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**President Obama's Plan for Regulatory Reform: Summary and Analysis**

On June 17, 2009, President Obama and Treasury Secretary Geithner released a white paper ("Obama Plan") detailing their plan for financial services regulatory reform. The much-anticipated and heavily-previewed report envisages a broad restructuring of the regulatory landscape for financial services firms, aggressively seizing the opportunity presented by the financial meltdown in an attempt to forestall future ones.

To enhance safety and soundness and improve investor protection, the Obama Plan reshuffles regulatory responsibilities, creates new authorities, and imposes new obligations on financial firms. And although the Administration has signaled its developing approach for some time, the plan is Obama's opening salvo in what will become a months-long negotiation between federal branches over the shape of the American capital markets. This memorandum summarizes the salient provisions of the Obama Plan and analyzes its prospects as it migrates down Pennsylvania Avenue to the halls of Congress.

***Systemic Risk Regulator.*** Most stakeholders appear united in the belief that regulatory reform will center around the creation of a systemic risk regulator to oversee and police the stability of the financial system. From there, opinions diverge on a number of key points. President Obama and some members of Congress are seeking to enhance the authority of the Federal Reserve in several critical regards, perhaps most importantly by designating the central bank as systemic risk regulator. Others are hesitant to give the Fed a greater role beyond controlling monetary policy.

Under the Obama Plan, the Fed would provide consolidated supervision of those financial firms found to be systemically significant (designated "Tier 1 Financial Holding Companies") based on their size, leverage and interconnectedness. These "too big to fail" firms would have higher capital, liquidity and risk management standards, and would have limitations placed on their commercial activities. Where excessive risks arise and/or capital depletes, the Fed could take prompt corrective action to prevent collapse. The Fed's supervision of Tier 1 FHCs would extend to the parent and all subsidiaries, although functionally regulated subsidiaries would continue to be regulated prudentially by their functional regulator.

Responding to congressional skepticism of the central bank, Obama provides that the Fed will receive consultation from a new body, the Financial Services Oversight Council, which is comprised of heads of the Treasury Department, Fed, CFTC, FDIC, Federal Housing Finance Agency, SEC and two newly-created agencies, the National Bank Supervisor and the Consumer Financial Protection Agency (see below). The Council will help identify emerging systemic risks and improve interagency coordination. It would have the power to require reports from any

financial firm to assess the firm's threat to the financial system, and would ultimately recommend which firms are too big to fail. However, the Council lacks any actual authority to override or supersede Fed decisions.

The Treasury would lead a working group to reexamine regulatory capital requirements for all banks and bank holding companies, including systemically significant Tier 1 FHCs. But it is the Fed that would enjoy the primary role in setting capital standards for all of these companies, a point of contention for some Fed critics who cite the Fed's opposition to higher capital standards under the Basel II regime and to maintaining the leverage ratio, and for relying too much on bank modeling and rating agencies under Basel II.

Obama's systemic risk proposal will likely be met with some pushback on Capitol Hill, and we expect that heavy negotiations will produce a slightly modified final version. Senate Republicans and Democrats are united in their opposition to expanding the Fed into systemic risk for a variety of policy reasons, both practical and ideological, a sentiment shared by House Republicans and some House Democrats. Many of these opponents would prefer a true council approach, one that puts the Fed on par with other regulators. In the end, if a systemic risk regulator is to emerge from Congress, it will likely include a stronger council with greater authority to work constructively with the Fed, rather than one with merely consultative empowerment.

***Resolution Authority.*** After AIG required massive injections of federal funds to stave off a collapse that would have reverberated throughout the financial system, many policymakers have coalesced around the idea that the government needs authority to preside over an orderly wind down of systemically significant institutions. This power would be akin to and modeled after the FDIC's power over certain depository institutions under the Federal Deposit Insurance Act.

Under Obama's plan, the Treasury Department would decide whether to resolve a failing firm, with consultation from the Fed and either the FDIC or the SEC, depending on the type of institution being wound down. The conservator or receiver of the failing firm (again, the FDIC or the SEC, depending on the firm) would assume broad powers over the firm's operations, including asset sales and transfers. Each systemically significant firm would be required to prepare and update a credible plan for a quick wind-down of the firm, should events warrant.

