



House Passes Financial Regulation Reform Package

On December 11, 2009, the U.S. House of Representatives approved, by a vote of 223-202, regulatory reform legislation, The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). The legislation contains fundamental changes to the structure and approach of financial regulation and supervision in order to address what are perceived to be the principal causes of the financial crisis that grew out of abuses in real estate finance, asset securitization, and unregulated participants in the financial services industry. This briefing discusses the major provisions of the bill that affect the supervision and regulation of depository institutions and systemically significant institutions. We will provide additional briefings on other elements of H.R. 4173 that affect compensation, derivatives, hedge funds, and other important topics.

The product of the House deliberations reflects the intense advocacy efforts from many sources and resulted in numerous compromises by leadership of the House Financial Services Committee. Nevertheless, the legislation includes many provisions that are not acceptable to the financial services industry. Significant differences exist between H.R. 4173 and the proposal of Senator Dodd, which is expected to be the subject of Senate Banking Committee debate in early 2010.

Improving Financial Stability and Enhancing Prudential Regulation

Systemic Supervision and Regulation. This legislation creates a Financial Services Oversight Council to monitor and take actions to address systemic risk. The Council will monitor the marketplace to identify potential threats to the stability of the financial system by strengthening the regulation and supervision of large, interconnected financial firms with the objective of reducing the likelihood of future crises. The Council would subject those financial companies and activities that it believes pose a threat to financial stability to stricter standards and regulation, including, with respect to companies, higher capital requirements, leverage limits, a debt-equity ratio of not more than 15:1, periodic stress tests, and limits on concentrations of risk. A financial company subject to the stricter standards would be required to develop a plan for its orderly dissolution in the event of severe financial distress. The Federal Reserve Board ("FRB") will serve as the agent of the Council in regulating systemically risky firms on a consolidated basis and systemically risky activities wherever they occur, ensuring broad accountability for such regulation.

The Council is authorized to subject financial activities or practices to stricter standards upon making certain determinations regarding the impact such activities or practices could have on the stability of the financial system or economy. Any determination under this authority could affect all financial institutions whether or not an institution is systemically significant.

All financial companies with more than \$10 billion of total assets would be required to conduct semi-annual stress tests and report the results to both the appropriate primary federal regulator and the FRB. In addition, the FRB could conduct stress tests of a financial company that is not systemically significant without regard to its asset size. A company that the FRB determined to be

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significantly or critically undercapitalized would be required to submit a rapid resolution plan.

The systemic provisions could apply to a company organized under the laws of another country that has significant operations in the United States (“foreign financial parent”) through a branch or agency of a foreign bank or a U.S. operating entity that engaged in financial activities. In considering whether to apply stricter standards to a foreign financial parent, a financial regulatory agency must consider the extent to which the company is subject to prudential standards on a consolidated basis that are administered and enforced by a comparable foreign supervisory authority. In addition, a federal financial regulatory agency, in applying standards to a foreign financial parent or its U.S. operations, would be required to take into account principles of national treatment and equality of competitive opportunity.

A financial company that does not control a bank but that is determined to present systemic risk would be required to form an intermediate holding company under a new section 6 of the BHC Act or to terminate any of its nonfinancial activities. The holding company would be subject to the activities restrictions of the Bank Holding Company Act of 1956, as amended (“BHC Act”), specific regulatory requirements, and supervision by the FRB.

Any financial holding company (“FHC”) would be required to meet the well-capitalized and well-managed standards that currently only apply to depository institution subsidiaries of bank holding companies and to foreign banks. The agencies would be required to consider the potential effect on financial stability of any proposed merger, acquisition or consolidation in considering whether to grant approval under the BHC Act or the Bank Merger Act. A financial holding company transaction involving the acquisition of more than \$25 billion of assets would be subject to prior FRB approval.

Improved Consolidated Supervision. H.R. 4173 would remove the problematic constraints under the Gramm-Leach-Bliley Act on the consolidated supervision of large financial companies by the FRB, and provides specific authority to the FRB and other federal financial agencies to regulate for financial stability purposes and quickly address potential problems. The FDIC would receive broader authority to conduct examinations related to its resolution responsibilities.

