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CLIENT ALERT

TREASURY DEPARTMENT PROPOSES MAJOR REFORMS TO REGULATION OF U.S. FINANCIAL SYSTEM

On June 17, 2009, the U.S. Department of the Treasury released a proposal for legislative and regulatory changes that, if adopted, would effect major change to the U.S. financial system. Most, but not all, of the components of the proposal derive from, or relate to, the crisis that has beset the global economy. Legislation and regulations to implement the proposal are being drafted and considered by Congress and the relevant departments and agencies. The goal of the Obama administration and Democratic leaders is to have such legislation and regulation enacted and adopted by the end of the year.

Significant components of the proposal provide for—

- identification of those financial firms whose failure would pose a threat to financial stability due to the combination of their size, leverage and interconnectedness (each such firm, a "Tier 1 financial holding company" or "Tier 1 FHC") and creation of a Financial Services Oversight Committee to coordinate the regulation of Tier 1 FHCs[1]
- adoption of stricter capital, liquidity and risk management standards for all financial holding companies and their subsidiaries and even higher standards for Tier 1 FHCs and their subsidiaries, with Tier 1 FHCs being

[1] The Financial Services Oversight Committee would comprise the secretary of the Treasury, who would serve as chairman, and the chairmen or directors of the Board of Governors of the Federal Reserve System, the National Bank Supervisor, the Consumer Financial Protection Agency, the SEC, the CFTC, the FDIC and the Federal Housing Finance Agency. Under the proposal, a Tier 1 FHC need not be or own an insured depositary institution.

regulated by the Federal Reserve and their subsidiaries being regulated primarily by their functional or bank regulator

- registration, with the Securities and Exchange Commission (SEC) under the Investment Advisers Act, of advisers to hedge funds, private equity funds and other private investment funds with assets under management over a "modest" threshold
- reporting, record-keeping and disclosure requirements applicable to all investment funds advised by an SEC-registered adviser, and regular SEC examinations of all such investment funds
- central clearing of standardized over-the-counter (OTC) derivatives and regulation of OTC derivatives dealers and other market participants
- creation of a Consumer Financial Protection Agency with sweeping powers both to protect consumers of credit, savings, payment and other consumer products and to regulate providers of such products and services
- elimination of both the federal thrift charter and safe harbors from regulatory oversight for certain "nonbank" financial institutions, as well as creation of a new government agency, the National Bank Supervisor, to conduct prudential supervision and regulation of all federal depository institutions and branches and agencies of foreign banks; removal of restrictions on interstate branch banking; registration of all companies that own an insured depository institution
- elimination of the SEC's Supervised Investment Banking Holding Company program and replacement of such supervision by the SEC with supervision by the Federal Reserve
- strengthening the regulatory framework around money market funds (MMFs) and, in the interest of limiting the risk of runs on MMFs, possibly imposing minimum liquidity buffers and limits on the maximum weighted average maturity and concentration of MMF assets and permitting MMFs to suspend redemptions in extraordinary circumstances
- establishment of an Office of National Insurance within Treasury to facilitate the development of a modern federal regulatory framework for insurance
- creation of standards and guidelines for executive compensation in the financial sector
- requiring a nonbinding shareholder advisory vote relating to executive compensation for public companies; strengthening compensation committee independence

- imposition of fiduciary duties on broker-dealers providing investment advice; elimination of mandatory arbitration clauses in agreements with retail customers
- requiring sponsors in securitizations to retain at least 5 percent of the credit risk of securitized exposures
- creation of a resolution regime, modeled on the existing authority of the FDIC, for failing bank holding companies and other Tier 1 FHCs that are not covered by the existing regime for insured depository institutions
- determinations as to the disposition of Fannie Mae, Freddie Mac and the Federal Home Loan Bank System
- a leading role for the United States in coordinating with other nations to develop consistent regulatory capital standards, oversee global financial markets, supervise internationally active financial firms and prevent and manage future crises.

TIER I FHCS

Under the proposal, the Federal Reserve will be responsible for analyzing the systemic importance of firms under stressed economic conditions and for developing appropriate capital, liquidity and risk management standards for those firms whose failure would pose a threat to financial stability (Tier 1 FHCs).[2] So that it may have the information necessary to carry out this responsibility, the Federal Reserve will have the authority to collect periodic and other reports from all U.S. financial firms that reach certain minimum size thresholds. In addition, other regulatory agencies, such as the SEC, would be directed to share with the Federal Reserve information they receive from financial firms they regulate. Each Tier 1 FHC would also be required to prepare and update a credible plan for rapid resolution of the firm in the event of severe financial distress, said plan to be reviewed regularly by the Federal Reserve.

EXECUTIVE COMPENSATION

Federal regulators are charged with issuing standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent practices that provide incentives injurious to the safety and soundness of supervised institutions. Such standards are to be integrated into the supervisory process. The proposal provides five broad principles for such standards: (i) measuring properly and rewarding performance; (ii) structuring compensation to account

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[2] The proposal identified several types of firms that could be Tier 1 FHCs, including hedge funds and other private funds, insurance companies and foreign firms with U.S. operations that could pose a threat to financial stability.

for the time horizon of risks; (iii) aligning compensation with sound risk management; (iv) reexamining golden parachutes and retirement packages to ensure they align the interests of executives and shareholders; and (v) promoting transparency and accountability in the process of setting compensation.

ADVISERS AND HEDGE FUNDS: REGISTRATION AND REPORTING REQUIREMENTS

Under the proposal, all advisers to hedge funds, private equity funds, venture capital funds and other private pools of capital with assets under management in excess of a "modest amount" will be required to register with the SEC under the Investment Advisers Act. Further, all funds advised by an SEC-registered adviser must satisfy disclosure requirements to investors, creditors and counterparties, as well as record-keeping and reporting requirements regarding assets under management, borrowings, off-balance sheet exposure and other information relevant to determining whether the fund or pool should be regulated as a Tier 1 FHC. Such reporting is to be done on a confidential basis. The funds also would be subject to regular, periodic examination by the SEC to assure compliance.

CONTACT INFORMATION

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