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A survey of current regulatory trends



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This chapter discusses how the global financial panic of 2008 unfolded in the United States, the emergency measures taken to end it, and the financial regulatory reforms that have been enacted to reduce the likelihood or magnitude of future panics.

The financial panic of 2008

The first signs of an impending financial crisis appeared in the US in 2007, when US real estate prices began to collapse and early delinquencies in recently underwritten sub-prime mortgages began to spike. It culminated in a genuine financial panic during September and October of 2008. The most serious recession since the Great Depression of the 1930s followed. The Federal Reserve and other organs of the US Government responded by flooding the markets with money and other liquidity, reducing interest rates, providing extraordinary assistance to major financial institutions, increasing Government spending, and taking other steps to provide financial assistance to the markets.

When real estate prices began to collapse in the second half of 2007, some investors started shorting real estate markets. The leveraged credit market dried up and billions of dollars of pending buy-out deals collapsed. Billions more in mortgage-backed securities (MBS) and collateralised debt obligations (CDOs) were written down. Several CEOs of major US financial institutions lost their jobs. Others saved their jobs by obtaining capital infusions from sovereign wealth funds, hedge funds, private equity funds and other pools of risk capital.

Real estate prices continued to collapse in early 2008, resulting in billions of dollars of additional CDO markdowns, the collapse and rescue of Bear Stearns, and extraordinary measures by the Federal Reserve to de-stigmatise the discount window for commercial banks and make emergency liquidity facilities available to the large investment banks. As the Federal Reserve responded to the crisis by reducing interest rates and flooding the market with money, the value of the dollar plummeted relative to other currencies. By the summer of 2008, the price of oil, agricultural products and other commodities – which are generally denominated in US dollars – soared almost in inverse proportion to any decline in the dollar.

The interbank credit markets seized up. The market value of US financial institutions,

especially US mortgage giants Fannie Mae and Freddie Mac,¹ collapsed throughout the summer. The US Government was particularly concerned about Fannie Mae and Freddie Mac because of their size and importance to the US housing market. On 30 June 2008, these two institutions had combined liabilities of over US\$5.5 trillion, on a combined total regulatory capital base of approximately US\$100 billion. Moreover, a widespread perception existed that their obligations were backed by an implicit guarantee from the US Government. The US Treasury asked Congress for a blank cheque – the power to inject unlimited amounts of additional capital into Fannie and Freddie, arguing that if the market knew that the Treasury had a ‘bazooka’ instead of a ‘squirr gun’, it was substantially less likely that the Treasury would be required to provide any financial assistance at all. Congress gave the Treasury that authority on 30 July 2008.²

The market value of Fannie and Freddie, however, continued to collapse throughout August. The Government determined that many of their assets needed to be written down, and concluded that they would not be able to plug the hole by raising additional capital from the capital markets. Alarmed that a failure of Fannie or Freddie could pull down the rest of the financial system, the US Treasury decided to exercise its new ‘bazooka’ authority on 6 September 2008 – approximately five weeks after receiving it – concluding that such action would calm the financial markets. The Government put Fannie and Freddie into conservatorship and pledged to inject up to US\$200 billion of new capital in the form of senior preferred stock and warrants. The terms of the transaction resulted in an immediate dilution of 80 per cent of common shareholder value, and a sharp drop in the value of junior preferred stock. The value of Fannie’s and Freddie’s senior and subordinated debt, however, soared because it was senior to the Government’s investment.

Rather than calming the markets, the ‘rescue’ of Fannie and Freddie may have added fuel to the worldwide financial panic that continued throughout September and October. In any event, on the following weekend Lehman Brothers and AIG collapsed, and Merrill Lynch was bought at what was then thought to be a fire sale price by Bank of America. The Federal Reserve exercised its emergency powers under section 13(3) of the Federal Reserve Act to rescue AIG, but the Government allowed Lehman Brothers to fail. The terms of the AIG rescue were similar to Fannie and Freddie – the Government received senior preferred stock and warrants, resulting in an immediate dilution of 80 per cent of common shareholder value, and a sharp drop in the value of junior preferred stock. But the value of AIG’s senior and subordinated debt soared, and the counterparties on its credit default swaps and other financial contracts were made whole.

1 Fannie Mae is a US Government-sponsored enterprise (GSE) formally known as the Federal National Mortgage Association. Freddie Mac is a US GSE formally known as the Federal Home Loan Mortgage Corporation. Their mission is to help provide liquidity to the US residential market by purchasing or guaranteeing payment on certain residential mortgages.

2 See Housing and Economic Recovery Act of 2008.

After the AIG collapse, the US Treasury asked Congress for express authority to invest up to US\$700 billion in toxic mortgage and other assets in order to clean up the balance sheets of the US financial sector. While the Treasury's request for what was later called the Troubled Asset Relief Program (TARP) was pending before Congress, Washington Mutual (the largest thrift in the United States) failed and was sold to JP Morgan, and Wachovia was rescued by Citigroup and then Wells Fargo. Commodity prices, which had spiked during the summer as the dollar fell, reversed course and began to fall as the market began to fear a depression more than a weakened US dollar.

The House rejected TARP on 30 September 2008, resulting in the largest one-day drop in the Dow Jones Industrial Average of 778 points, or US\$1.3 trillion in market value. The Senate quickly passed a bill during the first week of October, the House reconsidered its action, and President Bush signed the bill into law on the same day the House approved it.

During the second week in October, the Treasury announced its Capital Purchase Program (CPP), which involved making investments of up to US\$250 billion in the preferred stock of US insured depository institutions and their holding companies. The US Federal Deposit Insurance Corporation (FDIC) temporarily increased deposit insurance coverage to US\$250,000 per person per institution, as well as announcing the creation of the Temporary Liquidity Guarantee Program (TLGP), which would provide credit support to debt capital market issuances and non-interest bearing transaction accounts.

The next several weeks saw a stampede of US financial institutions seeking to acquire insured depository institutions in the United States in order to qualify for CPP money. The US Government announced an additional US\$20 billion in capital support and a related US\$301 billion asset guarantee programme for Citigroup in late November. The US Government announced a similar programme of extraordinary support for Bank of America in early 2009 to facilitate BofA's acquisition of Merrill Lynch, which continued to haemorrhage value between signing and closing. Similar failures, rescues and financial assistance programmes were announced throughout 2009 after the height of the panic receded.

The financial panic of 2008, and the economic uncertainty created by various Government actions taken or feared subsequently, have resulted in the worst recession since the Great Depression. It is far worse than the shrinkage caused by the US savings and loan crisis of the late 1980s and early 1990s. Unemployment has persisted for nearly a year at close to ten per cent, and many believe that the percentage of the normal workforce out of work is actually much higher, possibly as high as 17 per cent, because of how US unemployment figures are calculated. They include people who are actively searching for employment, but not those who have become so discouraged that they have given up searching for a job altogether or those who have obtained part-time employment. Fears of future inflation are rampant, while the risk of deflation in the near term is not out of the question.

Meanwhile, the US continues to be in the midst of the largest wave of bank and thrift failures since the US savings and loan crisis ended in the early 1990s. The FDIC resolved over 25 failed institutions in 2008, 140 in 2009 and more than 100 as of July 2010. As of 31 March 2010, the FDIC had nearly 780 insured institutions on its 'problem list', with over US\$430 billion in aggregate assets,³ suggesting that it may be forced to resolve many more closed institutions before the current wave of failures is over. At the same time, the Deposit Insurance Fund, which is used to resolve failed institutions, has fallen to a negative balance.

Emergency responses to end the panic

This section will give only a brief overview of the US Government programmes that were designed or implemented to arrest the financial panic of 2008. Anyone who is interested in a more complete analysis of the programmes proposed or implemented in the United States should consult *The Davis Polk Financial Crisis Manual*,⁴ which contains a thorough analysis of the laws, regulations and contracts used in the United States to end the panic.

The US programmes designed to battle the financial panic consisted primarily of the following:

- the Troubled Asset Relief Program (TARP) implemented by the Treasury under the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA);
- various programmes implemented by the Federal Reserve under its traditional discount window authority for commercial banks and section 13(3) of the Federal Reserve Act;
- the FDIC's use of its Deposit Insurance Fund to provide critical assistance to the banking system, including resolving failed banks and thrifts, temporarily increasing deposit insurance coverage to US\$250,000 per person per institution and its Temporary Liquidity Guarantee Program (TLGP); and
- the Treasury's rescue of Fannie Mae and Freddie Mac pursuant to the authority granted by the Housing Economic Recovery Act of 2008 (HERA).

