

# The Administration's Financial Regulatory Reform Proposals

WILLIAM S. ECKLAND, DENNIS C. HENSLEY, AND NORMAN D. SLONAKER

*This article summarizes the key provisions of the Financial Reform Plan proposed recently by the Obama Administration.*

On June 17, 2009, the Obama administration outlined its much-anticipated framework for financial regulatory reform (the “Financial Reform Plan” or “Plan”) in its release “Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation”<sup>1</sup> and the accompanying fact sheets.<sup>2</sup> Introducing the Plan, President Obama said “With the reforms we’re proposing today, we seek to put in place rules that will allow our markets to promote innovation while discouraging abuse. We seek to create a framework in which markets can function freely and fairly, without the fragility in which normal business cycles suddenly bring the risk of financial collapse; we want a system that works for businesses and consumers.”

Following the release of the Financial Reform Plan, on June 18, 2009, Secretary of the U.S. Department of the Treasury (“Treasury”) Timothy Geithner testified on the Financial Reform Plan before the U.S. Senate Committee on Banking, Housing & Urban Affairs.<sup>3</sup>

The Financial Reform Plan focuses on five areas:

- promotion of robust supervision and regulation of financial firms;
- establishment of comprehensive regulation of financial markets, including asset-backed securities, over-the-counter (“OTC”) derivatives and clearing systems;
- protection of consumers and investors from financial abuse through creation of a new consumer protection agency and stronger regulation;
- creation of new government resolution authority over key non-bank financial institutions; and
- raising international regulatory standards and improving international cooperation.

This article summarizes the key provisions of the Financial Reform Plan. These proposals are already generating significant discussion and debate, and some of the more controversial topics are highlighted here.

---

William S. Eckland is a partner in the Washington, D.C., office of Sidley Austin LLP. His practice focuses primarily on financial institutions, with particular emphasis on federal regulatory issues governing the operations of depository institutions and their holding companies. Dennis C. Hensley, a partner in the firm’s Regulatory Practice group, has over 30 years of experience in securities regulatory and enforcement matters. He advises a wide array of financial services firms — including investment and commercial banks, broker-dealers and hedge funds — on a broad variety of regulatory, enforcement, compliance, and transaction matters. Norman D. Slonaker is a senior partner in the New York office of Sidley Austin LLP, with a practice in corporate securities and extensive experience in a variety of transactions, with particular emphasis on structured securities, investment grade debt securities, medium term note programs, Rule 144A offerings and convertible and exchangeable securities. The authors can be reached at [weckland@sidley.com](mailto:weckland@sidley.com), [dhensley@sidley.com](mailto:dhensley@sidley.com) and [nslonaker@sidley.com](mailto:nslonaker@sidley.com), respectively.

Many proposals remain rather conceptual in nature, while others provide details that cannot be adequately addressed in a summary document, such as this article.

## **A. PROMOTE ROBUST SUPERVISION AND REGULATION OF FINANCIAL FIRMS**

In order to address perceived gaps in the consolidated oversight of the financial industry, the first part of the Financial Reform Plan focuses on reforming the current oversight structure by, among other things, (i) creating a new Financial Services Oversight Council, (ii) providing new authority to the Board of Governors of the Federal Reserve System (the “Fed”) to regulate systemically important financial institutions, regardless of whether those institutions own banks or other insured depository institutions, (iii) providing stricter prudential oversight of systemically important financial firms, (iv) increasing capital requirements, (v) consolidating the Office of the Comptroller of the Currency (the “OCC”) and the Office of Thrift Supervision (the “OTS”) into a single National Bank Supervisor (the “NBS”), (vi) eliminating the federal thrift charter in its entirety and eliminating exceptions to Fed holding company regulation for entities that own thrifts, industrial loan companies (“ILCs”), credit card banks (“CCBs”), non-bank banks and trust companies insured by the Federal Deposit Insurance Corporation (the “FDIC”), (vii) requiring advisers to hedge funds and other private pools of capital to register with the Securities and Exchange Commission (the “SEC”), (viii) revising the regulation of money market mutual funds to avoid circumstances that can create runs on such funds and (ix) creating a new Office of National Insurance (the “ONI”) to work toward international cooperation in the regulation of the insurance industry, to identify insurance companies that should be regulated by the Fed as systemically important financial institutions and to provide the mechanism to explore further options for federal regulation of certain aspects of the insurance industry.

### **(1) Creation of a Financial Services Oversight Council.**

The Financial Reform Plan calls for the creation of a permanent Financial Services Oversight Council (the “Council”) that will be tasked with “[facili-

tating] interagency discussion and analysis of financial regulatory policy issues to support a consistent well-informed response to emerging trends, potential regulatory gaps, and issues that cut across jurisdictions.” The Council would replace the President’s Working Group on Financial Markets. It would be chaired by Treasury and its membership would consist of the federal bank regulatory agencies, including the newly-proposed NBS and the Consumer Financial Protection Agency (the “CFPA”), and the SEC, the Commodity Futures Trading Commission (the “CFTC”) and the Federal Housing Finance Agency.

Although the Council would function mainly in a consultative role, such as by recommending to the Fed firms to be made subject to supervision as financial holding companies (“FHCs”) that qualify as Tier 1 FHCs as described below, and consulting with the Fed on setting material prudential standards for Tier 1 FHCs, as described further below, the administration proposes to give the Council its own dedicated staff and the authority to require “periodic and other reports” from any U.S. financial firm solely to determine the extent to which it poses a threat to the overall financial stability of the nation. With regard to federally-regulated firms, the proposal states that the Council should rely upon the reports that are already being gathered by the Council’s members, in a structure similar to the existing Bank Holding Company Act (the “BHCA”) model of Fed supervision of functionally-regulated subsidiaries of bank holding companies (“BHCs”). As indicated by questioning during Secretary Geithner’s testimony before the Senate Committee on Banking, Housing & Urban Affairs, however, there remains interest among some in Congress in providing the proposed Council a more active role in regulatory oversight.

### **(2) Implement Heightened Consolidated Supervision and Regulation of Systemically Important Financial Firms.**

The Financial Reform Plan proposes the regulation and supervision of all systemically important financial firms — “any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed” — by the Fed, regardless of whether such firms own a depository institution; these firms would be designated “Tier 1 FHCs.” This

would be a dramatic expansion of the Fed's jurisdiction in order to address perceived gaps in systemic risk oversight within the financial industry, and will be of particular concern for entities that play significant roles in the financial markets, including certain large hedge funds and financial companies, but have not been subject to holding company supervision. Indeed, the Fed has in other contexts defined "financial" broadly to include all activities that are "financial in nature" or "incidental" to a financial activity under Section 4(k) of the BHCA. As such, despite Secretary Geithner's assurances during testimony that the Fed initially would be looking to capture only major commercial and investment banks, it is possible that a wide range of entities engaged in banking, lending, securities, insurance, investment management, financial transaction or data processing and a variety of related activities could be captured by the Fed's expanded oversight.

Once an institution is designated as a Tier 1 FHC, the Fed's supervisory authority would extend to the parent company and all subsidiaries, U.S. and foreign, including regulated subsidiaries of such institution, and the Fed's constraints under the Gramm-Leach-Bliley Act to supervise and require reports from functionally-regulated subsidiaries would be loosened. Thus, although existing federal and state regulators would still be the primary regulatory agencies for such subsidiaries, the Fed would have new authority to duplicate that oversight and to set more stringent activity restrictions or prudential requirements on them than may be required by their primary regulatory agencies.

