Financial Institutions

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Obama Administration Outlines Proposal for Comprehensive Financial Regulatory Reform

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Today, the Obama Administration released its long-awaited proposal to reform the U.S. financial regulatory structure. The proposal is intended to address gaps and deficiencies in supervision and regulation that contributed to the current financial crisis. The Administration's proposal is ambitious and sweeping; the proposal calls for "a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market."

The following is a summary of the key provisions of the Administration's proposal, organized by the proposal's five key objectives.

I. Promote Robust Supervision and Regulation of Financial Firms

- *Creation of a Financial Services Oversight Council*. Under the Administration's proposal, a Financial Services Oversight Council (FSOC) would be established to facilitate information sharing and coordination between the federal financial regulatory agencies, identify emerging risks, provide a forum for resolving jurisdictional disputes between regulators, and advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability.
    - The membership of the FSOC would consist of the Secretary of the Treasury as Chair, and representatives from the federal financial regulatory agencies, including the Chair of the Federal Reserve Board, the Director of the newly created National Bank Supervisor, the Chair of the FDIC, the Chair of the SEC, and the Chair of the CFTC.
    - The FSOC would have authority to require periodic and other reports from any U.S. financial firm for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates poses a threat to financial stability.
- *Heightened Supervision of Tier 1 FHCs*. The Administration's proposal would define a new category of regulated financial organization – a Tier 1 Financial Holding Company (or Tier 1 FHC). As contemplated by the Administration, a Tier 1 FHC would generally be any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed, without regard to whether the firm has an insured depository institution subsidiary. Such firms would be subject to consolidated supervision and regulation by the Federal Reserve, and would also be subject to the nonfinancial activity restrictions of the Bank Holding Company Act.
    - The Federal Reserve would consider certain factors in determining whether an individual financial firm could pose a threat to financial stability and should be deemed a Tier 1 FHC, namely: (1) the impact that the firm's failure would have on the financial system and the economy; (2) the firm's combination of size, leverage (including off-

balance sheet exposures) and degree of reliance on short-term funding; and (3) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. The Federal Reserve would also have the discretion to apply other factors to individual financial firms in identifying Tier 1 FHCs. (For the purpose of identifying Tier 1 FHCs, the Federal Reserve would also be authorized to collect periodic and other reports from all U.S. financial firms that meet certain minimum size thresholds, and the FSOC would advise the Federal Reserve in connection with the identification of Tier 1 FHCs.)

  - The Administration's proposal contemplates that Tier 1 FHCs would be subject to prudential standards, including capital, liquidity, and risk management standards, that would be stricter and more conservative than for other regulated financial organizations to account for the greater risks that failure of a Tier 1 FHC poses for the financial system. Tier 1 FHCs would also be subject to a prompt corrective action regime that requires the firm or its supervisor to take corrective actions if the firm's regulatory capital levels decline below prudent levels.

  - The Federal Reserve would engage in consolidated supervision of Tier 1 FHCs that would extend not only to the parent company but also to all of its subsidiaries -- regulated and unregulated, U.S. and foreign. Such consolidated supervision would focus on the risk that the firm poses to the system as a whole.

- *Strengthen Capital and Other Prudential Standards Applicable to All Banks and BHCs*. Treasury, with participation by the federal financial regulatory agencies and outside experts, will conduct a reassessment of the existing regulatory capital requirements for banks and BHCs, including the proposed new Tier 1 FHCs. Treasury will also reassess the supervision of banks and BHCs in light of the lessons learned about banking supervision and regulation from the recent financial crisis. Treasury will issue a report with its conclusion on how to strengthen regulatory capital requirements by December 31, 2009, and a report on its conclusions on how to strengthen regulatory supervision by October 1, 2009.

  - The Administration's proposal also urges the federal financial regulatory agencies to issue standards and guidelines that better-align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices that could threaten the safety and soundness of supervised institutions. In addition, the Administration will support legislation requiring all public companies to hold non-binding "say on pay" shareholder resolutions on compensation and to make compensation committees more independent.[1]

  - The Administration recommends that all entities currently regulated as financial holding companies (FHCs) be required to achieve and maintain well-capitalized and well-managed status on a consolidated basis and not just at their insured depository institution subsidiaries.

  - The Administration recommends that the Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB), and the Securities and Exchange Commission (SEC) review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information.

