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Obama Administration Delivers Proposed Bank and Financial Services Reform Legislation to U.S. Congress

On July 22, 2009, the Obama Administration continued its push to enact its financial services reform proposals into law by delivering to the U.S. Congress broad proposed legislation ("Proposed Legislation") that would implement many provisions in its White Paper, issued on June 17, 2009.[1] Consisting of six titles, the Proposed Legislation provides for a host of reforms, including several "sleepers" concerning technical banking points that, if enacted, could bring about significant changes to the U.S. financial regulatory system.

The highlights of the Proposed Legislation include:

- Significant amendments to the Bank Holding Company Act of 1956, as amended ("BHCA"), giving systemic risk regulator authority to the Board of Governors of the Federal Reserve System ("Federal Reserve") as well as strengthening restrictions on bank transactions with affiliates and banks' single-borrower lending limits;
- Establishment of a systemic risk advisory council composed of the heads of major U.S. financial services regulatory agencies;
- The repeal of exemptions that had permitted many companies controlling depository institutions to avoid regulation as Bank Holding Companies ("BHC"); and
- Requirements that the banking regulators and the Securities and Exchange Commission ("SEC") enact regulations that would require securitizers of asset-backed securities ("ABS") to retain an economic interest in a material portion of the credit risk associated with the assets underlying the securitization.

Late on July 23, the Obama Administration released additional draft reform legislation addressing, among other things, the combination of the regulatory agencies in charge of national banks and thrift institutions and resolution authority for large, interconnected financial firms. This legislation will be the subject of a future client alert.

The Federal Reserve as Systemic Risk Regulator

Tier 1 Financial Holding Companies

The "Bank Holding Company Modernization Act of 2009", Title II of the Proposed Legislation, assigns the role of systemic risk regulator to the Federal Reserve, which would be authorized to impose the status of a Tier 1 financial holding company ("Tier 1 FHC") on any firm that engages in whole or in part in financial activities in

[1] The Proposed Legislation is available at http://www.treas.gov/press/releases/tg227.htm. The White Paper is discussed in our earlier Client Alert (dated June 23, 2009) available at http://www.shearman.com/fia-062309-us-financial-regulatory-reform-implications-for-banking-institutions/.

the United States (regardless of whether such firm controls a "bank" for purposes of the BHCA) . It would also have the authority to prescribe standards for and supervise Tier 1 FHCs.

Tier 1 FHCs would be subject to generally the same restrictions that are imposed by the BHCA, but also to additional enhanced requirements due to the threats to financial stability that their failure could pose. The Proposed Legislation's findings note that the sudden collapse of large investment banks and insurance companies in 2008 represented extreme shocks to the financial system and that, despite controlling federally insured depository institutions similar in many ways to commercial banks, those companies were not subject to the consolidated supervision of the Federal Reserve.[2] The Proposed Legislation seeks to ensure that all systemically important financial institutions would be subject to consolidated supervision by the Federal Reserve.

Designation of Tier 1 FHCs

The Proposed Legislation would grant the Federal Reserve the authority to designate as a Tier 1 FHC any company that engages, directly or indirectly, in financial activities in the United States if it determines that material financial distress at the company could pose a threat to U.S. or global financial stability.[3] The Federal Reserve may impose the Tier 1 FHC designation on companies organized outside the United States.[4] In determining whether the company poses a threat to financial stability, the Federal Reserve must take into consideration the following criteria:

- The amount and nature of the company's financial assets;
- The amount and type of the company's liabilities, including the degree of reliance on short-term funding;
- The extent of the company's off-balance sheet exposures;
- The extent of the company's transactions and relationships with other major financial companies;
- The company's importance as a source of credit;
- The recommendation of the Financial Services Oversight Council ("FSOC"), discussed below; and
- Any other factors the Federal Reserve deems appropriate.

