA be authorized to implement a process under which a provider, acting reasonably and in good faith, could obtain the equivalent of a “no action” letter for disclosure and other communications for a new product.

The CFPA would be authorized to use measures to ensure that alternative mortgages were obtained only by consumers who understood the risks and could manage them, such as:

- Imposing a warning label on all alternative products;
- Requiring providers to have applicants fill out financial experience questionnaires; and
- Requiring providers to obtain the applicant's written "opt-in" to products.

The CFPA could impose a duty:

- On originators to disclose material information such as the consumer's likely ability to qualify for a lower interest rate based on the consumer's risk profile;
- On mortgage brokers of best execution with respect to available mortgage loans; and
- On mortgage brokers to determine affordability for borrowers.

Promotion of "Plain Vanilla" Products

The White Paper proposes that the CFPA be authorized to define standards for "plain vanilla" products that are simpler and have straightforward pricing, and to require all providers and intermediaries to offer these products prominently alongside whatever other lawful products they choose to offer. The White Paper further suggests that the CFPA should assume responsibility over the Federal Reserve regulations issued last year, which will take effect in October 2009, that impose extra protections and higher penalties on "alternative" or "higher cost" loans.

According to the White Paper, originators and purchasers of "plain vanilla" mortgages will benefit from a strong presumption that the products are suitable and affordable for the borrower, while originators and purchasers of alternative products will not enjoy such a presumption, and would be subject to significantly higher penalties for violations. These proposals are likely to make it make it more difficult for borrowers to shop among a wide range of financial products.

Placing Restrictions on Terms and Practices

The White Paper proposes that the CFPA be authorized to place tailored restrictions on product terms and provider practices, giving the CFPA the authority to review complex financial contracts and to determine that prepayment penalties should be banned for certain types of products, or for all products. The White Paper also suggests allowing the CFPA to adopt a "life of loan" approach to regulating mortgages. In addition, the CFPA could require that originators receive a portion of their compensation over time, contingent on loan performance, rather than in a lump sum at origination. If the CFPA finds that disclosure is not an adequate remedy, it could ban yield spread premiums for mortgage originators.

Duties of Care on Financial Intermediaries

The White Paper proposes that, in addition to adopting measures for meaningful disclosure, there need to be standards for appropriate business conduct and regulations. The White Paper grants the CFPA the authority to impose duties of care on financial intermediaries, such as a duty of care to counteract a conflict of interest, or to align conduct with consumers' reasonable expectations. As noted below under the section on Imposing New Fiduciary Obligations, the White Paper separately proposes imposing fiduciary duties and customer disclosure obligations on broker-dealers that provide investment advice about securities to retail investors.

Treatment of Hybrid Products

The White Paper proposes similar disclosure treatment for similar products and leaves it to the judgment of the CFPA to determine whether products with hybrid features that fall under different statutes call for different treatment. For products such as overdraft protection plans that have not been regulated as credit and may not be regarded by consumers as a credit product, the proposal suggests that the CFPA would nevertheless be authorized by existing statutes to regulate these products similar to credit products, with Truth in Lending Act disclosures as appropriate.

Community Reinvestment Act and Fair Lending Laws

A critical part of the CFPA's mission would be to promote access to financial services, especially for households and communities that have traditionally had limited access. To this end, the CFPA would enforce fair lending laws and would have sole authority to implement the Community Reinvestment Act, which has traditionally been overseen by federal bank regulators. This proposal is likely to put more pressure on banks to make more loans to low-income borrowers. Under the proposal, the CFPA would also maintain a fair lending unit with attorneys, compliance specialists, economists and statisticians, as well as a group of examiners specially trained and certified in community development investment to conduct Community Reinvestment Act examinations of larger institutions. Furthermore, the CFPA would have primary fair lending jurisdiction over federally supervised institutions and concurrent authority with the states over other institutions. The CFPA would also have the authority to collect data on mortgages and small business lending.

