Financial Institutions

E-ALERT March 27, 2009

Treasury Outlines Framework for Financial Regulatory Reform

COVINGTON
COVINGTON & BURLING LLP

BEIJING
BRUSSELS
LONDON
NEW YORK
SAN DIEGO
SAN FRANCISCO
SILICON VALLEY
WASHINGTON

WWW.COV.COM

On March 26, 2009, the Department of Treasury released an initial outline of its proposal for comprehensive financial regulatory reform. The outline was released coincident with Secretary Timothy Geithner's testimony before the House Financial Services Committee on the need for resolution authority over systemically significant financial institutions that fall outside of the Federal Deposit Insurance Corporation's (FDIC) existing resolution regime.

The following is a summary of the key elements of Treasury's current proposal for financial regulatory reform:

Systemic Risk Regulation

- A single independent regulator with responsibility over "systemically important firms" and critical payment and settlement systems should be created.
- "Systemically important firms" would not be limited to banks or bank holding companies, but could include any financial institution that was deemed to be systemically important in accordance with legislative requirements. In defining the term "systemically important firms," the following characteristics should be taken into account: (1) the financial system's interdependence with the firm; (2) the firm's size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding and (3) the firm's importance as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.
- Regulatory authority over payment and settlement systems, including overnight and short-term lending markets and over-the-counter (OTC) derivatives, should be clarified and consolidated within a single entity.

Higher Capital and Risk Management Standards

- Capital requirements for systemically important firms should be "more conservative" than for other institutions and sufficiently robust to be effective in a wider range of adverse economic scenarios.
- Systemically important firms should also be subject to liquidity, counterparty, and credit risk management requirements that are "more stringent" than for other financial firms. A prompt corrective action regime that forces protective actions as a systemically important firm's regulatory capital levels decline should also be put in place.

Hedge Fund Registration

- All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed a certain threshold (Covered Funds) should be required to register with the Securities and Exchange Commission (SEC).

- All Covered Funds advised by an SEC-registered investment adviser should be subject to investor and counterparty disclosure requirements, as well as to regulatory reporting requirements that include reporting, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability.
- The SEC should share the reports that it receives from Covered Funds with the systemic risk regulator, so it can determine whether any such funds pose a systemic threat and should be subject to the prudential standards regarding capital and key areas to be established by the systemic regulator.

Regulation of the OTC Derivatives Market

- The markets for credit default swaps and over-the-counter derivatives should be federally regulated. All OTC derivatives market dealers should be subject to a "strong regulatory and supervisory regime" as systemically important firms.
- All standardized OTC derivative contracts should be cleared through appropriately designed central counterparties, and greater use of exchange traded instruments should be encouraged. Central counterparties should be subject to comprehensive settlement systems supervision and oversight. All non-standardized derivatives contracts should be reported to trade repositories and should be subject to robust standards for documentation and confirmation of trades, netting, collateral and margin practices, and close-out practices.
- Central counterparties and trade repositories should be required to make aggregate data on trading volumes and positions available to the public and to make individual counterparty trade and position data available on a confidential basis to appropriate federal regulators.
- All market participants should be subject to robust eligibility requirements and, where appropriate, standards of care, as well as to recordkeeping and reporting requirements.

Strengthen Regulation of Money Market Funds

- The SEC should strengthen the regulatory framework for money market funds to reduce the credit and liquidity risk profile of individual funds and to make the money market fund industry as a whole less susceptible to rapid withdrawals.

Resolution Authority Over Non-bank Financial Institutions

- A resolution regime that provides authority to avoid the disorderly liquidation of any non-bank financial institution whose failure would have serious adverse effects on the financial system or U.S. economy should be created.
- This new resolution authority should cover financial institutions that have the potential to pose systemic risks to the economy but that are not currently subject to the resolution authority of the FDIC. This new systemic resolution authority would include bank and thrift holding companies, holding companies that control broker-dealers, insurance companies, futures commission merchants, or any other financial firm that could pose substantial risk to the economy.
- Before emergency measures can be taken under the new systemic resolution authority, the Secretary, upon the recommendation of both the Federal Reserve Board and the FDIC and in consultation with the President, would have to make a triggering determination that (1) the relevant non-bank financial institution is in danger of becoming insolvent; (2) its insolvency would have serious adverse effects on economic conditions or financial stability in the United States; and (3) taking emergency action would avoid or mitigate those adverse effects.

- Upon the triggering of the new systemic resolution authority, the Secretary and the FDIC would decide, taking account of recommendations from the Federal Reserve Board and the appropriate federal regulatory agency (if different from the FDIC), whether to provide financial assistance to the institution or to place the institution into conservatorship or receivership. Financial assistance could include loans, purchase of the institution's obligations or assets, assumption or guarantee of the institution's liabilities, and purchase of an equity interest in the institution. Treasury and the FDIC would place an institution into conservatorship with the aim of returning it to private hands and into receivership with the aim of winding down the institution. The trustee of a conservatorship or receivership would have broad powers, including to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's contracts (including with its employees), and to deal with the institution's derivatives book. A conservator could also restructure the institution by, for example, replacing its board of directors and senior officers. None of these actions would be subject to the approval of the institution's creditors.
- Systemic resolution authority over non-bank financial institutions would be modeled on the FDIC's existing resolution authority over insured depository institutions and the Federal Housing Finance Agency's existing resolution authority over the GSEs, except that systemic resolution authority conservatorships and receiverships would aim to minimize the impact of the potential failure of the institution on the financial system and consumers as a whole, rather than simply addressing the rights of an institution's creditors as in bankruptcy.
- Institutions covered by the new systemic resolution authority would be required to fund the authority; funds from the Deposit Insurance Fund would not be used.

Attorneys in Covington's Financial Institutions Group have advised many clients on recent financial services and banking developments. The Financial Institutions Group's expertise derives from advising clients on the impact of such developments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

Stuart Stock	202.662.5384	sstock@cov.com
D. Jean Veta	202.662.5294	jveta@cov.com
Keith Noreika	202.662.5497	knoreika@cov.com
Mark Plotkin	202.662.5656	mplotkin@cov.com
David Martin	202.662.5128	dmartin@cov.com
Bruce Bennett	212.841.1060	bbennett@cov.com
David Engvall	202.662.5307	dengvall@cov.com
Michael Nonaka	202.662.5727	mnonaka@cov.com