Enhanced Regulation for Non-Banks. H.R. 4173 would place additional safeguards on industrial loan corporations (“ILCs”) and other non-bank depository institutions, bringing them under a consolidated supervisory framework. Existing non-bank banks, ILCs, and similar companies that engage in commercial activities

but are not currently subject to bank holding company regulation will not be forced to divest, but their financial activities will be brought under a regulated holding company structure and will face limits on transactions with their commercial affiliates. The bill also would close prospectively the ILC exemption from the definition of “bank,” so that no additional commercial companies would be allowed to own banks or ILCs without conforming their nonbanking activities and investments to the restrictions of the BHC Act.

The exemption from the definition of “bank” would continue for credit card banks. Indeed, the scope of the exemption would expand by (i) permitting commercial loans to small businesses and (ii) applying to an institution that issues virtual or intangible devices that function as credit cards.

Consolidation of the OTS into the OCC. The House Financial Services Committee holds the view that the existing system resulted in a bias toward “lighter touch” regulation and arbitrage among federal bank and thrift regulators. To address this concern, the bill would consolidate the Office of Thrift Supervision (“OTS”) with the Office of the Comptroller of the Currency (“OCC”). The bill would not eliminate the thrift charter for organizations dedicated to mortgage lending, but would subject thrift holding companies to supervision by the FRB. The Chairman of the FRB or his designee would become a member of the FDIC Board of Directors to replace the Director of OTS.

Restrictions on Assistance in Times of Crisis. Under H.R. 4173, the FDIC could extend Emergency Financial Stabilization loan guarantees to solvent banks and predominantly financial companies only in a liquidity crisis. This facility, which will only result in a government payout if a guaranteed loan defaults, will be funded by fees paid by financial companies that request guarantees. A similar facility managed by the FDIC generated positive net revenues for the government in the recent liquidity crisis. This authority sunsets on December 31, 2013, unless extended by Congress.

The Federal Reserve’s use of lending authority under section 13(3) of the Federal Reserve Act (“FR Act”) would be subject to significant new restrictions. Use of this authority would require approval by two-thirds of the members of the Council and the consent of the Treasury Secretary after certification by the President that an emergency exists. This authority could not be used to provide assistance to individual companies, and Congress would be able to disapprove further use of the authority.

Dissolution Authority

The bill provides for orderly dissolution of failing firms with the intent of putting an end to the concept that an entity might be “too big to fail.” The legislation provides for authority that would enable regulators to dissolve large, highly complex financial companies in an orderly and controlled manner, ensuring that shareholders and unsecured creditors bear the losses. When a firm enters the dissolution process, management responsible for the failure would be dismissed, shareholders and unsecured creditors would be the principal bearers of losses, and the firm would cease as a going concern.

The FDIC would be able to unwind a failing firm so that existing contracts could be dealt with and the claims of secured creditors could be addressed. However, unlike traditional bankruptcy, which does not account for complex interrelationships of such large firms and could endanger financial stability, the intention of this process is to help prevent contagion and disruption to the entire system and the overall economy.

Dissolution costs would be repaid first from the assets of the failed firm at the expense of shareholders and creditors, and any shortfall would be repaid by assessments on all large financial firms. As a result, the financial industry would pay for any problem arising from the financial sector for which financial assistance is necessary for an orderly dissolution.

A financial company with \$50 billion or more of assets would be subject to risk-based assessments to fund a “Systemic Dissolution Fund” that would be available to ensure that any losses incurred in connection with the resolution of a systemically significant institution would be borne by the financial industry. The Systemic Dissolution Fund could be used to help wind down failing financial institutions, but not to preserve them. The Fund would also be pre-funded by assessments on hedge funds with more than \$10 billion in assets. This authority would sunset on December 31, 2013, unless extended by Congress.

