News Bulletin

June 18, 2009

Newton's Third Law and the White Paper

Aside from being famous for sitting under an apple tree and getting hit in the head by an apple, Newton is also credited with the third law of motion. According to high school physics and also Wikipedia, the principal gist of that third law is that for every action, there is an equal and opposite reaction. Given the direction and the force of the financial crisis, it was logical to expect that the force of the reaction, in the form of new regulatory reforms, would be strong. On June 17th, the Treasury Department (Treasury) released its much anticipated white paper, titled "Financial Regulatory Reform: A New Foundation." The white paper sets out the key proposals intended to restore confidence in the integrity of the financial system. The full text of the white paper and the various accompanying fact sheets may be accessed from our Financial Crisis website.

This alert provides a brief overview of the proposals detailed in the white paper. We intend to supplement this alert with more detailed analyses and discussions of particular aspects of the suggested reforms, the potential concerns raised by the reforms for market participants, and the questions to be answered by policymakers as we move from aspiration to legislation and regulation. We also will provide regular updates on the other set of inevitable reactions—those of industry groups and other interested commentators regarding these proposals.

Objectives and Overview

The white paper notes that the reform proposals are intended to address five key objectives:

- Promoting robust supervision and regulation of financial firms;
- Establishing comprehensive supervision and regulation of financial markets;
- Protecting consumers and investors from financial abuse;
- Improving tools for managing financial crises; and
- Raising international regulatory standards and improving international cooperation.

Please see our chart, which is Appendix A, summarizing the proposals under each of these five key objectives.

In furtherance of these objectives, the white paper introduces several new regulators or agencies that will have new oversight responsibilities. Restructuring the regulatory framework and creating these new entities is intended to remedy the perceived "gaps" or opportunities for regulatory arbitrage that are identified as having contributed to the financial crisis. The below table summarizes these changes.

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Changes in Regulators/Oversight		
New	**Purpose**	**Composition/Structure**
Financial Services Oversight Council	To identify emerging systemic risks and improve interagency cooperation	Chaired by Treasury; will include heads of principal federal financial regulators as members (8 members)
National Bank Supervisor	To supervise all federally chartered banks	Separate status in Treasury
Consumer Financial Protection Agency	– To protect consumers across the financial sector from deceptive practices – To focus on credit, savings, and payments markets – Authority to reform mortgage laws	Independent entity
Office of National Insurance	To coordinate regulatory policy in the insurance sector	Separate status in Treasury

Under the proposals, the Federal Reserve and the FDIC maintain their "respective roles in the supervision and regulation of state-chartered banks." In many important respects, the authority of the Federal Reserve would be enhanced as a result of the proposals. We have summarized below the additional authority that would reside with the Federal Reserve.

Federal Reserve
Summary of new/additional authority
– Supervise all firms that could pose a threat to financial stability, even those that do not own banks (Tier 1 FHCs) – Oversee payment, clearing, and settlement systems – Enhanced authority over market infrastructure – A right to assess risks and set higher standards for a Tier 1 FHC to protect against excessive risk taking

Credit unions would continue to be supervised by the National Credit Union Administration. The SEC and the CFTC would maintain their authorities as market regulators, although the white paper recommends the harmonization of the statutory and regulatory frameworks for futures and securities. Special resolution authority to address institutions that are "too big to fail" (TBTF) would reside with the Treasury, as we discuss below.

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The introduction to the white paper ends with the following exhortation: "We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial markets." Then follow the 80+ pages of proposals.

I. Supervision and Regulation of Financial Firms

The white paper identifies several problems. First, that although our largest financial institutions all were subject to supervision and regulation, regulation proved inadequate and inconsistent. Relatedly, responsibilities for regulating various operations of financial institutions were divided among different agencies, resulting in fragmentation and regulatory "loopholes" that provided an opportunity for regulatory arbitrage. Capital and liquidity requirements were too low and regulators did not require institutions to plan for stress scenarios where access to liquidity would be constrained. Finally, the paper notes that regulators did not take into account the full systemic impact, given the interconnectedness of our markets, of the failure of one of the largest financial institutions.

