



FINANCIAL SERVICES ALERT

Squire, Sanders & Dempsey L.L.P.

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US Financial Services Regulation: Modernization, Re-Regulation and Reform **An Overview of the Obama Administration's Proposals Affecting the Financial Services Industry**

On June 17, 2009 President Obama's speech, and a concurrently released white paper, clarified his administration's plans to prevent future financial crises by modifying key aspects of US law regulating commercial banks, insurance companies, securities firms and other major players in the US financial services industry. That speech, which followed several months of hearings by various committees and subcommittees of the US Congress and wide-ranging consultation with most concerned constituencies, was preceded by statements by Secretary of the Treasury Timothy Geithner and Director of the National Economic Council and Assistant to the President for Economic Policy Lawrence Summers. The Republican Congressional delegation also released an outline of a plan of its own in June. This effort is not a part of the recent Federal Reserve emergency financing programs and economic stimulus measures directed at rescuing and stimulating the US economy, but an effort to modernize and reform the federal government's regulation of the US financial services industry. A plan this comprehensive was last seen in the review and legislation that resulted in the Federal Deposit Insurance Corporation (FDIC) and the separation of commercial banking from investment banking following the onset of the Great Depression of the 1930s.

President Obama first pointed out that, among the "cascade" of mistakes, failures and missed opportunities contributing to the current economic downturn, one of the most significant was a "lack of regulatory structures to prevent abuse and excess." Citing a combination of a "culture of irresponsibility...from Wall Street to Washington to Main Street," sophisticated 21st century product developments leaving 20th century financial regulation in the dust and executive compensation "unmoored from long performance or even reality," he announced "a sweeping overhaul of the financial regulatory system."

To assist Squire Sanders' clients and our friends with tracking and influencing this process, below we identify the topics and issues that we believe have the greatest likelihood of being included in the final legislation. Final legislation will in some instances provide for the creation of new government agencies and agency rulemaking, processes that would allow for agency, industry and public input to the final rules and add many months or years before significant changes in the regulations are adopted. The following pages provide an overview of The following pages provide an overview on issues of timing and substance as well as what we expect to see in any final legislation.

Timing

It is expected that within a matter of days one or more bills will be introduced in the House of Representatives Financial Services Committee, to be followed later in the summer by the introduction of legislation in the Senate. Chairman Barney Frank has stated that he would like to see a final House vote approving legislation by the fall of 2009 and that Chairman Christopher Dodd hopes to have Senate legislation debated in the fall and enacted by the end of the year. It is believed that such timing would be acceptable to the Obama Administration, but competing priorities for comprehensive health care reform, Supreme Court confirmation hearings and a major energy bill may delay financial services reform, particularly if the current economic environment continues to improve. In addition, on June 18, Secretary Geithner testified before House and Senate committees and was quizzed by legislators on many aspects of the Administration Plan.

The Substance of the Administration's Plan

Partisan politics, industry and public interest group lobbying, legislative maneuvering, economic events and conditions, international pressures and other factors will determine the final form and substance of any legislation adopted by the House and Senate and signed into law by the president.

The following summary of the Obama Administration Plan for financial regulatory reform is arranged in accordance with the topic headings that have been in customary use over the past year. Since the Plan divides itself into five policy-oriented parts, we have placed the Plan's features under the applicable customary headings and have noted heading topics not directly impacted by the Plan. In certain areas we have also referred to the Republican Congressional delegation's recently released reform plan as ideas expressed in that plan will be debated and, in some cases, incorporated into the final legislation. Chairman Frank has already indicated that he agrees with several of that plan's recommendations.