The Proposed Legislation does not indicate a numerical threshold beyond which a company represents a systemic risk, but it may indicate a floor: it grants the Federal Reserve the authority to require a company to submit information necessary for a determination of whether it is a Tier 1 FHC only if such company has $10 billion or more in assets, $100 billion or more in assets under management, or $2 billion or more in gross annual revenue.[5] For foreign financial companies, those thresholds are $10 billion or more in *U.S.* assets, $100 billion or more in assets under management *in the U.S.*, and $2 billion or more in gross annual revenue *in the U.S.* Foreign financial companies that are not banks and/or do not control a bank but meet these thresholds could potentially become subject to U.S. banking law restrictions (discussed below in additional detail) for the first time under the Proposed Legislation.

It appears that any company that would be designated as a Tier 1 FHC would be given prior notice of the proposed designation and an opportunity to contest the

[2] Bear Stearns and Lehman Brothers participated in the SEC's now defunct Consolidated Supervised Entities program, created in 2004 as a way for global investment bank conglomerates that lack a supervisor under law to voluntarily submit to consolidated regulation. AIG's consolidated supervisor was the Office of Thrift Supervision, as AIG was a thrift holding company.

[3] Section 204(a) of the Proposed Legislation, adding a new Section 6 to the BHCA.

[4] For companies organized outside the United States, however, the Proposed Legislation instructs the Federal Reserve to consider only the threat the company's financial distress poses to *U.S.* stability and the *U.S.* economy. Similarly, the factors the Federal Reserve must consider in determining whether such foreign company should be designated as a Tier 1 FHC are limited to the company's assets and operations in the United States.

[5] Section 6(a)(2) of the BHCA, added by Section 204(a) of the Proposed Legislation.

determination, subject to an "emergency exception" that would shorten the time periods for contesting the proposal.[6] It is not clear whether the company would become a Tier 1 FHC prior to the Federal Reserve's final determination. The Federal Reserve is given authority to require information from a company to be used for the purpose of making this determination and to conduct an examination of the company if necessary.[7]

Limits on Tier 1 FHCs

Tier 1 FHCs that are not otherwise subject to the BHCA because they do not control a bank would be required to comply with the activity restrictions applicable to financial holding companies under the Gramm-Leach-Bliley Act of 1999 ("Gramm-Leach-Bliley Act"). They would be given five years to conform to these limitations, and would be subject to a requirement to establish an intermediate holding company that would hold the financial businesses of the organization separate from the nonfinancial businesses. During this five-year period, the intermediate holding company would be subject to the restrictions of Section 23A of the Federal Reserve Act ("Section 23A") as though it were a Federal Reserve member bank.[8] Tier 1 FHCs would be subject to certain BHCA limits on acquisitions of banks and of nonbank companies of large size.[9]

It appears that the Federal Reserve has the authority to designate a lower-tier company within an organization as a Tier 1 FHC, leaving a higher-level company free of the Tier 1 FHC constraints. While it is not clear why the Federal Reserve would do so, the language of the Proposed Legislation does not clearly preclude such a result.[10] It appears not to say that a Tier 1 FHC is necessarily a BHC, but rather that it must comply with various provisions of the BHCA; if a Tier 1 FHC were a BHC for all purposes, acquisitions of Tier 1 FHCs would in every case be subject to prior approval by the Federal Reserve. If this is a correct interpretation, then it is conceivable that certain major commercial companies might find that a lower-tier subsidiary must comply with the Tier 1 FHC requirements but not the parent.