Financial Services Oversight Council

A Financial Services Oversight Council (FSOC), which will be chaired by Treasury, will fill supervisory gaps, facilitate coordination of policy and resolution of disputes, and identify emerging risks. FSOC will advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability as a result of their size, leverage or interconnectedness. Such an entity will be identified and referred to as a Tier 1 FHC.

Consolidated Supervision and Regulation; Stricter Capital Standards

Every Tier 1 FHC will be subject to consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution. The Federal Reserve should have authority over and accountability for Tier 1 FHCs. Tier 1 FHCs will be subject to stricter standards, which will include capital, liquidity and risk management standards. Regulation will extend to all subsidiaries of a Tier 1 FHC, regulated and unregulated, domestic or foreign. The Federal Reserve will have authority to collect information and reports from financial institutions of a certain size, as well as to impose activity restrictions on subsidiaries of Tier 1 FHCs.

A National Bank Supervisor (NBS), that merges the OCC and the OTC, shall conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks.

The federal thrift bank charter would be eliminated, but the related interstate branching rules will be retained and applied to state and national banks. Entities that control an insured depository institution (for example, a thrift, ILC, credit card bank, trust company or other non-traditional bank) would become subject to consolidated supervision and regulation by the Federal Reserve and subject to the nonbanking activity restrictions of the Bank Holding Company Act (BHCA) in order to eliminate any regulatory loopholes. The SEC's consolidated supervision programs should be eliminated. Investment banks seeking consolidated supervision by a U.S. regulator would be subject to the Federal Reserve's supervision and regulation.

All banks and bank holding companies (BHCs) will be subject to new capital and other prudential standards. Treasury will lead a working group that will assess existing regulatory capital requirements and will issue its conclusions by year-end. Another working group will assess supervision of banks and BHCs.

Regulation of Hedge Funds and Private Pools of Capital

In addition to the potential classification of hedge funds and other private pools of capital as Tier 1 FHCs (and the potential for much greater regulation, as such), the white paper includes a number of proposals that would affect the oversight of the private fund industry through both broader investment adviser registration requirements and

enhanced data reporting obligations for registered investment advisers (IAs) with respect to the private investment pools that they manage.

In a significant departure from prior approaches to the regulation of the hedge fund industry, the white paper proposes to treat hedge funds, private equity funds and venture capital funds identically. This lack of nuance seems at odds with the case set out for the new regulatory approach in the white paper, which cites prominently the role played by the deleveraging of hedge funds during the financial crisis in 2008. The white paper posits that the lack of regulatory oversight of hedge funds left the government unable to access data regarding the size and systemic implications of hedge funds during the recent crisis. The white paper also noted that hedge funds and other private pools of capital require investor protection. Accordingly, the white paper proposes to expand the regulation of hedge funds and other private capital pools, by:

- Requiring IAs of hedge funds and other private pools of capital to register with the SEC as investment advisers under the Advisers Act, if the IAs meet a modest specified amount of assets under management;
- Requiring registered IAs to provide the SEC with sufficient data to permit an assessment of the private fund's status as a Tier 1 FHC;
- Subjecting hedge funds and other private pools of capital advised by registered IAs to record-keeping obligations, including confidential reporting of assets under management by each investment pool (importantly, however, the white paper anticipates these obligations and requirements will vary depending on the nature of the investment pool; and
- Recommending that the SEC conduct regular compliance examinations.

Consistent with its stated goal of extending federal government access to data related to private pools of capital, the white paper supports the implementation of the G-20 recommendations requiring registration of and reporting on hedge funds (noting that the recommendations of the white paper extend that recommendation to private equity, as well as hedge funds).

Money Market Funds

The regulatory framework applicable to money market funds should be strengthened in order to make money market funds less susceptible to downturns.

Executive Compensation

Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value. Compensation practices should not incentivize excessive risk-taking. Non-binding shareholder proposals on executive compensation and additional independence requirements for compensation committees should be supported.

Review of Accounting Standards

Accounting standard setters should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information.

Insurance

Although the white paper lists among its key objectives, "promoting robust supervision and regulation of financial firms," and on multiple occasions cites the failure of the American International Group as evidence of the U.S. regulatory system, neither the proposed new regulators or agencies such as the FSOC nor the proposed

comprehensive regulatory system, including the regulations applicable to Tier 1 FHCs, reflect current insurance regulations or regulators.