Given the challenges associated with the failures of AIG, Bear Stearns and Lehman Brothers, and the widely-held perception that a more orderly wind down would have been less disruptive to the markets and less costly to taxpayers, there is strong support in Congress for resolution authority for "too big to fail" firms. In the House, resolution authority will likely be paired with a systemic risk regulator bill and possibly over-the-counter derivatives reform, and the package could be moved more quickly than other components of Obama's plan, possibly passing the House by August recess. The Senate has signaled a more protracted approach – Banking Committee Chairman Dodd has indicated he will consider a broader, more complete package, and not until the fall (with Senator Kennedy ailing, Dodd has taken a primary role in shaping health care legislation on the front-burner between now and then).

**Consumer Financial Protection Agency.** To correct perceived shortfalls in the ability of existing regulators to protect consumers of certain financial products, the Obama Plan would establish a new independent agency, the Consumer Financial Protection Agency. The agency would have sole authority to set rules and police abusive practices relating to an array of consumer, credit, savings, and payments system products – e.g., mortgages, credit cards, payday lending – and to regulate the providers of those products. The plan advocates for stronger regulations to improve transparency and simplicity for consumers, restrictions on unfair product terms and provider practices, and better enforcement of fair lending laws. The CFPA would not have authority over securities and commodities products, which would continue to be regulated by the SEC and the CFTC.

Creation of a new bureaucracy for “consumer protection,” and one whose mandate could clearly overlap with that of existing banking regulators, will be highly controversial on the Hill. While Chairmen Dodd and Frank have expressed support for the concept, many lawmakers will oppose on various grounds (we expect quiet pushback from bank regulators who could see their jurisdiction eroded). Along with the designation of the Fed as systemic risk regulator, the CFPA will engender some of the most ardent opposition. We expect that it will be decoupled from other components of the Obama Plan, and its consideration could be pushed off until the more pressing (and achievable) pieces have passed.

**Regulation of Over-the-Counter Derivatives.** Over-the-counter derivatives have been labeled as “weapons of mass destruction” and broadly blamed in the media for creating the financial crisis. Accordingly, lawmakers have targeted OTC derivative market reform as a top-of-the-list priority. In May, Secretary Geithner floated the Administration’s proposal on OTC derivatives to Capitol Hill, advocating for greater clearing, exchange trading and reporting of certain products. The Obama Plan builds upon that framework with greater detail and specific recommendations.

The Obama Plan would require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs). CCPs would impose strong margin and capital requirements, as well as business conduct and risk controls, on participants. Customized derivatives would be exempt from the clearing requirement, although policymakers will surely look to draft the rules in a way that does not create a “customization loophole” in the clearing requirement. Customized trades not cleared through a CCP must be reported to a central trade data repository, which would be required to (a) make aggregate data on open positions and trading volumes publicly available, and (b) make individual counterparty trades and position data available to the government on a confidential basis, thereby allowing the government to monitor these open positions for systemic risk. Customized trades would also be subjected to higher capital charges.

The plan encourages the movement of standardized trades to regulated futures exchanges and trading platforms, which along with the clearing requirement, will purportedly improve market transparency, stability, efficiency and price discovery. Furthermore, all derivatives dealers like Morgan Stanley and any other firm with large OTC exposures would be subject to supervision by the Fed, as systemic risk regulator, which would be empowered to take remedial action to constrain that firm’s risky positions. Clearing and settlement systems would retain their primary

regulator (either the CFTC or SEC), but the Fed would also gain oversight authority over systemically significant systems.

Although much of the criticism of OTC derivatives embodied in media reports rests on a poor understanding of the products and the benefits derivatives provide for American businesses, the fact remains that there exists widespread support for greater transparency and regulation. Lawmakers draw a direct parallel between the massive taxpayer bailout of AIG and the insurer's credit default swap obligations, helping drive the perception that derivatives were a primary cause of the recession. Recent congressional hearings have demonstrated that Democrats and Republicans alike see greater clearing and reporting of OTC derivatives as a necessary step. Industry has warmed to this reality, offering solutions that will preserve (albeit, increasing regulate) derivatives' use. Derivatives reform is perhaps the lowest hanging fruit in the panoply of reform options, and accordingly, is one of the most likely to receive congressional activity.

***Prudential Regulation.*** While the plan would maintain the dual federal-state banking system, the plan creates a new National Bank Supervisor to regulate federally-chartered depository institutions. The NBS would be a separate agency within Treasury that would inherit the prudential responsibilities of the Office of the Comptroller of the Currency and Office of Thrift Supervision. The federal thrift charter will be eliminated and pulled into this authority. Industrial loan companies and other "non-bank banks" would also now be regulated under the Bank Holding Company Act, thereby limiting their commercial activities. The Fed and FDIC would retain their roles in the supervision of state-chartered banks, and the National Credit Union Administration would retain authority over credit unions.

