

OBAMA ADMINISTRATION'S PLAN FOR FINANCIAL REGULATION REFORM

On June 17, 2009, the Obama Administration unveiled its comprehensive plan to overhaul the U.S. financial regulatory system. Through enactment and implementation of this extensive set of legislative and regulatory proposals, the Administration seeks to revamp existing rules governing financial institutions; regulate financial businesses that heretofore have not been closely regulated — or regulated at all — by the federal government; create a new federal agency to regulate consumer financial products; and establish a mechanism for identifying and monitoring major businesses the financial health of which has implications for the U.S. economy as a whole. Click here http://www.financialstability.gov/docs/regs/FinalReport_web.pdf to access the full text of the Obama Administration plan.

This memorandum briefly summarizes the key elements of the plan, organized according to the financial industry sectors principally affected by those elements; discusses the congressional schedule for consideration of the plan; and addresses the political environment in which Congress and the affected constituencies are debating the plan. From time to time, we will issue more detailed analyses regarding specific aspects of the plan.¹

PROPOSALS AFFECTING KEY FINANCIAL SECTORS*“Systemically Significant” Financial Institutions*

Under the Administration's plan, the Federal Reserve Board (the “Fed”) would consolidate supervisory authority over “financial firms” the failure of any of which could pose a threat to U.S. financial stability. Such funds potentially include a wide variety of businesses involved in finance, including hedge funds, private equity and venture capital firms, and insurance companies. The Fed would identify and designate such “Tier 1 Financial Holding Companies” (“Tier 1 FHCs”) based on criteria to be established by Congress. Those criteria would take into account the Tier 1 FHC's “size, leverage, and interconnectedness” to the financial system. The Fed's authority would extend to an FHC's parent company and all its subsidiaries, irrespective of whether any one of them is unregulated, is regulated by another federal agency, or is a domestic or foreign concern.

¹ Our client memorandum entitled “PRESIDENT OBAMA ANNOUNCES PROPOSED NEW OVERSIGHT REQUIREMENTS FOR PRIVATE FUND MANAGERS” was issued on June 18, 2009; our client memorandum entitled “PRESIDENT OBAMA'S PLAN FOR HARMONIZATION OF BROKER-DEALER AND INVESTMENT ADVISER REGULATION AND INCREASED FEDERAL RESERVE AUTHORITY OVER CLEARING AND SETTLEMENT SYSTEMS” was issued on June 19, 2009; our client memorandum entitled “PRESIDENT OBAMA'S PROPOSALS FOR REGULATION OF THE OTC DERIVATIVES MARKET” was issued on June 25, 2009.

Tier 1 FHCs would have to comply with strict capital, liquidity, and risk management standards as well as limits on nonfinancial activities similar to restrictions now imposed on bank holding companies. Each Tier 1 FHC would be required to develop and maintain a realistic plan for its own resolution, which the Treasury Department would be authorized to implement in the event that the firm's financial condition endangered the financial system or the economy. The decision to resolve a failing firm would be made by the Treasury Department in consultation with the President and with the participation of other federal financial regulators.

A new Financial Services Oversight Council, chaired by the Secretary of the Treasury and composed of representatives from the principal federal financial regulatory agencies, would complement the Fed's role by, among other things, monitoring financial market developments, identifying emerging risks in firms and market activities, and managing interagency policy coordination. The Council would have no direct regulatory authority over financial firms.

OTC Derivatives

The Administration's plan would require comprehensive regulation of the markets for over-the-counter ("OTC") derivatives, including credit default swaps. Proposals address: centralized execution and clearance of standardized OTC derivative trades; transparency of trades and positions; regulation of OTC derivative dealers and other major market participants; recordkeeping and reporting requirements; and new enforcement mechanisms against fraud, market manipulation, and other market abuses. So-called "customized" or "bespoke" derivative contracts would still be permitted, but the parties to such a contract would be subject to capital requirements. In addition, the plan would attempt to prevent inappropriate marketing of OTC derivatives to unsophisticated investors as well as market activities that pose risks to the financial system. The Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") would be the primary regulators, but the Fed would also have authority over systemically important payment, clearing, and settlement systems. The plan would require the CFTC and the SEC to report and make recommendations to Congress with respect to harmonizing their respective regulations. For a more detailed discussion of the Administration's proposals regarding OTC derivatives, please see http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3017/President_Obama_Proposals_For_Regulation.pdf.