Instead of including existing insurance regulators or establishing a new federal insurance regulator, the legislation contemplates the establishment of an Office of National Insurance (ONI) within Treasury, mandated to gather information, monitor the insurance industry, negotiate international agreements and identify regulatory problem areas that could lead to future market crises. Most significantly, the ONI also would recommend to the Federal Reserve any insurance companies it believes should be supervised as Tier 1 FHCs. The ONI would also assume governmental responsibilities under the Terrorism Risk Insurance Act. The white paper then identifies six principles for guiding modernization of the U.S. system of insurance regulation, addressing (i) effective systemic risk regulation, (ii) strong capital standards for insurance companies and capital allocation matched with liabilities, (iii) meaningful and consistent consumer protection, (iv) national uniformity in insurance regulation, (v) consolidated regulation of insurance companies and their non-insurance affiliates, and (vi) international coordination.

The white paper does not address the many concerns previously raised by opponents of federal insurance regulation, including how such regulation would coordinate with existing state insurance regulation in the areas of consumer protection, consumer complaints, rate making, insolvency and state guaranty funds. In particular, if an insurance company or insurance holding company were to be deemed a Tier 1 FHC and become subject to the proposed financial reform regulations, which are principally designed for bank holding companies, would state insolvency and guaranty fund statutes become pre-empted? If so, would policyholders no longer have any guaranty fund coverage? If not, how would such state statutes interact with the federal statutes? Would the holding company suddenly be required to hold higher amounts of capital? Would that immediately have adverse effects on the insurance company?

Other questions as to the means by which the ONI will accomplish its mandates and the mechanisms for implementing the principles articulated in the white paper without duplicating existing insurance regulation remain to be examined. On June 16, 2009, in testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, Michael T. McRaith of the National Association of Insurance Commissioners (NAIC) reiterated its position that the NAIC does not believe the insurance sector poses systemic risk, due principally to the existing system of state insurance regulation, and that the principles articulated in the white paper are best addressed through the state regulatory system in coordination with a federal system.

Future of the GSEs

Treasury and the Department of Housing and Urban Development will develop recommendations for the future of Fannie Mae and Freddie Mae, as well as the Federal Home Loan Bank system.

The white paper puts forward various options for GSE reform, including: "(1) returning them to their prior status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals; (2) gradual wind-down of their operations and liquidation of their assets; (3) incorporating the GSEs' functions into a federal agency; (4) a public utility model where the government regulates the GSEs' profit margin, sets guarantee fees, and provides explicit backing for GSE commitments; (5) conversion to providing insurance for covered bonds; and (6) the dissolution of Fannie Mae and Freddie Mac into smaller companies."

II. Regulation of Financial Markets

Securitization

The white paper notes the benefits of securitization, particularly as a means of funneling credit to families and businesses to finance the consumption necessary to sustain economic growth. However, the white paper also

finds faults with the current securitization model. In the Administration's view, by breaking the direct link between borrowers and lenders, securitization led to a general erosion of lending standards, resulting in a serious market failure that fed the housing boom and deepened the housing bust. The Administration believes that this problem was exacerbated by compensation practices that incentivized securitization participants to focus on production volumes rather than on loan quality. Finally, the Administration believes that investors have not had sufficient information regarding underlying loans, causing an over-reliance on the recommendations of credit rating agencies.

The Administration addresses these perceived failings with five general recommendations to strengthen the supervision and regulation of the securitization markets:

- Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.
- Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.
- The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS).
- The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process.
- Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

For each of these five general recommendations, the white paper sets forth a number of sub-recommendations that are discussed in detail, resulting, by one count, in approximately twenty-four separate recommendations. A detailed listing of these recommendations is beyond the scope of this alert. See Appendix B to this alert for a list of proposals. However, we note that a number of these recommendations, especially those pertaining to securitization reporting and disclosure and to regulation of the credit rating agencies, are already being actively pursued by various securitization industry regulators and constituencies. For example, a number of the recommendations regarding credit rating agencies are already being addressed by the SEC in its far-reaching rulemaking proceedings regarding the regulation of credit rating agencies and the use of private ratings for governmental purposes. Similarly, many securitization reporting and disclosure issues are being addressed by the securitization industry itself through its principal trade organization, the American Securitization Forum, or ASF, and its Project Restart initiative. Below, we discuss several proposals that have not been subject to previous widespread public discussion and that we believe are likely to generate the most controversy.