Tier 1 FHCs would be subject to capital requirements and liquidity standards in excess of those applicable to BHCs (including under severe stress scenarios), would be required to maintain a well capitalized and well managed status on a consolidated basis, would be subject to "enhanced" public disclosure requirements, would be subject to new reporting requirements (including reports as to "the nature and extent to which other major financial institutions are exposed to it"), would be required to maintain "rapid resolution plans" in the event of severe financial distress and would be subject to Fed "prompt corrective action" authority to be modeled on the existing FDIC authority over insured depository institutions under the Federal Deposit Insurance Act (the "FDIA").

Importantly, all Tier 1 FHCs under the proposal will be subject to the full range of regulations govern-

ing BHCs, *regardless* of whether they control a bank or other insured depository institution. In determining whether a financial firm will be considered a Tier 1 FHC, the Fed will consider several factors, including the impact the firm's failure would have on the financial system and the economy; the firm's combination of size, leverage (including off balance sheet exposures) and degree of reliance on short term funding; and the firm's importance as a source of credit for households, businesses and state and local governments and as a source of liquidity for the financial system. Such a determination is at the Fed's discretion; it is not clear from the Plan whether the Fed's determination will be subject to any level of judicial review.

Contrary to the earlier plan proposed by former Secretary of Treasury Paulson, on which much of the Financial Reform Plan is based, a determination that a financial firm is to be considered a Tier 1 FHC would subject such firm to the restrictions of the BHCA on nonfinancial activities (in addition to the capital, liquidity and other standards mentioned above), which could have potentially severe effects on firms that are affiliated with nonfinancial entities but would become Tier 1 FHCs as a result of a Fed assessment of their systemic risk. Such firms would be required to divest themselves of any such nonfinancial subsidiaries within five years. This could have a dramatic impact on companies that could find themselves subject to activities limitations not because of any affirmative decision to avail themselves of a charter that triggers such limits, but rather because of the overall significance of their "financial" activities.

The Fed would be given the authority to obtain reports from institutions of a minimum size threshold in order to determine whether to designate such an institution as a Tier 1 FHC, and to examine such institutions for the same purpose, although in each case the Fed is directed to rely, in the first instance, on reports available through the institution's principal supervisory agencies.

### **(3) Strengthen Capital and Other Prudential Standards Applicable to All Banks and BHCs.**

#### **(a) Capital and Management Requirements.**

FHCs (including Tier 1 FHCs) would be required to maintain "well capitalized" and "well managed"

status on a consolidated basis in order to engage in the broad set of financial activities permitted to FHCs. For institutions that become FHCs because of their systemic exposures rather than through the acquisition of a bank, this may prove particularly problematic, since failure to maintain those standards would restrict new activities to those historically permissible for BHCs as “closely related to banking” under Section 4(c)(8) of the BHCA.

**(b) Executive Compensation Reforms.**

The Financial Reform Plan proposes that Treasury will support other federal regulators in establishing standards of executive compensation for supervised financial firms to reward performance, account for the time horizon of risks, implement sound risk management, determine whether golden parachutes align with the interests of shareholders and promote transparency and accountability.<sup>4</sup> The proposed legislation would include providing compensation committees the authority and resources to hire independent compensation consultants and outside counsel.

**(c) Affiliate Transaction Restrictions.**

The Financial Reform Plan also calls for heightened restrictions on bank transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including tougher restrictions on banks engaging in OTC derivatives and securities financing with affiliates and full collateralization of covered transactions between banks and affiliates for the life of the transaction. The Plan also calls for these restrictions to be applied to transactions between banks and private investment vehicles sponsored or advised by the banks. Interestingly, this proposal limits the Fed’s discretion to provide exemptions from Section 23A and 23B firewalls, despite the general increase in the Fed’s authority throughout the rest of the Financial Reform Plan. Presumably, this limitation is in response to the flexibility the Fed provided to a number of institutions to address pressing needs during the recent financial crisis.

**(d) Treasury Working Groups.**

Treasury will lead a series of working groups to examine proposed changes to banks and BHCs. The

capital requirements working group will review proposals that address issues including reducing procyclicality, analyzing the use of contingent capital instruments to satisfy capital requirements, increases on capital requirements for high level investments and exposures and simpler leverage measures. The Financial Reform Plan calls for the issuance of this report by December 31, 2009. The supervision working group will address issues surrounding supervision of banks and BHCs, including coordination among federal and state regulators. The Financial Reform Plan calls for the issuance of this report by October 1, 2009.

**(4) Closing “Loopholes” in Bank Regulation.**

**(a) Creation of a National Bank Supervisor.**

As noted above, the proposal calls for the consolidation of the OCC and the OTS into a new National Bank Supervisor which would inherit its predecessors’ powers to require reports, conduct examinations, impose requirements and supervise national banks. This is in accordance with the Plan’s more general call for a uniformity of regulation and supervision of national banks, state member banks and state non-member banks, although the administration demurred on any consolidation of such regulatory authority beyond the merger of the OCC and OTS. Presumably such consolidation would preserve the effect of prior OCC regulations and precedent (except to the extent specifically modified, such as in connection with consumer regulations as described below).

**(b) Elimination of Thrift Charter and Unregulated Non-Bank Holding Companies.**

Under the Financial Reform Plan, the federal thrift charter would be eliminated, “subject to reasonable transition arrangements.” The administration indicates this change is driven by the belief that (i) such institutions are exposed to undue mortgage concentration (although no other asset concentration limits are proposed as part of the Plan) and (ii) the charter type presents opportunities for regulatory arbitrage (although the Plan provides no evidence that such “arbitrage” was implicated in the failure of any institution). Presumably this element of the Plan means that federal thrifts would be required to convert to bank, or state thrift, charters.

In addition, companies that own thrifts, ILCs, CCBs, FDIC-insured trust companies, and certain grandfathered depository institutions would become BHCs, subject to all the restrictions of the BHCA, including the nonfinancial activities restriction discussed above, and consolidated regulation and supervision by the Fed. In the absence of some form of grandfathering, all commercial companies that own such entities, such as retailers that own thrifts, ILCs or CCBs would be forced to divest those entities.

### **(c) Interstate Branching.**

In one of the few benefits to the financial industry, the Financial Reform Plan calls for the application of a federal thrift's unrestricted ability to branch across state lines to all national and state banks, eliminating residual limitations from earlier attempts to facilitate interstate banking.

In one of the few benefits to the financial industry, the Financial Reform Plan calls for the application of a federal thrift's unrestricted ability to branch across state lines to all national and state banks, eliminating residual limitations from earlier attempts to facilitate interstate banking.

### **(5) Eliminate the SEC's Programs for Consolidated Supervision.**

The Financial Reform Plan calls upon the SEC to eliminate its programs for consolidated supervision. The SEC already addressed this, in part, by eliminating the "consolidated supervised entities" ("CSEs") structure in September 2008 and the Plan now seeks the elimination of the "supervised investment bank holding companies" ("SIBHCs") structure. The SIBHC structure was adopted in 2004, as required by Section 17(i) of the Securities Exchange Act of 1934 (the "Exchange Act") and it allows certain financial institutions — those without certain types of bank affiliates and that have a subsidiary broker-dealer with a substantial presence in the securities market — to be supervised solely by the SEC on a group-wide basis (rather than a legal entity basis). The Plan states that investment banks that want consolidated supervision and regulation should be subject to supervision and regulation by the Fed. This appears to imply that institutions that do not own insured depository insti-

tutions and that are not systemically significant may be able to "opt in" to Fed regulation, presumably as FHCs.