- *Creation of a National Bank Supervisor (NBS) to Supervise and Regulate All Federally Chartered Depository Institutions*. Under the Administration's proposal, a new National Bank Supervisor would be created to assume the responsibilities of both the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) with

[1] For more information on the Administration's proposals regarding "say on pay" resolutions and the independence of compensation committees, see our prior alert "Obama Administration Outlines Executive Compensation Reform Plans" (June 10, 2009).

respect to all prudential supervision and regulation of federally chartered depository institutions.

- The federal thrift charter would be eliminated, as would the separate supervisory regime applicable to thrift holding companies.
- Current interstate branching rules for federal thrifts would be preserved and applied to national and state banks. Also, state minimum age requirements for the acquisition of in-state banks by out-of-state banking firms would be eliminated.
- All companies that control an insured depository institution, including thrift holding companies and companies that control industrial loan companies (ILCs), would be subject to consolidated supervision and regulation by the Federal Reserve under the BHC Act, including the Act's restrictions on nonfinancial activities. The current BHC Act exceptions for credit card banks and trust companies would also be eliminated.

- *Eliminate the SEC's Supervised Investment Bank Holding Company Program*. Investment banking firms that seek consolidated supervision by a U.S. regulator would be subject to supervision and regulation by the Federal Reserve rather than by the SEC.
- *New Requirements for Hedge Funds and Other Private Investment Funds*. As proposed by the Administration, advisers to hedge funds (and other private investment funds such as private equity funds and venture capital funds) with assets under management over a certain "modest" dollar threshold would be required to register with the SEC under the Investment Advisers Act. Under current law, such advisers are not required to register with the SEC if they have fewer than 15 clients.
  - Registered investment advisers would be required to report information to the SEC regarding the funds they manage that is sufficient to enable the government to assess whether the fund poses a threat to financial stability. It is not clear whether the scope of such information is greater than that currently required to be reported by registered advisers under the Investment Advisers Act.
  - All funds advised by an SEC-registered investment adviser would become subject to a range of new requirements, including: (i) rules regarding disclosures to fund investors, creditors, and counterparties; (ii) recordkeeping requirements; and (iii) a requirement to report to the SEC, on a confidential basis, the fund's 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.[2]
  - Funds advised by an SEC-registered investment adviser would also be subject to regular, periodic examinations by the SEC to monitor compliance with the foregoing requirements.
  - The SEC would share the reports it receives from funds with the Federal Reserve, which would use such information to assess whether any fund or fund family meets the criteria for designation as a Tier 1 FHC. Any fund or fund family meeting such criteria would become subject to the prudential supervision and regulation of the Federal Reserve as a Tier 1 FHC, as described in greater detail above.
- *Strengthened Regulatory Framework for Mutual Money Market Funds (MMFs)*. The SEC has announced plans to consider rules this summer to enhance the credit quality, maturity and liquidity standards applicable to MMFs. The Administration urges the SEC to move forward with these plans and specifically to consider new rules that (i) require MMFs to maintain substantial liquidity buffers; (ii) reduce the maximum weighted average maturity of MMF assets; (iii) tighten credit concentration limits for MMFs; (iv) improve the credit risk analysis and management of MMFs; and (v) permit MMFs to suspend redemptions in extraordinary circumstances to protect fund shareholders.

[2] The white paper notes that it may be appropriate to tailor some of these requirements according to the type or category of investment fund; presumably such variations would be the subject of rulemaking by the SEC.

- *Enhance Oversight of the Insurance Sector*. The Administration will propose that Congress authorize the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.
  - In addition, the Administration supports the following six principles for insurance regulation: (1) effective systemic risk regulation with respect to insurance; (2) strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies; (3) meaningful and consistent consumer protection for insurance products and practices; (4) increased national uniformity through either a federal charter or effective action by the states; (5) improve and broaden the regulation of insurance companies and affiliates on a consolidated basis; and (6) international coordination.
- *Determine the Future Role of the Government Sponsored Enterprises*. Treasury and the Department of Housing and Urban Development, in consultation with other agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Freddie Mac and Fannie Mae, and the Federal Home Loan Bank system.

