

Obama Administration Proposes Comprehensive Changes to Financial Services Regulation

On Wednesday, June 17, 2009, the Obama Administration released a detailed proposal to change the financial services regulatory regime in the United States. The “white paper,” entitled “Financial Regulatory Reform: A New Foundation,” calls for the most significant overhaul of the American financial regulatory landscape since the Great Depression and is intended to mitigate or forestall future financial crises. This client update highlights some of the most significant aspects of the proposal, much of which must still be set forth in legislative language. The official release can be found [here](#).

Financial Services Oversight Council

The proposal would create a Financial Services Oversight Council chaired by the Secretary of the U.S. Department of the Treasury (“Treasury”), and which includes the heads of the federal banking, housing, securities and commodities regulators. It would replace the President’s Working Group on Financial Markets, which was established after the market break in 1987, and would be designed to facilitate information-sharing and coordination, identify emerging risks, provide a forum for resolving disputes among regulators, and advise the Federal Reserve Board (“FRB”) on the identification of systemically significant companies. Because the FRB would take on the role of regulator of all systemically significant companies, with the Council acting only in an advisory role, the Council would be much less powerful than initially hoped by some of its supporters.

Expansion of the Powers of the Federal Reserve Board

Expanded FRB Authority Over Systemically Significant Financial Firms. Systemically significant companies, i.e., companies that are identified as posing a threat to the financial system because of a combination of their size, leverage, and interconnectedness in the national economy, would be designated as “Tier 1 FHCs” and would be supervised and regulated by the FRB, regardless of whether those firms control a depository institution subsidiary. As Tier 1 FHCs, they will be subject to enhanced capital, liquidity and risk management requirements as well as restrictions on their non-financial activities that would extend to the parent and to all subsidiaries, including non-U.S. subsidiaries. Each Tier 1 FHC will be required to prepare and continuously update a “credible plan” for the rapid resolution of the firm in the event of severe financial distress. The FRB and Treasury would develop rules to guide the FRB in identifying Tier 1 FHCs, and the Council could separately advise the FRB whether a firm should be designated as a Tier 1 FHC. The FRB also would receive expanded examination authority to help identify potential additional Tier 1 FHCs and would gain oversight over payment, clearing and settlement systems that are determined to be systemically important.

Expanded FRB Authority Over Nonbank Holding Companies. The proposal would also expand the FRB’s authority to supervise and regulate as bank

holding companies (“BHCs”) all companies that control insured depository institutions, including state chartered, FDIC-insured industrial loan companies. As a result, companies that own a “nonbank” depository institution such as an industrial loan company, credit card bank or trust company will no longer be able to avoid FRB regulation at the holding company level, including the Bank Holding Company Act’s (“BHCA”) general prohibition on the conduct of nonbanking activities.

No Grandfathering. No grandfathering is proposed for Tier 1 FHCs and nonbank holding companies. Rather, those companies simply would be given five years to conform their activities to the BHCA which, as a practical matter in many cases, will require divestitures. This represents a fundamental change likely to be vigorously opposed by retailers and other commercial firms that have long operated these types of entities. Moreover, subjecting nonbank holding companies to the BHCA may lead to proposals to eliminate those charters entirely, for example by requiring them to convert to state or national banks. These moves are likely to be highly controversial among state regulators, particularly in states such as Utah, which has become the favored jurisdiction for licensing industrial loan companies, and one would expect substantial political resistance from these quarters and their supporters in Congress.

Capital Requirements. All financial holding companies, including Tier 1 FHCs, would be required to be “well capitalized” and “well managed” on a *consolidated* basis to engage in the broader set of “financial in nature” activities permitted under Section 4(k) of the BHCA.

Changes in FRB Structure and Review of Bank Regulation. The FRB, in consultation with Treasury and others, would be required to propose recommendations by October 1, 2009, to better align the FRB’s structure and governance with these new authorities and responsibilities. Perhaps more importantly, Treasury will lead a working group that will conduct a “fundamental reassessment” of the supervision of banks and BHCs, and issue its conclusions by October 1, 2009, a provision which could be interpreted in Congress and elsewhere as undermining to some extent the Administration’s current proposals.