Coordination with Other Agencies

Concurrent Authority of the Federal Trade Commission

The White Paper provides that the FTC's primary authority for financial product and services protections would be transferred to the CFPA, but that the FTC would 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 would remain the lead federal consumer protection agency on matters of data security, with privacy protection related to financial issues transferred to the CFPA. In addition, the FTC would be given new authority to conduct rulemaking and obtain civil penalties for unfair and deceptive practices in areas remaining under its authority.

Financial Consumer Coordinating Council

The White Paper proposes the creation of a Financial Consumer Coordinating Council through which the CFPA would work together with the SEC, the FTC and other state and federal regulators.

SEC's Investor Advisory Committee

The White Paper further proposes that the Investor Advisory Committee recently established by the SEC to advise on the SEC's regulatory priorities,

The Financial Consumer Coordinating Council would be:

- Authorized to establish mechanisms for state attorneys general, consumer advocates and others to make recommendations on issues to be considered or regulatory gaps to be filled;
- Required to report to Congress and the member agencies semiannually with recommendations for legislative and regulatory changes to strengthen consumer and investor protection; and
- Authorized to sponsor studies or engage in consumer testing to identify regulatory gaps, share information and find solutions for improving consumer protection across a range of financial products.

The Financial Consumer Coordinating Council:

- Would be led by the Financial Services Oversight Council
- Would consist of the heads of:
  - SEC;
  - FTC;
  - The Department of Justice;
  - CFPA; and
  - Other federal and state agencies.

including issues concerning new products, trading strategies, fee structures and the effectiveness of disclosure, be given a permanent role by statute.

Strengthening the SEC

To better protect investors in securities, the White Paper also proposes legislation to give the SEC greater authority to take action on several ongoing areas of controversy.

Promoting Transparency in Investor Disclosures

The White Paper proposes authorizing the SEC to require disclosures (like a summary prospectus) be provided to individual investors at or before the point of sale if it finds that such disclosures would improve investor understanding of the particular financial products and their costs and risks. Furthermore, the proposal recommends funding the SEC to conduct consumer testing of investor disclosures. The proposal seems intended to validate SEC activity in this area: the SEC in the past has proposed and field tested point-of-sale disclosures of broker-dealer commission charges and conflicts of interests in sales of mutual funds, but has refrained from acting not due to a lack of authority, but rather due to industry objections given the costs imposed.

Imposing New Fiduciary Obligations

The White Paper proposes to resolve controversies over the duties owed to customers by broker-dealers and investment advisers by legislating a fiduciary duty and customer disclosures for broker-dealers that provide investment advice about securities to retail investors. Investment advisers are already subject to these standards. The White Paper also proposes that legislation ban certain unspecified conflicts of interest and sales practices and give the SEC authority to align the duties of broker-dealers and advisers and ban certain compensation practices that encourage the sale of products that are not in the investor's best interest. This legislation would make clear the SEC's ability to address the blurring of broker-dealer and investment adviser functions in response to court rulings that overturned SEC rules distinguishing these roles. Some broker-dealers fear that a fiduciary duty enforced in the federal courts would effectively make them the guarantor of investments they recommend to customers.

> The White Paper proposes legislation that would clarify the SEC's ability to address the blurring of broker-dealer and investment adviser functions

A significant challenge for brokers posed by the proposed fiduciary obligations is that, as fiduciaries, they would be precluded from acting in a principal capacity and thus could not sell securities out of their inventories unless the customer waived the conflict. The SEC has taken the position that the conflict has to be waived on a transaction-by-transaction basis, which is burdensome and has effectively precluded that type of activity. Should the SEC impose a fiduciary duty on brokers, one question that arises is whether the SEC will make some accommodations for some highly liquid products for which there is full price transparency.

Mandatory Arbitration Clauses

Similar to the authority given to the CFPA to ban mandatory arbitration clauses, the White Paper recommends legislation that clearly authorizes the SEC to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. If adopted, investors would be empowered to pursue their claims in federal court, as often occurred before these clauses became widespread. Before banning mandatory arbitration clauses, the SEC must study whether such clauses have harmed investors by blocking effective redress of legitimate grievances, and whether changes would improve the investor arbitration system.

