The Department of the Treasury Announces A New Foundation for Financial Regulatory Reform

On June 17, 2009, President Obama and Treasury Secretary Geithner unveiled the Department of the Treasury's proposed set of sweeping financial regulatory reforms.[1] Billed as a "new foundation" for the U.S. and world economies to build upon going forward, the reforms have five stated objectives:

- promote robust supervision and regulation of financial firms;
- establish comprehensive regulation of the financial markets;
- protect consumers and investors from financial abuse;
- provide the government with the tools it needs to manage financial crises;
- and raise international regulatory standards and improve international cooperation.

The reforms come in response to what Treasury describes as "the most severe financial crisis since the Great Depression." Below is a brief summary of certain significant elements of the proposal.

I. Increased Regulation of Financial Firms

Tier 1 FHCs

In order to mitigate the risk presented by highly leveraged and interconnected financial institutions, Treasury has proposed the creation of a new regulatory classification for financial firms whose failure could pose a threat to financial stability due to their combination of size, leverage and interconnectedness: Tier 1 FHC. A new oversight body to be formed, the Financial Services Oversight Council, will advise the Federal Reserve in identifying such institutions and will have "the authority to gather information from any financial firm."

Under criteria that will be detailed in forthcoming legislation from the Treasury, the Federal Reserve will be tasked with identifying firms that classify as Tier 1 FHC and will be subject to supervision and regulation by the Federal Reserve. Such regulation will include stricter and more conservative capital, liquidity and risk management standards. Consolidated supervision of a Tier 1 FHC is proposed to extend to the parent company and to all of its subsidiaries -- regulated and unregulated, U.S. and foreign. Investment banking firms that seek consolidated supervision by a federal regulator will come under the supervision and regulation of the Federal Reserve, as Treasury has also proposed eliminating the SEC's Supervised Investment Bank Holding Company program. By October 1, 2009, the Federal Reserve, in consultation with Treasury, will propose recommendations to better align its structure and governance with these new authorities and responsibilities.

Other Banks and Companies Controlling Insured Depository Institutions

Tier 1 FHCs are not the only financial firms that may become subject to heightened standards of review. Treasury is also leading working groups that will conduct fundamental reassessments of the supervision of, and existing regulatory capital requirements for, all banks and bank holding companies, with reports to be issued on these topics on October 1, 2009 and December 31, 2009, respectively. A new federal government agency, the

---

[1] *Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation*, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

National Bank Supervisor, is to be created with the authority to conduct prudential supervision and regulation of all federally chartered depository institutions and all federal branches and agencies of foreign banks. Further, the proposal broadly takes the position that all companies that control an insured depository institution should be subject to "robust consolidated supervision and regulation at the federal level by the Federal Reserve and should be subject to the nonbanking activity restrictions of the BHC [Bank Holding Company] Act." It is proposed that the policy of separating banking activity from commerce should be "re-affirmed and strengthened." In addition to banks, this aspect of the proposal would cover thrift holding companies, industrial loan companies, credit card banks, trust companies and "nonbank" banks.[2]

Private Investment Vehicles

Treasury has also targeted hedge funds and other private investment vehicles, such as private equity funds and venture capital funds, for increased scrutiny. If the assets under management by such private pools of capital exceed a modest threshold (not stipulated in the proposal), they would be required to register with the SEC under the Investment Advisers Act and to report information on the funds they manage sufficient to assess whether any fund poses a threat to financial stability.

Money Market Funds

Strengthening the regulatory framework applicable to money market funds is a further objective of the proposal. This focus is stated to have been prompted by the incident in the Fall of 2008 when the Primary Reserve Fund, a money market fund that had invested in Lehman Brothers debt, "broke the buck" when the value of that debt was written down upon the filing of the Lehman bankruptcy.[3]

The Insurance Industry

Legislation will be proposed to establish an Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve the system of insurance regulation in accordance with the following six principles:

- effective systemic risk regulation with respect to insurance;
- strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies;
- meaningful and consistent consumer protection for insurance products and practices;
- increased national uniformity through either a federal charter or effective action by the states;
- improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business; and
- international coordination.