### **(6) Require Advisers to Hedge Funds and Other Private Pools of Capital to Register.**

Noting that in the years leading up to the current financial crisis, hedge funds and other private pools of capital operated "completely outside of the supervisory framework," the Financial Reform Plan recommends that advisers to pooled vehicles be required to register with the SEC. This recommendation would essentially resurrect the registration requirement that the SEC imposed on hedge fund advisers in 2004 and the U.S. Court of Appeals for the District of Columbia Circuit vacated in 2006. The Plan's proposal goes beyond the SEC's original rule, however, by recommending that not only hedge fund advisers but advisers to all private pools of capital whose assets under management exceed a "modest threshold," including private equity funds and venture capital funds, be regulated.

The Financial Reform Plan does not, as some suggested, recommend that private pools themselves, as distinct from their managers, be required to register. To address systemic risk, it does recommend that all investment funds advised by an SEC-registered investment adviser be subject to recordkeeping requirements, requirements with respect to disclosures to investors, creditors, and counterparties and confidential reporting requirements. According to the Plan, the reporting requirements would include:

- the amount of assets under management;
- borrowings;
- off-balance sheet exposures; and
- other information necessary to assess whether the fund or fund family is so large, highly leveraged or interconnected that it "poses a threat to financial stability."

The Plan recommends that the SEC conduct regular, periodic examinations to monitor compliance with these requirements. In addition to SEC oversight, the Plan further recommends that the SEC share with the Fed the reports it receives confidentially from private fund advisers and that the Fed supervise and regulate

private funds that meet the Tier 1 FHC criteria described above.

### **(7) Reduce the Susceptibility of Money Market Mutual Funds (“MMFs”) to Runs.**

The factors leading to the Reserve Primary Fund “breaking the buck” in September 2008 inspired much analysis and discussion regarding the effectiveness of MMF regulation. The Plan notes that the massive redemptions experienced by MMFs resulted in severe liquidity pressures, not only on MMFs but also on banks and other financial institutions. In that regard, the Plan recommends strengthening the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to sudden and extraordinary redemptions.

To enhance investor protection and mitigate the risk of MMF runs, the Plan recommends that the SEC should consider several reforms to strengthen the MMF regulatory framework, including:

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

In addition, the Plan recommends that the President’s Working Group on Financial Markets prepare a report, due by September 15, 2009, assessing whether more fundamental MMF regulatory changes are necessary to address systemic risk, *e.g.*:

- moving away from the concept of a stable net asset value; or
- requiring MMFs to obtain access to emergency liquidity facilities from private sources. Such liquidity facilities should, according to the Plan,

be reliable, scalable and designed in such a way that drawing on the facilities to meet redemptions would not disadvantage the remaining MMF shareholders.

### **(8) Enhance Oversight of the Insurance Sector.**

The Financial Reform Plan proposes two primary initiatives with respect to the insurance industry: the establishment of the ONI within Treasury and the modernization of insurance regulation in accordance with the six principles described below.

As proposed, the ONI would monitor all aspects of the insurance industry, primarily by gathering information and identifying the emergence of potential regulatory problems or gaps that could contribute to a financial crisis. It does not seem that the ONI would have any enforcement powers. The ONI, however, is envisaged as being empowered to:

- work with other nations to better represent U.S. interests and increase international cooperation on insurance regulation, including the authority to enter into international agreements. As the Financial Reform Plan notes, the U.S. is the only country in the over 90 member International Association of Insurance Supervisors that is not represented by a federal insurance regulatory entity;
- carry out the federal government’s existing responsibilities under the Terrorism Risk Insurance Act; and
- recommend to the Fed any insurance companies that the ONI believes should be regulated as a Tier 1 FHC (described above in Section A(2)), which, in addition to other insurance regulations, could have a significant impact on large insurance companies.

The Financial Reform Plan briefly lays out six principles that Treasury will support for modernizing the regulation of insurance:

- Effective systematic risk regulation with respect to insurance;
- Strong capital standards and an appropriate match between capital allocation and liabilities;

- Meaningful and consistent consumer protection for insurance products and practices;
- Increased national uniformity through an optional federal charter or effective action by the states;
- Regulation of insurance companies and affiliates on a consolidated basis, including non-insurance affiliates; and
- International coordination.

It is not clear from the Financial Reform Plan how the administration intends to implement these principles of reform, whether through federal statute (which could include an optional federal charter for insurance companies), collective action at the state level or some other implementation procedure.

### **(9) Determine Future Role of the Government Sponsored Enterprises (“GSEs”).**

The Financial Reform Plan does not offer a view on the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Rather, Treasury and the Department of Housing and Urban Development, “together with other government agencies, will engage in a wide-ranging process and seek public input to explore options regarding the future of the GSEs” and report at the time of the President’s 2011 budget in January 2010. Possible options cited for GSE reform range from a return to the previous paired public/private status to the dissolution of Fannie Mae and Freddie Mac into many smaller companies.

## **B. ESTABLISH COMPREHENSIVE REGULATION OF FINANCIAL MARKETS**

This element of the Financial Reform Plan is aimed at filling perceived gaps in the regulation of the securitization market, OTC derivatives and payment, clearing and settlement systems and related activities.

### **(1) Strengthen Supervision and Regulation of Securitization Markets.**

The Financial Reform Plan would effect a number of significant changes related to the asset-backed securities market. These changes are aimed at addressing perceived flaws which the administration

blames for having undermined such market and, in turn, the credit markets more generally. These flaws are stated to have included a general erosion of lending standards resulting from the “originate and distribute” business model practiced in the lending market; compensation practices that incentivized market participants to focus on quantity and not quality; the lack of adequate information about underlying credits; over-reliance by investors on credit rating agencies in making investment decisions; and weaknesses in credit rating agency practices.

In order to address these perceived flaws, the Financial Reform Plan proposes reforms aimed at creating a better alignment of industry incentives; increased market transparency and market discipline; and reducing incentives for over-reliance on credit rating agencies.

#### ***(a) Requiring Loan Originators to Retain Five Percent of the Credit Risk of Securitized Exposures.***

Under the Financial Reform Plan, the federal banking agencies would be required to mandate that loan originators or sponsors retain five percent of the credit risk of securitized exposures. Loan originators would be prohibited from hedging (or otherwise transferring) the retained risk. This proposal is similar in concept to the five percent retention requirement approved in May 2009 by the European Parliament in the European Capital Requirements Directive (although the Financial Reform Plan requirement appears to be styled as a direct originator requirement rather than an investor restriction as in the European Capital Requirements Directive). The proposal has the potential for increasing (instead of reducing) the risk to financial institutions originating securitizations and may also increase the capital charges imposed on such institutions (because, under current rules, enhanced levels of regulatory capital may have to be maintained against retained securitized interests) as well as for creating “true sale” and other issues. Under the Financial Reform Plan federal banking agencies would have the authority to specify how the five percent retention requirement should be satisfied (e.g., whether it would be required to be satisfied by retention of a first loss piece or could be satisfied in some other manner, including through retained amounts in other tranches in the securitization,

such as a vertical slice) and the minimum duration of the retention requirement. Federal banking agencies would also have the authority to provide exceptions or adjustments to these requirements “as needed,” including the authority to raise or lower the five percent threshold and to provide exemptions from the “no hedging” requirement. It is not clear, what, if any, requirements would apply to non-bank originators or sponsors, raising issues as to whether entities not subject to the jurisdiction of the federal banking agencies would be subject to these requirements.