II. Establish Comprehensive Regulation of Financial Markets

- *Strengthened Supervision and Regulation of Securitization Markets*. The Administration proposes several initiatives to address the perceived breakdown in market discipline regarding securitization credit standards.
  - Federal banking agencies should adopt rules requiring the originator or sponsor of a securitized credit exposure to retain at least five percent of the credit risk of that exposure, and originators and sponsors should be prohibited from directly or indirectly hedging or transferring their retained risk. The rules adopted by the banking agencies could specify permissible forms of risk retention (such as first loss position or pro rata vertical slice), minimum duration of the retained risk, and any exceptions to these requirements.
  - Regulators should adopt rules to align the compensation of securitization market participants (including brokers, originators, sponsors, and underwriters) with the longer-term performance of the underlying loans.
  - The SEC should take further action to improve the transparency and consistency of disclosures regarding asset-backed securities (ABS). For each securitization, issuers of ABS should be required to disclose loan-level data (by loan broker or originator), risk retention, and information regarding the nature and extent of broker, originator and sponsor compensation.
  - Regulators should reduce their use of credit ratings in regulations and supervisory practices, where possible. In addition to rules adopted in January 2009, the SEC should take further action to regulate credit rating agencies. Among other things, the SEC should adopt rules requiring credit rating agencies to: (i) maintain robust policies and procedures for managing and disclosing conflicts of interest; (ii) differentiate ratings assigned to structured credit products from those assigned to unstructured debt; and (iii) provide clear public disclosures regarding credit rating performance measures for structured credit products, the risks that credit ratings are designed to assess, and the methodologies used by the agencies for rating structured finance products.
- *Create Comprehensive Regulation of Over-the-Counter (OTC) Derivatives*. The Administration recommends that the markets for OTC derivatives, including credit default swaps (CDS), be brought under a comprehensive regulatory regime in order to prevent systemic financial risks, improve transparency, prevent market manipulation and fraud, and protect unsophisticated parties to whom OTC derivatives may be marketed.

- The Commodity Exchange Act and the federal securities laws would be amended to require that all "standardized" OTC derivatives be cleared through regulated central counterparties (CCPs), which would be required to impose robust margin requirements on counterparties, as well as other risk controls to ensure that customized OTC derivatives are not used solely as a means to avoiding use of a CCP.
- All OTC derivatives dealers, and all other firms whose activities create large exposures to counterparties, would be subject to a robust regime of prudential supervision and regulation, including capital requirements (more conservative than existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, and conservative margin requirements.
- The CFTC and/or SEC would be given authority to impose recordkeeping and reporting requirements on all OTC derivatives which could be satisfied by clearing standardized transactions through a CCP or reporting customized transactions to a regulated trade repository.
- To improve market efficiency and price transparency, the SEC and/or CFTC should require that standardized parts of the OTC derivatives markets be moved onto regulated exchanges and regulated transparent electronic trade execution systems, and that a system for the timely reporting of trades and prompt dissemination of prices and other trade information be developed.
- The Commodity Exchange Act and the federal securities laws would be amended to ensure that the CFTC and the SEC have clear authority to police and prevent fraud, market manipulation and other market abuses involving OTC derivatives.

- *Harmonize Futures and Securities Regulation*. The Administration recommends that the SEC and the CFTC make recommendations to Congress, by September 30, 2009, regarding changes to applicable laws and regulations that would harmonize regulation of futures and securities, at least in the case of instruments that have similar characteristics or are economically equivalent (e.g., an option on a security and a futures contract on the same underlying security).
- *Strengthen Oversight and Functioning of Systemically Important Payment, Clearing, and Settlement Systems and Related Activities*. The Administration's proposal recommends that the Federal Reserve be given authority to conduct oversight of systemically important payment, clearing and settlement systems, and activities, of financial firms. Under the proposal, the Federal Reserve, in consultation with the FSOC, would identify covered systems and set risk management standards for their operation. (A covered system would be any payment, clearing, or settlement system 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.)
- *Strengthen Settlement Capabilities and Liquidity Resources of Systemically Important Payment, Clearing, and Settlement Systems*. The Administration's proposal also recommends that the Federal Reserve have the authority to provide systemically important payment, clearing, and settlement systems access to Reserve Bank accounts, financial services, and the discount window.

III. Protect Consumers and Investors from Financial Abuse

- *Create a New Consumer Financial Protection Agency (CFPA)*. The Administration proposes the creation of a new Consumer Financial Protection Agency with responsibility for protecting consumers in the financial products and services markets (other than investment products and services already regulated by the SEC or Commodity Futures Trading Commission (CFTC)). The CFPA would have consolidated authority over the related functions of writing rules, supervising and examining institutions' compliance, and administratively enforcing violations.