Federal Reserve programmes

Despite the greater press and political attention paid to the TARP and the TLGP, the programmes implemented by the Federal Reserve under section 13(3) of the Federal Reserve Act represent the largest portion of US Government intervention. Section 13(3) was used by the Federal Reserve to provide liquidity to Wall Street and

3 FDIC, First Quarter 2010, Quarterly Banking Profile, March 2010, at 3.

4 *The Davis Polk Financial Crisis Manual: A Guide to the Laws, Regulations and Contracts of the Financial Crisis*, September 2009, available at www.davispolk.com/files/News/7f041304-9785-4433-aa90-153d69b92104/Presentation/NewsAttachment/3c9302c0-409f-4dd1-9413-24e8cd60cd93/Financial_Crisis_Manual.pdf.

US companies, rescue Bear Stearns and AIG, and conduct monetary policy. Indeed, it was the Government's tool of choice until the Bush administration asked for new congressional authority – first to inject capital directly into Fannie Mae and Freddie Mac, and then to purchase troubled assets from and inject capital directly into the US financial system as a whole. As a result of such programmes, the Federal Reserve's balance sheet more than doubled from August 2007 to December 2008, and its total assets at 31 December 2008, at the height of the crisis, were more than US\$2 trillion, more than twice the highest year-end total in its history.⁵

Section 13(3) permitted the Federal Reserve to make secured extensions of credit to any 'individual, partnership, or corporation'. It was not limited to depository institutions, but it could be invoked only under 'unusual and exigent circumstances' upon the affirmative vote of at least five members of the Federal Reserve. Until 2008, it had not been used since the Great Depression.

TERM SECURITIES LENDING FACILITY (TSLF)

The Federal Reserve's first use of its section 13(3) authority during the global financial crisis was to establish the TSLF on 11 March 2008. In the weeks leading up to the programme, the credit markets had become frozen for certain highly leveraged market participants. The TSLF was designed as a term lending facility for primary dealers.⁶ It was created to provide liquidity to primary dealers, and specifically to add liquidity to the mortgage-backed securities (MBS) market. The Federal Reserve Bank of New York was authorised to lend up to US\$200 billion of Treasury securities to primary dealers secured for a term of 28 days by a pledge of eligible collateral, including MBS. In effect, the programme allowed primary dealers to swap lower-quality securities for higher-quality Treasury securities that could be used more easily to obtain credit in the interbank or capital markets. The TSLF was closed on 1 February 2010, after all loans extended by the facility had been repaid in full, with interest.

BEAR STEARNS

Despite the implementation of the TSLF, Bear Stearns suffered a classic 'run on the bank'. Its cash reserves fell from over US\$20 billion to US\$2 billion in approximately one week. By 14 March 2008 Bear Stearns was prepared to file for bankruptcy in the absence of a significant capital infusion. Since no significant capital infusion was forthcoming from the private sector, the Federal Reserve was left as the only player that could quickly rescue Bear Stearns from bankruptcy.

5 Niel Willardson, *Actions to Restore Financial Stability*, Federal Reserve Bank of Minneapolis: The Region, December 2008 at 16, available at www.minneapolisfed.org/pubs/region/08-12/willardson.pdf.

6 Primary dealers are the 18 large financial institutions that are the counterparties with which the Federal Reserve undertakes open market operations. Many of the 18 were also Wall Street's most prominent investment banks.

On 14 March 2008 the Federal Reserve, by the unanimous vote of all available members, authorised an extension of credit to Bear Stearns through JPMorgan Chase Bank under section 13(3). The Federal Reserve Bank of New York made an overnight loan of US\$12.9 billion to JPMorgan Chase Bank through its normal discount window facilities. The loan was non-recourse and was fully secured by US\$13.8 billion of Bear Stearns assets. The loan was a simultaneous back-to-back transaction, whereby JPMorgan Chase Bank provided secured financing to Bear Stearns and took as collateral the same assets that JPMorgan Chase Bank used to secure its loan from the Federal Reserve.

After the Federal Reserve's emergency loan, the focus turned to finding an acquirer for Bear Stearns – before the opening of business in Asia on Monday morning, 17 March (Sunday evening, 16 March in the United States). JPMorgan initially offered to acquire Bear Stearns for US\$2 per share, or approximately US\$236 million in total, but later raised its price to US\$10 per share, or approximately US\$1.1 billion in total, in order to obtain approval for the transaction from Bear Stearns shareholders. Since JPMorgan did not want to acquire certain illiquid Bear Stearns assets, the Federal Reserve was needed to absorb the risks associated with such assets. The Federal Reserve only had the authority to lend and did not have the authority to purchase assets, so any structure had to be based on the Federal Reserve making a loan.

The Federal Reserve Bank of New York was authorised to make a secured loan of up to US\$30 billion to a special purpose vehicle, Maiden Lane, in order to purchase 'less liquid' assets of Bear Stearns and facilitate the acquisition of Bear Stearns by JPMorgan. The loan was authorised pursuant to section 13(3). JPMorgan was required to lend Maiden Lane US\$1 billion. The Federal Reserve's loan was secured by the assets held by Maiden Lane.

PRIMARY DEALER CREDIT FACILITY (PDCF)

Although Bear Stearns had been rescued, there was a fear that other investment banks with similar funding models could also face liquidity squeezes and ultimately the risk of failure. In order to provide these institutions with more liquidity and prevent this outcome, the Federal Reserve announced the creation of the PDCF on 16 March 2008, under section 13(3). The PDCF was a temporary overnight liquidity facility that provided secured loans to primary dealers. The PDCF allowed primary dealers to borrow funds from the Federal Reserve secured by a broader range of collateral than is permissible to secure borrowings under the discount window. Since the primary dealers included the largest investment banks in the United States, the PDCF provided the largest US broker-dealers with temporary access to a Federal Reserve facility that is very similar to the Federal Reserve discount window. In light of improved functioning of financial markets, the Federal Reserve closed the PDCF on 1 February 2010.

AIG

In the third quarter of 2008, AIG started to experience an increasingly serious liquidity crunch, largely because of its securities lending business and the credit default swap portfolio of its affiliate, AIG Financial Products (AIGFP). Under AIG's securities lending programme, AIG lent securities on behalf of its insurance company subsidiaries against cash collateral that was received from borrowers and invested in securities, including residential mortgage-backed securities (RMBS). AIG was responsible for any deficit in the cash collateral pool caused by any losses sustained in investing it or if AIG's credit rating were downgraded. Under AIGFP's credit default swap contracts, AIGFP was required to post collateral if the CDOs protected by its credit default swaps fell in value or AIG's credit rating were downgraded.

Because of drops in the value of RMBS and CDOs in August, AIG was required to post US\$3.3 billion of additional collateral into its securities lending programme and AIGFP was required to post US\$5.9 billion of additional collateral to secure its credit default swap obligations. After downgrades in AIG's credit ratings in early September, AIGFP estimated that it would need an additional amount in excess of US\$20 billion in order to fund additional collateral requirements under its credit default swap obligations. The inability to refinance its commercial paper commitments, sharp declines in AIG's common stock, and regulatory constraints on AIG's ability to borrow from its insurance company subsidiaries left AIG in severe difficulty during the weekend of 13 – 14 September. AIG explored the possibility of a secured lending facility from the private sector, but was unable to obtain the necessary liquidity or capital from that avenue.

On 16 September 2008, pursuant to section 13(3), the Federal Reserve authorised the Federal Reserve Bank of New York to lend AIG up to US\$85 billion under a secured revolving credit facility. As a condition to the loan, AIG also agreed to issue to a trust established for the benefit of the Treasury a series of senior preferred stock and warrants equal to approximately 80 per cent of the economics and voting power of the company.

The loan was restructured in November to include loans to two new special purpose vehicles. The Federal Reserve lent approximately US\$19.5 billion to Maiden Lane II so that the SPV could purchase MBS from AIG. It lent approximately US\$19.6 billion to Maiden Lane III so that the SPV could purchase from AIGFP's counterparties US\$62 billion of CDOs that were protected by AIGFP's credit default swaps.