***(b) Other Proposals Designed to Better Align Incentives.***

The administration proposes that the securitization process should be reformed to provide appropriate incentives for participants to best serve the interests of their clients, the borrowers and investors and, to that end, proposes that the compensation of brokers, originators, sponsors, underwriters and others involved in the securitization process should be linked to the longer term performance of the securitized assets, rather than only to the production, creation or inception of those products. For example, the Plan proposes that U.S. Generally Accepted Accounting Principles (“GAAP”) would be changed to eliminate the immediate recognition of “gain on sale” by originators at the time of securitization and require instead that income be recognized as the securitized assets perform over time. The proposed changes to GAAP would also require that “many securitizations” be consolidated on the originator’s balance sheet and their asset performance be reflected in the originator’s financial statements. It is not clear whether this proposal is recommending changes to GAAP beyond those effectuated by Financial Accounting Standards 166 and 167 (adopted by the Financial Accounting Standards Board last week) which will bring many securitizations on balance sheet. Fees and commissions received by loan brokers and loan officers with no ongoing relationship with the loans they generate would be required to be disbursed over time and reduced if underwriting or asset quality problems emerge (although no mechanism for effectuating this requirement is suggested). Sponsors of securitizations would be “required to provide assurances to investors,” in the form of “strong,” standardized rep-

resentations and warranties regarding origination and underwriting practices, but the proposal is not specific as to how these representations and warranties should differ from the customary representations and warranties currently in use.

***(c) Requiring Increased Disclosure and Reporting by Issuers of Asset-Backed Securities.***

The Financial Reform Plan provides that issuers of asset-backed securities would be required to disclose loan level data as well as the nature and extent of broker, originator and sponsor compensation for each securitization, although no specifics are provided as to what data, beyond that already required by the SEC’s Regulation AB, should be required to be provided. The Financial Reform Plan would also require that investors and credit rating agencies have access to the information “necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity and other risks of [asset-backed securities].” It is unclear if the administration intends to reintroduce the SEC’s 2008 proposed amendment to its regulations under the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Reform Act”) to require public disclosure of all information provided to credit rating agencies by an issuer, sponsor or underwriter on a transaction with an “issuer pay” conflict and used to determine ratings or in ratings surveillance. The SEC declined to adopt this requirement when it finalized the 2009 amendments (the “2009 Rating Agency Reform Act Amendments”) to its regulations under the Rating Agency Reform Act. The administration also proposes that the SEC be given authority to require “robust ongoing reporting” by issuers of asset-backed securities. It is unclear if this reflects an intent to exclude issuers of asset-backed securities from the Section 15(d) Exchange Act provisions regarding suspension of the duty to file reports if the issuer’s securities are held by a limited number of holders.

***(d) Other Proposals Designed to Increase Market Transparency and Market Discipline.***

The administration also urges the industry to standardize legal documents for securitized transactions

to make it easier for market participants to accurately value the securitization, but no recommendations are provided as to how this should be effectuated. As part of this, the administration urges the industry to adopt uniform rules for servicers in modifying home mortgage loans if those modifications would benefit the trust as a whole.

**(e) Rating Agency Reform.**

The Financial Reform Plan would require that credit rating agencies differentiate the ratings that they assign to “structured credit products” from those they assign to corporate bonds, a proposal the SEC declined to adopt when it finalized the 2009 Rating Agency Reform Act Amendments. It should be noted that responses to a Moody’s request for comment in 2008 indicated widespread opposition by industry participants, including investors, to Moody’s proposal for a separate ratings scale for structured finance securities.

Credit rating agencies would also be required to manage and disclose conflicts of interest and to publicly disclose what risks their ratings are designed to assess; to report on credit rating performance; to disclose additional information about the methodology used to rate structured products; and to disclose non-public rating agency data and methodologies to the SEC. Significantly, the proposal does not seek to eliminate, as some have proposed, the quasi-regulatory role that ratings play in setting legal investment, financial institution capital and other regulatory thresholds and requirements; instead regulators are urged to reduce their reliance on credit ratings in regulations and supervisory practices, “wherever possible.” The proposal would require that capital requirements (which under federal banking agencies’ current Basel I and Basel II regulations incorporate a ratings-based approach) reflect the risk of structured credit products and minimize opportunities for firms to use securitization as a method of reducing capital requirements without an actual reduction in risk.

Notably, the proposal does not explicitly seek to impose additional liability on the credit rating agencies for the quality of their work or require changes in the “issuer paid” model, criticized by some as misaligning incentives among credit rating agencies and the users of credit ratings because credit ratings are

paid for by issuers.

**(2) Create Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (“CDS”).**

The Financial Reform Plan proposes a comprehensive new regulatory regime for OTC derivatives and intermediaries in OTC derivative transactions. These markets have been largely unregulated since the passage of the Commodity Futures Modernization Act in 2000. The OTC derivatives markets are perceived by some to have been a primary contributor to the recent financial crisis. The Financial Reform Plan identifies four broad public policy objectives to be addressed in the regulation of the OTC derivatives markets: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

The Financial Reform Plan proposes to bring the OTC derivatives markets within a new coordinated regulatory framework. All “standardized” OTC derivative transactions would be required to be executed in “regulated and transparent venues” (i.e., on regulated exchanges or through so called “transparent electronic trade execution systems”) and to be cleared through regulated central counterparties (“CCPs”). CCPs would be subject to “robust” margin requirements and other necessary risk controls with respect to cleared OTC derivative contracts.

Distinguishing between “standardized” and non-standardized OTC derivatives will be difficult, and the Financial Reform Plan does not attempt to draw a line except to propose (a) an anti-avoidance rule that would prevent sham customization of otherwise standardized OTC derivatives for the purpose of avoiding the clearing requirement and (b) a presumption that any OTC derivative contract accepted for clearing by a CCP be treated as standardized and therefore subject to mandatory clearing by a CCP. OTC derivative contracts that are already cleared through existing OTC clearing systems would be considered “standardized” if this presumption is adopted.

If the proposals with respect to trading of stan-

standardized OTC derivatives in regulated and transparent venues and clearing of standardized OTC derivatives by CCPs are adopted, they could greatly alter the nature of the “voice brokerage” business in standardized OTC derivatives as it is currently conducted, as such trading would be required to move onto regulated exchanges. It could also effectively end all bilateral trading in standardized OTC derivatives, such as so called “look alike” contracts, which are common in the energy derivatives markets and other OTC derivatives markets.

