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SECURITIES INDUSTRY

ALERT

FRR Report Proposes Three New Regulatory Agencies

On June 17, 2009, President Obama announced a proposal to redesign the financial system of supervision and regulation. Coupled with this announcement, the U.S. Department of the Treasury released a report titled "*Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation*" (FRR Report).

Significantly, Section One of the FRR Report, titled "Promotion of Robust Supervision and Regulation of Financial Firms," focuses on creating a stronger and more consolidated regulatory framework to identify and manage firms that pose potentially significant risks to the entire financial system. To accomplish this seemingly insurmountable feat, there are proposals to create three new regulatory agencies: (1) the Financial Services Oversight Council (FSOC); (2) the National Bank Supervisor (NBS); and (3) the Office of National Insurance (ONI). As part of this new approach, the FRR Report advocates increased transparency of hedge funds and legislation to reduce the consequences of money market fund runs.

Financial Services Oversight Council

The proposed FSOC will be an independent agency with authority to gather information from any financial firm whose size or "interconnectedness" may pose a threat to the system if it were to fail. As such, some firms that may own insured depository institutions will not be exempt from FSOC scrutiny if those firms pose significant risks to the overall system. The FSOC's duties will include:

- Coordinating information sharing between regulatory agencies;
- Identifying and advising the Federal Reserve Board (FRB) of firms that pose prospective threats to the stability of the financial system;
- Reducing supervisory gaps; and
- Providing a forum for jurisdictional disputes between regulators.

The FSOC membership will include the Secretary of the Treasury; the chairs of the FRB, SEC, CFTC and FDIC; and the directors of the National Bank Supervisor, the Federal Housing Finance Agency, and the Consumer Financial Protection Agency. Despite this coordination, the actual possession and implementation of regulatory power will still predominantly remain with various regulators.

National Bank Supervisor

The FRR Report also proposes the creation of the NBS, a federal banking agency within the Treasury Department. Presently, four federal agencies have authority over depository institutions:

(1) Office of the Comptroller of the Currency (OCC), regulating national banks;
(2) Office of Thrift Supervision (OTS), regulating savings and loan associations;
(3) FRB, representing member banks; and
(4) FDIC, covering all insured depository institutions.

The current system allows a bank to select its own regulator or, to be more precise, regulatory reporting structure. However, the NBS' creation will amend that system since the NBS will supervise and regulate all federally chartered depository institutions as well as all national branches of foreign banks. Effectively, the NBS will succeed the OCC and OTS, but the FDIC and FRB will largely continue their same roles.

Other Proposed Changes in the FRR Report

If the FRR Report's recommendations are enacted, banks and bank holding companies (BHC) would also have their capital and other requirements strengthened. For example, the SEC's Supervised Investment BHC Program would be eliminated, causing all investment banking firms seeking consolidated supervision by a regulator to be subject to the FRB. Another proposal would allow the Treasury Department to reassess existing regulatory capital

requirements for banks, issue new executive compensation standards and implement more forward-looking loan loss provisions. Stronger firewalls to protect the federal safety net were also recommended.

Other legislation proposals would increase transparency in both the insurance and hedge fund industries, requiring all hedge funds, private equity firms and other private pools of capital advisers to register with the SEC under the Investment Advisers Act of 1940. No longer will investment advisers be exempt from registration through current client or definitional exceptions if these proposals are approved. If passed, these entities will be subject to increased disclosure, record keeping and supervision. Another proposal would create the ONI within the Treasury to monitor the insurance industry. The ONI would gather information and identify regulatory gaps that may lead to future financial crises.

Finally, the FRR Report also proposes increased regulation of money market funds (MMF), special mutual funds that generally avoid large credit risks and volatility. However, as was seen with the Lehman Brothers failure, an MMF run—multiple investors simultaneously recalling their assets when the financial institution may not have sufficient reserves—may occur, resulting in severe liquidity issues. To strengthen the MMF regulatory framework, the FRR Report proposes that the SEC:

- Require MMFs to maintain larger liquidity buffers;
- Reduce the maximum weighted average maturity of MMF assets;
- Tighten the credit concentration limits applicable to MMFs;
- Improve the credit risk analysis of MMFs; and
- Empower MMF boards of directors to suspend redemptions in extraordinary circumstances.

In sum, these new proposals may result in changes to the entire supervisory and regulatory structure of our domestic financial system. Creation of new government agencies such as the FSOC, NBS and ONI will certainly impact the regulatory structure and investigations. Thus, clients will need to carefully understand the changes, especially the broader power of the FRB, in contemplating future business decisions. Fox Rothschild LLP attorneys will continue to monitor this situation and report when necessary.

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