On 17 April 2009, the Federal Reserve Bank of New York restructured its loan by establishing an additional equity capital commitment of up to US\$30 billion through the purchase of AIG Series E Preferred Stock and reducing the interest rate on the loan by removing the existing floor of 3.5 per cent on the LIBOR rate. On 1 December the Federal Reserve entered new transactions where it received preferred interests in two SPVs, AIA Aurora LLC and ALICO Holdings LLC, that had been formed to hold the outstanding common stock of AIG's largest foreign insurance subsidiaries, AIA Group and American Life Insurance Company (ALICO). In exchange, AIG's

outstanding balance under the revolving credit facility was reduced by US\$25 billion.

Four months later, on 1 March 2010, AIG announced the sale of AIA to Prudential PLC for approximately US\$35.5 billion. AIG said it would use cash proceeds from the sale to redeem the preferred interests held by the Federal Reserve in AIA Aurora and repay US\$9 billion of the money it had borrowed from the revolving credit facility. That transaction did not close, however, because the shareholders of Prudential voted against the transaction.

On 8 March 2010, AIG announced it would sell ALICO to MetLife, Inc for approximately US\$15.5 billion, and said it would use cash from the sale to redeem US\$9 billion of preferred interests held by the Federal Reserve in ALICO Holdings.

ASSET-BACKED COMMERCIAL PAPER MONEY MARKET MUTUAL FUND LIQUIDITY FACILITY (AMLF) AND COMMERCIAL PAPER FUNDING FACILITY (CPFF)

By the autumn of 2008, money market mutual funds were facing severe liquidity pressure. After the failure of a large money market mutual fund, Reserve Primary Fund, investors began a run on money market mutual funds that lasted for weeks. Redemptions totalled over US\$100 billion. In the face of redemptions, money market mutual funds had to start selling assets, including commercial paper. Because of these fire sales, commercial paper issuers started to face liquidity pressures of their own, forcing many of them to draw on back-up lines of credit from banks. This put further pressure on the banking system because most banks had not anticipated that so many of these back-up facilities would be drawn at once. In order to address the fire sales of commercial paper as a result of redemption pressures and the lack of liquidity in the commercial paper market, the Federal Reserve created the AMLF and the CPFF.

The AMLF was authorised by the Federal Reserve on 19 September 2008 to provide funding to US depository institutions and bank holding companies and their US broker-dealer subsidiaries to finance purchases of high-quality asset-backed commercial paper from money market mutual funds. The programme lent more than US\$150 billion in its first ten days of operation, but as the markets improved, there was no new borrowing through the AMLF from 8 May 2009 to the programme's closing on 1 February 2010. The CPFF was authorised on 14 October 2008 to establish an SPV to purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers, including any US commercial paper issuer, even those with foreign parents. Both of these programmes were closed on 1 February 2010, after repaying all loans in full, with interest and in accordance with the terms of each facility. The CPFF incurred no losses, and earned nearly US\$5 billion primarily from interest income, credit enhancement fees and registration fees. The remaining commercial paper holdings of the CPFF matured on 26 April 2010, and the CPFF LLC will be dissolved after the payment of expenses and the termination or expiration of existing contracts.

TERM ASSET-BACKED SECURITIES LOAN FACILITY (TALF)

The financial crisis deeply affected the securitisation market. In a period of months, the pendulum swung from a condition in which the financial markets assigned too low a value to the risk of certain securitisation asset classes – such as sub-prime mortgages – to one in which seemingly the only securities that were readily marketable were those with an explicit or implicit Government backing. Issuance of securities backed by credit card receivables and auto loans slowed to a trickle, and the sale of new commercial MBS (CMBS) ceased altogether. The absence of a functioning securitisation market in turn severely constrained the practical ability of banks and other financial institutions to extend new loans to consumers and businesses.

In an effort to revive the asset-backed securities (ABS) markets and provide a critical channel for the supply of new credit to households, the Federal Reserve created TALF, which began operations in March 2009 under the administration of the Federal Reserve Bank of New York. Treasury Secretary Geithner characterised TALF as ‘[o]ne of the most important’ Federal Reserve programmes.⁷ Through TALF, the Federal Reserve Bank of New York provided non-recourse loans to borrowers, secured by qualifying non-mortgage-backed ABS and, more recently, CMBS. Initially greeted with tepid interest, the programme gained momentum during the second quarter of 2009. As of 31 March 2010, the Federal Reserve Bank of New York, after loaning approximately US\$70.8 billion under TALF, stopped making new loans for non-mortgage-backed ABS and legacy CMBS (or certain ‘high quality’ CMBS issued before 1 January 2009). TALF was closed on 30 June 2010, after it stopped making loans for newly issued CMBS.

Treasury programmes

The original vision of the TARP was that the Treasury would purchase up to US\$700 billion of ‘troubled assets’ from ‘financial institutions’. The TARP facility was expected to be used to purchase mortgages and other real estate-related assets in order to stabilise, enhance or at least establish reliable market values for illiquid assets. That original vision, however, was never implemented. Instead, the Treasury and the Federal Reserve quickly abandoned that plan and used TARP funds to make direct investments in the US financial system through the Capital Purchase Program.

CAPITAL PURCHASE PROGRAM (CPP)

The CPP earmarked US\$250 billion for direct investments in US financial institutions. When the CPP was officially announced, regulators had already summoned the CEOs of the nation’s nine largest financial institutions to a meeting in Washington to inform them that their institutions had been designated as

⁷ *Written Testimony of Treasury Secretary Timothy Geithner: Hearing Before the Cong Oversight Panel*, 111th Cong (2009) (statement of Timothy Geithner, Secretary, US Dep’t of the Treasury), available at <http://cop.senate.gov/documents/testimony-091009-geithner.pdf>.

systemically important, and that, therefore, they would be required, whether they or their boards felt their institutions needed it or not, to sign the term sheets put in front of them and accept the Government investment. The CEOs of these institutions all signed the one-page term sheets that day, which formed the basis of securities purchase agreements for the purchase of preferred stock and warrants that were later signed by the financial institutions. Unlike the preferred stock the Government purchased from Fannie Mae, Freddie Mac and AIG, this preferred stock was not senior to outstanding preferred stock. Instead, it was *pari passu*. In addition, the warrants were for a relatively small amount of common stock rather than 80 per cent of the company. These terms reflected a fundamental shift in policy from a focus on preventing moral hazard to a focus on restoring public confidence in the US financial system.

After the Treasury set aside US\$125 billion for the nine largest financial institutions, it offered the remaining US\$125 billion to other US banking institutions, including regional and community banks, but only the banking institutions other than the top nine that were determined to be ‘healthy’. Indeed, after the initial announcement, many regional financial institutions requested CPP investments to avoid being tainted as ‘unhealthy’. There was widespread fear that banks that did not request CPP investments would suffer deposit runs and possibly failure because their customers would conclude that they were unhealthy. The Treasury had invested a total of US\$204.9 billion in 707 qualifying financial institutions (QFIs) through the CPP, and US\$135.8 billion had been repaid by 31 March 2010. The CPP was closed on 29 December 2009 and will not disburse any new funds.

SYSTEMICALLY SIGNIFICANT FAILING INSTITUTIONS PROGRAM/AIG INVESTMENT PROGRAM

On 10 November 2008, the Treasury announced a restructuring of the Government’s financial support to AIG. As part of that overhaul, the Treasury indicated that it would purchase US\$40 billion of newly issued preferred stock, under the Systemically Significant Failing Institutions Program (also called the AIG Investment Program), with the proceeds used in part to reduce the total amount available under AIG’s 22 September 2008 secured revolving credit agreement with the Federal Reserve Bank of New York. Also, on 17 April 2009, the Treasury committed US\$29.8 billion to an equity capital facility that AIG could draw from. By 31 March 2010 AIG had drawn down US\$7.5 billion from the facility and had not yet repaid any TARP funds.

TARGETED INVESTMENT PROGRAM

The Treasury first issued guidelines for the Targeted Investment Program on 2 January 2009, after previously announcing its investment in Citigroup on 22 November 2008 and beginning discussions with Bank of America about additional TARP investments in December 2008 in anticipation of the closing of its purchase of Merrill Lynch on 1 January 2009.

The Treasury invested US\$20 billion via the Targeted Investment Program in both Citigroup and Bank of America by purchasing perpetual preferred securities. The

Treasury's investment supplemented the initial TARP investments made under the CPP in these financial institutions.

In December 2009, both Citigroup and Bank of America repurchased their respective preferred securities, and the Targeted Investment Program effectively ended. Bank of America repurchased its shares on 9 December 2009 as part of a joint CPP and Targeted Investment Program repayment to the Treasury. Citigroup completed the sale of US\$20.5 billion of new debt and equity securities and used the proceeds of this sale to repurchase its preferred securities on 22 December 2009.