The Financial Reform Plan proposes that regulated financial institutions be “encouraged” to make greater use of exchange-traded derivatives. Especially given that many financial institutions have received financial assistance from the federal government and that many end users have fiduciary responsibilities, mere encouragement alone may have the effect of chilling activity in the OTC derivatives markets. In addition, the Financial Reform Plan proposes to increase regulatory capital requirements for banks and BHCs on OTC derivatives that are not centrally cleared.

The Financial Reform Plan also proposes that OTC derivatives dealers and all other firms active in the OTC derivatives markets whose activities create large counterparty exposure should be subject to a new supervisory and regulatory regime. These firms would be subject to conservative capital requirements (more stringent than current bank regulatory requirements applicable to OTC derivatives), business conduct standards, reporting requirements and conservative requirements for initial margin on counterparty credit exposure (applicable to OTC derivatives not cleared by a CCP). Regulatory capital requirements for banks and BHCs would also be raised with respect to non-cleared OTC derivatives.

The Financial Reform Plan would give the SEC and CFTC authority to impose recordkeeping and reporting requirements (including audit trails) on all OTC derivative transactions. Certain of these requirements would be deemed satisfied by clearing through a CCP or reporting bi-lateral trades to a regulated trade repository. CCPs and trade repositories would be required to make aggregate information on open positions and trading volumes available to the public and to make individual market participants’ trades and positions available confidentially to the

SEC, CFTC and the CCP’s or trade repository’s primary regulators. The SEC and CFTC would also be given authority to police and prevent fraud, market manipulation and other abuses involving OTC derivatives. The CFTC would be given the authority to set position limits for OTC derivatives that perform a significant price discovery function with respect to regulated markets.

The Financial Reform Plan also calls for enhanced protection of unsophisticated parties, indicating that the current limits are not sufficiently stringent. It indicates that the CFTC and SEC are currently reviewing participation limits to recommend tightening the participation criteria or imposing additional disclosure requirements or standards of care in the marketing of OTC derivatives to less sophisticated parties. The Financial Reform Plan specifically mentions small municipalities as one category of customers that may no longer be allowed to participate in OTC derivatives.

Potential issues raised by the Financial Reform Plan include:

- Bifurcating the regulations based on whether an OTC derivative contract is “standardized” may create line drawing problems at the margins, as even the most heavily negotiated OTC derivatives currently used have many non-negotiated terms that may be thought of as “standardized” terms (as that is a primary purpose of using standardized documentation for OTC derivatives).
- The anti-avoidance rule would be difficult to implement effectively if it is drafted as an inquiry solely into whether the parties entered into a purportedly “customized” derivative with the “intent” of avoiding the clearing requirement, because an inquiry into intent will be inherently subjective and will create an untenable evidentiary burden.
- The OTC derivatives markets have already been moving toward a variety of different centralized clearing models, in many cases based on pressure from regulators but also in response to demand by OTC derivatives market participants for reduced credit risk. To the extent that contracts are amenable to being cleared, they are either already being cleared (for example, plain vanilla interest rate swaps and certain index CDS) or will

be cleared in the coming months (for example, single name CDS). This is an argument that has been put forward against mandating clearing of OTC derivatives.

- By effectively defining a “standardized OTC derivative” as a contract that is accepted for clearance by a CCP, the concept will ultimately turn on the capabilities of the CCPs’ risk management systems. The large OTC derivative dealers have developed systems to manage the risk of OTC derivatives and these systems have often been touted by the dealers as more flexible and robust than those used by many CCPs — a view that has not necessarily been accepted by the regulators. Be that as it may, “standardized OTC derivative” could turn out to be a fluid concept that is determined primarily by the capabilities of the CCPs.

### **(3) Harmonize Futures and Securities Regulation.**

The Financial Reform Plan would leave the SEC’s and CFTC’s respective areas of regulatory responsibility and authority largely intact. It also does not call for the agencies to be merged; however, it would require that the statutory and regulatory frameworks for futures and securities regulations be “harmonized” and that gaps and inconsistencies in the regulation of futures and securities be addressed. Economically equivalent instruments (for example, options and futures on the same underlying assets) would be regulated in the same manner, irrespective of whether the SEC or CFTC had jurisdiction over the instruments.

The Financial Reform Plan attempts to walk a fine line in calling for changes to the SEC’s and CFTC’s respective statutory and regulatory regimes, calling on both agencies to move toward principles-based regimes, but with more precision than the principles-based regime currently in place under the Commodity Exchange Act and CFTC regulations. The SEC and CFTC are also being called on to adopt consistent procedures for reviewing new financial products and for approval of self-regulatory organizations (“SRO”) rules. The Financial Reform Plan indicates that the SEC needs to move more quickly on new products and SRO rule changes and expand the types of filings that are effective upon filing. It calls on the CFTC to

require advance approval of more types of SRO rules, while allowing for sufficient time for the approval of such rules to be completed.

The Financial Reform Plan recommends that the SEC and CFTC report to Congress by the end of September 2009 on areas where securities and futures legislation and regulations conflict. The agencies should either justify those conflicts or make recommendations of ways to eliminate the conflicts. If the agencies are not able to come to agreement on elements of the report, their areas of disagreement will be referred to the new Council to address and report back to Congress within six months of its formation.

### **(4) Strengthen Oversight and Functioning of Systemically Important Payment, Clearing and Settlement Systems and Related Activities as well as Settlement Capabilities and Liquidity Resources.**

The Financial Reform Plan would give the Fed responsibility and authority to identify and oversee “systemically important payment, clearing and settlement systems” the failure or disruption of which “could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the financial system” (“covered systems”). It is possible that several SEC-regulated securities clearing agencies such as the National Securities Clearing Corporation and the Depository Trust Company would be covered systems, as would several CFTC-regulated derivatives clearing organizations (“DCOs”) such as the Clearinghouse Division of the Chicago Mercantile Exchange and ICE Clear US. (The Options Clearing Corporation is unique in that it is both a registered securities clearing agency and a DCO, and is accordingly regulated by both the SEC and the CFTC.) For other payment systems, it does not appear from the face of the Plan that the administration intends to expand coverage beyond those entities historically considered to be “systemically important systems” under the Fed’s Policy on Payment Systems Risk.

Where, as in the case of the examples given, a covered system is subject to comprehensive regulation by either or both the SEC or CFTC, that agency will remain the primary regulator. The Fed, as the

systemic risk regulator, will have authority to impose risk management standards, which are to take into account international standards and are subject to periodic review in consultation with the Council. The Fed may participate with the other regulators in examinations of covered systems, access relevant reports submitted to the other regulators and consult on proposed rule changes by covered systems that affect risk management. While primary enforcement responsibility remains with the primary regulators, the Fed has emergency enforcement authority, after consultation with the Council, if the Fed and the primary regulator fail to agree on enforcement action. The relationship between the Fed and the primary regulators is patterned after examination authority granted to the Fed in the Gramm-Leach-Bliley Act and the “back up” authority granted to the FDIC in the FDIA.

The Fed also would have authority to give covered systems access to Federal Reserve Bank accounts, financial services and the discount window in order to ensure that they have the ability to meet settlement obligations on a timely basis. Many systemically important payment, clearing and settlement systems currently depend on commercial banks to perform critical payment and other financial services and to provide them with the liquidity necessary to convert collateral to cash when necessary to complete settlement. The Financial Reform Plan notes that, “[d]uring the recent financial crisis some systemically important settlement systems have encountered performance and other issues with their banks.” Use of Federal Reserve Bank services could make covered systems less dependent on commercial banks, although use of the discount window would be reserved for emergency use only.

