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Client Alert

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THE OBAMA WHITE PAPER ON FINANCIAL REGULATORY REFORM

On June 17, 2009 the Obama Administration released its proposal for strengthening the regulation of U.S. financial markets. The Administration's White Paper proposes: (i) a new Financial Services Oversight Council of regulators to identify emerging risk and coordinate interagency cooperation; (ii) new authority for the Federal Reserve to supervise all firms that could pose systemic risk (referred to as "Tier 1 FHCs"), including firms that do not own a depository institution; (iii) stronger capital, liquidity and other prudential standards for all financial firms and yet-higher standards for Tier 1 FHCs; (iv) a new National Bank Supervisor to supervise all federally chartered depository institutions and federally licensed branches of foreign banks (essentially a merger of the Office of Thrift Supervision into the Office of the Comptroller of the Currency); (v) the elimination of the federal thrift charter and the OTS; (vi) regulation of parents of industrial banks, thrifts, credit card banks and trust companies as bank holding companies; (vii) regulation of the OTC derivatives market, including credit default swaps; (viii) the registration with the Securities and Exchange Commission of advisers to all hedge funds, private equity funds and other pools of capital (apparently including such advisers as CDO and CLO managers), (ix) the reporting of information by these advisers about their managed funds to enable an assessment of whether these funds pose a risk to financial stability and (x) the creation of a new Consumer Financial Protection Agency with broad new powers to regulate the sale of financial products. The White Paper, including "fact sheet" summaries of its principal recommendations, can be found at <http://www.ustreas.gov/news/index1>.

This Client Alert will not attempt to replicate the White Paper's own summaries. Rather, it highlights aspects of the proposals that, if adopted, are likely to have important practical consequences to financial market participants. These aspects are the following:

1. *Prepare for capital increases.* The proposals are replete with references to the need to increase capital requirements. Tier 1 FHCs would become subject to "more stringent" requirements on their capital. A working group led by Treasury would conduct a "fundamental reassessment of the design and structure of existing regulatory capital requirements" for banks and BHCs (presumably leading to changes in the U.S. implementation of the Basel II framework). All FHC's would be required to meet "well capitalized" standards on a consolidated basis, not just as to their subsidiary banks. Customized OTC derivatives would be subject to "higher capital charges."

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2. *The end of preemption?* The White Paper proposes a significant erosion if not an elimination of federal preemption at least as to products and services to be regulated by the new Consumer Financial Protection Agency. Its rules are to constitute a “floor, not a ceiling.” States are to be given the authority both to enforce federal law regardless of charter and to adopt “stricter rules for institutions of all types.”
3. *Interstate branching.* In what is perhaps the White Paper’s sole deregulatory proposal, the thrift charter and the OTS would be abolished but national and state-chartered banks would gain thrifts’ more generous interstate branching powers through the elimination of states’ restrictions on interstate branching.
4. *Expansion of 23A restrictions.* Current restrictions on banks’ transactions with affiliates are to be “strengthened.” They would be extended for the first time to derivative transactions, a move deferred when Regulation W was first adopted, and would be applied to transactions with investment funds sponsored or advised rather than those sponsored and advised by an affiliate. The Federal Reserve’s power to grant exemptions under section 23A would be curtailed to an unspecified extent.
5. *Accounting standards.* Accounting standards are to be reviewed with a view to “more forward-looking loan loss provisioning practices” and greater disclosure of “the cash flow management expects to receive from investments.”
6. *Skin in the securitization game.* Federal banking agencies are to issue regulations requiring “loan originators or sponsors to retain five percent of the credit risk of securitized exposures.” It is unclear how this requirement would apply to the originators of loans that might end up in a securitized product.
7. *National insurance charter?* The Administration reportedly backed down on an early proposal to create a national insurance charter. The White Paper stops short of recommending a national charter but, by proposing a new Office of National Insurance within Treasury and urging “increased national uniformity through either a federal charter or effective action by the states,” invites Congress to take this step with the Administration’s support.
8. *Questions for non-U.S. banks and other non-U.S. financial firms.* The White Paper opens the door to the treatment of foreign banks and, possibly, other non-U.S. firms as Tier 1 FHCs. Foreign financial firms “whose U.S. operations pose risks to the U.S. financial system will be subject to the same robust prudential regulation and oversight” as comparable U.S. firms.
9. *Executive compensation guidelines for all financial firms.* Federal regulators would have the authority to set standards “to better align executive compensation practices of financial firms with long-term shareholder value.” All federal regulators will be supported by Treasury in this effort, including the SEC with respect to investment banks and now-to-be-registered hedge fund managers.
10. *Nonfinancial activity restrictions for all Tier 1 FHCs.* The White Paper does not propose any liberalization of the current ability of private equity firms to invest in BHCs and banks. Indeed, it proposes that all Tier 1 FHCs be subject (after a five-year transition period) to the non-banking prohibitions of the Bank Holding Company Act, thus raising the possibility that systemically significant hedge and private equity funds could become subject to these activity restrictions even without investing in a BHC or bank.

11. *Single federal regulator?* Despite press reports that the Administration had rejected the idea of creating a single federal regulator of the financial markets, the proposal to create a Financial Services Oversight Council might evolve as a major step in that direction. Because it will have a permanent staff in the Treasury and have “authorities and responsibilities with respect to . . . coordination of financial regulation,” the Council might well come to oversee its eight constituent members much as a single regulatory agency might manage that many internal divisions. The single-regulator model would be further promoted by the proposal to “reduce the differences in the substantive regulations and supervisory policies applicable to national banks, state member banks and state non-member banks.”

The White Paper will reportedly be converted to a concrete legislative proposal at which time it will be introduced for consideration by the relevant congressional committees. Although the Administration is pressing for enactment of the proposals by the end of the year, other parties are calling for more time to debate the measures given their significance. Attention will no doubt now shift to the chairmen of the House and Senate banking committees.

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