Prudential and regulatory requirements of Tier 1 FHCs

The Proposed Legislation grants the Federal Reserve the authority to prescribe prudential standards for Tier 1 FHCs, which must be more stringent than those applicable to BHCs, as well as the authority to supervise Tier 1 FHCs. In addition, Tier 1 FHCs would be subject to reporting requirements, examinations, and enforcement authority in essentially the same manner as are BHCs but would also be required to maintain a so-called "funeral plan": a plan for the Tier 1 FHC's rapid and orderly resolution in the event of severe financial distress.[11]

In addition, the FDIC would be given "Back-Up Examination Authority." In the event that the FDIC believes that a Tier 1 FHC is not in compliance with the Proposed Legislation or rules or orders adopted under it, or that it poses a material risk to an insured depository institution, the FDIC may recommend that the Federal Reserve conduct an examination, and if the Federal Reserve does not do so within 60 days, the FDIC may initiate an examination.[12]

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6 Section 6(a)(1)(D) and (E), added by Section 204(a).

7 Section 6(a)(2), (3) and (4), added by Section 204(a).

8 Section 6(g), added by Section 204(a). Section 23A (12 U.S.C. § 371c) imposes strict limits on a member bank's transactions with affiliates; the Federal Reserve's Regulation W (12 C.F.R. Part 223 (2008)) provides additional detail on its requirements and several exceptions.

9 Section 6(i), added by Section 204(a).

10 Also, at least one other provision seems unnecessary if a Tier 1 FHC must be the top-tier parent of the organization. If a Tier 1 FHC is significantly undercapitalized, then among other things the Federal Reserve may require it to comply with Section 23A as if it were a member bank. Section 6A(f)(2)(B)(i), added by Section 204(b). Because subsidiaries of member banks are generally not "affiliates", this provision would seem principally applicable only in the case in which a Tier 1 FHC was a lower-tier subsidiary; "affiliates" would then be other subsidiaries of the parent.

11 Sections 6(c) and (d), added by Section 204(a).

12 Section 6(d) and (e), added by Section 204(a).

Tier 1 FHCs would be subject to a "prompt corrective action" regime very similar to that applicable to FDIC-insured banks.[13] However, the Federal Reserve would also have the authority, in the case of a "critically undercapitalized" Tier 1 FHC, to require that it file a petition for bankruptcy under Section 301 of the Bankruptcy Code or file one itself against the Tier 1 FHC under Section 303 of the Bankruptcy Code.[14]

Finally, Tier 1 FHCs would be subject to a concentration limit of 25 percent of the Tier 1 FHC's capital stock and surplus on their aggregate exposure to any other unaffiliated company.[15] The limits appear to be modeled in certain respects on the Federal Reserve's Regulation F, which imposes limits on interbank exposures pursuant to Section 23 of the Federal Reserve Act, but broader in the potential scope and with more precise definitions of the types of exposures to which they apply, including exposures generated by derivatives and securities lending.[16] The provision is subject to an attribution rule, apparently patterned on a similar rule in Section 23A, providing that any transaction with a third party will be deemed to be subject to the concentration limit of another company if the proceeds are used for the benefit of, or are transferred to, that company.[17] The limit would not be effective until three years after the effective date of the section, subject to extension for an additional two years by the Federal Reserve.

Strengthening the Wall Between Banking and Commerce

Definition of "bank" for purposes of the BHCA

The White Paper had recommended closing loopholes in the BHCA that permitted companies controlling thrifts, industrial loan companies, credit card banks, trust companies, and grandfathered "nonbank banks" to avoid regulation as a BHC. In keeping with its elevation of function over form, the "Bank Holding Company and Depository Institution Regulatory Improvement Act of 2009", Title VI of the Proposed Legislation, ends those exemptions.[18] The provision has been somewhat controversial as it could force important industrial conglomerates to relinquish their consumer finance arms.

Additional BHCA amendments

In addition, the Proposed Legislation contains a host of diverse changes. It removes restraints, originally enacted in the Gramm-Leach-Bliley Act, on the authority of the Federal Reserve to obtain reports and conduct examinations of functionally-regulated subsidiaries of BHCs (e.g., broker-dealers, investment advisers, and insurance companies).[19] The Proposed Legislation would also amend the BHCA to raise the capital and management standards for BHCs engaged in interstate bank acquisitions by requiring them to be well capitalized and well managed. On the other hand, the Proposed Legislation also expands the ability of national banks and state banks to engage in de novo branching outside of their "home" states, a provision that goes hand-in-hand with the White Paper's proposed elimination of the federal thrift charter (which allowed unrestricted interstate de novo branching).[20]

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13 Section 6A of the BHCA, added by Section 204(b).

