PROSKAUER ROSE LLP

Client Alert

Economic Crisis Response Group

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Obama Administration Outlines Comprehensive Proposal for Financial Regulation

On June 17, the Obama administration unveiled a comprehensive proposal for regulatory reform that would restructure financial regulatory authorities and expand their powers to prevent and manage future financial crises. The proposed plan is designed to meet five key objectives: (1) promoting robust supervision and regulation of financial firms; (2) establishing comprehensive supervision and regulation of financial markets; (3) protecting consumers and investors from financial abuse; (4) improving the tools for management of financial crises; and (5) raising international regulatory standards and improving international cooperation.

The proposal provides for the creation of a new regulatory regime, including, among other things:

- *Expansion of the Federal Reserve's authority to include consolidated supervision of financial firms that pose a systemic risk to financial markets*. The plan would grant the Federal Reserve Board the authority and accountability for consolidated supervision and regulation of any financial holding company ("FHC") whose combination of size, leverage and interconnectedness to other financial institutions could pose a threat to financial stability if it failed (a "Tier 1 FHC"). The Federal Reserve's consolidated supervision of a Tier 1 FHC would extend to both its U.S. and foreign parent and subsidiaries, regardless of whether such entities are currently subject to regulation by U.S. regulatory authorities. The plan would remove the constraints that the Gramm-Leach-Bliley Act imposes on the Federal Reserve's ability to require reports from, examine, or impose higher standards or restrictions on the functionally regulated or depository institution subsidiaries of Tier 1 FHCs. The plan would also grant the Federal Reserve the authority to set minimum capital requirements, conduct oversight of systemically important payment, clearing and settlement systems, and activities of financial firms, as well as the authority to provide systemically important payment, clearing and settlement systems access to Federal Reserve accounts, financial services and the discount window.

- *Creation of the Financial Services Oversight Council.* The plan would provide for the creation of a Financial Services Oversight Council (the "Council"), an eight-member body chaired by the Secretary of the Treasury that would also include the Chairman of the Board of Governors of the Federal Reserve System, the Director of the National Bank Supervisor, the Director of the Consumer Financial Protection Agency, the Chairman of the SEC, the Chairman of the CFTC, the Chairman of the FDIC and the Director of the Federal Housing Finance Agency. The Council would advise the Federal Reserve in identifying Tier 1 FHCs and would provide a forum for resolving jurisdictional disputes between regulatory authorities. The plan would also give the Council the authority to obtain information from any financial firm, as well as the responsibility to refer emerging risks to the appropriate regulators.

- *Creation of the Consumer Financial Protection Agency.* The plan would provide for the creation of the Consumer Financial Protection Agency ("CFPA") to protect consumers of credit, savings, payment and other consumer financial products and services, and to regulate the providers of such services. The CFPA would have supervisory authority to examine compliance by regulated institutions, which include insured depositories and a range of firms not previously subject to comprehensive federal supervision, as well as the power to administratively enforce violations and rule-making authority over the statutes it implements. The CFPA would be authorized to require that company disclosures and other communications be reasonable, clear and balanced in their presentation of costs, risks and benefits. It is envisioned that rules promulgated by the CFPA would set a minimum standard; states would have the option to adopt consumer protection rules stricter than the rules promulgated by the CFPA.

- *Creation of the National Bank Supervisor; Federal Thrift Charter Eliminated.* The plan would eliminate the federal thrift charter and the Office of Thrift Supervision ("OTS"), which supervises federally chartered thrifts and thrift holding companies, and create a National Bank Supervisor ("NBS"), a new federal agency to supervise and regulate all federally chartered depository institutions and all federal branches and agencies of banks. The NBS would inherit the prudential responsibilities of the Office of the Comptroller of the Currency, which currently charters and supervises nationally chartered banks and federal branches and agencies of foreign banks, as well as the responsibility for the institutions currently supervised by the OTS.

- *Creation of a Resolution Regime for Failing Bank Holding Companies.* The plan would create a resolution regime for failing bank holding companies ("BHCs"), including Tier 1 FHCs, for companies where a disorderly resolution would have serious adverse effects on the financial system or the economy. The proposed regime is modeled on the "systemic risk exception" contained within the existing resolution regime for FDIC-insured depository institutions and would supplement the FDIC regime. This new special resolution regime would grant the FDIC the authority to obtain examination reports prepared by the Federal Reserve with respect to any BHC, as well as back-up examination authority over BHCs.

- *Establishment of the Office of National Insurance.* The plan would establish the Office of National Insurance within the Treasury Department to gather information, develop expertise, negotiate international agreements and coordinate policy in the insurance sector.