ASSET GUARANTEE PROGRAM (AGP)

The Asset Guarantee Program was announced as a package with the Targeted Investment Program. Under the Asset Guarantee Program, the US Government entered into a definitive agreement with Citigroup to share losses with respect to a pool of US\$301 billion in assets of Citigroup. Although the Government agreed to the terms of a similar programme with Bank of America with respect to a pool of US\$118 billion of assets, the majority of which were assumed as a result of the Merrill Lynch acquisition, the parties never executed definitive documents for that programme. On 21 September 2009 Bank of America announced that it had reached an agreement with regulators to pay a US\$425 million fee to terminate the term sheet.

Pursuant to its agreement with the Government, Citigroup would absorb the first losses in its covered assets portfolio up to US\$39.5 billion. The Federal Reserve Bank of New York, the Treasury and the FDIC would share any additional losses with Citigroup, with the Government absorbing 90 per cent of that loss and Citigroup ten per cent of the loss. Citigroup was required to manage the assets in the pool in accordance with guidance from a template issued by the Government, including mortgage modification procedures adopted by the FDIC. On 23 December 2009, the Asset Guarantee Program agreement was terminated in connection to Citigroup's repayment of the Treasury's Targeted Investment Program investment. The Government made no payments and retained US\$5.2 billion in preferred shares as compensation for the protection extended by AGP.

CAPITAL ASSISTANCE PROGRAM (CAP) AND STRESS TESTS

CAP was announced by Treasury Secretary Geithner on 10 February 2009. There were two main components of CAP:

- stress tests to determine whether certain institutions needed additional capital buffers; and
- a capital assistance programme through which eligible public institutions could apply for capital infusions from the Treasury.

The programme's emphasis on capital composition in the stress tests and preferred stock terms that included the ability to convert to common stock demonstrated the Treasury's continued concern with increasing tangible common equity in recipient

financial institutions.

CAP enabled qualifying financial institutions (QFIs) to issue mandatory convertible preferred stock to the Treasury in order to provide such institutions with contingent common equity ‘as a bridge to private capital in the future’, as is necessary to ‘retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital’.⁸ The capital infusions were meant to increase capital buffers at QFIs to guard against economic conditions that are worse than expected. QFIs that issued mandatory convertible preferred stock under CAP were also required to issue to the Treasury warrants to purchase shares of the institution’s common stock. Of the 19 banks participating, only GMAC indicated a need for capital, and this need was lower than anticipated at the time the SCAP results were announced. CAP was closed on 9 November 2009.

PUBLIC–PRIVATE INVESTMENT PROGRAM (PPIP)

The PPIP was an initiative to address the enduring problem of illiquid and troubled assets on financial institutions’ balance sheets. The programme, announced by Treasury Secretary Geithner on 23 March 2009, was originally hailed as a vital component of the Government’s plan to heal the financial sector. It received a warm welcome from Wall Street, with the Dow Jones Industrial Average rising seven per cent on the day of its announcement.

Enthusiasm for the PPIP waned almost immediately, however, because of the increasingly anti-Wall Street tone of the new Obama administration and the congressional leadership – the same leadership that had encouraged and authorised the various emergency assistance programmes under the Bush administration. In particular, both the new administration and the congressional leadership became highly critical of all of the bank holding companies that had received capital injections under the CPP, including the systemically important ones that had not requested additional capital but had been required to accept it for the ‘good of the system’, and those who took the capital solely to avoid being stigmatised as ‘unhealthy’. Suddenly, all the banks that had received CPP capital found themselves stigmatised for having taken it, regardless of the reasons for having done so. This caused potential investors to question whether the US Government was a reliable trading partner. They started to fear that the Government might retroactively change the terms of their partnership if it appeared that they might make ‘excessive’ returns on their investments, as determined by hindsight. This distrust of Government doomed the PPIP.

As originally contemplated, the PPIP had two halves: the Legacy Securities Program run by the Treasury and the Legacy Loans Program run by the FDIC. Both programmes

8 Bd of Governors of the Fed Reserve Sys, Press Release, *Joint Statement by Secretary of the Treasury Timothy F Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C Dugan, Comptroller of the Currency* (6 May 2009), available at www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm.

contemplated the formation of investment funds capitalised with equity from the Treasury and private investors to be leveraged with potentially attractive Government financing in the form of either direct loans or debt guarantees, each fund a public-private investment fund or PPIF.

A key principle underlying the PPIP was a belief that, with the assistance of Government capital and leverage, the private sector could be induced to purchase these troubled and illiquid assets at prices substantially in excess of the then current market price. Both the Government and the banks believed that such market prices simply reflected speculative ‘vulture’ funds taking advantage of the distress of the banks and the dysfunctional credit markets to purchase assets at fractions of their underlying economic value.

In June 2009 the FDIC indefinitely postponed the Legacy Loans Program for lack of private sector interest. While the Treasury moved forward with the Legacy Securities Program, only very limited private sector interest ever materialised.

FANNIE MAE AND FREDDIE MAC

On 6 September 2008, the US Government took control of Freddie Mac and Fannie Mae as conservator, pursuant to the authority granted by HERA that Congress passed only several weeks prior. In connection with the conservatorship, the US Government provided each of the GSEs with up to US\$100 billion of direct financial assistance in the form of senior preferred stock and temporary access to the Federal Reserve’s discount window. The Treasury also agreed to purchase an unspecified amount of MBS backed by the GSEs in the open market. As part of its fee for providing the financial support, the Treasury took a 79.9 per cent interest in the common stock of each institution. The rescue of Fannie Mae and Freddie Mac is the largest Government-assisted transaction in US history, as these two institutions held or guaranteed a combined US\$5.5 trillion of mortgage-backed securities at the time they were put into conservatorship.

To further boost market confidence in the two GSEs, on 18 February 2009, the Treasury announced that the funding commitments would be increased to US\$200 billion for each institution. On 24 December 2009, the Treasury essentially offered unlimited support for the GSEs for three more years, stating that it was amending its preferred stock purchase agreements ‘to allow the cap on Treasury’s funding commitment under these agreements to increase as necessary to accommodate any cumulative reduction in net worth over the next three years’.⁹ As of 23 June 2010, the Treasury had injected nearly US\$150 billion of capital into Fannie and Freddie, and the Congressional Budget Office has estimated that it will take approximately US\$390 billion in total capital injections before these institutions

⁹ Treasury Issues Update on Status of Support for Housing Programs, available at www.ustreas.gov/press/releases/2009122415345924543.htm.

will be stabilised.¹⁰ Unlike the banks that quickly repaid most of the capital injections under the CPP, almost no one expects Fannie or Freddie to ever be able to repay more than a small fraction of its taxpayer assistance.

In addition to the Treasury's financial assistance, the Federal Reserve established programmes to purchase up to a total of US\$200 billion of direct obligations of the GSEs and to purchase up to a total of US\$1.25 trillion of MBS that are guaranteed by the GSEs. The Federal Reserve had purchased US\$432.3 billion of MBS from Freddie Mac and US\$703.6 billion of MBS from Fannie Mae by 31 March 2010. Moreover, the Federal Reserve purchased US\$67.1 billion in debt from Freddie Mac and US\$67.4 billion in debt from Fannie Mae from December 2008 to March 2010. It is not clear whether the Federal Reserve will be able to sell such a large portfolio of MBS into the capital markets or, if so, how long it will take to do so without disrupting the markets. In any event, it is unlikely that Fannie and Freddie will be in position to buy back any of these MBS in the foreseeable future.

FDIC's Temporary Liquidity Guarantee Program (TLGP)

The FDIC Board approved the TLGP in October 2008 as part of an effort by the FDIC, the Treasury and the Federal Reserve to stabilise the nation's financial system. There are two parts to the TLGP: the Debt Guarantee Program and the Transaction Account Guarantee Program. Through the Debt Guarantee Program, the FDIC guaranteed certain senior unsecured debt issued by participating insured depository institutions, their holding companies or their affiliates. Through the Transaction Account Guarantee Program, the FDIC provided unlimited deposit insurance for certain transaction accounts at participating insured depository institutions.

The Debt Guarantee Program was highly attractive to participating entities, particularly the larger bank holding companies, because it provided access to funding at relatively low cost. Regardless of the participating entity's credit rating, the three major credit rating agencies rated debt issued under the TLGP with their highest ratings based on the FDIC guarantee. Most fixed-rate debt issued under the Debt Guarantee Program bore an annual interest rate between of 1.5 and three per cent.

