CLEARY GOTTLIEB Alert Memo

NEW YORK JUNE 18, 2009

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President Obama's Financial Regulatory Reform Plan: Key Issues for Market Participants

On June 17, 2009, the U.S. Treasury released a White Paper, "Financial Regulatory Reform: A New Foundation," outlining the Obama Administration's proposal for the most extensive reforms to the U.S. financial regulatory system since the Great Depression.

The Obama Administration's financial reform program announced yesterday is ambitious. If adopted, it will produce far-reaching changes in the financial markets and the financial regulatory landscape.

The purpose of this note is not to add to the pile of summaries describing the Administration's proposal. Instead, we have identified below those elements of the proposal that we believe may have the greatest consequences for market participants and have highlighted the issues we expect to be the most important in the policy and political debate that has already begun on Capitol Hill.

Understanding these issues is important not only to evaluate and plan for potential changes in law, but also to anticipate the critical areas where supervisory and regulatory standards and industry practices may change in response to the Administration's proposal.

Notable features of the Administration's proposal include the following:

- **Creation of a separate federal Consumer Financial Protection Agency with rule-making and enforcement authority, responsible both for substantive regulation of financial products and related disclosure.**
    - Consumer protection would be moved out of bank regulatory agencies, where it largely resides currently. Issues include whether such a separation is necessary or desirable and potential overlap or conflicts with other federal agencies.

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  - Additional state regulation would not be preempted. Issues include the need for, and extent of, state involvement, including by state attorneys general.

  - Mandatory arbitration of disputes regarding consumer financial products would be restricted or banned.

  - Offering of "plain vanilla" products would be encouraged.

- **Creation of a new comprehensive regulatory framework for OTC derivatives.**

  - The emphasis on standardization and exchange-trading and clearing of OTC derivatives could unduly curtail the availability of customized OTC solutions for end-users.

  - There would be no preemption of potentially inconsistent state regulation of OTC derivatives—*e.g.,* the model state insurance law initiative to regulate covered CDS as insurance and to prohibit the sale of CDS that do not insure a specific risk.

  - The scope of the proposed market transparency requirements with respect to OTC derivatives, and the related, potential impact of such requirements on market liquidity, are unclear.

  - Potentially duplicative and/or inconsistent regulatory requirements (including, particularly, registration requirements) could arise from the expansion of the CFTC's and the SEC's jurisdiction with respect to OTC derivatives market participants.

  - The recommendations for harmonizing futures and securities regulation do not address the fact that many differences are rooted in fundamental statutory provisions, such as the national market system enshrined in the Exchange Act. The process of harmonization may result in the futures regime more closely resembling the securities regime, rather than the converse.

  - The proposal seems to herald the long-term survival of the SEC with a robust administrative mandate.

  - With European initiatives relating to OTC derivatives imminent, it is important to monitor U.S. and European developments in parallel to ensure that disparities do not arise that will distort the competitive landscape.

- **Radical changes to the regulation of financial institutions, broadly defined.**
  - A new class of large, systemically significant, interconnected financial institutions (called Tier 1 Financial Holding Companies, or Tier 1 FHCs) would be identified and be subject to more restrictive regulations and closer supervision and oversight.
  - The Federal Reserve would have greatly expanded powers to regulate Tier 1 FHCs and all other institutions owning banks on a consolidated basis, including specifically with respect to capital, liquidity and leverage.
  - A major shift in the Federal Reserve's oversight role would result. The Fed would be allowed to impose regulatory requirements on subsidiaries, including companies regulated functionally by other agencies, eliminating existing limitations on the Fed's power in this area.
  - A Financial Services Oversight Council composed of multiple agencies and chaired by Treasury would be created. The Council would succeed to the President's Working Group but play a more formal role in the regulatory process, and would have a dedicated staff within Treasury.
  - The separation of banking and commerce would be reinforced.
  - The federal thrift charter would be eliminated, while giving one of the key advantages of the federal thrift charter—nationwide branching powers—to commercial banks.
  - So-called "loopholes" that currently exempt companies that own bank-like entities (such as credit card banks, industrial banks and grandfathered banks) from Federal Reserve regulation as bank holding companies would be eliminated. Issues include possible divestitures or potential grandfather rights for commercial firms that already own these entities.
  - The OCC would be combined with the OTS, which would be eliminated, in a new National Bank Supervisor within Treasury. Other federal bank regulatory agencies would be maintained.
- **Creation of a new resolution authority for systemically significant financial institutions.**
  - The new resolution authority would be applicable to any bank holding company and any Tier 1 FHC (whether or not it holds a bank) if its insolvency would have serious financial or economic consequences.