Non-Hedged Risk Retention. The white paper proposes that federal banking agencies promulgate regulations that require loan originators or sponsors to retain 5% of the credit risk of securitized exposures. These regulations would further prohibit an originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these regulations. The requirement of a retained interest is intended to ensure that the originator and/or sponsor of a securitization continue to have "skin in the game" in the form of ongoing exposure to the credit risk of the assets. This proposal raises a host of issues that will likely be difficult to sort out. For example, it is unclear how the 5% retention would be accounted for on the books of the originator or sponsor—that is, at book value or at "fair value" requiring periodic mark-to-market adjustments. Also, there may be questions regarding the impact of the retention on the originator's and/or sponsor's ability to de-recognize, or treat as sold, the 95% securitized interest under the new FASB pronouncements, FAS 166 and FAS 167, which substantially revised the sale and consolidation principles previously embodied in FAS 140 and FIN 46(R). Moreover, it is unclear whether only one party to a securitization transaction must retain a 5% interest, or if

multiple parties in a multi-step transaction must independently retain a 5% interest. For example, if an originator sells loans to a securitization conduit sponsor that actually issues the securitization instruments, must the originator and the sponsor each retain a 5% interest?

Further issues are raised by the requirement that the 5% retention be unhedged. Clearly, the purpose of this requirement is to ensure that the originator or sponsor bears the full brunt of any credit losses on the 5% retention. However, this principle flies in the face of the broader principle emphasized in the white paper that financial institutions should adhere to strict risk management procedures. From a risk management standpoint, it may not be sensible for a financial institution to retain exposure on a substantial portfolio position, at least if the protection can be economically obtained. To the extent that hedging is not obtained, the originator or sponsor has greater exposure to credit risk and therefore itself poses a greater risk of failure, which is in turn destabilizing to the financial markets.

Compensation and Elimination of Gain on Sale. The white paper proposes that the compensation of loan brokers, originators, sponsors, underwriters and others involved in the securitization process be linked to the longer term performance of the securitized assets, rather than only to the production of those products. For example, the proposal states that the fees and commissions received by loan brokers and loan officers, who otherwise have no ongoing relationship with the loans they generate, should be disbursed over time and should be reduced if underwriting or asset quality problems emerge over time.

The white paper also proposes that the immediate recognition of income, or gain on sale, by originators at the inception of a securitization be eliminated under GAAP, and that originators should instead be required to recognize income over time. It also states that many securitizations should be consolidated on the originator's balance sheet and their asset performance should be reflected in the originator's consolidated financial statements. While many of the accounting changes suggested by the white paper with respect to originators are already under discussion by the accounting profession or have already been incorporated in the newly issued FASB pronouncements, FAS 166 and FAS 167, the proposals to compensate individuals and other transaction participants, such as underwriters, over time will likely be extremely difficult to administer in an industry where compensation is traditionally paid currently.

The white paper is vague on how these changes would be implemented. However, if fully implemented as suggested, one must imagine that mortgage industry workers will become similar to actors or songwriters receiving residuals over a period of years. It remains to be seen what type of administrative infrastructure and payment clearinghouse would need to be established to track workers' entitlements to compensation over the life of a long-term loan. In addition, the servicing cost of applying performance criteria and dividing loan payments among brokers, underwriters and others may be considerable relative to the presumably small amounts involved.

As we noted above, the white paper contains a number of other recommendations, some more controversial than others and some more likely to be implemented than others. The process of fleshing out the details of these proposals, including the completion of the regulatory actions necessary to implement them, will likely be a lengthy process. Until these proposals are resolved through implementation or rejection, the securitization market is likely to remain closed as a result of the uncertainty created by the white paper's recommendations. While many of these measures may appear to provide benefits to investors and borrowers, most impose economic or liability burdens on originators, servicers and sponsors of securitizations that, at the margin, make it less likely that an originator will choose to pursue a securitization strategy.