14 Section 6A(h), added by Section 204(b). A conforming amendment to the Bankruptcy Code would also be made by the Proposed Legislation. Section 204(c) of the Proposed Legislation.

15 Section 6B of the BHCA, added by Section 204(d). The Federal Reserve has the authority to lower the percentage and to exempt transactions, in whole or in part, from the definition of credit exposure.

16 Section 6B(b) and (c) of the BHCA, added by Section 204(d). Regulation F is at 12 C.F.R. Part 206 (2008).

17 Section 6B(d) of the BHCA, added by Section 204(d).

18 Section 602 of the Proposed Legislation, amending Section 2 of the BHCA.

19 Section 604 of the Proposed Legislation, amending Section 5(c) of the BHCA and repealing Section 10A.

20 Sections 612 and 613 of the Proposed Legislation.

Additional requirements

Section 23A, which restricts bank transactions with affiliates, would be amended to define an investment fund for which the member bank is an investment adviser as an affiliate of the member bank and add derivatives transaction credit exposure to the list of covered transactions.[21] It would also require explicit concurrence of the FDIC to grant an exemption from Section 23A, a requirement currently followed in practice, and would repeal the special treatment given to transactions with financial subsidiaries.[22]

The lending limits applicable to national banks would be amended to explicitly add exposures due to derivative transactions, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions to the exposures subject to single-borrower lending limits, with a broad definition of "derivative transaction".[23] Derivatives transactions have not been treated as being subject to the lending limit in the past; rather, they were subject to a requirement that a national bank have policies and procedures in place to limit such exposures. In addition, the national bank lending limits would be imposed on all FDIC-insured State banks.[24]

Finally, the Federal Reserve would be required to assess fees on State member banks with total assets of over $10 billion and all BHCs, including Tier 1 FHCs, to fully defray the costs of examinations. The Federal Reserve and FDIC would be required to make such assessments at the same rate as the National Bank Supervisor ("NBS") assesses national banks.[25] The Federal Reserve traditionally has not assessed such fees.[26] The NBS would also be required to set fees on smaller national banks that are no greater than the average fees charged by State bank supervisors for State bank examinations.

Creation of the Financial Services Oversight Council

Establishment of FSOC

The "Financial Services Oversight Council Act of 2009", Title I of the Proposed Legislation, would establish the FSOC as a systemic risk consultative body. The FSOC would be composed of the heads of the most prominent U.S. financial regulatory bodies and chaired by the Secretary of the Treasury. The Proposed Legislation charges the FSOC with advising the Federal Reserve on several systemic risk matters. The Federal Reserve, for its part, would be required to consult the FSOC before taking certain actions relating to systemic risk regulation.[27] Commentators and regulators have disagreed whether the FSOC should be an advisory council or whether it should have powers to set standards for Tier 1 FHCs,[28] but the Proposed Legislation establishes the FSOC as a consultative body.

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[21] Section 607 of the Proposed Legislation. The inclusion of exposures due to derivative transactions with affiliates appears to reverse a provision in the Gramm-Leach-Bliley Act pursuant to which the Federal Reserve was given the authority, but not required, to impose limits on such exposures, which led to the somewhat limited provisions in Regulation W (see Section 223.33).

[22] Sections 607(a)(9) and (10) and 608 of the Proposed Legislation. The same restriction is imposed on granting exemptions from Section 23B of the Federal Reserve Act, which applies to a wider range of transactions with affiliates than Section 23A.

[23] Section 609 of the Proposed Legislation.

[24] Section 610 of the Proposed Legislation.