- o Tier 1 FHCs would be required to maintain a "rapid resolution plan" and be subject to a prompt corrective action framework similar to that for banks under current bank regulatory authority.

- o Resolution would be triggered by a multi-agency mechanism (Federal Reserve Board vote, FDIC Board or SEC vote, Treasury consultation with the President and Treasury determinations regarding the firm's condition and the impact of the firm's failure).

- o Once triggered, Treasury would determine how resolution powers would be exercised.

- o Treasury could appoint the FDIC (or the SEC, if the largest subsidiary is a broker-dealer or securities firm) as conservator or receiver of the failing firm. This expansion of powers could be an issue.

- o Treasury would be authorized to lend to the FDIC or the SEC as conservator or receiver and to fund these loans with public debt. The source of other funding that would be used in the resolution or pre-resolution processes is not specified.

- o The cost of loans by Treasury would be recouped by assessments on bank holding companies. Both the "insurance" method of recoupment and its apparent limitation to bank holding companies and not other Tier 1 FHCs could be issues.

- **Significant reforms to the securitization process.**

  - o Loan originators and sponsors would be required to retain at least 5% of the credit risk in a securitization (so-called "skin-in-the-game"), with a prohibition on hedging or transferring the retained risk.

  - o Regulators would be granted authority to prescribe the forms of retention and to raise or lower the percentage and to provide exemptions from the "no hedging" requirement, particularly in the case of safety and soundness concerns. The skin-in the-game concept and its administration could be issues.

  - o Compensation would be tied to long-term performance of securitized assets, both for firms participating in origination and securitization and for individuals involved in the process. Although accounting changes and interpretations can address this concept at the firm level, the mechanisms to implement this concept at the individual level may become issues.

- The SEC and others would be encouraged to continue disclosure reforms and improvements—*e.g.,* loan-level data is likely to become a disclosure requirement.

- **Emphasis on the need for international coordination in a range of areas.**

  - The proposal gives rise to the potential for differences with the regime under consideration in the EU, raising issues about cross-border distribution of securities.

  - Non-U.S. financial firms would be subject to categorization as Tier 1 FHCs, potentially raising conflicts between U.S. and home country regulation.

  - Although the proposal supports a coordinated international approach through a revision of Basel II, the United States may not wait for a revision before changing its capital requirements, which could encourage the United Kingdom to go forward on its own.

  - Similarly, despite the proposal's support for compensation and governance changes, it is not clear how these changes would be implemented in a coordinated fashion on a cross-border basis, thus posing a challenge for large organizations doing cross-border business.

  - The proposal recognizes the need for colleges of supervisors, but it is unclear how effective they would be, beyond sharing information.

  - Perhaps most importantly, it is unclear whether it is feasible to have a coordinated approach to resolution authority, without which there would be continued pressure to ring-fence assets and force financial institutions to do business through regulated subsidiaries, as opposed to branches.

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It will be critical for market participants to monitor the White Paper's proposed reforms as they evolve during the legislative process, along with corresponding developments outside the United States. Questions regarding the Administration's White Paper, as well as developments in non-U.S. jurisdictions and their impact on your organization, can be directed to your regular contacts at the firm or to any of our partners and counsel listed under Banking and Financial Institutions or Capital Markets in the Practice Area section of our web site, at www.cgsh.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax