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Obama Administration Submits Additional Legislation to U.S. Congress

On July 23, 2009, the Obama Administration pushed forward its financial services reform proposals into law by submitting to the U.S. Congress broad proposed legislation ("Proposed Legislation") that would implement many reforms suggested in its White Paper, issued on June 17, 2009.[1] The latest Proposed Legislation consists of three titles that address, among other things, the combination of the respective regulatory agencies responsible for supervising national banks and federal thrift institutions, the regulation and supervision of important payment, clearance and settlement systems, and the establishment of a resolution scheme for large, interconnected financial firms.

The highlights of the Proposed Legislation include:

- Creating the National Bank Supervisor as a new bureau within the U.S. Department of Treasury ("Treasury") by consolidating the Office of Thrift Supervision ("OTS") and the Office of the Comptroller of the Currency ("OCC");
- Eliminating the federal thrift charter and thrift holding company supervisory framework;
- Creating uniform standards for the management of risks by systemically important "financial market utilities" and for the conduct of systemically important payment, clearing, and settlement activities; and
- Giving the federal government the tools to avoid the disorderly resolution of large, interconnected firms, one of which is to provide Treasury the ability to appoint the Federal Deposit Insurance Corporation ("FDIC") or the Securities and Exchange Commission ("SEC") as conservator or receiver for a failing financial firm that poses a threat to financial stability.

Creation of the National Bank Supervisor and Termination of the Federal Thrift Charter

Establishment of the National Bank Supervisor

The "Federal Depository Institutions Supervision and Regulation Improvements Act of 2009", Title III of the Proposed Legislation, establishes the National Bank Supervisor as a bureau in Treasury.

The National Bank Supervisor would be formed to succeed to the authority and statutory rights and powers

[1] The Proposed Legislation is available at http://www.ustreas.gov/press/releases/tg229.htm. The White Paper is discussed in our earlier client publication (dated June 23, 2009) available at http://www.shearman.com/fia-062309-us-financial-regulatory-reform-implications-for-banking-institutions/.

of the OTS and OCC.[2] The operations and functions of the OTS and OCC would transfer to the National Bank Supervisor within 18 months after enactment of the Proposed Legislation.[3]

As described more fully below, a principal objective of the Proposed Legislation is to harmonize standards that apply to federal savings associations (currently regulated by the OTS) with those that apply to commercial banks (including national banks regulated by the OCC), thereby removing what Treasury deems the "central sources of arbitrage in the bank regulatory system."[4]

Responsibilities and Powers of the National Bank Supervisor

Under the Proposed Legislation, the National Bank Supervisor would become the primary regulator of national banks – a function currently carried out by the OCC. In furtherance of that function and in order to fund its activities, the National Bank Supervisor would be vested with the power to impose and collect assessments, fees and other charges on national banks.[5]

The President of the United States would appoint the Director of the National Bank Supervisor (the "Director") to serve as the agency's most senior official. The Director of the National Bank Supervisor would also have a permanent seat on the Financial Services Oversight Council.[6] A Deputy Director, appointed by the Secretary of Treasury, would serve as acting Director when necessary.[7]

Termination of the Federal Thrift Charter and Transition Periods

The OTS currently supervises approximately 740 federal savings associations or federal "thrifts".[8] The Proposed Legislation would abolish the Federal thrift charter, requiring federal savings associations to elect to be chartered and regulated as one of the following:

- national bank;
- mutual national bank;
- State bank; or
- State savings association.

Each savings association would have six months after the enactment of the Proposed Legislation to inform the OTS, OCC and the National Bank Supervisor of the charter it will seek to obtain and must file documentation with the appropriate regulatory agency for the charter alternative that it has chosen. Any federal savings association that either has not made an election or has not successfully converted to a State bank within one year after enactment would automatically become a national bank.[9]

As a general matter, savings associations are required to comply with certain lending and investment restrictions (e.g., expressed as a percentage of the savings association's total assets) that do not also apply to national banks. The Proposed Legislation lays out a "phase-in schedule" that would gradually (over a 5-year period) lift these restrictions for a savings association converting into either a National bank or a State bank.

Under current law, certain savings associations may be able to hold securities/investments that are not permitted by a national bank. Federal and State savings

2 Sections 322(a) of the Proposed Legislation.

3 Sections 323-324 of the Proposed Legislation.

The default transfer date (i.e., absent any extensions) of the transfer of the functions of the OTS and OCC to the National Bank Supervisor is one year after enactment of the Proposed Legislation.

4 While the business and powers of national banks and federal savings associations have been converging, such entities are currently subject to distinct statutory and supervisory frameworks.

5 Section 334(a)(1)(A) of the Proposed Legislation.

6 Section 312(a) of the Proposed Legislation. The Financial Services Oversight Council is discussed in our client publication (dated July 24, 2009) available at http://www.shearman.com/obama-administration-delivers-proposed-bank-and-financial-services-reform-legislation-to-us-congress/.

7 Section 313(a) of the Proposed Legislation.

8 Section 351(a)(1) of the Proposed Legislation.

The term "federal savings associations" includes both federal savings banks and federal savings and loans associations.