31 October 2009 was the last day for a participating entity to issue guaranteed debt under the TLGP. The FDIC established a limited, six-month emergency guarantee facility following the expiration of the Debt Guarantee Program on 31 October 2009, which was closed on 30 April 2010. Under the FDIC's general deposit insurance programme, deposits that are not subject to the transaction account guarantee are insured up to US\$250,000 per person per institution, until 31 December 2013. The Transaction Account Guarantee Program provided unlimited insurance coverage for any balances in a non-interest bearing transaction account until 30 June 2010.

10 See, eg, Brian M Carney, 'Fan and Fred and the Problem of Narrative', *Wall Street Journal*, 26 July 2010, available at <http://online.wsj.com/article/SB10001424052748703467304575383451809694546.html?KEYWORDS=fan+and+fred#printMode>; Thomas F Cooley, *The Bottomless Pit of Fannie and Freddie*, *Forbes.com*, 23 June 2010, available at www.forbes.com/2010/06/23/banking-finance-fannie-mae-opinions-columnists-thomas-f-cooley.html; Binyamin Appelbaum, 'Cost of Seizing Fannie and Freddie Surges for Taxpayers', *New York Times*, 19 June 2010, available at www.nytimes.com/2010/06/20/business/20foreclose.html?_r=1&pagewanted=print.

US financial regulatory reform

The financial panic of 2008, and the scope of emergency public assistance required to stem the tide, created the perfect storm for new financial regulation. On 21 July 2010 the US enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act).

Impact of the Dodd-Frank Act

The Act marks the greatest legislative change to US financial regulation since the explosion of financial legislation in the 1930s, which resulted in the Federal Deposit Insurance Act, the Securities Act of 1933, the Glass-Steagall Act, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, to name only the most important. While the full weight of the Act falls more heavily on large, complex financial institutions, smaller institutions will also face heavier regulation.

Proponents of the Act lauded it as landmark legislation that will reduce the likelihood and magnitude of future financial panics, end taxpayer bailouts of Wall Street, and enhance consumer protection. Critics on the left argued that it was too weak, and did not punish Wall Street enough for causing the panic. Critics on the right argued that it amounted to a vast expansion of Government control over the financial sector without addressing the real causes of the financial panic, ending too-big-to-fail or addressing the continuing public assistance to or moral hazards caused by Fannie Mae and Freddie Mac.¹¹ Others observed that it was a lost opportunity because it did not simplify the US regulatory infrastructure along the lines of the 2008 Treasury Blueprint,¹² or improve cross-border coordination, but instead created an even more complicated structure, increasing the risks of regulatory arbitrage and inefficiency.¹³ Some economists predicted that its short-term effect would be to further contract the supply of credit, reduce GDP and create further upward pressure on already high unemployment,¹⁴ thus pushing against the Federal Reserve's liberal monetary policy and making the same mistake of tightening credit by other means that the Federal Reserve made during the Great Depression.

11 See, eg, Brady Dennis, 'Congress Passes Financial Reform Bill', *The Washington Post*, 16 July 2010, available at www.washingtonpost.com/wpdyn/content/article/2010/07/15/AR2010071500464_pf.html; Jeff Madrick, 'Obama's Risky Business', *The New York Review of Books*, 15 July 2010, available at www.nybooks.com/blogs/nyrblog/2010/jul/15/obamas-risky-business; Associated Press, *Historic Financial Overhaul Signed to Law by Obama*, NPR, 21 July 2010, available at www.npr.org/templates/story/story.php?storyId=122793558.

12 See The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure, March 2008, available at www.ustreas.gov/press/releases/reports/Blueprint.pdf.

13 See, eg, Michael Helfer, Panel Discussion, *Regulatory Reform Overview – What's Next?*, at SIFMA Regulatory Reform Summit, 15 July 2010.

14 See, eg, Institute of International Finance, *Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework*, June 2010, available at www.iif.com/.

One thing is certain – the Act will contribute to legal uncertainty in the United States in the short run.¹⁵ For the most part, the legislation creates only a general framework, leaving most key issues to be resolved by implementing regulations. Indeed, the Act requires at least 243 new federal rule-makings to implement its provisions. In the next phase of US financial regulatory reform, regulators will face an intense period of rule-making for at least 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staff of the various agencies involved.

Adding to this legal uncertainty, the legislation did not enjoy bipartisan support. Instead, it was enacted largely along party lines, with nearly unanimous opposition from Republicans. House Minority Leader, John Boehner, for example, called for its immediate repeal and promised to dismantle it if Republicans again took control of Congress and the White House.

Summary of key provisions of the Dodd-Frank Act

The Dodd-Frank Act will not change the fundamental contours of the US financial regulatory structure. It will only cause a limited amount of shuffling of the regulatory boxes. For example, the Office of Thrift Supervision (OTS), which regulated a sector of the banking industry focused on real estate lending, will disappear. A new consumer financial protection agency and a new systemic risk council of regulators, will be created. But otherwise, the US financial regulatory structure will remain the same.

The Act will, however, result in several fundamental changes to the shape and scope of US financial regulation, summarised in the table below:

Key reforms in the Dodd-Frank Act	
Systemic Risk Regulation	Securitisation – Credit Risk Retention
Financial Stability Oversight Council	Executive Compensation
Office of Financial Research	Elimination of the OTS
Enhanced Prudential Standards	Deposit Insurance Reforms
Living Wills	Enhanced Regulation of Banking Entities
Orderly Liquidation Authority	Payment, Clearing and Settlement Systems
Volcker Rule	Consumer Financial Protection
Swaps Pushout rule	Restrictions on Emergency Stabilisation
Bank Capital (Collins Amendment)	Federal Reserve Governance
Derivatives	Pay it Back Act
Hedge Funds	Insurance
Investor Protection	International Sovereign Assistance
Enhanced Regulation of Securities Markets	Mortgage Market Reforms
Credit Rating Agencies	

¹⁵ See, eg, ‘The Uncertainty Principle’, *Wall Street Journal*, 14 July 2010, at A18, available at <http://online.wsj.com/article/SB10001424052748704288204575363162664835780.html?KEYWORDS=uncertainty+principle>; The Uncertainty Principle II, *Wall Street Journal*, 16 July 2010, available at <http://online.wsj.com/article/SB10001424052748704682604575369402612040086.html?KEYWORDS=uncertainty+principle>.

This section will provide only a brief overview of the Dodd-Frank Act. Anyone who is interested in a more complete summary of the Act should consult one of the many summaries that have been published by various US law firms and are available on their websites,¹⁶ including memos and graphical illustrations of the effectiveness and implementation timelines of the various provisions with delayed effectiveness¹⁷ or immediate effectiveness.¹⁸

SYSTEMIC RISK REGULATION

The Act creates a new systemic risk council of regulators called the Financial Stability Oversight Council to serve as an early warning system identifying risks in firms and market activities, to enhance oversight of the financial system as a whole and to harmonise prudential standards across agencies. In other words, it will be responsible for macroprudential policies. A new Office of Financial Research will serve as the information-gathering arm of the Council. The Council is empowered to identify 'systemically important' non-bank financial companies, thus bringing such companies under regulation by the Federal Reserve, and to recommend heightened prudential standards for the Federal Reserve to impose on these companies. The Council also has the power to recommend heightened prudential standards to primary financial regulators to apply to any activity that the Council identifies as contributing to systemic risk.

The Federal Reserve will have expanded power over systemically important bank holding companies, as well as non-bank financial companies that are designated as systemically important by the Council. These systemically-important institutions will be subject to the Federal Reserve's consolidated supervision based on the current model for supervising bank holding companies in the US Bank Holding Company Act of 1956.

The vast majority of the systemic risk provisions require implementing regulation, and many give regulators discretion to modify the statutory standards or issue exemptions. In addition, the Council is not yet operational and has not yet put in place internal rules of procedure. As a result, significant unknowns remain on the scope and content of systemic risk regulation, and the manner in which the Council will operate.

16 See, eg, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on 21 July 2010*, Davis Polk Client Memorandum, 21 July 2010, available at www.davispolk.com/files/Publication/efb94428-9911-4472-b5dd-006e9c6185bb/Presentation/PublicationAttachment/efd835f6-2014-4a48-832d-00aa2a4e3fdd/070910_Financial_Reform_Summary.pdf.