Limits on FRB Authority. In the future, the FRB would need the written approval of the Secretary of the Treasury before it could exercise its emergency powers under Section 13(3) of the Federal Reserve Act (the provision that the FRB relied upon to provide assistance to AIG, among others). This move may be designed to address criticism about concentrating too much power in the FRB, but it also will likely raise concerns over politicizing the FRB’s role. The FRB also would lose its consumer regulatory authority as discussed below.

New Resolution Regime

The proposal calls for the creation of a resolution regime—modeled after the FDIC’s powers for resolving insured depository institutions, but not housed exclusively within the FDIC—that would allow for the orderly unwinding of certain bank holding companies and Tier 1 FHCs. It would enable the receiver or conservator to take control of the operations of the company and prevent counterparties from terminating protected or qualified financial contracts. The proposal could result in a conflict between the new resolution regime and the existing bankruptcy laws because BHCs and Tier 1 FHCs would generally remain eligible debtors under the Bankruptcy Code. Furthermore, the uncertainty concerning the exact resolution process for BHCs and Tier 1 FHCs may steer creditors and investors away from these institutions or cause them to charge higher risk premiums when dealing with these institutions.

National Bank Supervisor and Interstate Banking

Elimination of Thrift Charter. The proposal would eliminate the federal thrift charter, subject to unspecified “reasonable transition arrangements” for it to become a national bank, which would potentially gloss over some key distinctions between the existing bank and thrift regulatory regimes. State-chartered thrifts would apparently still be permitted, although the proposal is silent on how they would be regulated.

National Bank Supervisor. The proposal would create a new National Bank Supervisor (“NBS”) within Treasury to succeed to the Office of Thrift Supervision and the Office of the Comptroller of

Currency (“OCC”). The FRB and FDIC would retain their supervisory responsibilities over state-licensed banks and branches and agencies of foreign banks.

Interstate Branching. Significantly, national as well as state banks would be given the same nationwide *de novo* branching powers that federal thrifts now enjoy, and states could not override that authorization. The proposal also calls for differences in regulatory treatment between state and national banks to be “further reduced,” and troubled banks would be prevented from converting charters. Although presumably not intended, these provisions, together with the limitations on federal preemption elsewhere in the proposal, may make the state charter option more appealing for many banks.

Federal Insurance Regulation

Increase of Federal Oversight. The proposal increases federal oversight of the insurance industry but does not propose to establish a broad federal regulatory role. While the proposal acknowledges that certain insurance companies are systemically important to the financial system, and it would impose FRB regulation on such companies [see “Expansion of the Powers of the Federal Reserve Board,” above], for the rest of the industry the proposal only contemplates a monitoring function at the federal level.

Office of National Insurance. The proposal calls for the creation of an Office of National Insurance (ONI) within the Treasury Department, which would serve as an information clearinghouse while providing a source of federal-level expertise on the state-regulated insurance sector. In addition to identifying insurance entities that could pose a systemic risk to the financial system, the ONI would serve as an industry voice in the international arena with the authority to work with other countries to increase international cooperation on insurance regulations, to enter into international agreements and to represent the industry in the International Association of Insurance Supervisors.

Proposed Basis for Future Insurance Regulatory Reform. Although broader regulatory reform for the insurance industry is not contemplated at this time, the proposal outlines six principles that the Administration would support as a basis for future insurance reform proposals: (i) effective systemic risk regulation for the insurance industry; (ii) strong capital standards and an

appropriate balance of capital allocation and liabilities for insurance companies; (iii) meaningful and consistent consumer protection for insurance products and practices; (iv) increased national uniformity through either a federal charter or effective state action; (v) improved and broadened regulation of insurance companies and affiliates on a consolidated basis, including non-insurance affiliates; and (vi) increased international coordination.

Securitization

Originators and/or sponsors of securitizations would be required to retain a material portion (at least 5 percent) of the securitized credit exposure. The federal banking agencies would have the ability to lower the 5 percent threshold and provide exemptions from the general prohibition on hedging those retained exposures. This proposal is designed to align the incentives of market participants with the long term performance of loans. The SEC will strengthen the regulation of rating agencies and issuers of asset-backed securities by, among other things, requiring additional loan-level data and other information needed to assess the credit quality of the underlying assets.