9 Section 351(a)(5) of the Proposed Legislation.

associations that elect to become a national bank or State bank (or state savings associations that retain their existing charter under State law) would be allowed to continue to hold "non-conforming" assets (i.e., assets that are not permissible for a national bank) for at least three years (and up to five years) following the Proposed Legislation's enactment.[10]

Termination of the Thrift Holding Company Supervisory Framework

One year after the date of enactment of the Proposed Legislation, each former federal savings association – as well as any remaining state chartered thrifts – would be treated as a "bank" for purposes of the U.S. Bank Holding Company Act of 1956, as amended ("BHCA"). As a consequence, "savings and loan holding companies" (i.e., generally, a company that directly or indirectly "controls" a savings association (or "thrift")) – which are currently supervised by the OTS – would become bank holding companies subject to Board of Governors of the Federal Reserve System ("Federal Reserve") supervision and examination. This convergence towards the bank holding company supervisory framework would result in the elimination of existing differences in the regulation and supervision of bank holding companies and savings and loan holding companies (e.g., in terms of the scope of permissible non-banking activities and minimum capital requirements – where, in each case, rules imposed on bank holding companies are generally more restrictive).[11]

Enhanced Federal Reserve Regulation of Systemically Important Payment, Clearing, and Settlement Systems

The "Payment, Clearing, and Settlement Supervision Act of 2009," Title VIII of the Proposed Legislation, provides the Federal Reserve with additional authority over any institution that provides payment, clearing or settlement services considered by the Federal Reserve to be "systemically important."[12] Effectively, this gives the Federal Reserve clear statutory authority to oversee the risk management of major payment, clearing and settlement systems in the United States; in the absence of that authority, the Federal Reserve has had to supervise payments systems based on a mixture of its supervisory authority over certain systems providers and its right to impose conditions on the use of Federal Reserve Bank settlement services by other systems.[13]

The Proposed Legislation gives the Federal Reserve the authority to designate a particular payment, clearing, or settlement activity as being, or being likely to become, systemically important, and to designate a particular multilateral system as a "designated financial market utility," which is, generally speaking, a legal entity engaged in a payment, clearing or settlement activity that is systemically important.[14] The Federal Reserve has the authority to issue risk management standards governing the operations of designated financial market utilities and the conduct of designated activities with a view to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system.[15] In doing so, the Federal Reserve is obligated to consult with appropriate

[10] Section 352(1)(a) of the Proposed Legislation.

[11] In general, savings and loan holding companies (commonly referred to as thrift holding companies) are permitted to engage in those activities permissible for a bank holding company as well as certain additional activities. A so-called "grandfathered unitary thrift holding company" is not currently subject to any activities restrictions and, thus, this aspect of the Proposed Legislation could have a particularly significant impact on this category of thrift holding companies.

The OTS does not currently impose either consolidated or unconsolidated minimum capital requirements on thrift holding companies.

[12] Section 804(a) of the Proposed Legislation.

[13] See Federal Reserve Policy Statement on Payments System Risk, IV F.R.R.S. ¶ 9-1000 et seq. (as amended effective Dec. 18, 2008), available at www.federalreserve.gov/paymentsystems/psr/policy.pdf .

[14] Section 803 of the Proposed Legislation.

[15] Section 805 of the Proposed Legislation.

financial supervisors of entities so designated and with the Financial Services Oversight Council.[16]

Every designated financial market utility will be examined at least annually by its principal supervisory agency (if the principal supervisory agency is not the Federal Reserve, the Federal Reserve may elect to participate in examinations).[17] The Federal Reserve is given authority to take emergency enforcement actions against a designated financial market utility when it has reasonable cause to believe that there is an imminent risk of substantial harm to financial institutions, critical markets, or the broader financial system.[18] Further, the Federal Reserve is permitted, as a general matter, to require any financial market utility or a financial institution engaged in a payment, clearing, or settlement activity to submit any information to enable the Federal Reserve to assess whether it is systemically important. The Federal Reserve is also authorized to permit a designated financial market utility to have an account at a Federal Reserve Bank and receive any service available to a bank, including access to the Discount Window.[19]

Enhanced Federal Government Resolution Authority to Improve Financial Crisis Management

In view of the disruption to the financial system caused by the recent collapse, or near collapse, of several of the largest and most connected U.S. financial institutions, the Administration has proposed the "Resolution Authority for Large, Interconnected Financial Companies Act of 2009", Title XII of the Proposed Legislation, to establish a federal resolution authority to unwind systematically important non-bank financial institutions. The proposed resolution authority is intended to supplement existing U.S. bankruptcy laws and address the threat of a disorderly and destabilizing resolution at a large financial institution in a manner similar to the FDIC's existing conservatorship/receivership authority with respect to U.S. depository institutions.