Increased SEC Enforcement Power Over Financial Firms and Public Companies

The White Paper also proposes the adoption of new legislation that would increase SEC enforcement power. The new legislation would amend the federal securities laws to:

- Provide a single explicit standard for primary liability to replace the different "tests" for primary liability formulated by various circuits, presumably reversing recent decisions that narrowed this liability;
- Authorize the SEC to establish a fund drawing on enforcement penalties to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards, since the SEC currently has the authority to compensate sources only in insider trading cases;
- Authorize the SEC to impose collateral bars against regulated persons from engaging in any form of securities activity based on misconduct in one type of securities activity, for which the SEC has long sought authority; and
- Extend the SEC's authority over public company corporate governance by authorizing the SEC to impose "say on pay" rules on all public companies, and require public companies to include on their proxies a non-binding shareholder vote on executive compensation, as in many other countries. For more information, please see Davis Polk's memorandum entitled SEC Publishes Proxy Access Proposal dated June 18, 2009. The Davis Polk corporate governance team is monitoring events in this area.

Employment-Based and Private Retirement Plans

The White Paper calls for the introduction of two of the initiatives proposed by the President in his 2010 budget to address the low personal savings rate in the United States: the "automatic IRA" for employees whose employers do not offer a savings plan and the modified saver's credit, which would act much like a matching contribution to incentivize retirement savings for families that earn less than $65,000. These initiatives are intended to increase incentives to save and expand plan coverage.

The White Paper further proposes that employee-directed workplace retirement plans, such as 401(k) plans, and automatic IRAs be governed by the same principles of transparency, simplicity, fairness, accountability and accessibility that govern consumer and investor protection in the retail marketplace. Accordingly, plans should provide information in easily understandable terms about the risks, returns and costs of different investment choices. Plans should also be free from conflicts of interest, such as those that can affect third-party providers. Plan sponsors and others who provide services to the plan or to individual employees, such as the management of employee investments, should be accountable and subject to appropriate oversight. Lastly, the plans should be accessible to all workers. The White Paper also encourages measures to restore more lifetime income throughout the retirement system, reduce costs and better preserve savings for retirement and strengthen the defined benefit plan system.

Treasury's bill excludes from the operation of the resolution authority:

- Insured depository institutions and their subsidiaries;
- SEC-registered brokers or dealers that are members of SIPC;
- US domestic insurance companies; and
- All of the following, provided they are not subsidiaries of covered holding companies:
  - Hedge funds,
  - Dealers in OTC derivatives,
  - Private equity funds,
  - Investment companies,
  - Investment advisers,
  - Uninsured depository institutions,
  - Securities clearing agencies,
  - Futures clearing organizations,
  - Payment system operators,
  - Commodity trading advisers, and
  - Any other financial institution.

Tools to Manage the Crisis

The White Paper proposes one new tool to manage financial crises, a special resolution authority for systemically important firms, and one change to an existing tool, Section 13(3) of the Federal Reserve Act.

Resolution Authority

The White Paper proposes the creation of a special resolution regime for systemically important firms. The White Paper contains only a relatively high-level summary of this resolution authority and offers substantially less detail than the bill on the resolution authority that Treasury proposed on March 25, 2009.[2] In general, the proposed special resolution authority is structurally similar to the authority described in Treasury's bill. Both are modeled on the FDIC's current resolution regime and supplement, rather than replace, bankruptcy and other existing resolution regimes.

[2] For an analysis of Treasury's bill, see Davis Polk's memorandum entitled Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies dated March 30, 2009.

However, the White Paper, which does not make reference to Treasury's bill, contains several important differences from the bill. Foremost among them is that it would subject any systemically important firm to the special resolution authority, regardless of its form. In addition, the White Paper provides that, if the failing firm's largest subsidiary is a broker-dealer or securities firm, then Treasury may appoint the SEC, rather than the FDIC, to act as conservator or receiver.

The details of the proposed special resolution authority are discussed and analyzed below.

Covered Firms

The special resolution authority would apply to any BHC or Tier 1 FHC whose failure poses a threat to the stability of the financial system. This definition would potentially extend the resolution authority to any systemically important firm, going well beyond Treasury's bill, which contained the numerous carve-outs set forth in the sidebar on the previous page. The White Paper does not indicate whether the special resolution authority would apply to subsidiaries of companies subject to the regime, as provided by Treasury's bill.