### **C. PROTECT CONSUMERS AND INVESTORS FROM FINANCIAL ABUSE**

The Financial Reform Plan would create a new federal agency, the CFPA, with jurisdiction over credit, savings, payment and other consumer financial products and services. Unlike some earlier proposals, the CFPA would not be given responsibility for mutual funds or other investment products, which would remain with the SEC and CFTC. Notably, the Plan would reverse long established principles of banking

preemption by subjecting federally chartered banks to both regulation and enforcement by states in addition to the new CFPA. The Plan also directs the SEC to adopt investor protection initiatives and seeks legislation to harmonize the standard of care applicable to investment advisers and broker-dealers that provide investment advice.

#### **(1) Create a New Consumer Financial Protection Agency.**

The CFPA would be an independent agency. Funding would come from fees assessed on regulated entities and transactions, a formulation that seems to contemplate the possibility of a new levy on transactions. The CFPA’s authority would extend to all entities engaged in a business covered by any of the “consumer protection” statutes the enforcement of which would now be delegated to the CFPA, including federal banks, state banks and non-bank financial providers. The Plan also indicates that jurisdiction would extend to service providers to CFPA-supervised entities, thus subjecting an even larger number of companies to its jurisdiction.

##### ***(a) The CFPA Would Have Sole Federal Rulemaking Authority.***

The CFPA would be granted sole authority to issue and interpret regulations under a broad array of existing laws, including consumer protection statutes, fair lending laws and the Community Reinvestment Act (the “CRA”), which stands alone as a more supervisory statute nevertheless delegated to the CFPA. Agencies that currently have rulemaking power, other than the Federal Trade Commission (the “FTC”), would be stripped of that authority, and it is unclear whether existing regulations would remain in force. The CFPA would also be given broad, general authority to regulate disclosures as well as business practices in the financial services sector.

##### ***(b) The CFPA Would Have Examination and Enforcement Authority.***

The CFPA would assume the role of supervising compliance with consumer regulations by banks and their affiliates. For non-bank entities, the CFPA would have jurisdiction but would rely on state agen-

cies as the primary regulators. The CFPA would cooperate with the Department of Justice with respect to formal enforcement through the courts. The Plan suggests that larger penalties, including in private litigation, may be needed as compared to current law. By placing the consumer compliance function with the CFPA, the Plan seeks to heighten attention to consumer matters. However, the Plan does not address how separating the compliance and prudential regulatory functions would eliminate the conflicts that arise between those functions, as it would seem to replace the possibility of *intra*-agency tension with *inter*-agency tension. The CFPA's authority for CRA examinations and enforcement also raises many questions, including whether new enforcement mechanisms or penalties are possible, because the existing CRA enforcement mechanisms are through decisions on applications which would not be within the CFPA's jurisdiction.

The CFPA would also be tasked with a broad data gathering and analysis mission. This power could be used to demand a significantly increased amount of reporting from supervised entities.

**(c) State Authority.**

Although the Financial Reform Plan would consolidate *federal* consumer protection regulation authority, it would greatly expand the role of states. States would be permitted to enact stricter laws and regulations, which would apply both to state and federally chartered institutions. Reversing existing federal preemption in this area, banks would have to devote substantial new efforts to compliance on a state-by-state basis. States would also have authority to enforce both state and federal laws, even against federally chartered entities.

**(d) Role of the FTC.**

The FTC would be given back up authority to enforce the statutes currently in its jurisdiction that would be shifted to the CFPA, would retain responsibility for fraud in the financial marketplace (together with the CFPA) and would be the lead agency for data security matters. The CFPA, however, would assume jurisdiction over other financial privacy protections. The FTC would be granted more streamlined rule-

making authority and enhanced authority to seek civil penalties.

**(2) Consumer Protection Principles.**

The CFPA would be charged with reforming consumer protection based on five principles: transparency, simplicity, fairness, access for all and accountability.

**(a) Transparency.**

Mandatory disclosure forms would be designed to be "clear, simple, and concise," and tested in the marketplace. The Plan singles out mortgage disclosures as particularly in need of reform in spite of recent changes. Although the mechanism is not clear, the duty to update disclosures when new products are developed would somehow be shared by companies and the CFPA.

Disclosures and other communications would also be subject to a new "reasonableness" standard, balancing the presentation of risks and benefits, that goes beyond technical compliance with the disclosure rules. Perhaps recognizing the difficulty of implementing such a standard, this duty would be subject to administrative enforcement only, and the CFPA would be authorized to develop a "no action" letter process. It is not clear, however, that this would preclude derivative state law litigation. The CFPA would have the power to encourage (or mandate) technological innovation to enhance disclosures, such as use of internet based real time calculators and disclosures that present real time information or choices to consumers at ATMs or point of sale.

**(b) Simplicity.**

The CFPA would have the power to define "plain vanilla" versions of consumer financial products, and could require providers to offer the "plain vanilla" products in order to be able to offer more tailored versions of such products. For any tailored products, the CFPA could require enhanced disclosures and warnings, could require greater diligence on whether the product was suitable and affordable for the borrower, could impose substantially higher penalties and could require that consumers first complete questionnaires or expressly opt out of the "plain vanilla" products.

The focus on “plain vanilla” products seems to create a substantial impediment to innovation in financial services.

**(c) Fairness.**

The CFPA would have the authority to regulate unfair, deceptive or abusive practices, using a cost-benefit analysis. The Plan calls out prepayment penalties and yield spread premiums — as well as consumer arbitration provisions — for criticism, and would give the CFPA power to prohibit such terms.

The CFPA would also have authority to impose standards of care on intermediaries, particularly debt counselors and mortgage brokers. The Plan suggests that mortgage brokers could be subject to a duty of “best execution” on behalf of their consumer clients, could be required to receive their compensation over the life of a loan and could be subject to a duty to determine the affordability of such products.

The Plan also calls for consistent regulation of products. Overdraft products, for example, could be subject to consistent regulation as credit products, rather than the current structure that subjects some to credit and some to non-credit regulatory requirements.

**(d) Access for All.**

The Financial Reform Plan rejects criticism of the CRA for contributing to the subprime mortgage problems and commits the CFPA to a new regime of CRA enforcement. The CFPA would have a dedicated fair lending staff, and the Plan seeks additional data elements in Home Mortgage Disclosure Act (“HMDA”) reporting (such as a flag for involvement of a broker, information about the type of interest rate, and identifiers that permit tying HMDA data to other databases).

**(e) Accountability.**

By consolidating federal regulatory authority in the CFPA, the Financial Reform Plan concludes that the agency would be more accountable for the success or failure of regulation. The Plan does not address, however, how the diffusion of authority to the states would impact this conclusion. Nor does it suggest how differences between the CFPA and prudential regulators would be resolved, even though it

acknowledges that there is a tension between those missions.