Derivatives Regulation

All OTC derivatives would be subject to a new regulatory scheme that includes (i) recordkeeping, price and position disclosure and reporting requirements and (ii) mandatory clearing of “standardized” OTC derivatives through regulated central counterparties (“CCPs”). “Customized” derivatives transactions would not be subject to the CCP requirement, but it is unclear whether market consensus, individual participants or regulators will determine which derivatives are standardized and which are customized.

Derivatives dealers and other firms with large derivatives exposures will be subject to supervision and regulation, including conservative capital requirements (in the case of Tier 1 FHCs), business conduct standards, reporting requirements and requirements as to initial margin and counterparty credit limits. It remains to be seen whether variations in margin standards would be permitted based upon the particular derivative product category or the sophistication of the parties to the trade; the extent to which margin requirements and capital requirements will overlap is

also unclear. Derivatives exposures also would be subject to higher regulatory capital requirements and derivatives transactions between banks and their affiliates would be subjected to tighter restrictions under the affiliate limitations in Section 23A.

New Consumer Financial Protection Agency

The proposal's call for the creation of a new federal agency, the Consumer Financial Protection Agency ("CFPA"), is likely to be one of the most controversial aspects of the proposal. The CFPA will have jurisdiction over consumer financial products and services, except for those investment products and services regulated by the SEC and the Commodity Futures Trading Commission.

The CFPA will write consumer protection rules, supervise and examine compliance by institutions with applicable laws and take enforcement action in the event of violations. While this concept may have some initial appeal as an appropriate way of protecting consumers, it may also adversely affect consumers and the regulation of banks and other consumer financial service providers. One concern likely to be raised is that the removal of regulatory supervision and examination from the federal banking agencies may undermine their ability to oversee bank operations and regulate the safety and soundness of those institutions. Moreover, the lines of authority between the new CFPA, the banking regulators and even other agencies such as the Federal Trade Commission, will be difficult to discern.

The CFPA proposal may well prove more costly in the long run to most consumers. First, the proposed requirement that the CFPA ensure availability of "plain vanilla" products would "commoditize" consumer loan products and stifle innovation by removing incentives to develop new products. Second, the costs of consumer lending and deposit taking likely would increase due to an additional layer of oversight and expense, potentially increased litigation exposure (as a result of proposals such as those requiring disclosures and other communications that are "reasonable" and those possibly limiting the use of mandatory arbitration clauses), and the application of inconsistent state and federal laws.

Although the proposal does not explicitly use the term "preemption," it clearly would eliminate this principle.

States would be permitted to enact more stringent restrictions than provided for under federal laws administered by the CFPA, and "federally chartered institutions [would] be subject to nondiscriminatory state consumer protection and civil rights laws to the same extent as other financial institutions." The proposal also would expressly authorize states to enforce state as well as federal consumer protection laws against federally chartered institutions, subject only to "appropriate arrangements with prudential supervisors." These changes are intended to "level the playing field" for consumer financial products between state and federally chartered institutions. The ability of states to exercise visitation and enforcement rights against federally chartered institutions would provide state attorneys general the leverage that they have sought for many years. More broadly, the elimination of federal preemption would undermine the ability of financial service providers to offer uniform products and services on a multi-state basis and potentially reduce the value of the federal charter for consumer lenders.

International Cooperation Initiatives

The proposal focuses on four core issues with respect to improving international standards: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management. However, achieving this progress in the short time frame contemplated by Treasury faces several obstacles: (i) the need to reach international consensus on a number of broad policy goals (e.g., developing an OTC derivatives action plan, improving Basel II), (ii) translating any achieved policy consensus into specific guidance that the global community can accept, (iii) the acknowledged weak mandate of the Financial Stability Board on which Treasury wants to rely to implement some international standards, and (iv) the inevitable inclination of national authorities to protect the institutions within their own jurisdictions even when doing so can have spillover effects for other countries.