This authority could apply only to entities that fall within the specific meaning of "bank holding companies" as defined by Title XII of the Proposed Legislation. A "bank holding company" for this purpose is an entity organized under Federal or State law that is either (i) a bank holding company under the BHCA, (ii) a company designated by the Federal Reserve as a Tier 1 Financial Holding Company ("Tier 1 FHC"), and/or (iii) a subsidiary of either such type of company other than a FDIC-insured depository institution, broker-dealer, or insurance company.[20] Thus, many types of companies controlled by BHCA bank holding companies or Tier 1 FHCs could be potentially subject to this authority. Non-U.S. companies such as foreign banks could not be directly subject to it.

Conditions to Use of the Resolution Authority

The resolution authority would include both (i) the ability of the FDIC to provide "emergency assistance" to, and (ii) the authority of the Treasury Secretary to appoint the FDIC or the SEC as conservator or receiver for, a failing covered bank holding company. The SEC is only appointed as a conservator or receiver when the largest subsidiary of a covered bank holding company is a registered broker or dealer. In either case, use of the resolution authority is contingent upon:

- Two-thirds vote by the members of the Federal Reserve Board;
- Two-thirds vote by the members of the Boards of the FDIC or the SEC; and
- A systemic risk determination by the Treasury Secretary.

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[16] The Financial Services Oversight Council is discussed in our client publication (dated July 24, 2009) available at http://www.shearman.com/obama-administration-delivers-proposed-bank-and-financial-services-reform-legislation-to-us-congress/.

[17] Sections 807(c) and 808(a) of the Proposed Legislation.

[18] Section 807(g) of the Proposed Legislation.

[19] Section 806 of the Proposed Legislation.

[20] Section 1202(2) of the Proposed Legislation. See our client memorandum (dated July 24, 2009), available at http://www.shearman.com/obama-administration-delivers-proposed-bank-and-financial-services-reform-legislation-to-us-congress/ for an explanation of a Tier 1 Financial Holding Company designation.

For these purposes, a systemic risk determination refers to a finding by the Treasury Secretary that: (1) a covered bank holding company is in "default or danger of default"; (2) the failure of the bank holding company would have serious adverse effects on financial stability or economic conditions in the U.S.; and (3) any action or assistance by the federal government would avoid or mitigate such adverse effects.[21]

Authority to Provide "Emergency Assistance"

Upon the Treasury Secretary making a systemic risk determination, the FDIC may, with the approval of the Secretary, take one or more of the following actions with respect to the failing "bank holding company":

- Make loans to, or purchase any debt obligation of, the company;
- Purchase assets of the company directly or through an entity established by the FDIC for such purpose;
- Assume or guarantee the obligations of the company to one or more third parties;
- Acquire any type of equity interest or security of the covered company;
- Take a lien on any or all assets of the company, including a first priority lien on all unencumbered assets of the company to secure repayment of any financial assistance provided under this subsection; or
- Sell or transfer all, or any part thereof, of any such acquired assets, liabilities, obligations, equity interests or securities of the company.[22]

Authority to Appoint a Conservator or Receiver

Under the Proposed Legislation, the resolution authority also provides the Treasury Secretary with the ability to appoint the FDIC or SEC as conservator or receiver for a failing "bank holding company" that threatens overall financial stability.[23] If appointed as conservator or receiver, the appropriate agency would then be required to terminate any case commenced against the company under title 11 of the U.S. Bankruptcy Code.

The appropriate agency acting as conservator or receiver would have the following duties and powers with respect to a failing "bank holding company":

- Take over the assets of and operate the distressed company with all the powers of the members or shareholders, the directors, and the officers of the distressed company and conduct all of the distressed company's business;
- Collect all obligations and money due to the distressed company;
- Perform all functions of the company in its name;
- Preserve and conserve the assets and property of the distressed company; and
- Provide by contract for assistance in fulfilling any function, activity, action, or duty of the appropriate federal regulatory agency (i.e., either the FDIC or the SEC) as conservator or receiver.[24]

The powers of the conservatorship/receivership authority with respect to "bank holding companies" are generally patterned after the conservatorship/receivership regime in place with respect to FDIC-insured depository institutions.

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[21] Section 1203(b) of the Proposed Legislation.

[22] Sections 1204(a)(1-6) of the Proposed Legislation.

[23] Section 1204(b) of the Proposed Legislation. Receivership generally involves liquidating the institution and winding up its affairs while conservatorship involves operating the institution as a going concern to protect its assets until it stabilizes or is closed and a receiver appointed.

[24] Sections 1209(a)(1)(B)(i-v) of the Proposed Legislation.

Moving Forward

The Proposed Legislation would change the U.S. banking and financial services regulatory system in significant ways. It is already becoming increasingly clear that many aspects of the Proposed Legislation are likely to undergo modifications as lobbyists, industry officials, and lawmakers all engage in a sharp debate on Capitol Hill over the Administration's plan and, more generally, the future of U.S. financial regulation. 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.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Laura Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Donna Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barnabas W.B. Reynolds
London
+44.200.7655.5528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

William R. Murdie
London
+44.20.7655.5149
bill.murdie@shearman.com

M. Holland West
New York
+1.212.848.4579
holland.west@shearman.com

Gregg L. Rozansky
New York
+1.212.848.4055
gregg.rozansky@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Michael J. Blankenship
New York
+1.212.848.8531
michael.blankenship@shearman.com

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