**(3) Strengthen the Framework for Investor Protection by Focusing on Principles of Transparency, Fairness and Accountability.**

Under the Financial Reform Plan, the SEC will act in substantially the same role as it has in the past — as a federal supervisor with comprehensive responsibilities for protecting investors against fraud and abuse. Certain aspects of the Plan may, however, raise jurisdictional issues with the proposed CFPA, since it may not always be clear where the line is drawn between “investment products” within the SEC’s jurisdiction and other products allocated the CFPA, particularly where hybrid products such as deposit sweeps are involved. The Plan directs the SEC to take certain actions to promote transparency, fairness and accountability while acknowledging that the SEC already has been making efforts to strengthen and streamline its enforcement process, the process for obtaining formal orders that grant the staff subpoena power and reviewing the manner by which it assesses risks and responds to leads of wrongdoing. The investor protection initiatives are discussed below.

**(a) Point of Sale Disclosure to Promote Transparency.**

The Financial Reform Plan anticipates revisions to the federal securities laws that would, among other things, make explicit that disclosures (*e.g.*, prospectuses) are required to be provided to investors at or before the point of sale, rather than after a sale has taken place. The SEC also is directed to evaluate the effectiveness of disclosures by conducting field tests and other assessments with individual investors.

**(b) Harmonization of Broker-Dealer and Investment Adviser Regulatory Schemes, as well as Imposition of a Fiduciary Duty on Broker-Dealers.**

In accordance with statements of SEC commissioners as well as the staff of the Financial Industry Regulatory Authority (“FINRA”), the Plan seeks to empower the SEC to establish a fiduciary duty for broker-dealers offering investment advice and harmonize

the regulation of investment advisers and broker-dealers. The Plan notes that retail investors often do not know the difference between investment advisers and broker-dealers because both can provide investment advice. The Plan further posits that retail investors do not know that investment advisers and broker-dealers are subject to different standards of care, *i.e.*, that investment advisers owe a fiduciary duty to investors while broker-dealers are required only to determine if a securities recommendation is "suitable."

As a result, the Plan seeks legislation that would impose the same investment adviser fiduciary standards on broker-dealers that provide securities investment advice. In connection with the leveling of the standard of care, legislation would be proposed to require basic disclosures that clearly delineate the scope of the relationship between retail investors and investment advisers as well as broker-dealers. In addition, the Plan seeks legislation prohibiting practices that are contrary to the interests of investors, which could include banning compensation arrangements that are profitable to broker-dealers but that are not in the best interests of investors. It should be noted that FINRA has been lobbying to be the SRO to oversee both investment advisers and broker-dealers.

**(c) Review of Mandatory Arbitration Clauses.**

The Plan also mandates a review of whether investors should be subject to mandatory arbitration with broker-dealers and investment advisers. The Plan states that mandatory arbitration may unjustifiably undermine investor interests and that legislation should be enacted that would give the SEC the authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory account agreements with retail investors, but before using such authority the SEC would need to conduct a study of mandatory arbitration clauses and their impact upon investors as well as consider whether changes to arbitration are appropriate.

**(d) Whistleblowers and Expansion of Sanctions Available to the SEC.**

The Financial Reform Plan states that the SEC should have the authority to establish a fund to pay whistleblowers for information that leads to enforce-

ment actions that result in significant financial awards. The fund would be supported by monies that the SEC collects from enforcement actions that are not distributed to investors. The Plan further supports an SEC initiative to impose collateral bars against regulated persons across all aspects of the financial industry rather than any specific segment of the industry.

**(e) "Say on Pay" Rules.**

Under the Plan, legislation would authorize the SEC to impose "say on pay" rules applicable to all public companies and thus allow shareholders the right to voice their opinions on executive compensation packages. This could be implemented through a requirement that public companies include in their proxies a nonbinding shareholder vote.

**(f) Financial Consumer Coordinating Council.**

The Plan proposes the establishment of a coordinating council, consisting of the SEC, the FTC, the Department of Justice, the CFPB and possibly other federal and state agencies, to meet on a periodic basis to identify gaps in consumer protection across financial products. Such a council would be intended to sponsor studies relating to consumers and financial products and to open communications with state attorneys general, consumer advocates and others about potential issues that could be considered or gaps that need to be filled. The council also would make regular reports to Congress concerning recommendations for legislative and regulatory changes that would be designed to improve consumer and investor protection.

In addition, the Plan proposes that the Investor Advisory Committee, which was recently established by the SEC and is composed of well respected investors, should be made permanent by statute and should continue advising the SEC on regulatory priorities, including new products, trading strategies, fee structures and other related issues.

**(g) Promotion of Retirement Security.**

In his 2010 budget, President Obama proposed (i) introducing an "Automatic IRA" and (ii) increasing tax incentives for retirement savings for families that earn less than \$65,000 by modifying the "saver's credit" and making it refundable. Those initiatives

are included in the Financial Reform Plan although it is unclear whether the administration intends to use this financial reform proposal to pass legislation on these issues. From the text of the Financial Reform Plan, it appears that the administration is seeking additional options to increase retirement savings.

## **D. PROVIDE THE GOVERNMENT WITH THE TOOLS IT NEEDS TO MANAGE FINANCIAL CRISES**

The fourth element of the administration's proposal is aimed at providing the government with more effective power to resolve large interconnected firms in an orderly manner.

### **(1) Creation of a Resolution Regime for Failing BHCs and Tier 1 FHCs.**

The Financial Reform Plan proposes the creation of a special resolution regime to allow for the orderly resolution of failing BHCs and Tier 1 FHCs in situations in which the stability of the financial system is at risk, similar in some respects to that which was contained in the "Resolution Authority for Systemically Significant Financial Companies Act of 2009," proposed by Treasury in March 2009.

The special resolution regime would supplement (rather than replace) and be modeled on the existing resolution scheme for insured depository institutions under the FDIA. The regime would come into play with respect to a particular BHC or Tier 1 FHC only when activated by Treasury and unless activated, the resolution of a BHC or Tier 1 FHC would continue to be governed by the Federal Bankruptcy Code. Although the Financial Reform Plan states that the Federal Bankruptcy Code will remain the dominant tool for handling BHC and Tier 1 FHC failures, the possibility that the special resolution regime could come into play is significant because there are important differences (some discussed below) between the FDIA resolution scheme and the Federal Bankruptcy Code which could significantly affect rights of creditors and other stakeholders.

The authority to decide whether to resolve a failing firm under the special resolution regime would be vested in Treasury, which could invoke the authority

only after consulting with the President and only upon a written recommendation of two thirds of the members of the Fed and two thirds of the board members of the FDIC. However, if the largest subsidiary of the firm (measured by total assets) is a broker-dealer, then the approval of the FDIC is not required and two thirds of the commissioners of the SEC must approve invoking the authority. If the failing firm includes an insurance company, then the Financial Reform Plan provides that the ONI will provide consultation to the Fed and the board members of the FDIC "on insurance specific matters."

Treasury would be given the power to decide resolution alternatives which would include, among others, the appointment of a conservator or receiver, or stabilizing the failing firm (including one in conservatorship or receivership) by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm or making equity investments in the firm. The Financial Reform Plan indicates that "generally" Treasury would appoint the FDIC to act as conservator or receiver in cases where it has decided to establish a conservatorship or receivership. Treasury also would have the authority to appoint the SEC as conservator or receiver when the largest subsidiary of the failing firm, measured by assets, is a broker-dealer or securities firm.