17 See, eg, *Davis Polk Regulatory Implementation Slides*, 21 July 2010, available at www.davispolk.com/files/Publication/bc70cd4c-c6bd-472d-ad37-0a63481fe36a/Presentation/PublicationAttachment/6a2f81d8-d5c5-4d5d-9b97-fef48b6821e6/070910_Implementation_Slides.pdf.

18 See, eg, *Dodd-Frank Wall Street Reform and Consumer Protection Act: Preliminary Assessment of Provisions Effective Immediately or Very Soon After Enactment*, Davis Polk Client Memorandum, 21 July 2010, available at www.davispolk.com/files/Publication/45ad4c88-8216-4efc-8e9c-6ecca08084a8/Presentation/PublicationAttachment/9a947ba9-a1ac-459b-9a34-70448c7035ea/072110_effective.pdf.

Financial Stability Oversight Council

(i) Membership

The Financial Stability Oversight Council will consist of 15 members: ten voting and five non-voting. The voting members are the Treasury Secretary, who serves as chairman, and the heads of the Federal Reserve, the Office of the Comptroller of the Currency (OCC), which regulates national banks, the new Bureau of Consumer Financial Protection (Consumer Bureau), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), the National Credit Union Administration (NCUA), the Federal Housing Finance Agency (FHFA) and an independent member with insurance expertise. The non-voting members are the Directors of the Office of Financial Research (OFR) and the Federal Insurance Office (FIO), a state insurance commissioner, a state banking supervisor and a state securities commissioner.

(ii) Powers and duties

The Council is charged with the goal of identifying risks to US financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or non-bank financial companies, or risks that could arise outside the financial services marketplace. The Council is also supposed to promote market discipline and respond to emerging threats to US financial markets.

(iii) Systemic Designation Authority

The Council is empowered to identify systemically important non-bank financial companies, financial activities or practices, financial market utilities and payment, clearance and settlement activities. Bank holding companies with US\$50 billion or more in consolidated assets are treated as systemically important; no designation is required. The Act refers to non-bank financial companies which are identified as systemically important as 'non-bank financial companies supervised by the Federal Reserve'. In this chapter, I will refer to them as 'systemically important non-bank financial companies', and together with bank holding companies with US\$50 billion or more in assets, as 'systemically important companies'.

(iv) Recommending standards

The Council is authorised to make recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to systemically important companies, to prevent or mitigate risk to US financial stability that could arise from the material financial distress, failure or ongoing activities of these companies. The Federal Reserve must consider these recommendations in prescribing enhanced prudential standards. The Council may also issue recommendations to apply heightened standards and safeguards for financial activities and practices if the

Council determines that the scope, size or interconnectedness of the activity could create or increase the risk of significant liquidity, credit or other problems.

Systemic Risk Regulatory Scheme

(i) Systemically important non-bank financial companies

The Act defines a ‘non-bank financial company’ as any company, other than a bank holding company or a company that is treated as a bank holding company, that is ‘predominantly engaged in financial activities’. The Council is charged with identifying such non-bank financial companies that are systemically important, which the Act identifies as those that could pose a threat to financial stability either due to the potential of material financial distress at the company or due to the company’s ongoing activities. Consideration of the company’s ongoing activities was added late in the conference process, thereby expanding the scope of companies potentially designated as systemically important.

(ii) Systemically important bank holding companies

Bank holding companies with US\$50 billion or more in assets are automatically subject to enhanced prudential standards. No Federal Reserve action or Council determination is required. There is no authority to lower the US\$50 billion threshold. The Federal Reserve has the authority to raise the limit, and the Council may recommend such action, but only with respect to the application of the contingent capital requirement, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosures and short-term debt limits. The Federal Reserve may not raise the threshold for risk-based capital requirements, leverage limits, liquidity requirements and overall risk management requirements. As of 31 March 2010, there are 36 domestic bank holding companies that exceeded the US\$50 billion threshold.

(iii) Enhanced prudential standards

GENERALLY

The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting, concentration limits and prompt corrective action to apply to systemically important companies. The Federal Reserve may, but is not required to, establish additional prudential standards, including contingent capital requirements, enhanced public disclosure requirements, short-term debt limits and other prudential standards that it, on its own or pursuant to Council recommendations, deems appropriate. In developing enhanced prudential standards, the Federal Reserve must take into account recommendations of the Council. Standards must be more stringent than the standards and requirements applicable to non-bank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States. For any bank

holding company with US\$50 billion or more in assets or any systemically important non-bank financial company, off-balance sheet activities must be taken into account for the purposes of meeting capital requirements. The Federal Reserve is permitted to require contingent capital, and the Council may make recommendations to that effect, but only after a Council study and subsequent report to Congress, which must be submitted within two years after enactment.

CONCENTRATION LIMITS

The Federal Reserve must prescribe standards to limit the risks posed by the failure of any individual company to a systemically important firm. The rules issued by the Federal Reserve must prohibit credit exposure of a systemically important company to any unaffiliated company that exceeds 25 per cent of capital stock and surplus, or such lower amount as the Federal Reserve may prescribe by regulation, of the 'company', presumably the systemically important company. Credit exposure is broadly defined to include derivatives, repos, securities loans and any transaction that the Federal Reserve determines to be similar. The Federal Reserve may exempt transactions from the credit exposure definition if in the public interest.

A separate provision prohibits any insured depository institution, depository institution holding company or systemically important non-bank financial company from merging with or acquiring substantially all of the assets or control of another company if the resulting company's total consolidated liabilities would exceed ten per cent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year. The Act provides an exception for acquisitions where the target bank is in default or in danger of default.

RISK COMMITTEES

The Act requires risk committees for systemically important, publicly traded non-bank financial companies, as well as any publicly traded bank holding companies with total consolidated assets of US\$10 billion or more. The Federal Reserve may impose the requirement on publicly traded bank holding companies with less than US\$10 billion in assets as necessary or appropriate to promote sound risk management practices. Risk committees must have the number of independent directors as determined by the Federal Reserve, and include one risk management expert having experience in risk management at large complex companies.

RESOLUTION PLANS (LIVING WILLS)

The Act requires systemically-important non-bank financial companies and large, interconnected bank holding companies to prepare and maintain extensive orderly resolution plans, which must be approved by the Federal Reserve and the FDIC. Plans are non-binding on bankruptcy courts, receivers or similar authorities. No private right of action may be based on any resolution plan.

The FDIC and the Federal Reserve must review a company's resolution plan to determine whether it is credible and whether it would facilitate an orderly resolution under the US Bankruptcy Code. If the resolution plan is found to be deficient, the company must resubmit the plan, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan. If a firm fails to adopt an acceptable plan, the FDIC and the Federal Reserve may impose more stringent capital, leverage or liquidity requirements, or restrictions on growth, activities or operations. After having imposed other requirements, the FDIC and the Federal Reserve may require a company to divest assets if the company's resolution plan is deficient and a suitable, revised resolution plan is not resubmitted within two years.

Resolution plans will almost certainly have an effect long before a financial institution fails. They could result in demands that financial groups simplify their corporate structures, or possibly replace their branch networks with separately capitalised subsidiaries. They could also result in increased demand for risk management information on a real-time basis, such as lists of all counterparties, individual and aggregate exposures, amounts and quality of collateral, legal opinions as to the enforceability of collateral arrangements, and deal-level documentation. In any event, they are almost certain to result in increased risk management and compliance costs.

STRESS TESTS

The Federal Reserve must conduct annual stress tests for all systemically important companies under at least three scenarios – baseline, adverse and severely adverse. The Federal Reserve must require each systemically important company to modify its living will based on the results of the analysis. The Federal Reserve will also publish a summary of the results of the stress tests. Each systemically important company must also conduct semi-annual internal stress tests and report the results of such stress tests to the Federal Reserve and its primary financial regulatory agency and publish a summary of the results as required by implementing regulations.

LIMITATIONS ON NON-BANK ACQUISITIONS

Systemically important companies must provide prior notice to the Federal Reserve before acquiring control of voting shares of a company engaged in activities that are financial in nature or incidental thereto that has US\$10 billion or more of consolidated assets.