Advisers to Hedge Funds and Other Private Pools of Capital

Advisers to hedge funds, private equity funds, and venture capital funds with assets under management above a "modest" amount would be required to register with the SEC pursuant to the Investment Advisers Act of 1940. Registered advisers would also be required to file confidential reports with the SEC (which could share them with the Fed) about the private funds they manage and would disclose on these reports the funds' assets under management, borrowings, off-balance sheet exposures, and other information as may be necessary to enable regulators to determine whether any of the funds poses a systemic threat. The Fed would have authority to designate and regulate an investment fund as a Tier 1 FHC. The following link provides a detailed discussion of the Administration's proposal for advisers to private funds: http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2999/President_Obama_Announces_Proposed_New_Oversight_Requirements.pdf.

Broker-Dealer and Investment Adviser Regulatory Harmonization

The Obama Administration's review of the existing regulatory regime concluded that there is no meaningful distinction in the retail setting between investment advisers and broker-dealers that give incidental investment advice about securities to their customers. Accordingly, the plan would establish a fiduciary duty for such broker-dealers. In addition, the Administration would seek new legislation to require "simple and clear" disclosures to investors regarding their relationships with investment professionals and to proscribe certain sales practices and other conduct that conflicts with investor interests. The plan would also authorize the SEC to ban mandatory arbitration clauses in contracts between broker-dealers and advisers and their retail customers, subject to the SEC's conducting a study of the effectiveness of such clauses in redressing investors' legitimate grievances.² The Administration did not explicitly recommend a self-regulatory organization for investment advisers, as many had anticipated. The following link provides additional analysis of this proposal: [http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3007/President Obama Plan for Harmonization.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3007/President%20Obama%20Plan%20for%20Harmonization.pdf).

Rating Agencies

The Obama plan does not seek a new regulatory scheme for credit-rating agencies. Rather, it encourages the SEC to continue its ongoing efforts to improve the regulation of credit-rating agencies and to enhance the integrity of the rating process. The Administration urges the SEC to adopt rules that require rating agencies to differentiate between credit ratings assigned to structured credit and those assigned to unstructured debt, and to adopt policies and procedures to manage and disclose conflicts of interest. In the interest of increased transparency, the Administration also urges the SEC to require rating agencies to make certain public disclosures, including with respect to their credit-rating performance measures for structured credit; the kind of risk their credit ratings assess as well as any material risks not reflected in ratings; an explanation of the differences between the risks posed by structured debt products and the risks associated with unstructured corporate debt; and information regarding their methodologies for rating structured finance products sufficient to allow the market participants to make an independent determination regarding the effectiveness of the methodologies employed.

Securitization

The plan primarily endorses a regulatory, rather than legislative, approach to strengthening the supervision and regulation of securitization markets. The Administration directs federal bank regulators to issue new rules directing originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures and encourages the SEC to

² Prohibition of mandatory arbitration clauses would appear to be inconsistent with the public policy embodied in the Federal Arbitration Act, which declared "a national policy favoring arbitration." See *Mastrubono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995) (citing *Southland Corp. v. Keating*, 465 U.S. 1 (1984)).

adopt measures that will increase transparency and standardization in securitization markets. The plan also seeks new authority for the SEC to require “robust reporting” by issuers of asset-backed securities.

Banks and Thrifts

The Administration proposes the creation of a new National Bank Supervisor to replace the Office of the Comptroller of the Currency and the Office of Thrift Supervision as federal bank regulators and assume their authorities. The federal charter for thrifts would be abolished, but the existing ability of thrifts to branch across state lines would be extended to national and state banks. In addition, companies that control an insured depository institution or certain other types of financial businesses and are not subject to the Bank Holding Company Act would fall under consolidated supervision by the Fed and be subject to the nonbanking activity restrictions of the Bank Holding Company Act. The legal separation between banking and commercial activities would be retained, reaffirmed, and strengthened. This would be achieved by, among other things, requiring that industrial loan companies (“ILCs”) become bank holding companies, a step that could reduce or eliminate their economic benefit to the commercial firms that have ILC charters.