1. Regulatory Agency Consolidation or Reorganization

With the exception of elimination of the Office of Thrift Supervision (OTS), the Administration Plan does not call for the elimination or major consolidation or reorganization of the Federal Reserve, Office of the Comptroller of the Currency (OCC), FDIC, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), National Credit Union Administration (NCUA) or Federal Housing Finance Agency (FHFA). This is partly because these agencies and the congressional committees and subcommittees that have legislative jurisdiction over their activities are likely strong enough to defeat any sweeping effort to rationalize and simplify the "regulatory architecture," and partly because many thoughtful and cautious legislators believe than any such sweeping reforms should not be undertaken until the current crisis has safely ended. However, the demise of several of the OTS' largest regulated institutions, coupled with the perception of overly lenient supervision, including allegations that senior OTS officials "backdated" capital increases have resulted in the Administration's recommendation that the OTS' functions be transferred to the OCC.

The OCC would be renamed the National Bank Supervisor (NBS), would continue to supervise national banks and federal branches of non-US banks and would supervise federal thrifts as they are phased out.

In a somewhat surprising development, the Administration's plan would phase out the industrial loan company (ILC) charter. The ILC charter has allowed retailers such as Target, automobile manufacturers and other firms to own bank-like institutions to finance their customer sales. Recent ILC applications by firms such as Wal-Mart and Home Depot have met with resistance from Congress, the FDIC and others, and were withdrawn.

While the forced merger of the OTS into the OCC was expected, the Administration Plan's phasing out of the thrift charter also came as a surprise to some observers. However, the liberal interstate branching rules applicable to federal thrifts would be made applicable to national banks. Taken together, the ILC and the thrift charter have considerable congressional support, and these changes may be altered in the legislative process.

While not included in the Administration white paper or the president's speech, the creation of an optional or mandatory federal insurance charter to provide federal supervision over the largest insurance companies will be part of the debate and might emerge as part of final legislation. The Administration Plan does provide for the creation of an Office of National Insurance in the Treasury that would study the question of an optional national charter and negotiate internationally for the United States in insurance matters. Apart from these possible ILC, thrift and insurance outcomes, many observers anticipate that final legislation will focus on filling gaps in the jurisdiction of the existing agencies, reducing regulatory arbitrage and gaps, and strengthening rules in the areas of capital adequacy, liquidity and risk (executive compensation and financial product safety) management.

The Republican Plan would streamline current agency architecture by, among other things, shifting all bank supervision into an expanded OCC which would in a separate new division take on the OTS, FDIC and Federal Reserve roles as primary federal bank supervisor; this move would preserve state charters and dual banking systems as one OCC division would focus on national banks and the other division would focus on state-chartered banks. This expanded agency would also supervise all bank and financial holding companies and would enforce all federal consumer protection laws applicable to depository institutions. According to the plan these changes would allow the Federal Reserve and the FDIC to "re-focus" their respective efforts on monetary policy and deposit insurance, and would also eliminate regulatory arbitrage and promote simplicity and consistent enforcement.

2. Systemic Risk Supervision and Resolution of Nonbank Institutions

The Administration Plan would retain and strengthen the Federal Reserve as the consolidated supervisor of all large, leveraged, interconnected financial firms whose failure could threaten the stability of the financial system. These systemic risk firms would be classified as Tier 1 Financial Holding Companies (Tier 1 FHC) under criteria to be included in proposed legislation. All of such a firm's subsidiaries, regulated and unregulated, US and non-US, would be included in this supervision. Some "de-regulatory" limits placed on such supervision by the Gramm-Leach-Bliley Act would be repealed.

A newly created council of regulators to be known as the Financial Services Oversight Council (FSOC) would have broad responsibility for identifying emerging risks and co-coordinating supervisory authority across the financial system (this new function is termed "macroprudential supervision"). Chaired by the Secretary of the Treasury, FSOC members would be the heads of

the Federal Reserve and the federal bank and securities regulatory agencies. Among other powers, the FSOC would:

- Police regulatory arbitrage by resolving jurisdictional disputes between agencies.
- Be empowered to gather information from any financial firm doing business in the United States.
- Refer emerging risks to the agencies with authority to take action (the “cops on the beat”).

Capital, liquidity and risk management requirements would be increased for all institutions, with the most stringent requirements reserved for the Tier 1 FHCs.