[25] Section 615 of the Proposed Legislation. The National Banking Supervisor would be the successor agency to the Office of the Comptroller of the Currency and the Office of Thrift Supervision under the Obama Administration's financial services regulatory reform proposals announced in its White Paper.

[26] There is no indication that the Federal Reserve would be required to assess such fees on branches and agencies of foreign banks or on Edge or Agreement corporations.

[27] Sections 102 and 103 of the Proposed Legislation.

[28] *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Financial Services*, 111th Congress (2009) (statement of Mary L. Schapiro, Chairman, SEC) available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/schapiro_testimony.pdf.

Membership

The FSOC would consist of:

- The Secretary of the Treasury, who will serve as Chairman;
- The Chairman of the Federal Reserve;
- The Director of the NBS. Prior to the establishment of the NBS, the Comptroller of the Currency and Director of the Office of Thrift Supervision will be members of the FSOC;
- The Director of the Consumer Financial Protection Agency (once established);[29]
- The Chairman of the Securities and Exchange Commission;
- The Chairperson of the FDIC; and
- The Director of the Federal Housing Finance Agency.

Responsibilities and Powers

Some have criticized the U.S. financial regulators for having "missed the forest for the trees" in the run-up to the current financial crisis. It is claimed that the build-up of systemic risk went unchecked as regulators focused primarily on the health of the individual entities they supervised while largely ignoring risks posed by interconnected firms to the financial system itself. In response, some regulators have argued for the creation of a body that would address issues that pose risks to the broader financial system (i.e., so-called macro-prudential supervision) and be a forum for information sharing and coordination among regulators.[30]

The FSOC would be just such a body. Under the Proposed Legislation, the FSOC will:

- Advise the Congress on financial regulation and make recommendations to strengthen the U.S. financial markets;
- Monitor the financial services marketplace to identify potential threats to financial system stability;
- Advise the Federal Reserve on the designation of Tier 1 FHCs and the designation of systemically important financial market utilities and payment, clearing, and settlement activities;
- Advise the Federal Reserve on standards for such companies and activities; and
- Facilitate information sharing and coordination among the members of the FSOC.

The FSOC may recommend financial firms to the Federal Reserve for designation as Tier 1 FHCs, but the decision-making power regarding Tier 1 FHC designation will remain with the Federal Reserve. The Proposed Legislation also requires the Federal Reserve to consult the FSOC prior to prescribing rules for the designation of Tier 1 FHCs, prior to prescribing material prudential standards for Tier 1 FHCs, and prior to designating any financial market utility or payment, clearing, and settlement activity as systemically important or prescribing material risk-management standards for such institutions.

The FSOC does have the "hard" power, however, to compel the submission of reports from any U.S. financial firm for the purpose of assessing the degree of systemic risk that the firm poses. Whenever possible, however, the FSOC must rely on information already being collected by the members of the FSOC. The FSOC will meet at least quarterly, and the Secretary of the Treasury is required to provide the FSOC with permanent staff for the fulfillment of its mission. The FSOC is authorized to establish advisory committees consisting of any person, whether or

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[29] The Consumer Financial Protection Authority is discussed in our earlier Client Alert (dated July 15, 2009) available at http://www.shearman.com/fia-071509-the-consumer-financial-protection-agency-act-of-2009/.

[30] *Regulating and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Committee on Banking, Housing and Urban Affairs*, 111th Congress (2009) (statement of Sheila Bair, Chairman, FDIC) available at http://www.fdic.gov/news/news/speeches/chairman/spmay0609.html.

not a member of the FSOC, and such committees would not be subject to the Federal Advisory Committee Act.[31]