Money Market Mutual Funds

The plan would not seek any new legislation to respond to the significant redemptions experienced by some money market mutual funds (“MMFs”) last year. Instead it calls on the SEC to consider new MMF “liquidity buffers,” reductions in the maximum weighted average maturity of MMF assets, restrictions on MMF credit concentration limits, enhanced MMF “credit risk analysis and management,” and authorization of MMF directors to “suspend redemptions in extraordinary circumstances.” The plan also recommends that the existing President’s Working Group on Financial Markets examine alternative approaches to the systemic risks posed by MMFs, in particular whether MMFs should be permitted to “move away from stable net asset value” or be required to establish emergency access to private sources for liquidity that could be used to make redemptions without disadvantaging “remaining MMF shareholders.” The Working Group’s report would be due by September 15, 2009. The Administration recognizes that such actions may reduce investor interest in regulated MMFs, and requests that the SEC and the President’s Working Group “carefully consider” the risk of “investor flight,” but offers no suggestions as to how to mitigate it.

International

The Obama Administration has stated that it intends to continue its incipient efforts to coordinate international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision. It will focus on implementing or improving multilateral cooperation with respect to internationally consistent bank regulatory capital requirements; improving oversight of global financial markets, including standardization and improved oversight of credit derivative and other OTC derivative markets; and establishing international cooperation regarding supervision of global financial firms.

Consumer Financial Protection Agency

The Administration plan seeks legislation to create a new Consumer Financial Protection Agency (the “CFPA”) that would have supervisory, examination, and enforcement authority over consumer-related financial services offered by financial entities. These services include mortgages and other credit or payment products. The CFPA would absorb and consolidate the powers now held by the federal regulators of depository institutions with respect to financial consumer protection laws, such as enforcement of the Truth in Lending Act, but it would not have jurisdiction over investment products and services already regulated by the SEC or the CFTC. The plan also would require the CFPA to study the effectiveness of mandatory arbitration clauses in contracts for consumer financial services and products and to have authority to establish conditions for the use of such clauses or ban them.

What Is Not in the Plan

The Administration’s proposals do not include one for the creation of an optional federal charter for insurance companies but, rather, for the creation within the Treasury Department of an Office of National Insurance that would be responsible for monitoring all aspects of the insurance industry, including gathering information and identifying potential problems or regulatory gaps that could trigger a potential crisis. Neither do the proposals substantively address the problems resulting from the failures of Fannie Mae and Freddie Mac, the housing-related government sponsored enterprises. Instead, the Treasury Department and the Department of Housing and Urban Development are directed to develop recommendations on the future of these entities.

PROSPECTS AND TIMING

The Administration has proposed an ambitious and far-reaching plan for financial reform that falls within the jurisdictions of numerous congressional committees and subcommittees, affects powerful and influential sectors of the financial industry, and generates controversy over what is in it as well as what was left out. It is unlikely that all the elements of the Obama proposal will be enacted but, at this point, it is unclear which parts of the proposal may ultimately be dropped.

Congressional hearings have already begun and will continue through June and July. The Obama Administration has promised to submit draft legislation very soon. The House Financial Services Committee is expected to take the lead in shepherding financial reform legislation through Congress. Committee Chairman Frank (D-MA) anticipates six days of hearings in July and has announced plans for a committee vote on a bill (which has not yet been drafted) to create the Consumer Financial Protection Agency for late July. Congress will be out of session in August. Therefore, assuming Chairman Frank can keep to his schedule, the earliest the House of Representatives could debate and vote on the bill would be after Labor Day.

The Senate schedule is less certain. Banking Committee Chairman Dodd (D-CT) is playing a major role in the development of health care reform legislation and does not expect to have the Banking Committee consider financial reform until sometime in the fall. Although President Obama has set a deadline of year-end for enactment of financial reform, it will be difficult to meet that deadline because of expected industry opposition to certain provisions — especially the new powers for the Fed, ILC restrictions, and the new CFPA — and a congressional agenda already crowded with other priorities.

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If you have any questions regarding this memorandum, please contact Russell L. Smith (202-303-1116, rsmith@willkie.com), Barbara Block (202-303-1178, bblock@willkie.com), or the attorney with whom you regularly work.

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