Process Used to Place a Firm in the Special Resolution Regime

The White Paper provides that, in all cases, either Treasury or the Federal Reserve could initiate the formal process for determining whether and how to use the special resolution authority. The White Paper provides that the FDIC would also have such initiating authority, unless the largest subsidiary of the failing firm is a broker-dealer or securities firm, in which case the SEC would have such initiating authority instead.

Once the process is initiated, Treasury has the power to apply the special resolution regime to a particular firm only upon the conditions set forth in the sidebar.

Additionally, if the failing firm includes an insurance company, the White Paper provides that the Office of National Insurance would consult with the Federal Reserve and FDIC Boards on insurance-specific matters.

This process is structurally similar to the process contemplated by the Treasury bill, but differs in two respects. First, it provides no role for the CFTC, whose two-thirds recommendation is required by the Treasury bill if the failing firm is, or is an affiliate of, either a futures commission merchant or a commodity pool operator registered with the CFTC. It is unclear whether this omission is intentional. Second, the test for whether the SEC's, rather than the FDIC's, recommendation is required is not based on the form of the failing firm. The Treasury bill requires the SEC's recommendation if the failing firm is, or is an affiliate of, an SEC-registered broker or dealer (other than an insured depository institution). The White Paper does not address any other aspect of this process, in contrast to the Treasury bill,

Treasury may only apply the special resolution regime to a particular firm:

- After consulting with the President;
- With the written recommendation of two-thirds of the members of the Federal Reserve Board and either:
  - Two-thirds of the members of the FDIC Board; or
  - If the largest subsidiary of the firm, measured by total assets, is a broker-dealer, two-thirds of the commissioners of the SEC; and
- Upon a determination by Treasury (a "systemic risk determination") that:
  - The firm is in default or in danger of defaulting;
  - The failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy; and
  - Use of the special resolution authority would avoid or mitigate these adverse effects.

which details a variety of others including the contents of the recommendation from the Federal Reserve and the other relevant regulatory agency, as well as the determination of which federal regulator's recommendation is required when more than one initially qualify.

Proposed Resolution Authority Would Change the "Rules of the Game" on the Eve of Bankruptcy

One potentially problematic feature of this process for putting a failing firm into the special resolution regime is that it makes the firm subject to the special resolution regime on the eve of a failing firm's bankruptcy. Assuming the special resolution regime is modeled on the FDIC's resolution authority for insured depository institutions, this would change the "rules of the game" with respect to determining the rights of creditors, counterparties and other stakeholders on the eve of bankruptcy. Among other things, the FDIC's resolution authority for insured depository institutions contains priorities and preference avoidance powers that are fundamentally different from the priorities and preference avoidance powers in the Bankruptcy Code, Securities Investor Protection Act and state insurance insolvency codes.

Changing these rules of the game on the eve of bankruptcy could disrupt the reasonable expectations of creditors, counterparties, customers or other stakeholders of any company that might be resolved under the new authority (*e.g.*, BHCs, Tier 1 FHCs or any of their affiliates) instead of the law that would otherwise apply. The potential harm to these stakeholders could be mitigated if (i) the priorities, preference avoidance powers and other key provisions of the proposed resolution power were harmonized with the laws it would be replacing, (ii) there were a reliable mechanism for obtaining *ex-ante* legal certainty on key issues and (iii) there were better judicial review of the process.

Specific Resolution Powers

Upon a systemic risk determination, Treasury would have the authority to:

- Place the firm into conservatorship or receivership;
- Lend to the firm;
- Purchase assets from the firm;
- Guarantee liabilities of the firm; and
- Make equity investments in the firm.