Other Actions Affecting Banking Organizations

Risk Retention for Securitizations. Lenders would be required to retain a portion of the risk they generate in order to provide market discipline for underwriting decisions. New rules from the banking regulators and the SEC would require creditors to retain at least five percent of the credit risk associated with any loans that are transferred, sold, or securitized.

Countercyclical Capital Requirements and Deposit Insurance Assessments. The bill would amend the International Lending Supervision Act of 1983 to require the agencies “to seek to

make such requirements countercyclical” to allow for capital requirements to decrease during times of economic contraction but subject institutions to increased capital requirements during times of expansion. In addition, the FDIC would have flexibility to maintain the size of the Deposit Insurance Fund in a countercyclical manner.

Changes to Section 23A. The bill contains several changes to the restrictions on bank transactions with affiliates under section 23A of the FR Act. The definition of “affiliate” would be expanded to cover any investment fund to which a bank or an affiliate is an investment adviser. Currently, the definition applies to companies that are “sponsored and advised” by the bank or an affiliate (or is otherwise controlled or defined as an affiliate). H.R. 4173 would also (i) expand the definition of “covered transaction” to include expressly a loan by a bank secured by “other debt obligations” of an affiliate rather than only covering transactions secured by “securities” of an affiliate; (ii) clarify that repos are extensions of credit rather than asset purchases; (iii) treat a securities borrowing and lending transaction with an affiliate as a covered transaction to the extent that the transaction creates credit exposure; (iv) treat current and future credit exposure on derivative transactions with an affiliate as covered transactions; and (v) remove the exemption for financial subsidiaries from the 10 percent limit on transactions with an affiliate. The FRB would be required to obtain the concurrence of the Chairman of the FDIC in order to grant an exemption by regulation or order and, in the case of a transaction or relationship involving a federally chartered or licensed institution, the concurrence of the OCC.

An amendment to section 18 of the Federal Deposit Insurance Act (“FDI Act”) would subject asset purchase and sale transactions between bank insiders and their related interests to a market terms requirement and, if the transaction is in an amount exceeding 10 percent of the bank’s capital, approval of the bank’s board of directors. The FDIC would have authority to issue regulations to implement this provision and comparable authority of the FRB under section 22 of the FR Act would be removed.

Scope of Transactions Subject to Lending Limits. Under the legislation, the scope of transactions subject to the national bank lending limits under section 84 of the National Bank Act would expand to include any liability of a bank to advance funds under a contractual commitment; and credit exposure arising from derivatives, repos, reverse repos, and securities lending and borrowing transactions. A similar amendment would be made to section 22 of the FR Act to subject these transactions to Regulation O when they involve insiders.

Charges for Holding Company Examinations. The FRB would be required to assess fees for any examination of a bank holding company with consolidated assets of \$10 billion or more. The FRB currently avoids imposing charges for holding company supervision by conducting “inspections” rather than examinations.

GAO Audits of the FRB. The legislation also substantially enhances the authority of the Government Accountability Office (“GAO”) to examine the FRB and the Federal Reserve Banks to provide greater transparency to Federal Reserve facilities and actions.

Consumer Financial Protection Agency. The agency, which will be headed by a single director for the first two years, would be authorized to restrict bank overdraft protection programs and impact bank interchange. A manager’s amendment that the

House adopted restores some preemption for national banks that the original Consumer Financial Protection Agency proposal took away. Specifically, the language provides that state laws that “prevent, significantly interfere with, or materially impair” the ability of national banks (or state banks in states with wild-card statutes) to engage in the business of banking may be preempted. This is closer to the preemption standards set forth in the Barnett Bank case.

Nationwide Deposit Cap. The bill would expand the scope of the restriction against agency approval of an interstate merger or acquisition that resulted in an acquirer controlling more than 10 percent of “bank” deposits to include thrift deposits.

Nationwide De Novo Branching. The bill would authorize state and national banks to establish de novo branches in any state.

The Financial Services Practice Group of Winston & Strawn represents a broad range of banking organizations, financial services companies, and their owners and investors on all aspects of their businesses, including legislative developments and proposals affecting the financial industry. If you have any questions regarding the matters discussed in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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