OTC Derivatives

The white paper recommends far-reaching changes in the regulation of OTC derivatives. We list the proposals in Appendix C to this alert. One of the primary drivers behind the Administration's proposal to establish a comprehensive regulatory framework for OTC derivatives is the view, as expressed in the white paper, that the build-up of risk in OTC derivatives became "a major source of contagion" through the financial sector during the

financial crisis. The white paper's proposals regarding regulation of the OTC derivatives markets are, for the most part, identical to those proposed by Secretary Geithner on May 13, 2009 and are intended to achieve the same four objectives:

- to prevent activities threatening the stability of the financial system;
- to promote market efficiency and transparency;
- to deter market manipulation, fraud and similar abuses; and
- to ensure that OTC derivatives are not marketed inappropriately to "unsophisticated" investors.

The white paper notes that a critical element in achieving these four objectives is that similar products and activities must be subject to similar regulations and oversight. Again, consistent with prior announcements, the white paper proposes statutory authority to mandate the central clearing of all standardized OTC derivatives through regulated central counterparties, or CCPs. This requirement is intended to improve market efficiency and price transparency. Both the SEC and the CFTC would have authority to regulate the OTC derivatives markets and the CCPs. CCPs would be required to impose robust margin requirements and other necessary risk controls. Regulation also would ensure that customized OTC derivatives are not used solely as a means to avoid clearing OTC derivatives through a CCP. For purposes of distinguishing between "standardized" and "customized" OTC derivatives, an OTC derivative will be presumed to be a standardized contract if it is accepted for clearing by one or more fully regulated CCPs.

All OTC derivatives dealers and all other firms whose activities in OTC derivatives markets "create large exposures to counterparties" would be subject to a "robust and appropriate" regime of prudential supervision and regulation. Such a regime would include the imposition of conservative capital requirements; business conduct standards; reporting requirements; and conservative requirements relating to initial margins on counterparty credit exposures.

The proposals recommend authorizing the CFTC and the SEC, consistent with their respective missions, to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Clearing standardized OTC derivatives through a CCP or reporting customized OTC derivatives to a regulated trade repository could be deemed to satisfy certain of these recordkeeping and reporting requirements. CCPs and trade repositories would be required to make available to the public aggregate data on open positions and trading volumes and to make available on a confidential basis to the CFTC, the SEC, and an individual counterparty's primary regulators data on the institution's trades and positions.

The standardized portion of the OTC derivatives markets would be moved onto regulated exchanges and regulated transparent electronic trade execution systems, which would require development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. Regulated financial institutions would be encouraged to make greater use of regulated exchange-traded derivatives.

The authority of the CFTC and the SEC would be strengthened in order to ensure that they have clear, unimpeded authority to "police and prevent" fraud, market manipulation, and other market abuses involving all OTC derivatives. The white paper also recommends tightening the eligibility limits for parties that participate in derivatives transactions or impose additional disclosure requirements or standards of care when marketing derivatives to less sophisticated counterparties such as small municipalities.

Payment, Clearing and Settlement Systems

The white paper recognizes that payment, clearing, and settlement systems and activities can be stabilizing or destabilizing forces during financial market crises. The white paper proposes four measures to strengthen the

oversight of systemically important payment, clearing, and settlement systems and activities (covered systems and activities) and the settlement capabilities and liquidity resources of covered systems:

- Assign the Federal Reserve stronger statutory authority to oversee covered systems and activities. The white paper recommends that Congress assign the Federal Reserve oversight authority of covered systems and activities, in part because of the Federal Reserve's special interests in promoting their safety and efficiency. The white paper recommends that the Federal Reserve's new authority supplement the existing authority of regulators of clearing and settlement systems (e.g., the SEC and the CFTC) and prudential regulators of financial firms.
- Enable the Federal Reserve to identify covered systems and activities. The white paper recommends that Congress define broadly covered systems and activities, and grant the Federal Reserve the authority to collect information not already available from other federal regulators for the purposes of identifying covered systems and activities.
- Coordinate oversight of covered systems and activities among the Federal Reserve and other federal regulators. The white paper recommends that covered system should be subject to regular, consistent, and rigorous safety and soundness examinations, led by the covered system's primary regulator with input by and consultation from the Federal Reserve. The white paper further recommends granting the Federal Reserve the authority to compel corrective actions by covered systems. The white paper also recommends, with respect to covered activities, that financial firms' primary Federal regulator, if any, enforce compliance with the risk management standards established by the Federal Reserve.
- Authorize the Federal Reserve to provide covered systems access to Reserve Bank accounts, financial services, and the discount window. The white paper recommends that Congress authorize the Federal Reserve to grant covered systems access to certain central bank services traditionally reserved for depository institutions, which could facilitate settlement during large participant or other emergency situations, once the covered system exhausts all contingency measures.

Harmonizing Broker-Dealer and IA Regulation

Recognizing the evolution of business practices of securities brokers, the white paper advances a proposal to reconcile the fiduciary status of broker/dealers and IAs under federal law, in order to hold brokers to the same types of fiduciary duties when providing investment advice to retail investors as apply to IAs under the Advisers Act.

III. Protect Consumers and Investors from Abuse

The white paper notes that while there are numerous federal and state regulations designed to protect consumers against fraud and to promote an understanding of financial products, as a result of both changes in the financial markets and fragmented regulation, there may have been gaps and weaknesses in such protection. In particular, the white paper cites concerns relating to mortgage lenders that were not regulated as banks.

The white paper proposes the creation of a new Consumer Financial Protection Agency (CFPA) to protect consumers of financial products and services and regulate the providers of such products and services. It envisions the CFPA as an independent agency with consolidated authority over all aspects of these products and services, thereby reducing gaps in federal supervision and enforcement. The CFPA would have broad jurisdiction over all consumer financial products that are not investment products and services already regulated by the SEC. It would also have sole rulemaking and enforcement authority with respect to consumer financial protection statutes.

The CFPA would be tasked with ensuring consumers have adequate information to make responsible financial decisions and are protected from unfair, deceptive or discriminatory practices. On a market-wide level, it would

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be charged with ensuring that consumer financial services markets operate fairly and efficiently with room for growth and innovation and that traditionally underserved consumers and communities would have access to such markets.

As well as taking over the Federal Trade Commission's current authority to regulate consumer financial products offered by nonbank institutions, the CFPA would have the authority to promulgate regulations and enforce consumer protection laws that apply to banks, which are currently subject to such supervision by their prudential regulator. The CFPA would also regulate mortgage companies that are not owned by banks and which are outside the current consumer regulatory structure for financial products. The CFPA would have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes that it implements, although the white paper envisions that it would coordinate with the Department of Justice to enforce the statutes under its jurisdiction in federal court. It would also coordinate enforcement efforts with the states.

The CFPA would also be authorized to encourage the development of "plain vanilla" products, i.e. products which are "easy for consumers to understand." The CFPA would be given authority to create new disclosures and requirements to ensure that complex products, like alternative mortgages, are obtained only by consumers who understood the risks and could manage them. Such new disclosures and requirements could include requiring institutions to provide a warning label, or requiring a customer to complete a financial experience questionnaire. "Plain vanilla" products would be presumptively suitable and affordable for the borrower. Alternative products would not have such a presumption, and originators of alternative products would be subject to significantly higher penalties for violations.

The Treasury also proposes various measures meant to ensure that companies treat consumers fairly. For example, the white paper report specifically proposes that the CFPA have authority to restrict or prohibit mandatory arbitration clauses. The CFPA also would be given the authority to ban prepayment penalties and yield spread premiums, and impose on mortgage brokers a fiduciary duty to provide a consumer with the best available mortgage loan and a duty to determine affordability for borrowers. The CFPA would also have the authority to prohibit charging for overdraft coverage under a plan unless the consumer opts-in to the plan.