---

[2] The term "nonbank" banks refers to certain companies that were grandfathered from being treated as banks under the BHC Act, as the term "banks" was amended in 1987. It is stated in the proposal that there is no economic justification for allowing these companies to continue to escape regulation under the BHC Act.

[3] On June 24, 2009, the SEC voted unanimously to propose rule amendments designed to significantly strengthen the regulatory framework for money market funds to increase their resilience to economic stresses and reduce the risks of runs on the funds.

Future Role of Government Sponsored Entities ("GSEs")

Treasury and the Department of Housing and Urban Development ("HUD"), in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. The proposal states that the continued stability and strength of the GSEs must be maintained during these difficult financial times. Treasury and HUD intend to report their views on options pertaining to the GSEs to Congress and the American public at the time of the President's 2011 Budget release.

II. Increased Regulation of Securitization Markets

In order to address the perceived abuses in the credit markets, which many view as the root of the current financial crises, Treasury also proposes measures to enhance the regulation of the securitization markets. Under the Treasury's proposal, Federal banking agencies would promulgate regulations that would require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures. In addition, regulators would issue additional regulations that would operate so as to align compensation for market participants with the long-term performance of underlying loans. The proposal urges the SEC to continue efforts to increase the transparency and standardization of reporting by issuers of asset backed securities ("ABS").

In addition to these regulatory initiatives, Treasury is also seeking to take steps to limit the involvement of the credit rating agencies in the debt markets. It is proposed that regulators reduce their use of credit ratings in regulations and supervisory practices wherever possible, while the SEC would simultaneously ramp up its regulation of the credit rating agencies.

The Treasury proposals also are directed at regulation of the over-the-counter derivatives markets, including the credit default swap markets. While specifics are not provided, Treasury regulations would aim to prevent activities in those markets from posing risk to the financial system and to prevent market manipulation, fraud and other market abuses. The proposal also asserts that the Federal Reserve should be assigned an oversight role with respect to the payment, clearing and settlement systems used in the OTC derivatives markets. Furthermore, the regulations would seek to promote efficiency and transparency in those markets, while also ensuring that over-the-counter derivatives are not marketed inappropriately to unsophisticated parties. Another key objective of this aspect of the proposals is a directive to the SEC and CFTC to make recommendations to Congress for changes in regulations that would harmonize regulation of futures and securities.

III. Consumer and Investor Protections

Having outlined proposals to enhance the oversight of a variety of financial institutions, Treasury also seeks to protect the perceived victims of "financial abuse"—the consumers — with respect to products like credit cards and mortgages. To do so, the Treasury proposes the creation of a single primary federal consumer protection supervisor, the Consumer Financial Protection Agency ("CFPA"), whose job it would be to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services. This new government agency would have sole federal rule-making authority for consumer financial protection statutes and would work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.[4] At the same time however, the agency's rules would be intended

[4] Among the statutes specifically mentioned are: the Truth in Lending Act, Home Ownership and Equity Protection Act, Real Estate Settlement and Procedures Act, Community Reinvestment Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act and Fair Debt Collection Practices Act.

to serve as a floor and not a ceiling, meaning that the states would have the ability to adopt and enforce stricter laws for institutions of all types.

Other consumer-oriented initiatives in the proposal set forth a broad range of remedial measures including authorizing the CFPA to restrict or ban mandatory arbitration clauses, increasing the clarity and simplicity of disclosures made to consumers concerning financial products, authorizing the CFPA to proposed standardized contract terms with a view to promoting fairness and preventing consumer abuse, increasing the accessibility of financial products for those whose access has been limited in the past, increasing investor protections achieved through SEC-required plain English disclosure rules, and promoting fair treatment of investors through the use of new regulatory tools (including establishing a fiduciary duty for broker-dealers offering investment advice to their clients, akin to the duty presently owed by investment advisers).