- The CFPA would have broad jurisdiction to protect consumers in relation to consumer financial products and services such as credit, savings, and payment products. The CFPA would have supervisory and enforcement authority and jurisdiction over both insured depository institutions and other firms not previously subject to comprehensive federal supervision that offer financial products and services within the CFPA's jurisdiction.
- The CFPA would have sole authority to promulgate and interpret regulations under an array of existing consumer financial services and fair lending statutes, including the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Real Estate Settlement and Procedures Act (RESPA), the Community Reinvestment Act (CRA), the Equal Credit Opportunity Act (ECOA), the Home Mortgage Disclosure Act (HMDA), and the Fair Debt Collection Practices Act (FDCPA).
- The CFPA would be an independent federal agency headed by a Director and with a Board that represents a diverse set of viewpoints and experiences.
- The CFPA's rules would serve as a floor and not a ceiling. Thus, the states would be permitted to adopt and enforce stricter laws for institutions of all types, federally chartered as well as state chartered. In addition, the states would be given authority to enforce federal law concurrently, again with respect to institutions of all types without regard to their charter. As a result, the Administration's proposal would effect a major readjustment in terms of federal preemption of state law and state enforcement, at least with respect to the regulation of consumer financial products and services.
- The Federal Trade Commission (FTC) would retain authority for dealing with fraud in the financial marketplace, including the sale of services such as advance fee loans, credit repair, debt negotiation, and foreclosure rescue/loan modification. But the CFPA would also have authority over such services.

■ *Reform Consumer Protection Standards*. The Administration's proposal urges that consumer protection legislation, regulations, and administrative measures reflect principles of transparency, simplicity, fairness, accountability, and access for all.

- The CFPA would be authorized to require that all disclosures and other communications with consumers be reasonable – balanced in their presentation of benefits and clear and conspicuous in their identification of costs, penalties and risks. Such disclosures and other communications with consumers should also effectively harness technology to make disclosures more dynamic and relevant to the consumer.
- The CFPA would be empowered to define standards for "plain vanilla" products that are simpler and have straightforward pricing. For example, the CFPA would have responsibility for defining "plain vanilla" mortgages versus so-called "alternative" or "higher cost" loans that should require other types of disclosures and receive additional scrutiny. And the CFPA would have authority to require financial services providers to offer these "plain vanilla" products prominently, alongside whatever other products they choose to offer.
- The CFPA would also be authorized to place restrictions on product terms and provider practices, if the costs outweigh the benefits. In addition, the CFPA would have authority to impose appropriate duties of care on financial intermediaries. And the CFPA would have authority to regulate unfair, deceptive, or abusive acts or practices.
- Finally, the CFPA would be given authority to enforce fair lending laws and the CRA to ensure that underserved consumers and communities have access to prudent financial services, lending, and investment.

- *Strengthen the Framework for Investor Protection*. The Administration would improve the SEC's ability to protect investors and would have it focus on principles of transparency, fairness, and accountability.
    - The SEC would be given expanded authority to promote transparency in disclosures to investors, including authority to require that certain disclosures (including a summary prospectus) be provided to investors at or before the point of sale.
    - The SEC would be given new tools to promote fair treatment of investors, including by establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers.
    - Financial firms and public companies would be made more accountable to their clients and investors by authorizing the SEC to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards and by expanding the sanctions available in enforcement actions.
    - Public companies would be required to have non-binding "say on pay" shareholder votes on executive compensation plans.
    - A Financial Consumer Coordinating Council, consisting of the heads of the SEC, FTC, Department of Justice, and CFPA, would be established to identify gaps in consumer protection across financial products and to coordinate consumer protection efforts. The Council would have authority to request recommendations from state attorneys general, consumer advocates and others; to make recommendations to Congress with respect to improvements in consumer and investor protection; and to sponsor studies and consumer testing to identify gaps in consumer financial protection. The SEC's recently created Investor Advisory Committee would also be made permanent by law.