Regulatory Capital Requirements

The proposal contains several components designed to increase and strengthen existing regulatory capital standards. Most broadly, the proposal calls for Treasury,

together with the federal financial regulators and “outside experts,” to conduct a “fundamental reassessment” of existing regulatory capital requirements for banks and bank holding companies and to issue a report with recommended changes by December 31, 2009. Issues to be addressed, virtually all of which also are referenced in other parts of the proposal, include stress-tested capital buffers, the use of certain types of convertible debt or “tail insurance” to satisfy capital requirements, and increased capital requirements for trading positions, equity investments, subprime loans, certain securitization exposures (including highly-rated asset-backed securities, exposures to off-balance sheet vehicles, resecuritizations), and certain OTC derivatives. The proposal also advocates broader application of heightened leverage capital requirements and endorses efforts already underway to modify Basel II international standards in these and other areas. Finally, the proposal calls for higher capital requirements to be imposed on derivatives dealers and financial holding companies, especially on systemically important financial holding companies, and unspecified revisions designed to tighten the existing definitions of the components of regulatory capital.

Investment Management Issues

Hedge Funds and Other Funds. Investment advisers to hedge funds and other private pools of capital (including private equity and venture capital funds) whose assets under management exceed a specified threshold would be required to register with the SEC. Once the advisers are registered, both the advisers and the private funds they manage would be subject to SEC examination, recordkeeping and regulatory reporting requirements, and requirements to make disclosures to investors, creditors, and counterparties. Among other things, funds would be required to report, on a confidential basis, financial information to assess leverage and potential threats to financial stability. This information would be used to determine if the funds should be subject to regulation as Tier 1 FHCs [see “Expansion of the Powers of the Federal Reserve Board,” above].

Money Market Mutual Funds. These funds would be subjected to additional requirements designed to reduce credit and liquidity risk. The SEC would be asked to consider whether such funds should be prohibited from

representing that they maintain a stable net asset value of \$1 per share, or whether to require such funds to obtain access to reliable emergency liquidity in order to maintain a stable net asset value.

Fiduciary Activities of Broker-Dealers. The proposal recommends that broker-dealers providing investment advice about securities be subject to the fiduciary standards applicable to investment advisers, and that the SEC “harmonize” the regulation of investment advisers and broker-dealers.

Foreign Banks

The proposal contains very few provisions that apply uniquely to non-U.S. banks, although their U.S. operations would of course be affected by other generally applicable provisions, including, for example, the expansion of interstate branching rights. In addition to a specific reference to transferring supervision of federal branches and agencies of non-US banks from the OCC to the new NBS, the proposal authorizes the FRB, in consultation with Treasury, to determine whether foreign financial institutions should be treated as a Tier 1 FHCs “based on whether their U.S. operations pose a threat to financial stability.”

The proposal indicates that the determination could be based on criteria applied to the worldwide operations, to the U.S. operations only, or to those operations that “affect” the U.S. markets. It also states that “due regard” should be given to the principles of national treatment and competitive equality, as well as the implications under international agreements. Finally, the proposal provides discretion to the FRB to determine what, if any, conforming changes should be made to the standards for non-U.S. banks to qualify as FHCs. The FRB could use this authority, for example, to apply the “well-capitalized” and “well-managed” standards to a non-US bank that owns or controls a U.S. bank but does not operate any branches or agencies in the United States.

Congressional Prospects

Despite its length, the proposal leaves many details unresolved and raises almost as many questions as it answers. Moreover, legislative language implementing the current proposal is not yet available. Secretary Geithner will testify on the proposal before Congress on June 18, and Treasury intends to deliver to

Congress specific legislative proposals in the coming weeks to effectuate the proposal.

Although President Obama said that Congress, stakeholders and regulators were consulted in the development of the proposal, many of its key components are controversial. Constituencies are already forming on key aspects of the proposal and opposition to some elements has already begun to surface. In particular, the role of the FRB was widely debated before the proposal's release and that debate continues, including among some key members of Congress in leadership positions who will have a direct impact on the legislation. The Republicans have also announced a significantly different proposal. Given these factors, the legislative calendar, and the clearly ambitious scope of Treasury's proposal, it is possible that Congress and the Administration may seek to prioritize certain aspects of the proposal and break off those elements on which there may be greatest consensus. In any event, release of the Administration proposal is probably only the first step in what is likely to be a lengthy and contentious process.

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