Once a systemic risk determination is made for the failing firm, Treasury would have the authority to decide how to resolve the firm. This may mark a significant departure from Treasury's bill, which empowered the FDIC, with the approval of the Treasury Secretary, to decide how to resolve the firm. The White Paper would empower Treasury to take a variety of actions with respect to the firm, listed in the sidebar. When choosing among resolution options, the proposal requires Treasury to consider the option's effectiveness at mitigating potential adverse effects on the financial system or the economy of the firm's failure, the option's cost to taxpayers and the option's potential for increasing moral hazard. Treasury's bill contains a comparable list of specific resolution authorities and a similar requirement.

Identity and Powers of the Conservator or Receiver

The White Paper provides that Treasury would "generally" appoint the FDIC to act as conservator or receiver of the failing firm. However, in a major departure from Treasury's bill, which does not permit any other agency to be the conservator or receiver, the White Paper would give Treasury the authority to appoint the SEC as conservator or receiver if the largest subsidiary of the failing firm, measured by total assets, is a broker-dealer or securities firm. This new role would constitute an expansion of the SEC's authorities and responsibilities. Under the proposal, the SEC could come to run systemically important financial institutions.

Whichever agency is appointed, the conservator or receiver would have "broad powers" to take action with respect to the failing firm. The White Paper lists as examples that the conservator or receiver would have the authority to take control of the operations of the firm or to sell or transfer any or all of the assets of the firm in receivership to a bridge institution or another entity. It makes clear that the conservator or receiver would have the authority to transfer the firm's derivatives contracts to a bridge institution and prevent the firm's counterparties from terminating such contracts in the event of such transfer, even if the counterparties have the contractual rights to do so if a receiver is appointed for the firm. The White Paper does not mention safe harbors or exemptions from repudiation for qualified financial contracts. The White Paper states, however, that "[t]he existing customer protections provided to insured depositors, customers of broker-dealers and futures commission merchants, and insurance policyholders under federal or state law should be maintained."

The White Paper would also require the conservator or receiver to coordinate with foreign authorities involved in the resolution of foreign subsidiaries of the firm. This recommendation points to another problem with making the FDIC the conservator or receiver for firms subject to the special resolution regime: the FDIC does not have much experience with such foreign regulatory authorities, as the core of its experience is in regulating small, domestic, community banks. While the SEC may be better positioned in this regard, the Federal Reserve probably has the closest relationship with foreign regulators, in addition to greater experience with complex, global and diversified financial groups.

Financing Mechanism

The proposal would authorize the entity acting as conservator or receiver to borrow from Treasury as necessary to finance exercise of its resolution powers, and would authorize Treasury to issue public debt to finance any such loans. This differs from Treasury's bill, which provided for an appropriation from Treasury to the FDIC. Further, the White Paper states that the costs of the Treasury loans should be paid by assessments on BHCs based on total liabilities other than those assessed to fund federal or state insurance schemes. It is not clear what "costs" of the loans means: Would this amount include the difference between the amount borrowed from Treasury and spent on the conservatorship or receivership and the amount recovered from the firm by the conservator or receiver? The interest on the loans?

Expanded FDIC Regulatory Authority

Finally, the White Paper would give the FDIC access to any examination report prepared by the Federal Reserve with respect to any BHC and back-up examination authority over all BHCs in connection with its role in the special resolution regime. This grant of new regulatory authority to the FDIC is potentially very significant to regulated entities. It is unclear how invasive it would be, as the White Paper does not indicate under what circumstances the FDIC could access BHC examination reports.

Furthermore, this grant might open the door to future regulatory expansion by both the FDIC and the SEC. The White Paper states that the FDIC's new authority would only apply to BHCs, but the rationale the Administration gives—"in light of the FDIC's role in the proposed special resolution regime for BHCs"—would suggest that the FDIC's new authority should extend to all firms subject to the special resolution regime, which would include a variety of other financial institutions. For that matter, the stated rationale applies equally to the SEC, as the SEC could play the same role as the FDIC in the resolution of certain BHCs and Tier 1 FHCs.