BREAKUP POWERS

Upon a finding by the Federal Reserve, with approval of two out of three votes of the Council, that a systemically important company poses a 'grave threat' to financial stability, the Federal Reserve must take actions necessary to mitigate such risk, including:

- limiting the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
- restricting the ability to offer a financial product or products;

- ordering termination of activities;
- imposing conditions on the manner in which the company conducts activities; or
- if the Federal Reserve determines that such actions are inadequate to mitigate a threat to US financial stability, requiring the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

LEVERAGE LIMITS

The Federal Reserve must require a systemically important company to maintain a debt-to-equity ratio of no more than 15 to one upon a determination by the Council that the company poses a grave threat to US financial stability and imposition of the leverage limit is necessary to mitigate such threat. In making a determination, the Council must consider the same factors as applicable to the systemically important designation of non-bank financial companies.

(iv) Systemically-important activities and practices

The Council may recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company subject to regulation by a primary financial regulatory agency, including insurance companies, if it finds that the conduct, scope, nature, size, scale or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and non-bank financial companies or the US financial markets. The activity or practice, rather than the financial institution, would be considered significant.

OFFICE OF FINANCIAL RESEARCH

In an unheralded section, the Act adds a new self-funded, largely independent Office of Financial Research (OFR) with the power to gather vast amounts of information from financial market participants and to require standardisation of financial information to be reported to the OFR and other regulators. The OFR has broad information-gathering authority backed by subpoena power, and all data it collects is subject to the Freedom of Information Act. Several of the OFR provisions appear to overlap and even conflict in some places, meaning the scope of the OFR's powers will not be known until developed through rule-making and practice.

Orderly Liquidation Authority

The Act includes a new Orderly Liquidation Authority that will replace the Bankruptcy Code and other applicable insolvency laws for liquidating financial companies and certain of their subsidiaries under certain circumstances. Under the new Liquidation Authority, the Treasury Secretary would have the authority to appoint the FDIC as receiver of any financial company if certain conditions are satisfied. The new Authority is modelled largely on

sections 11 and 13 of the Federal Deposit Insurance Act, which governs the receivership or conservatorship of insured banks, but with several important differences. These differences were designed to harmonise the rules defining creditors' rights with those contained in the Bankruptcy Code, discourage bailouts, ensure due process, protect customer property and reduce the moral hazard that could result if shareholders, unsecured creditors or management are insulated from the consequences they would have suffered in a liquidation under the Bankruptcy Code or other applicable insolvency law. The result is a law that attempts to balance the goals of the bankruptcy and customer protection laws with the goals of preserving or restoring financial stability, public confidence and reasonable risk-taking that may have been disrupted as a result of a financial panic.

The Volcker Rule

The Volcker Rule will require bank holding companies to restructure or divest their proprietary trading and hedge fund and private equity businesses. While the Volcker Rule will restrict the US activities of non-US banks and the worldwide activities of US domestic banking holding companies, it will not apply to the activities of non-US banks 'solely outside the United States', provided that no hedge funds or private equity funds are marketed to US residents. The Volcker Rule will also require systemically important non-bank financial companies to carry more capital and be subject to other quantitative limits (including possibly ownership limits) on these activities. The Volcker Rule was named after Paul Volcker, the former Chairman of the Federal Reserve, who first proposed the restrictions for many months in vain.

Neither the Obama administration nor any of the US financial regulatory agencies nor anyone on Capitol Hill seemed particularly interested in the Volcker Rule until the political firestorm that arose on 19 January 2010 when Republican Scott Brown upset Democrat Martha Coakley in a special election for the Massachusetts Senate seat that had been left vacant by the death of Senator Edward Kennedy.¹⁹ After ignoring the Volcker Rule for months, the administration suddenly announced it as a new central element of its financial regulatory package on 21 January 2010, only two days after Brown's stunning victory. The administration apparently viewed the Volcker Rule as a way to regain the political advantage after the Massachusetts defeat. Wall Street remained unpopular, and the Volcker Rule was viewed as a popular way to bash Wall Street. Indeed, the day after the Brown upset, Arianna Huffington, one of the Obama administration's most prominent, left-wing supporters and critics, had published an editorial in the *Wall Street Journal* urging the administration to turn on Wall Street as a way to regain the political advantage.²⁰

The proposal initially received a frosty reception from the Senate Banking Committee, with Chairman Dodd describing it as coming too late in the day.

19 Alexander Burns, *Scott Brown Pulls Off Historic Upset*, Politico.com, 20 January 2010, available at www.politico.com/news/stories/0110/31674.html.

20 Arianna Huffington, 'Democrats Should Dump their Banker Friends', *Wall Street Journal*, 20 January 2010, available at <http://online.wsj.com/article/SB10001424052748704320104575014974041048224.html>.

Indeed, the widespread view, even after the administration issued the proposed legislative text,²¹ was that the Volcker Rule was ‘dead on arrival’. When Senators Merkley and Levin introduced their Prop Trading Act on 10 March 2010²² it was taken as further evidence that the Volcker Rule was dead, because otherwise the Merkley-Levin bill would not have been proposed separately from the overall financial reform bill. Even on the Friday before the Senate released its 15 March 2010 version of what became the Dodd-Frank Act, senior Senate staffers on both sides of the aisle were saying that the Volcker Rule would not be part of the bill, although some warned that it could be proposed as an amendment during the debate of the bill on the floor of the Senate.

The Volcker Rule picked up steam after the administration succeeded in pressing the Senate leadership over the 13–14 March weekend to include its version of the Volcker Rule in the 15 March version of the Senate bill. The Volcker Rule picked up further momentum when the SEC filed fraud charges against Goldman Sachs on Friday afternoon, 16 April 2010, alleging that Goldman had failed to make appropriate disclosures in connection with structuring and marketing certain CDOs based on certain sub-prime reference assets. The fraud charges were followed by hearings in the Senate, led by Senator Carl Levin, in which Goldman was severely criticised for failing to disclose that John Paulsen, who intended to short the CDOs, had been involved in selecting the reference assets for the CDO pool.

Swaps Pushout Rule

The Swaps Pushout Rule will require US insured depository institutions and the US branches and agencies of non-US banks to push dealing in certain swaps out of these banking units and into separately capitalised affiliates. The range of covered swaps is unclear, but the rule will not apply to insured depository institutions with respect to hedging or dealing in swaps based on reference assets that a national bank is permitted to own.

The Swaps Pushout Rule was originally proposed by Senator Blanche Lincoln, who faced a serious challenge from the left in her Democratic primary election. Like the Volcker Rule, the Swaps Pushout Rule was promoted as an anti-Wall Street measure. But unlike the Volcker Rule, on which US bank regulators remained largely silent, most of the US bank regulators issued public statements opposing the Swaps Pushout Rule as likely to undermine the safety and soundness of the US banking system. Even Paul Volcker publicly suggested that the Swaps Pushout Rule was probably unwise, while expressly

21 *Treasury Proposes ‘Volcker Rule’ Legislative Text*, Davis Polk Client Memorandum, 4 March 2010, available at www.davispolk.com/files/Publication/35a35c0a-d2eb-4e0e-97a5-12cb9614a5ca/Presentation/PublicationAttachment/abb79d18-5d6e-4937-958e-5575e129c594/030410_volcker_rule.pdf.

22 *New ‘Prop Trading Act’ Would Expand ‘Volcker’ Prohibitions*, Davis Polk Client Memorandum, 11 March 2010, available at www.davispolk.com/files/Publication/4e8bde45-e552-4cca-9e86-2fa263df22ac/Presentation/PublicationAttachment/530b9c6c-6e1a-48fc-98fe-31f772098db2/031110_merkley_levin.pdf.

stating that to the extent proprietary trading in swaps should be prohibited, the Volcker Rule would do the job. In its original form, the Swaps Pushout Rule would have required all swaps activities to be pushed out of insured depository institutions and possibly bank holding company groups altogether. It did not contain any exceptions for using swaps for hedging purposes or to deal in swaps based on bank-eligible reference assets.

The Swaps Pushout Rule remained controversial to the end. Compromise language was finally agreed to during the early hours of the morning (between approximately 02:00 and 04:00am) on the day the Senate and House Conference Committee approved the final bill. The final version contains a number of ambiguities, contradictions and technical errors that will need to be clarified during the regulatory implementation process, or through the congressional technical amendments process.

Bank Capital (Collins Amendment)

The Collins Amendment, originally drafted by the FDIC staff and reflecting the views of Chairwoman Sheila Bair, imposes, over time, the risk-based and leverage capital standards currently applicable to US insured depository institutions on US bank holding companies, including US intermediate holding companies of foreign banking organisations, thrift holding companies and systemically important non-bank financial companies. One of the effects of the Collins Amendment is to eliminate trust preferred securities as an element of Tier 1 capital. Implementing regulations must be issued no later than 18 months after enactment and there are highly negotiated transition periods and grandfathering exemptions.