A “resolution mechanism” would be created to allow for the orderly resolution of any financial holding company whose failure might, under “extraordinary circumstances,” threaten the stability of the financial system, so that the government would no longer be forced to make an untenable choice between bailouts and financial collapse. While no specific mention of the FDIC or other existing agency was made as to who would carry out these resolution functions, the Administration Plan did indicate in nuanced language that, “The [resolution] regime would supplement (rather than replace) and be modeled on to the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act”.

The Republican Plan categorically rejects “bailouts,” adopts the principle that no firm is “too big to fail” and advocates the creation of a new chapter of the Federal Bankruptcy Code to provide for the orderly failure of firms important to the US financial system. This plan also calls for the creation of a new Market Stability and Capital Adequacy Board to monitor the health of the financial system from a very macro-economic perspective. This board would not have independent enforcement or supervisory authority, but would rather monitor and advise the existing functional and other financial regulatory agencies (also the “cops on the beat”). The Republican Plan calls for fundamental reform of the Federal Reserve by, among other things, restricting its invocation of “unusual and exigent” powers under Section 13(3) of the Federal Reserve Act.

3. Capital Adequacy and Related Prudential Standards

As noted, the Administration Plan calls for increased capital, liquidity and risk management requirements for all financial institutions, with the most stringent requirements being applicable to the Tier 1 FHCs. Two Treasury working groups would have until the fall of 2009 to conduct a “fundamental reassessment” of the capital adequacy standards for Tier 1 FHCs and BHCs and of the overall supervision of banks and bank holding companies. The Obama Administration Plan indicates that this effort would “close loopholes in bank regulation.”

The Republican Plan would create a new Market Stability and Capital Adequacy Board chaired by the Secretary of the Treasury to, among other things, review and make recommendations with respect to the capital and other supervisory policies and requirements of the existing regulatory agencies.

4. Closing Regulatory Gaps Arising From Hedge, Private Equity, Venture Capital and Certain Other Large Funds, From Asset-Backed Securities and From Certain Derivatives

The Obama Administration Plan responds to recent growth in financial activity outside of the traditional banking system by:

- Requiring all advisers to hedge, private equity and venture capital funds whose assets exceed "some modest threshold" to register with the SEC under the Investment Advisers Act and to report such information on the funds they advise as to allow the Federal Reserve and the FSOC to determine if any such funds poses systemic risks.
- Imposing increased reporting requirements on the issuers of asset-backed securities.
- Reducing financial institution and investor reliance on credit agency ratings and thereby increasing internal due diligence.
- Requiring the sponsors or brokers of securitization transactions to retain a nonhedgeable financial interest in the performance of the asset ("permanent skin in the game").
- Harmonizing the regulation of futures and securities while preserving the SEC and CFTC as separate agencies.
- Providing oversight of OTC derivatives markets including credit default swap (CDS) markets to decrease systemic risk, prevent fraud, manipulation and other abuse, and increase investor protections.
- Providing new safeguards for payment, clearance and settlement systems, including access to key Federal Reserve services and support.

The Republican Plan does not focus on the regulation of nontraditional products, but its proposed Market Stability and Capital Adequacy Board would be charged with monitoring the interactions of various sectors of the financial system identifying risks that would endanger the financial system, and pointing out gaps in the current regulatory structure to the existing regulatory agencies. The Republican Plan also addresses credit rating agency reform.

5. Executive Compensation

The Administration Plan calls for the federal financial regulatory agencies to issue standards and guidelines to better align executive compensation with long-term shareholder value and safety and soundness. Congress is encouraged to enact securities legislation favoring shareholder "PaySay" rights and more independence for board compensation committees.

6. Consumer and Investor Financial Protection

The Administration Plan calls for stronger consumer and investor protections across the financial system.

With respect to consumer financial products, the Plan calls for legislation to create a new, dedicated Consumer Financial Protection Agency (CFPA) covering credit, savings, payment and other consumer financial products and services. The CFPA would:

- Have the power to write and enforce regulations against bank and nonbank lenders alike.
- Have visitation authority to examine banks onsite.