The plan also proposes the following regulatory reforms:

- *Impose Stricter Capital and Liquidity Requirements on Bank Holding Companies.* The plan would require stricter prudential standards for Tier 1 FHCs, including capital, liquidity and risk management standards. The plan also calls for the formation of a Treasury Department working group to conduct a fundamental reassessment of existing regulatory capital requirements for banks and BHCs, including new Tier 1 FHCs, by December 31, 2009.
- *End the SEC's Supervised Investment Bank Holding Company program.* Investment banks seeking consolidated supervision would be subject to regulation by the Federal Reserve.
- *Require hedge funds and other private pools of capital to register with the SEC.* All advisors to hedge funds, private equity funds, venture capital funds and other private pools of capital with assets above a "modest threshold" would be required to register under the Investment Advisers Act of 1940, and advisers would be required to report information on the funds they manage sufficient to assess whether any fund poses a threat to financial stability.
- *Close existing loopholes in bank regulations.* The plan would close loopholes in the Bank Holding Company Act, which currently excludes thrift holding companies, industrial loan companies, credit card banks, trust companies and grandfathered "nonbank" banks from regulation.
- *Create comprehensive regulation of all over-the-counter derivatives, including credit-default swaps.* All derivatives markets would be subject to comprehensive regulation in order to prevent activities that would pose risk to the financial system, promote transparency and efficiency, prevent market manipulation and fraud and ensure that such derivatives are not marketed to unsophisticated parties. All over-the-counter derivatives would be subject to regulation by the SEC and CFTC and all such transactions would be required to clear through regulated central counterparties. The plan would also give the CFTC the authority to set position limits on over-the-counter derivatives that perform or affect a significant price discovery function with respect to regulated markets.
- *Modify the Federal Reserve's Emergency Lending Authority*. The plan would require the Federal Reserve to obtain the written approval of the Secretary of the Treasury prior to making any extensions of credit to individuals, partnerships or corporations in "unusual and exigent circumstances." The Federal Reserve Board may currently authorize such loans upon a vote of five or more members without the approval of the Secretary of Treasury.

- *Encourage regulators to issue new executive compensation standards*. The plan would require regulatory authorities (including bank regulatory authorities and the SEC) to issue standards to align executive compensation practices with long-term shareholder value and prevent practices that threaten the safety of supervised institutions. The administration also stated in its proposal that it would support legislation requiring public companies to submit non-binding resolutions to their shareholders with respect to all senior executive compensation packages, as well as new requirements to make compensation committees more independent.
- *Require loan originators to retain a material interest in securitized loans*. The plan would require regulators to issue rules requiring loan originators to retain at least five percent of the credit risk of securitized credit exposures.
- *Strengthen the integrity of the credit ratings process*. The plan would require credit rating agencies to maintain robust policies and procedures for managing and disclosing conflicts of interest and to provide public disclosure about precisely what risks their credit ratings are designed to assess (e.g., the likelihood of default and/or loss severity in the event of default), as well as the material risks not reflected in such ratings. Credit ratings agencies would also be required to distinguish credit ratings of structured credit products from credit ratings of unstructured debt and to disclose their methodologies for rating structured finance products. Credit rating agencies would disclose any unpublished rating agency data and methodologies to the SEC.

The plan also details requests for the following reviews, assessments and requests for recommendations from regulatory authorities:

- The Federal Reserve would propose recommendations by October 1, 2009 to better align its structure and governance with its new authorities and responsibilities.
- A review by the Financial Accounting Standards Board, the International Accounting Standards Board and the SEC to determine how financial firms should account for forward-looking loan loss provisions, incorporate a broader range of available credit information and review fair value accounting rules.
- A report from the President's Working Group on Financial Markets assessing necessary changes to reduce the money-market mutual fund industry's susceptibility to bank runs.
- Recommendations from the Treasury and the Department of Housing and Urban Development to maintain the stability of the government-sponsored enterprises such as Fannie Mae and Freddie Mac, and the Federal Home Loan Bank System.
- The plan rejects consolidation of the SEC and CFTC and instead requests recommendations from the SEC and CFTC to harmonize regulation of futures and securities markets.

In addition, the plan refers to the administration's efforts to influence international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision, focusing on reaching international consensus on regulatory capital standards, oversight of global financial markets, supervision of internationally active financial firms, and crisis prevention and management.

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets; issues concerning investments in financial services companies; and complex financial instruments and transactions, including structured finance products, as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

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