The CFPA would be independent, although at least one seat on its board would be reserved for the head of a prudential regulator. It would have sole authority both to promulgate and to interpret regulations under existing consumer financial services and fair lending statutes such as the Truth in Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Settlement and Procedures Act (RESPA), Community Reinvestment Act (CRA), Equal Credit Opportunity Act (ECOA), Home Mortgage Disclosure Act (HMDA), and the Fair Debt Collection Practices Act (FDCPA). It would enjoy similar rulemaking authority under any future consumer protection law addressing the consumer credit, savings, collection, or payment markets. Its rulemaking authority would be intended to serve as a floor, rather than a ceiling, for state regulators. The white paper also suggests that the CFPA pursue measures to promote effective regulation such as periodic regulatory reviews and maintaining and consulting with an outside advisory panel akin to the Federal Reserve's Consumer Advisory Council.

Funding for the CFPA would come in part from fees assessed on entities and transactions across the financial sector, including bank, nonbank institutions, and other providers, as well as covered products and services.

IV. Tools for Managing Financial Crises

Resolution Authority

Much has been written about how to address institutions that are deemed "too big to fail" (TBTF) and whose failure would pose systemic risk. The white paper provides for a supplemental process to address the TBTF entities. Special resolution authority will:

- Reside with Treasury;
- Give Treasury authority to appoint a receiver or a conservator for the TBTF entity (which may be the FDIC or, in limited cases, the SEC);
- The conservator or the receiver will have broad powers, including authority to operate the TBTF entity or to sell or transfer assets (in the case of the TBTF entity's derivatives, the conservator or the receiver will have the power to transfer those contracts to a bridge institution and thus avoid termination of those contracts by the TBTF entity's counterparties, notwithstanding any contractual right of those counterparties to terminate the contracts upon the appointment of a receiver or conservator);
- Convey the authority to provide loans, assume liabilities or inject capital;
- Be invoked by Treasury only after consulting with the President and upon the written recommendation of two-thirds of the members of the Federal Reserve, and the FDIC or SEC, as appropriate;
- In order to invoke the authority, Treasury must determine that:
    - The firm is in default or in danger of defaulting;
    - The failure of the firm would have serious adverse effects on the financial system; and
    - The use of the special resolution authority would avoid or mitigate these adverse effects.

Exigent Circumstances

The white paper proposes legislation that amends Section 13(3) of the Federal Reserve Act (relied upon during the financial crisis) to require Treasury's prior written approval for any extensions of credit by the Federal Reserve in "unusual or exigent circumstances."

V. International Standards

The white paper notes that given the interrelatedness of financial markets, regulation of financial institutions that is national in scope enables financial institutions to move their operations or businesses to jurisdictions with looser standards. The recommendations in the white paper support those announced earlier in the year at the G-20 meeting in London. Essentially, the white paper suggests focusing on reaching international consensus on four core issues: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management.

Consistent with the G-20 commitment, among other things, the white paper recommends:

- Standardization and improved oversight of credit derivative and other OTC derivatives markets through the use of CCPs;
- Strengthening of arrangements for international cooperation on supervision of global financial firms;
- BCBS modifications and improvements to Basel II through refining of risk weightings applicable to derivatives and securitized products, introduction of a supplemental leverage ratio and improvements to the definition of capital;
- The imposition of registration and disclosure requirements for hedge funds or their managers; and
- The introduction of executive compensation schemes that better align compensation with long-term shareholder value.

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Conclusion

As we note above, this alert is intended as a preliminary summary of the many proposals contained in the white paper. The white paper presents proposals and a number of more fully formed recommendations; however, in quite a number of areas, the white paper mandates additional studies or the formulation of policy recommendations from working groups or from government agencies.

The white paper proposals attempt to close gaps in and streamline the regulatory system, but political compromises are incorporated in an effort to propose a set of reforms that can actually be enacted into law. Regardless of the wisdom of the individual reforms, the white paper will shortly move into the legislative process, resulting in additional political compromises and changes. Financial market participants will need to follow the progress of the proposals carefully and be prepared to take steps to both influence the outcome of the political process and to adapt their business models to the resulting new regulatory environment.