The proposal states the principle that financial firms and public companies should be accountable to their clients and investors and urges expanded protections for whistleblowers, expanded sanctions available in enforcement actions, a harmonized liability standard under the federal securities laws[5] and a requirement that there be non-binding shareholder votes on executive compensation packages.

In light of the intersection among the consumer protection initiatives proposed and other regulatory schemes presently in place, the proposal contemplates the establishment of the Financial Services Oversight Council. This body would be comprised of the heads of the SEC, Federal Trade Commission, the Department of Justice and the Consumer Protection Agency, or their designees. The Council would meet quarterly to "identify gaps" in consumer protection across financial products. Among other things, the Council would be empowered to establish mechanisms for state attorneys general, consumer advocates, and others to make recommendations to the Council on issues to be considered or gaps to be filled.

A fifth proposal under the heading of consumer protection is to promote retirement security for all Americans by strengthening employment-based and private retirement plans and encouraging adequate savings. In order to address this issue, the President has proposed two initiatives in his 2010 Budget: (1) introducing an automatic IRA (with opt-out) for employees whose employers do not offer a plan; and (2) increasing tax incentives for retirement savings for families that earn less than $65,000 by modifying the saver's credit and making it refundable. It is hoped that together these initiatives will expand plan coverage, combat inertia, and increase incentives to save.

IV. Tools to Manage Financial Crises

It is proposed that there be a new authority, modeled on the existing authority of the FDIC, that should allow the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the financial system is at risk. It is recommended that a resolution regime be created to avoid the disorderly resolution of failing bank holding companies, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace); and be modeled on; the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act.

5 The aim of the proposal is to amend the federal securities laws to provide a single explicit standard for primary liability to replace various circuits' formulations of different "tests" for primary liability.

In order to improve accountability in the use of other crisis tools, it is also proposed that the Federal Reserve Board receive prior written approval from the Secretary of the Treasury for emergency lending under its unusual and exigent circumstances authority.

V. Raise International Regulatory Standards and Improve International Cooperation

The proposal attempts to address the tendency of financial crises to spread across national boundaries. It therefore states there will be a focus on reaching international consensus on four core issues: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management. A number of the specific proposals in this section of the Report parallel those made with respect to domestic regulations and include calls for expanded regulation of foreign financial firms that are Tier 1 FHCs, expanded regulation of hedge funds,[6] introduction of better compensation practices, stronger regulation of money laundering/terrorist financing and tax information exchange. The proposal also urges improved consistency of accounting standards (including treatment of impairment of financial instruments and loan loss provisions) and enhanced regulation with respect to oversight of credit rating agencies. In addition, the proposal calls for the strengthening of the Financial Stability Board (FSB)[7] through the institutionalization of the FSB's mandate to promote financial stability. The proposal recommends that the FSB, along with national 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. The proposal also recommends that the FSB expedite its work to improve cross-border financial crisis prevention and management such that it will be completed by year end 2009.

As with each of Treasury's proposals, it remains to be seen how Treasury's stated goals will transition into working legislation. Until then, it is too early to speculate on which provisions in this "new foundation" for financial regulatory reform will evolve into a workable and effective financial regulatory structure.

*   *   *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; or Ted B. Lacey at 212.701.3669 or tlacey@cahill.com.

---

6 In April 2009, the European Union ("EU") issued a proposal for establishing regulatory and supervisory standards for hedge funds, private equity and other systemically important market players, available at http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf. On June 22, 2009, the International Organisation of Securities Commissions (IOSCO), an organization representing regulators from over 100 countries, including the United States, Japan and the 27-nation EU, announced its backing for compulsory registration of hedge fund managers.

7 The FSB is the successor to the Financial Stability Forum ("FSF") and was formed at the 2009 London G-20 summit. It includes all G-20 countries, FSF members, Spain, and the European Commission. The FSB has been tasked with collaborating with the International Monetary Fund to provide early warning of macroeconomic and financial risks and the actions needed to address them, reshaping regulatory systems so that authorities are able to identify and take account of macro-prudential risks, and extending regulation and oversight to all systemically important financial institutions, instruments and markets. http://www.g20.org/Documents/g20_communique_020409.pdf