> This grant of resolution authority might open the door to future regulatory expansion by both the FDIC and the SEC

Improved Cross-Border Resolution Mechanisms and Crisis Prevention and Management Arrangements

In support of ongoing International Monetary Fund, Financial Stability Board, World Bank and Basel Committee on Banking Supervision efforts in the areas of cross-border resolution and crisis management, the White Paper calls for international cooperation to:

- Create a set of powers for the resolution of financial firms providing for continuity of systemically important functions. The Administration also calls for more predictable and consistent closure criteria;
- Improve cross-border information-sharing, particularly with the objective of increasing understanding of how national resolution regimes interact with one another in the resolution of global financial firms;
- Enhance the efficiency and effectiveness of crisis management and resolution under the currently prevailing "separate entity" approach, and request that the Basel Committee explore further the feasibility and desirability of methods for allocating the financial burden of the failure of a global financial firm to maximize resolution options;

- Improve the existing rules for the clearing and settlement of cross-border financial contracts and large-value payment transactions, including by providing options for maintaining contractual relationships during insolvency, such as through the bridge institution option available under US bank receivership law; and

- Implement the [Financial Stability Board Principles For Cross-Border Cooperation on Crisis Management] endorsed by the G-20, with the home country regulators for each major global financial firm responsible for ensuring that the authorities with a common interest in each financial institution meet at least annually.

Federal Reserve's Section 13(3) Lending Authority

The White Paper indicates that the Administration will propose legislation requiring the Federal Reserve to obtain the prior written approval of the Secretary of the Treasury for any lending under Section 13(3) of the Federal Reserve Act.

This measure may be intended to sugarcoat the pill of the Federal Reserve's expanded systemic risk powers for critics who have been frustrated with the central bank's perceived lack of accountability during the financial crisis. These critics include important legislative constituencies, such as Senator Dodd, who co-sponsored a non-binding amendment that called upon the Federal Reserve to make certain disclosures about its emergency liquidity facilities that passed the Senate by a vote of 96 to 2 in early April. Another non-binding amendment calling for the Federal Reserve to publish the identities of discount window borrowers passed the Senate by a vote of 59 to 39 at the same time.[3]

The Interaction of International and US Regulatory Reform

Financial reform has become an international activity. The contours of the post-crisis reform agenda are first largely set in international fora and then implemented within the dynamics of the domestic political process of each country.

> However, in a time of parallel financial regulatory reform, Congress should not ignore what is happening in the EU

[3] American Banker, "With Senate Demands, Fed's Role in Jeopardy," April 6, 2009.

As a result, US financial regulators are active in the G-20 and watch carefully what is being put in place in the EU. Congress, by contrast, has historically been less attentive to international financial regulatory developments and EU regulatory efforts. However, in a time of parallel financial regulatory reform, Congress should not ignore what is happening in the EU. The EU has shown a new determination to set the regulatory agenda, by influencing US regulatory reform, asserting extra-territorial jurisdiction and implementing standards that require non-member (*i.e.*, US) financial firms to be subject to "comparable" or "equivalent" regulation at home.

Moreover, global financial institutions increasingly regard both sides of the Atlantic with equal attention. From the perspective of such firms, regulations adopted in one country can influence their worldwide operations. These firms view these changes as global, not national, risk management matters.

One policy that is explicitly present in virtually all UK government statements on regulatory reform is the need to maintain the UK's international competitiveness as a financial center. Similarly, implicit in many of the EU's proposals is its interest in helping its financial firms and market infrastructure compete globally. The benefit to the American economy, and the US dollar, that comes from being a leading financial center must be part of the US public discourse and is, we hope, understood by many of the leading stakeholders.

The benefit to the American economy, and the US dollar, that comes from being a leading financial center must be part of the US public discourse and is, we hope, understood by many of the leading stakeholders

In this regard, we believe that Treasury, and this Administration, are very much aware of the challenges and opportunities present in the current parallel efforts. The White Paper includes a section that reviews the international efforts and makes it clear that Treasury intends to follow through on the G-20 commitments agreed to by the US in the Declaration on Strengthening the Financial System.

White Paper's International Focus

In the White Paper, the Administration states that it will focus on reaching international consensus on four core issues: regulatory capital standards, oversight of OTC derivatives markets, cross-border supervision of significant global financial firms and improved cross-border resolution mechanisms and crisis prevention and management arrangements. As discussed above, each of these is a key area of focus in the domestic agenda described in the White Paper.