A number of overarching themes run through the white paper, which may be worth reflecting on when evaluating individual recommendations. Although the white paper does not purport to provide an analysis of the root causes of the financial crisis, it does note that, in significant part, the fragmented or dispersed nature of regulation of financial institutions created "gaps" in supervision and oversight. Market developments also led to the formation of a number of entities that engaged in financial services and offered financial products but were not subject to the same level of regulation and supervision that was applicable to depository institutions. A lack of coordinated international regulation and supervision over certain financial products and services and over internationally significant and active financial institutions also created "loopholes." All of these factors contributed to the potential for inconsistent regulatory standards and the possibility for regulatory arbitrage. The white paper advances quite a number of proposals intended to cast a wider net and impose more uniform and consistent regulatory standards—in part through the creation of a number of new regulatory entities and in part by subjecting firms engaged in offering financial services and products to a similar regulatory scheme. Finally, by endorsing the G-20 recommendations, which are intended to harmonize regulatory standards applicable to financial institutions and financial products, the white paper also suggests that the opportunity for arbitrage will be limited.

We will continue to evaluate the individual recommendations of the white paper in light of its broad themes, and the outcomes of the numerous studies proposed. In that regard, we initially note that the stated objective of creating a simple or straightforward regulatory framework may be difficult to achieve with the addition of new agencies and broader authorities for existing agencies and the Federal Reserve. Additionally, the enhanced scope of the regulatory bodies over a broader set of entities will add complexity. Regulation by entity, including new regulations for investment pools, insurance companies, finance companies and others, and regulation by product, including securitization instruments, derivatives and all consumer financial products will also receive close analysis.

Perhaps proving the intrinsic truth of Newton's third law, only one thing seems certain: opposing reactions to the proposals will likely be forceful.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Appendix A

White Paper Summary				
Supervision of Regulation of Financial Firms	Regulation of Financial Markets	Consumer and Investor Protection	Resolution Authority (a/k/a TBTF)	International Standards
• Financial Services Oversight Council • Identifying Tier 1 FHCs • Expanding BHC status • Stronger capital standards • National Bank Supervisor • Regulation of "non-banks" or "shadow banking system" • Office of National Insurance • Elimination of thrift charter • Assessment of the role of GSEs	• Enhanced regulation of participants in the securitization market • Oversight and regulation of NRSROs • Regulation of OTC derivatives and OTC derivatives dealers • Harmonizing futures and securities regulation • Fed oversight of payment, clearing & settlement systems	• Consumer Financial Protection Agency • Financial Consumer Coordinating Council • Transparency, fairness, accountability, access, and appropriateness of consumer and investor products • "Plain vanilla" products	• Addressing Too Big To Fail problem • Resolution authority for Tier 1 FHCs • FDIC or SEC as conservator or receiver • Fed to obtain Treasury approval for SEC 13(3) lending	• Support for G-20 initiatives • Foreign firms to be tested for FHC status

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Appendix B

Summary of Proposed Securitization Related Reforms

- Change incentive structure for securitization participants
- Risk retention of 5% of the credit risk of securitized exposures
- No hedging of retained risk
- Tie broker, originator and sponsor compensation to the long-term performance of the securitization
- Eliminate gain on sale accounting
- Require standardized, stronger representations and warranties
- Require enhanced disclosure requirements, including loan level disclosure and disclosure regarding the compensation for the broker, originator and sponsor
- Expand TRACE reporting to include ABS
- Require conflicts of interests policies and procedures for credit rating agencies
- Differentiate structured finance ratings
- Require credit rating agencies to explain the meanings of ratings for ABS and the way in which such ratings differ from corporate debt ratings
- Credit rating agencies should disclose information on methodologies and originator reviews

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Appendix C

Summary of Proposed OTC Derivatives Regulations

- Require transparency for all OTC derivatives trades and positions through recordkeeping and reporting requirements
- Empower market regulators to take enforcement action against fraud, market manipulation and other abuses
- Conservative regulation of all OTC derivatives dealers and other participants in the OTC derivatives markets
- Require standardized derivatives to be centrally cleared through regulated central counterparties (CCPs) and executed on exchanges
- CCPs will be required to impose robust margin requirements and other risk controls
- Impose higher capital charges for customized OTC derivatives
- Presumption that an OTC derivative that is cleared through a CCP is a "standardized" derivative
- Harmonize regulation of futures and derivatives
- CFTC and SEC report to Congress by September 30, 2009

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