Reforms for the Asset-Backed Securitization Process

Securitization is widely regarded as having been a key factor in the accumulation of unrecognized systemic risk, and the "Investor Protection Act of 2009", Title IX, Subpart E, of the Proposed Legislation, seeks to address the issue, in part, by ensuring that securitizers of ABS have "skin in the game", thereby incentivizing strong underwriting standards. The Proposed Legislation would amend the Securities and Exchange Act of 1934, as amended ("Exchange Act") to require that within 180 days of its passage the federal banking agencies and the SEC jointly prescribe regulations that would require any securitizer to retain an economic interest in a material portion of the credit risk for any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party.[32]

The Proposed Legislation specifies that such regulation must require the securitizer to retain at least five percent of such credit risk, and prohibit the securitizer from hedging or otherwise transferring such risk. The Proposed Legislation would also amend the Exchange Act to apply its periodic reporting requirements to ABS even if the number of holders of an issue falls below 300, as well as imposing other information requirements.[33]

Treasury Approval Required for Federal Reserve Section 13(3) Lending

As the Proposed Legislation grants the Federal Reserve new powers with respect to the supervision of the largest and most influential financial companies operating in the United States, it has faced pushback by those who claim it would accumulate too much power.[34] The Proposed Legislation would limit the broad lending power the Federal Reserve enjoys in "unusual and exigent circumstances" under Federal Reserve Act Section 13(3). Section 13(3) authorizes the Federal Reserve to authorize the opening of the discount window to any individual, partnership or corporation (regardless of whether it is a bank or BHC) in "unusual and exigent circumstances" by the affirmative vote of five members of the Federal Reserve. Section 13(3) lending was utilized in the Federal Reserve's rescue operations with AIG, Bear Stearns, and other non-bank operations during the current financial crisis including the Commercial Paper Funding Facility and the Term Asset-Backed Securities Loan Facility. Under Title XIII of the Proposed Legislation, the Federal Reserve must obtain the prior written approval of the Secretary of the Treasury before engaging in any Section 13(3) lending.

Office of National Insurance

Title V of the Proposed Legislation, the "Office of National Insurance Act of 2009", creates an Office of National Insurance ("ONI") within the U.S. Department of the Treasury. The Proposed Legislation does not create a federal insurance charter. The Director of the ONI is given the responsibility of monitoring all aspects of the insurance industry, including identifying regulatory gaps, recommending to the Federal Reserve that it designate an insurer as a Tier 1 FHC, and various other advisory, monitoring, and consultative functions.[35]

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31 Sections 105 and 109 of the Proposed Legislation.

32 Section 951 of the Proposed Legislation, amending Section 15 of the Exchange Act.

33 Section 952 of the Proposed Legislation, amending Section 15 of the Exchange Act.

34 See Tom Brathwaite, *Democratic Senator Sees Fed as Block to Reform*, FINANCIAL TIMES, July 23, 2009, at 2 (noting Senator Christopher Dodd's reluctance to grant systemic risk regulation powers to the Federal Reserve). Indeed, in one sense this debate is only a new chapter in the long-standing discussion over the Federal Reserve's fundamental purpose and nature as both the nation's central bank and as a bank supervisory authority.

35 Section 502(a)(3) of the Proposed Legislation, adding 31 U.S.C. § 313(c) and (e).

The Director of the ONI would have the authority to represent the United States in the International Association of Insurance Supervisors and in negotiating agreements with other countries' insurance supervisors, and would have the authority to find that a State insurance measure is preempted if it treats a foreign insurer less favorably than a U.S. insurer and is inconsistent with an International Insurance Agreement on Prudential Measures, subject to notice and comment requirements.[36]

[36] 31 U.S.C. § 313(f), added by Section 502(a)(3).

Moving Forward

The Proposed Legislation represents a broad overhaul of the U.S. banking and financial services regulatory system. As details of the Proposed Legislation get debated, incorporate compromises, and become finalized, the Proposed Legislation is likely to undergo significant modifications, especially in view of expected lobbying and commentary by certain constituencies. We will continue to monitor and report on these and related proposals and counterproposals as the legislation evolves.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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