The Collins Amendment echoes changes that have been proposed but not yet adopted by the Basel Committee on Banking Supervision in the 'Basel III' process and those that are contemplated in the new US systemic risk regulatory regime.

Derivatives

The Act comprehensively regulates most derivatives transactions formerly deregulated by the Commodity Futures Modernization Act of 2000. Largely following the historical jurisdictional divisions between the CFTC and the SEC, the Act categorises the derivatives transactions within its scope as either 'swaps', which are subject to primary regulation by the CFTC, 'security-based swaps', which are subject to primary regulation by the SEC, or 'mixed swaps', which are subject to joint regulation by the CFTC and SEC.

The most significant aspects of the derivatives section are: (i) mandatory clearing through regulated central clearing organisations and mandatory trading through either regulated exchanges or swap execution facilities, in each case, subject to certain key exceptions; (ii) new categories of regulated market participants, including swap dealers and major swap participants; and (iii) the push-out from banks into bank affiliates of many swap activities.

As with other parts of the Act, many of the details of the new regulatory regime relating to swaps are left to the regulators to determine through rule-making, which in most cases will occur during the first 360 days following enactment.

Credit rating agencies

Credit rating agencies have faced criticism for the failure of credit ratings to accurately reflect the riskiness of complex structured products in the lead-up to the financial crisis. As the financial crisis unfolded and the assumptions underpinning rating methodologies for such instruments were shown to be overly optimistic, rating downgrades contributed to a pricing collapse that left the market for structured products virtually non-existent. In evaluating the performance of credit rating agencies and, in particular, nationally recognised statistical rating organisations, critics and regulators have attributed such rating failures to a lack of internal controls, conflicts-of-interest inherent in the issuer-pay business model, a lack of transparency and a perceived absence of accountability for credit rating agencies. In addition, various commentators have asserted that the use of credit ratings in US statutes and regulations has contributed to an over-reliance on credit ratings and an incorrect assumption that such credit ratings bear an implicit Government seal of approval.

The Act seeks to address these perceived deficiencies with new governance and compliance requirements, new liability rules and penalties, allowing certain private rights of action, restrictions on conflicts of interest, accountability for ratings procedures, required procedures and methodologies, enhanced disclosure requirements, removal of certain references to rating agencies in various statutes, and enhanced SEC supervision.

Securitisations – credit retention requirements

Congress adopted the view that securitisation abuses were a major contributing factor to the financial crisis. In an attempt to better align market participants' incentives, the Act creates a framework for a scheme whereby securitisers will be required to retain a portion of the credit risk with regard to the ABS they sell. However, many key details will only emerge in regulations yet to come. Additional provisions require heightened disclosure and reporting relating to ABS under the securities laws.

Executive compensation

The Act includes provisions relating to executive compensation arrangements at financial institutions and public companies. The Act does not impose rigid limits and prohibitions of the nature contained in previous TARP legislation, and most of the principles-based provisions require implementing regulations. Notable provisions include the requirement for listed companies to have independent compensation committees and a mandatory non-binding say on pay vote.

Deposit insurance reforms

Among other things, the Act permanently increases the deposit insurance limit to US\$250,000 per person per insured institution.

Payment, clearing and settlement

The payment, clearing and settlement provisions of the legislation are meant to reduce the risks of contagion among financial firms and markets. Recognising that financial market utilities that conduct or support multilateral payment, clearing or settlement functions, and related financial activities, have the potential to create and concentrate risks to the financial system, the Act aims to reduce these risks through greater prudential regulation and oversight of these entities and activities.

The impact of this provision will largely be limited to financial market utilities and those organisations that engage in payment, clearing, and settlement activities. Utilities and these organisations will face the prospect of being designated, or having a portion of their activities designated, as systemically important, thereby subjecting the utility or organisation to the payment, clearing and settlement provisions in the Act, including risk management standards and examinations by regulators.

Consumer financial protection

The Act establishes the Bureau of Consumer Financial Protection as a new executive agency with very broad powers and a substantial budget. The Bureau will assume most of the consumer protection functions exercised by regulators under certain existing federal consumer protection laws. The Bureau will also enjoy independent authority under the Dodd-Frank Act itself with respect to covered persons. Carved out from the Bureau's authority are a number of entities and activities, including persons regulated by the SEC and the CFTC and the business of insurance.

The greatest impact of the new Bureau will be felt by banking organisations with assets of US\$10 billion or more, with respect to which the Bureau will have exclusive rule-making and examination, and primary enforcement, authority under federal consumer financial law. Smaller banks will not escape the rule-making authority of the Bureau, but will be largely free of Bureau supervision and enforcement authority. Certain non-bank covered persons will also be subject to the full complement of Bureau rule-making, supervisory and enforcement authority.

The legislation establishes a new framework for federal pre-emption of state consumer financial laws applicable to national banks and thrifts. Most significantly, the drafters sought to curtail the OCC's pre-emption authority by providing that the OCC may pre-empt a state law only in accordance with the holding of the Supreme Court in *Barnett Bank v Nelson*, on a case-by-case basis and on the basis of 'substantial evidence'. The legislation also expands the authority of state attorneys-general and state regulators in two ways: first, by declaring that state consumer financial laws are

fully applicable to subsidiaries and affiliates of national banks or thrifts, contrary to the Supreme Court's holding in *Watters v Wachovia*; and second, by citing the Supreme Court's holding in *Cuomo v Clearing House Ass'n* to clarify that no provision of the National Bank Act relating to state visitorial authority may be construed so as to limit the authority of state attorneys-general to bring actions to enforce any applicable law against a national bank.

The passage of this legislation will likely bring with it a material increase in compliance costs for covered persons, particularly in light of the 50-state consumer protection regime with which covered persons must comply in the absence of blanket federal pre-emption.

Emergency stabilisation powers

The Act makes a variety of changes to the Federal Reserve and FDIC's emergency financial stabilisation powers, designed to balance the ability of regulators to provide liquidity to the markets during times of distress with concerns regarding the potential moral hazard, costs and conflicts of interest associated with such action. The Federal Reserve would no longer be able to provide lending assistance to a single and specific firm unless it is part of a broad-based programme, and new substantive and procedural requirements would govern the FDIC's ability to establish programmes like the Temporary Liquidity Guarantee Program.

Insurance

The Act creates a Federal Insurance Office (FIO) with certain limited powers. Although it will not have substantive regulatory responsibilities, the FIO will facilitate the development of insurance expertise within the Treasury and could portend increased federal involvement in the industry. Even with limited powers, the FIO is likely to provide an impetus for efforts to promote greater levels of national uniformity and will provide a federal focus for the coordination of international insurance regulation. In addition, the legislation enacts relatively non-controversial measures to streamline the market for non-admitted insurance and reinsurance by limiting interstate application of regulation and encouraging implementation of uniform standards in these areas. Representative Barney Frank stated recently that there will be a 'major push' in Congress to provide for an optional federal charter after the passage of broader financial regulatory reform, although he intends to stay neutral in the debate.

Loose ends

The Dodd-Frank Act left a number of important issues unresolved. Most importantly, it did not deal with Fannie and Freddie. Both the Obama administration and the congressional leadership have said that reform of these institutions will have to wait, but promised a reform proposal in the near future. Reform of Fannie and

Freddie always has to wait. Ironically, and almost certainly unintentionally, the Act actually gives the Council authority to designate Fannie and Freddie as systemically important non-bank financial companies, subject to the consolidated supervision of the Federal Reserve and the heightened prudential standards for systemically important financial companies.

The Orderly Liquidation Authority in the Dodd-Frank Act, while an important step forward, failed to create a federal framework for resolving systemically important insurance companies. Instead, it leaves the 50-state framework largely intact. Finally, the Orderly Liquidation Authority does not provide a credible solution for resolving systemically important financial companies with worldwide operations, like AIG. At most, it is a first step in solving that puzzle, requiring further international harmonisation and cooperation or alternative mechanisms such as bail-ins, contingent capital or other recapitalisation programmes that can work on a global basis.

Conclusion

The US and the rest of the world experienced a genuine financial panic in September and October of 2008. The US responded by taking a series of emergency actions to stabilise the financial system. The financial panic of 2008, and these emergency measures, created the ‘perfect storm’ for new financial regulation. The Dodd-Frank Act is the most extensive revision of US financial regulation since the 1930s, although it has left some important issues unresolved.