The remainder of the White Paper's international section is designed to remind other countries and their financial regulators of elements, agreed to

Financial Stability Board:

- Established at G-20 Summit in April 2009 as successor to the Financial Stability Forum.
- Specific responsibilities include:
  - Assessing system vulnerabilities;
  - Promoting coordination and information exchange among authorities;
  - Advising and monitoring best practices to meet regulatory standards;
  - Setting guidelines for and supporting the establishment of supervisory colleges; and
  - Supporting cross-border crisis management and contingency planning.

by the G-20, that are of particular importance to the US but that may not be as high on the policy agenda of other countries. These include the promotion of stronger anti-money laundering standards, combating the financing of terrorism and tax information exchange. These also include the usual warning that international standards need to be raised and that a race to the bottom should be avoided. Since the developed world is currently engaged in a race to regulate more, this warning, as well as being an implicit criticism of the now-discredited UK "light touch" model of regulation, discreetly reminds other countries that competition in financial regulation for domestic purposes cannot be the most important policy objective.

The White Paper also supports the development of the Financial Stability Board's institutional capabilities to serve its new mandate to promote financial stability. In so doing, the White Paper calls for the Financial Stability Board to focus attention on international cooperation in relation to prudential regulatory standards.

Finally, the White Paper calls for improvement of the International Cooperation Review Group process for identifying jurisdictions that are not complying with international anti-money laundering standards or combating the financing of terrorism standards and recommends action against them, an effort the White Paper indicates the US will lead as co-chair of the International Cooperation Review Group.

UK and EU Proposals

Last week, both the UK and the EU released new information about their regulatory reform plans. This section briefly summarizes both and, where applicable, compares them to the proposals set forth in the White Paper.

United Kingdom

In a speech on June 17, 2009, UK Chancellor of the Exchequer Alistair Darling provided glimpses into his proposals to reform the UK financial system, due to be released in coming weeks. In contrast to the US approach based on enhanced supervisory regulation and consumer protection, Chancellor Darling envisions corporate governance as the UK's "first line of defense." An independent review chaired by former financial services regulator Sir David Walker will examine and issue recommendations on how to improve board management at UK banks. It is to be expected that these corporate governance recommendations, like past UK corporate governance recommendations, will have an influence on US practices over time. Chancellor Darling also suggested aiming compensation reform to

In contrast to the US approach based in enhanced supervisory regulation and consumer protection, Chancellor Darling envisions corporate governance as the UK's "first line of defense"

incentivize long-term success, echoing the White Paper proposal and G-20 proposals to align executive compensation with long-term shareholder value.

Chancellor Darling also called for central banks to monitor the threat institutions pose to financial stability. Chancellor Darling would require banks themselves to develop plans to mitigate risk and manage their own potential failure, rather than relying on the government to do so. Also, like the White Paper proposals, Chancellor Darling's proposals may require banks to maintain higher capital and liquidity cushions. Chancellor Darling added that he supports an international mechanism to resolve large, failed multinational banks—a proposal that has the support of both the US and the G-20.

Interestingly, Chancellor Darling's proposals differ in significant respects from the reforms favored by Mervyn King, Governor of the Bank of England. Governor King supports restricting the size of banks to address the problem of "too big to fail," an idea that has also been advocated by some in the US. Governor King also supports separating retail banks from riskier investment banks as the US did under the Glass-Steagall Act, an argument that has also been picked up by some US commentators.

European Union

The European Council of Ministers has largely adopted the principles of the de Larosière Report, as recommended in a European Commission Communication. Following the recommendations of the Commission, the European Council agreed in principle to create two agencies to improve regulation of the financial system—the European Systemic Risk Board and the European System of Financial Supervisors.[4] The proposals will, however, require legislation, which is expected to be proposed by the European Commission in the early fall—around the same time as the next G-20 summit and the Senate hearings on the White Paper proposals.

The proposed European Systemic Risk Board would monitor and assess threats to financial stability. In contrast to the proposed powers of the Federal Reserve under the White Paper, the European Systemic Risk Board would only be able to issue non-binding risk warnings and recommendations. The head of the European Systemic Risk Board would be elected by the European central banks.