- Build on the recent credit card legislation and predatory lending legislation and regulations.
- Enforce the Community Reinvestment Act (CRA), a controversial feature as some observers have suggested that the subprime mortgage problem was caused in large part by the CRA's incentives and requirements to extend credit to less than well-qualified applicants.
- Be an independent agency with stable funding, possibly based upon assessments.
- Have sole national rulemaking authority for federal, but not state, statutes.
- Level the playing field by making many fringe, rogue or other effectively unregulated lenders subject to the same rules as major banks and consumer finance companies. This is a political plus for the Obama Administration as this feature garners the support of large establishment lenders.
- Be assisted by an outside advisory council (another political plus).
- Enforce statutes and regulations that are a floor, not a pre-emptive ceiling, allowing states to enact, and state attorneys general to enforce, more stringent state rules if desired (another political plus).
- Authorize enforcement of its federal rules by state attorneys general.
- Dictate and/or approve Truth-in-Lending and similar disclosures.
- Require that financial service providers offer consumers "plain vanilla" mortgage, credit card and other products before offering more complex products.
- Limit or restrict consumer financial services product terms and conditions and provider practices, subject to a cost-benefit analysis.
- Be authorized to prescribe suitability, fiduciary and similar duties on financial service providers.

With regard to investor protection, the Administration Plan would give the SEC expanded authority to:

- Establish a fiduciary duty on broker-dealers that provide investment advice.
- Harmonize the regulation of broker-dealers and investment advisers.
- Expand whistle blower protections within financial firms and public companies.
- Require nonbinding "PaySay" votes by shareholders of financial firms and public companies.

Other proposals are to create a Financial Services Oversight Council and to strengthen retirement security by improving employer-based and private retirement plans and by encouraging individual retirement savings.

The Republican Plan focuses on improved disclosures, financial literacy training and complaint resolution, suggesting the installation of a toll-free telephone number and website to receive complaints as part of the existing federal Financial Literacy Commission.

7. Loan Securitization

The Administration Plan would:

- Instruct the federal banking agencies to issue regulations requiring originators and sponsors of securitized credit to (1) maintain a nonhedgeable interest in the securitized credit ("permanent skin in the game") and (2) align compensation of transaction participants with the longer term performance of the underlying loans.
- Give the SEC authority to require enhanced initial disclosure and continued periodic reporting by issuers of asset-backed securities.
- Give the SEC increased regulatory authority over credit rating agencies including compensation, conflicts of interest and clarity in differentiating complex structures from traditional risks at the initial and continuing rating stages.

8. Government-Sponsored Residential Mortgage Entities (Fanny Mae, Freddie Mac and the Federal Home Loan Banks)

The Administration Plan:

- Recognizes that during the current crisis the strength and stability of the government-sponsored entities must be maintained.
- Tasks Treasury and the Department of Housing and Urban Development (HUD) to develop recommendations for the future of the entities for inclusion in the President's 2011 budget message.

The Republican Plan's government-sponsored entity reform provisions express alarm at the size of their mortgage and mortgage-backed securities portfolios and would phase out government subsidies of Fannie and Freddie, sunset their current FHFA conservatorship into a receivership, require the payment of taxes and SEC registration for either that emerges from receivership and provide for their eventual shrinkage and privatization.

9. International Regulatory Cooperation

The Administration Plan indicates that the United States should seek to raise global standards of financial regulation along with its own, stating that the United States would lead the effort to improve financial regulation and supervision around the world. The Administration Plan:

- Recommends that the Basel Committee on Banking Supervision (BCBS) improve Basel II risk weights of securitized products, add a leverage ratio and refine the definition of capital.
- Urges national authorities to standardize and improve oversight of credit, OTC and other derivative products a la the recent Group of 20 commitment.
- Endorses EU practices with respect to "supervisory colleges" in the supervision of global financial firms (an apparent change in US policy).
- Recommends that the BCBS expedite its work on cross-border crisis management and resolution of global financial firms.