While the Financial Reform Plan indicates that the regime should be modeled on the FDIA scheme for the resolution of insured depository institutions, it does not provide many specifics beyond that. As a result, many important details will need to be worked out in the legislative process. It is specifically contemplated, however, that, as under the FDIA resolution regime, the conservator or receiver would have the power to repudiate contracts (even those which are not executory and so would not be subject to repudiation if the affected entity was resolved under the Federal Bankruptcy Code), and to transfer all or part of the assets of the affected entity to another entity including to a bridge financial institution. In addition, the Plan appears to contemplate a mechanism similar to that contained in the FDIA (which has no counterpart in the Federal Bankruptcy Code) under which the counterparties to securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements would be temporarily delayed in their ability to close out net such contracts pending

a determination by the receiver as to whether to transfer such contracts to another entity, notwithstanding any contractual rights to terminate the contracts if a receiver is appointed.

Additionally, the Plan would permit the entity acting as conservator or receiver to borrow from Treasury when necessary to finance the exercise of the authorities under the resolution regime and Treasury would be authorized to issue public debt to finance any such loans. The Plan proposes that the costs of any such loans should be paid from the proceeds of assessments on BHCs. Such assessments would be based on total liabilities (other than liabilities that are assessed to fund other federal or state insurance schemes).

The Financial Reform Plan leaves open the interplay of a Financial Reform Plan conservatorship, receivership or other resolution, with resolution procedures instituted against subsidiaries or other affiliated entities under the Federal Bankruptcy Code or other applicable resolution schemes, including the circumstances, if any, under which such entities could be pulled into a conservatorship, receivership or other resolution of an entity being resolved under the Financial Reform Plan's special resolution procedures. Also left to be resolved is improvement in the international framework for cross-border resolution of financial firms. The Plan contains a number of suggestions in this regard, including that the Basel Committee on Banking Supervision (the "BCBS") be encouraged to expedite its work on the subject and develop recommendations by the end of the year.

## **(2) Amendments to the Fed's Emergency Lending Authority.**

Section 13(3) of the Federal Reserve Act currently authorizes the Fed to make emergency extensions of credit to individuals, partnerships or corporations, subject to certain additional requirements. During the credit crisis, the Fed has used this authority to create various liquidity facilities (including its Term Asset-Backed Securities Loan Facility and its Commercial Paper Funding Facility) and to extend loans to individual financial institutions, such as AIG. The Financial Reform Plan would amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of Treasury to make loans thereunder. Since, as a matter of practice, the Fed

has consulted with Treasury in formulating its Section 13(3) emergency lending programs, this does not appear to impose a significant additional restriction on such authority.

## **E. RAISE INTERNATIONAL REGULATORY STANDARDS AND IMPROVE INTERNATIONAL COOPERATION**

The Financial Reform Plan proposes a number of improvements to international regulatory standards, such as the Basel II capital standards, and to international cooperation regarding financial issues. It would appear that this section of the Financial Reform Plan is the most aspirational, as it is unclear whether the U.S. will be able to obtain the necessary cooperation of other nations in order to effectuate these recommendations. For the most part, this section of the proposal calls on the BCBS, the Financial Stability Board (the "FSB"), the Committee on the Global Financial System and foreign governments to adopt various G-20 resolutions on updating and strengthening international regulatory standards and international cooperation on financial issues. The main areas of interest include the following:

- Strengthening the international capital framework by calling for the BCBS to implement reforms to Basel II, including strengthening the definition of regulatory capital, adopting the G-20-endorsed non-model based measure of leverage and modifying capital requirements for trading book and securitization exposures.
- Improving the oversight of global financial markets through the adoption of standardized oversight of credit and other OTC derivatives with the cooperation of central counterparties in each nation.
- Enhancing supervision of internationally active financial firms via the continued establishment and operational development of "supervisory colleges" for significant global financial institutions.
- Reforming crisis prevention and management authorities and procedures by increasing cooperation among the U.S. and its international counterparts in improving cross-border resolution of

financial firms and cross-border financial crisis management.

- Strengthening the FSB.
- Strengthening prudential regulations by calling on the BCBS and national authorities to create a global framework for promoting stronger liquidity buffers and calling on the FSB to work with the Bank for International Settlements to develop the tools necessary to monitor systemic economic health on a global basis.
- Expanding the scope of Tier 1 FHC regulation by having the Fed, in cooperation with Treasury, develop guidelines to determine which foreign financial firms should be categorized as Tier 1 FHCs (discussed above). The Fed could choose to examine the target firm's global operations, or only those operations that affect the U.S. financial markets. The "well capitalized" and "well managed" tests proposed for FHCs also would apply to these foreign FHCs. In addition, the proposal expands upon the G-20's recommendations regarding regulation of hedge funds to include registration of advisers to other pools of private capital, along with additional recordkeeping and disclosure requirements.
- Introducing better compensation practices in accordance with the standards discussed above.
- Promoting stronger standards in the prudential regulation, money laundering/terrorist financing and tax information exchange areas; in particular, calling for the U.S. to work with the International Cooperation Review Group to identify and engage with nations that are not compliant with international anti-money laundering standards.
- Improving accounting standards with an eye towards establishing a single set of global accounting standards, as well as recommending

making standards for loan loss provisioning more forward looking, rather than the current incurred loss approach.

- Tightening oversight of credit rating agencies by calling on national authorities to register and oversee all credit rating agencies whose ratings are used for regulatory purposes consistent with the Code of Conduct Fundamentals for Credit Rating Agencies of the International Organization of Securities Commissions and to ensure compliance with their oversight regimes.

## NOTES

<sup>1</sup> The text of the Financial Reform Plan is available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf), and President Obama's speech introducing the Financial Reform Plan is available at: [www.whitehouse.gov/the\\_press\\_office/Remarks-of-the-President-on-Regulatory-Reform/](http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/).

<sup>2</sup> The accompanying fact sheets are available at: [http://www.financialstability.gov/docs/regulatoryreform/requiring\\_strong\\_supervision\\_reg\\_finfrms.pdf](http://www.financialstability.gov/docs/regulatoryreform/requiring_strong_supervision_reg_finfrms.pdf); [http://www.financialstability.gov/docs/regulatoryreform/strengthening\\_reg\\_core-markets\\_infrastructure.pdf](http://www.financialstability.gov/docs/regulatoryreform/strengthening_reg_core-markets_infrastructure.pdf); [http://www.financialstability.gov/docs/regulatoryreform/strengthening\\_consumer\\_protection.pdf](http://www.financialstability.gov/docs/regulatoryreform/strengthening_consumer_protection.pdf); [http://www.financialstability.gov/docs/regulatoryreform/providing\\_govt\\_tools\\_manage\\_fin\\_crisis.pdf](http://www.financialstability.gov/docs/regulatoryreform/providing_govt_tools_manage_fin_crisis.pdf); and [http://www.financialstability.gov/docs/regulatoryreform/improving\\_internatl\\_reg\\_standards\\_co-op.pdf](http://www.financialstability.gov/docs/regulatoryreform/improving_internatl_reg_standards_co-op.pdf).

<sup>3</sup> Secretary Geithner's prepared remarks are available at <http://www.treas.gov/press/releases/tg176.htm>. Secretary Geithner's testimony before the U.S. House of Representatives Committee on Financial Services, also scheduled to occur on June 18, 2009, was postponed and will be rescheduled at a later date.

<sup>4</sup> The Financial Reform Plan also reiterates the administration's support of proposed "say on pay" and compensation committee independence legislation.