The European System of Financial Supervisors would consist of three European Supervisory Authorities—a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority. The European Supervisory Authorities would be responsible for improving the quality and uniformity of national

[4] The EU agreement largely reflects a compromise between the UK, which sought to protect the member nations' autonomy, and France and Germany, which sought to strengthen the EU's centralized regulatory power.

supervision, establishing supervisory colleges to strengthen oversight of cross-border institutions and creating a single regulatory rulebook for the EU. The European Supervisory Authorities would be built up from the existing EU Committees of Supervisors. National supervisors would retain responsibility for day-to-day supervision, but, in a large concession by advocates of member nations' autonomy, especially the UK, the European Supervisory Authorities would have binding authority to determine whether a national supervisor is complying with the EU rulebook and other EU law and issue binding decisions in the case of a disagreement.

Many hope that the three European Supervisory Authorities will eventually lead to European level financial supervision and enforcement which has, until now, been politically unpalatable. The focus on binding decisions reflects the experience that, even with identical legal texts, harmonized standards or permitted variants from "floors," the EU experience with multiple interpreters and enforcers of the law has not resulted in effective regulation.

However, the relationship between the proposed European Supervisory Authorities and national authorities remains unclear, perhaps deliberately so. As a result of pressure from the UK, EU leaders have expressly declared that "the decisions taken by the European Supervisory Authorities should not impinge in any way on the fiscal responsibilities of Member States," and a European Supervisory Authority is not allowed to require a member state to spend its taxpayers' money.

Contrast to US

Interesting questions are raised by the different US and EU implementations of the G-20 principles. While the central banks would be the systemic risk regulators in both the EU and US, in the EU they would have no real power. The comparison between the US Financial Services Oversight Council, with purely advisory power, and the European Supervisory Authorities, with the power to issue binding decisions in limited areas, is interesting but not really on-point. The European Supervisory Authorities represents the first step in building any pan-European financial regulatory authorities, whereas the US Financial Services Oversight Council is more like a college of supervisors of existing federal level authorities. How all of these new regulatory bodies will interact with one another over time, both within each of the two systems and cross-system, remains to be seen.

Annex: Hearings and G-20 Summit Schedule

House Financial Services Committee Hearing Schedule (Tentative)

"Regulatory Restructuring: Enhancing Consumer Financial Products Regulation," Full Committee, Wednesday, June 24, 2009

"Role of the Federal Reserve," Domestic Policy Subcommittee, Thursday, July 9, 2009

"Hearing on Derivatives," Full Committee, Friday, July 10, 2009

"Financial Regulatory Restructuring: Academics and Experts on the Subject," Full Committee, Monday, July 13, 2009

"The Securities and Exchange Commission," Capital Markets Subcommittee, Tuesday, July 14, 2009

"Financial Regulation and Restructuring," Full Committee, July 15, 16, 17, 22 and 25, 2009

Senate Committee on Banking, Housing & Urban Affairs

"Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks," June 22, 2009

G-20

Summit, September 24-25, 2009, Pittsburgh, Pennsylvania

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References

Below are hyperlinks to

- Treasury Press Release (June 17, 2009)
- Treasury White Paper (June 17, 2009)
- Fact Sheet: Requiring Strong Supervision And Appropriate Regulation Of All Financial Firms (June 17, 2009)
- Fact Sheet: Strengthening Regulation Of Core Markets And Market Infrastructure (June 17, 2009)
- Fact Sheet: Strengthening Consumer Protection (June 17, 2009)
- Fact Sheet: Providing The Government With Tools To Effectively Manage Failing Institutions (June 17, 2009)
- Fact Sheet: Improving International Regulatory Standards And Cooperation (June 17, 2009)
- Geithner Opening Statement Before the Senate Banking Committee (June 18, 2009)
- Senate Banking Hearing, "The Administration's Proposal to Modernize the Financial Regulatory System" (June 18, 2009)
- Geithner OTC Letter and Press Release (May 13, 2009)

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