IV. Provide the Government with the Tools It Needs to Manage Financial Crises

- *Create a Resolution Regime for failing BHCs and Tier 1 FHCs*. The Administration proposes to create a resolution regime for failing BHCs, including Tier 1 FHCs, in order to avoid disorderly resolutions that would have serious adverse effects on the financial system or the economy. The Administration's proposed regime would supplement and be modeled on the FDIC's existing resolution regime for insured depository institutions.
    - Under this new resolution regime, Treasury would decide whether to resolve a failing firm, after consulting with the President and only upon the written recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the members of the FDIC's Board (or, instead of the FDIC, two-thirds of the commissioners of the SEC, if the largest subsidiary is a broker-dealer or securities firm). To invoke this resolution authority, Treasury would have to determine that (1) the firm is in default or in danger of defaulting, (2) the failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy, and (3) use by the government of the special resolution regime would avoid or mitigate these adverse effects.
    - The Treasury would also have authority to decide <u>how</u> to resolve a failing firm. The alternatives available would include appointing the FDIC (or SEC if the largest subsidiary is a broker-dealer or securities firm) as conservator or receiver for the firm, providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm. In selecting one of these alternatives, Treasury would be required to consider the effectiveness of an action in mitigating potential adverse effects on the financial system or the economy, the action's cost to the taxpayers, and the action's potential for increasing moral hazard.

- *Amend the Federal Reserve's Emergency Lending Authority*. The Federal Reserve Board's authority to lend under section 13(3) of the Federal Reserve Act – the Federal Reserve's authority to lend to any individual, partnership or corporation "under unusual and exigent circumstances" – would be made subject to prior written approval from the Secretary of Treasury. The Federal Reserve has utilized this authority to implement a number of programs during the recent financial crisis.

V. Raise International Regulatory Standards and Improve International Cooperation

- *Strengthen the International Capital Framework*. The Administration recommends that the Basel Committee on Banking Supervision (BCBS) continue to improve the Basel framework for consistent bank regulatory capital requirements. The Administration particularly urges the BCBS to complete an in-depth review of the Basel II framework to mitigate its procyclical effects.
- *Improve the Oversight of Global Financial Markets*. The Administration urges that national authorities continue to work to raise international standards for credit derivative and other OTC derivatives markets, further integrate market infrastructures, and avoid measures that may result in market fragmentation.
- *Enhance Supervision of Internationally Active Financial Firms*. The Administration recommends that the Financial Stability Board (FSB) and other authorities implement G-20 commitments to strengthen arrangements for international cooperation on supervision of global financial firms through establishment and continued operational development of supervisory colleges.
- *Reform Crisis Prevention and Management Authorities and Procedures*. The Administration recommends that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009.
- *Strengthen the Financial Stability Board*. The Administration recommends that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009.
- *Strengthen Prudential Regulations*. The Administration recommends that the BCBS and national authorities work to develop a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions, by 2010.
- *Expand the Scope of Regulation*. The Administration recommends that the Federal Reserve, in consultation with Treasury, develop rules to guide the identification of foreign financial firms as Tier 1 FHCs based on whether their U.S. operations pose a threat to financial stability. In this connection, the Administration proposes that the "well-capitalized" and "well-managed" tests for FHC status would apply to foreign financial institutions operating in the United States in a manner comparable to that of U.S.-owned financial institutions. The Administration also urges national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively.
- *Introduce Better Compensation Practices*. In accordance with G-20 commitments, the Administration urges national authorities to put in place guidelines to align compensation with long-term shareholder value and to promote compensation structures that do not provide incentives for excessive risk taking. The Administration also recommends that the BCBS integrate the FSB principles on compensation into its risk management guidance by the end of 2009.
- *Promote Stronger Standards in the Prudential Regulation, Money Laundering/Terrorist Financing, and Tax Information Exchange Area*. The Administration urges the FSB to establish and coordinate peer reviews to assess compliance and implementation of international regulatory standards, with particular attention to the international cooperation elements of prudential regulatory standards.

- *Improve Accounting Standards*. The Administration recommends that accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009. Accounting standards for loan loss provisioning should also be improved by making them more forward looking, so long as the transparency of financial statements is not compromised.
- *Tighten Oversight of Credit Ratings Agencies (CRAs)*. The Administration urges that national authorities enhance their regulatory regimes to oversee credit ratings agencies, consistent with international standards and the G-20 Leaders' recommendations.

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Attorneys in Covington's Corporate and Financial Institutions Groups have advised many clients on recent financial regulatory reform proposals. The Groups' expertise derives from advising clients on the impact of such proposals over the course of the past three decades. If you have any questions concerning the material discussed in this client alert, please contact the following members of our financial institutions practice group:

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