- Recommends that the Financial Stability Board complete its restructuring and institutionalize its global stability mandate by the fall of 2009.
- Recommends that the BCBS improve global liquidity management standards and work with the Bank for International Settlements and other standard setters to develop macroprudential tools.
- Urges national authorities to implement the Group of 20's (1) hedge fund registration and disclosure recommendations, and (2) executive compensation guidelines.
- Urges national and international bodies to enhance anti-money laundering and anti-terrorist funding rules and enforcement.
- Recommends that international accounting standard setters work to agree upon a single set of international accounting standards by the end of 2009, including improved rules with respect to fair value and loss provisioning.
- Urges national authorities to enhance the oversight of credit rating agencies.

10. Accounting Issues

The Administration Plan calls for the accounting standards setters including FASB, the SEC and the International Accounting Standards Board (IASB) to consider more forward-looking (that is, less pro-cyclical and more counter-cyclical) loan loss provisioning rules and fair value/mark-to-market/OTTI accounting rules.

11. More Balanced Tax Issues

None are directly addressed.

12. Short Selling of Financial Institution Shares

Not directly addressed.

13. Insurance Regulation

As noted the Administration Plan does not include a federal insurance company option but does create an Office of National Insurance in Treasury to gather information, develop expertise, negotiate international agreements and coordinate policy in the insurance sector.

14. Banking and Commerce: Gramm-Leach-Bliley Act, Underwriting by Banking Organizations, Glass-Steagall and Bank Holding Company Rule Reform

The Administration Plan would:

- Reaffirm the traditional policy of separating banking from Commerce.
- Strengthen firewalls between banks and nonbank affiliates.
- Close BHC Act loopholes for thrift holding companies, ILCs, credit card banks, trust companies and grandfathered "nonbank banks."
- Reconsider recent weakening of Glass-Steagall principles in the Gramm-Leach-Bliley Act and Federal Reserve interpretations of BHC Act rules (i.e., Section 20 affiliates).

- Eliminate the SEC's Consolidated Supervised Entity Program and its Supervised Investment Bank Holding Company Program which are believed by some to have contributed to the failure of Lehman Brothers and Bear Stearns.

15. Money Market Mutual Funds (MMFs)

To address recent runs and “breakings of the buck” of several MMFs the Administration Plan calls for strengthening the regulatory framework to reduce credit and liquidity risk profiles of specific MMFs. The president’s Working Group on Financial Markets will also assess whether more fundamental changes are necessary.

16. Credit Rating Agencies

As noted above, the Administration Plan would reduce investors’ and regulators’ reliance on credit-rating agencies.

The Republican Plan would “reform” credit-rating agencies by discouraging blind reliance on their ratings, water down the importance of the Nationally Recognized Statistical Rating Organizations (NRSRO) seal of approval, and require existing regulatory agencies to more thoroughly examine bank internal due diligence and corporate governance as they relate to the accurate evaluation of credit risk.

17. Regulation: Rule Based or Principle Based? Role of Cost Benefit Analysis?

These issues are not directly addressed.

18. The Payment, Clearance and Settlement Systems

The Administration Plan:

- Recommends that Congress grant the Federal Reserve responsibility and authority to oversee systemically important systems, whether the systems are free-standing organizations or payment clearance and settlement parts of larger financial firms.
- Recommends that the Federal Reserve allow such systems access to Federal Reserve accounts, support and services.

19. Too Big to Fail, National Total Deposit Caps, and Higher Capital and/or Liquidity Levels for Huge Institutions

As noted above, the Administration Plan calls for higher liquidity and risk management capital levels for systemically significant firms.

The Republican Plan rejects the concept of too big to fail and related government bailouts.

20. Deposit Insurance Issues

None are directly addressed.

21. Federal Pre-Emption

Addressed in connection with the proposed new Consumer Financial Protection Agency.

22. Residential Mortgage Modification – Bankruptcy Cram Down, Servicer Safe Harbor

None are directly addressed.

23. Off-Shore Financial Centers

None are directly addressed.

Squire Sanders Financial Crisis Response Team

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