***Securitization Reforms.*** It is widely believed that securitization played a primary role in the financial crisis by encouraging weaker underwriting standards and facilitating an "originate to distribute" model of capricious lending. Accordingly, and following the lead of regulators in Europe, the Obama Plan would establish greater restrictions on the securitization process. Most notably, the plan would impose a requirement that securitizers (i.e. originators or sponsors) retain at least 5 percent of the underlying risk, which securitizers could not hedge. The plan further calls for the SEC to increase transparency and standardization in securitization markets and tighten regulation of credit rating agencies.

***Hedge Funds and Private Equity.*** Policymakers has been critical of the lack of regulation of what is termed the "shadow banking system" -- i.e. less regulated hedge funds and other private pools of capital. The Obama Plan seeks to impose greater oversight of such funds by requiring fund advisers to register with the SEC as investment advisers and to be subject to certain recordkeeping and reporting standards.

***Role of the SEC.*** Despite widespread criticism for its handling of the financial crisis, the Madoff scandal and other high-profile missteps, the SEC would retain its investor protection mandate under the Obama Plan. Although a CFTC-SEC merger was considered and deemed politically impossible to undertake, the Obama Plan does call for greater harmonization of disparate CFTC and SEC rules for similar products. The plan urges legislative revisions to enable the SEC to provide better and more timely disclosures to investors, and calls for an expansion of the sanctions available to the SEC in policing the securities laws.

On investment advice, the Obama Plan also calls for a harmonization of rules relating to broker-dealers and investment advisers, urging legislation to empower the SEC to (a) establish a fiduciary duty for broker-dealers offering investment advice, (b) require clear disclosure to investors about the nature of their relationship with investment professionals, and (c) prohibit abusive sales practices where products sold to an investor are not in his or her best interest. As such, the plan buttresses efforts underway in the SEC to establish such a fiduciary relationship.

To avoid runs on money market mutual funds (MMFs), Obama encourages the SEC to move forward on plans to strengthen the MMF regulatory framework to reduce the credit and liquidity risk profile of individual funds, including possible changes to the use of a stable net asset value.

In addition, the plan suggests that the SEC study the use of mandatory arbitration in investor contracts, calling for legislation authorizing the SEC to prohibit such pre-dispute arbitration clauses. This undoubtedly lends support to the efforts of congressional Democrats who are currently promoting anti-arbitration legislation in the House and Senate.

***Executive Compensation and Accounting.*** Congress and the Administration have become increasingly focused on banks' executive compensation policies, and the Obama Plan would require regulators to issue standards that better align compensation practices with long-term shareholder value. Obama would empower the SEC to require companies to give shareholders a non-binding vote on a company's pay packages. Furthermore, fair value (mark-to-market) accounting rules would be reviewed to improve transparency and accuracy of different types of investments held by financial institutions.

***Conclusion.*** The Fed has clearly gained a significant degree of authority under the Obama Plan. Indeed, the plan's only appreciable reduction in Fed authority is in the directive that the Treasury must approve of any exercise by the Fed of emergency lending powers or liquidity facilities. Taken as a whole, the plan seeks to continue and codify the heightened cooperation between federal banking regulators, the Treasury Department and the Fed that has characterized the Paulson and Geithner responses to the financial crisis. At the same time, the Obama Plan is an aggressive expansion of the federal role in the financial markets, and as such, will meet political resistance from certain Hill constituencies.

Working from the assumption that at least some of these priorities will be enacted, the major questions are timing (Will any components of these reforms be enacted in 2009?) and process (Will Congress pass a comprehensive reform bill, or look to break reform into smaller, staggered pieces?). On the latter, and despite Chairman Dodd's statements to the contrary, we anticipate that reform will proceed in stages, with a initial push for a systemic risk regulator, resolution authority and/or OTC derivatives reform. The House will likely move first, as Chairman Frank and Speaker Pelosi seem intent on passing a bill either before the August recess or shortly thereafter. Chairman Dodd and Senate leadership will delay consideration until at least the fall. Given the crowded legislative calendar, in which the Judge Sotomayor Supreme Court nomination and health care reform will predominate, passage of a smaller reform package in 2009 will be challenging, but certainly possible. More controversial and granular efforts, including the Consumer Financial Protection Agency, could easily be pushed into next year.

There is a sense among President Obama and Democratic leadership in Congress that the window of opportunity for substantive reform will close at some point, and that they must strike while the iron is hot. Without doubt, however, both ideological opposition and procedural rules in the Senate will ensure that meaningful negotiations will impact the shape of reform between now and then.