Financial Regulation Reform: What to Expect in the 111th Congress

Analysis by James Hamilton, J.D., LL.M.

CCH Principal Analyst

Introduction

As the nation approaches the most fundamental reform of the financial and securities markets since President Franklin Roosevelt's New Deal, the central figure in the effort will certainly be President Barack Obama. It is thus instructive to examine the six key principles that must guide next year's reform legislation, as described in a briefing paper setting out Mr. Obama's beliefs in this area. Obviously, events can work changes during the interregnum before Mr. Obama is sworn in as President next January. I recall from history that conditions deteriorated significantly during the President Hoover-President Roosevelt interregnum, which was longer because FDR was not sworn in until March of 1933. We are perhaps fortunate that this experience led to the shortening of the presidential interregnum so that the needed reform process can begin sooner.

At the same time, it is now certain that the two key congressional overseers of the financial markets will remain in place for what promises to be the historic 111th Congress. Barney Frank, Chair of the House Financial Services, and Christopher Dodd, Chair of the Senate Banking Committee, have both expressed the need to completely overhaul the regulation of the financial markets.

The following reforms, among others, are likely to happen next year:

- reform of the securitization process
- federal regulation of credit rating agencies
- creation of a market stability or risk management regulator

© 2008, CCH. All rights reserved.

- federal regulation of hedge funds and other alternative investment vehicles
- mandated shareholder advisory votes on executive compensation
- reform of fair value accounting
- consolidation of federal financial regulatory agencies
- regulation by objective
- increased cross-border regulatory cooperation
- creation of a Financial Products Safety Commission
- increased transparency in the financial markets
- federal regulation of credit default swaps
- investor protection regulation placed on equal footing with safety and soundness

Guiding Principles of President-Elect Obama

The President-elect has enunciated six broad principles that will guide his effort to reform the oversight of financial markets. One such principle is that the nation must devise a financial regulatory regime for the 21st century to replace one that is still essentially a 1930s regulatory apparatus. This means first and foremost ending the current balkanized framework of overlapping and competing regulatory agencies. Prior to the 1999 repeal of the Glass-Steagall Act, financial institutions fell into easily delineated categories such as commercial banks and investment banks and were regulated by specific entities such as the SEC, the FDIC and the CFTC. However, the large, complex institutions that currently dominate the financial landscape no longer fit into discrete categories. Thus, President-elect Obama endorses a streamlined system of federal oversight.

A second guiding principle is that the Fed must have authority over any financial institution to which it may make credit available as a lender of last resort. The Federal Reserve does not exist to bail out financial institutions, declared the President-elect, but rather to ensure stability in the financial markets. There must be prudential oversight commensurate with the degree of exposure of specific financial institutions.

In light of the widespread valuation problems of complex financial instruments such as mortgage-backed securities, a third principle of the Obama reforms will be enhancing capital requirements and the development and rigorous application of new standards for managing liquidity risk. President Obama will also call for an immediate investigation into the ratings agencies and their relationships to securities' issuers, similar to the investigation the European Union conducted, which led to a proposal to require the registration of credit rating agencies in the EU and the end of voluntary regulation.

© 2008, CCH. All rights reserved.

A fourth principle is to regulate financial institutions for what they do rather than who they are. The current oversight structure is rooted in the legal status of financial firms. This must end, said the President-elect, since this fragmented structure is incapable of providing the oversight necessary to prevent bubbles and curb abuses. President-elect Obama believes that regulation should identify, disclose, and oversee risky behaviors regardless of what kind of financial institution engages in them. This is essentially a regulation by objective approach favored by many, including the recent Volcker report. Former Fed Chair Paul Volcker is a senior adviser to the President-elect.

Barack Obama also believes, as a fifth principle, that the SEC should aggressively investigate reports of market manipulation and crack down on trading activity that crosses the line to fraudulent manipulation. In the last eight years, the SEC has been sapped of the funding, manpower and technology to provide effective oversight. The SEC's budget was left flat or declining for three years and is currently less than it was in 2005. The President-elect cited a 2007 GAO report finding that the SEC lacked the computer systems to effectively make use of internal audits conducted by stock exchanges, which may limit the SEC's ability to monitor unusual market activity, make decisions about opening investigations, and allow management to assess case activities, among other thing.

As a result, during a period of increasing market uncertainty and opacity, the SEC enforcement division has not effectively policed potentially manipulative behavior. The SEC's FY2009 budget request itself shows that the percentage of first enforcement actions filed within two years of opening an investigation or inquiry fell from 69 percent in 2004 to 54 percent last year. Mr. Obama believes that there must be an effective, functioning cop on the beat to identify market manipulation, protect investors and avoid excessive speculation in financial markets.

More broadly, a sixth principle of financial markets reform is to establish a mechanism that can identify systemic threats to the financial system and effectively address them. The President-elect calls for the creation of a Financial Market Oversight Commission that would meet regularly and report to the President, the President's Financial Working Group and Congress on the state of the financial markets and the systemic risks that face them. He also calls for the establishment of a standardized process to resolve such systemic risk in an orderly manner without putting taxpayer dollars at risk. This goal may presage the creation of a systemic risk regulator as some congressional leaders are championing.

Volcker Report

With former Federal Reserve Board Chair Paul Volcker reported to be President-Elect Obama's principal adviser on the financial and securities markets, a recently-released report by Mr. Volcker on the structure of financial regulation takes on heightened importance. The report, under the auspices of the Group of Thirty, seems to favor the twin peaks model of financial regulation over other models, such as the integrated regulator approach of a single universal regulator, which is used in the U.K.

© 2008, CCH. All rights reserved.

The twin peaks approach was recommended for U.S. financial regulation by the Treasury blueprint for reform issued earlier this year. The two other regulatory models examined in the report are the functional approach under which regulation is determined by the business being transacted by the entity; and the institutional approach under which the firm's legal status determines which regulator oversees it.

According to the report, the twin peaks approach is designed to garner many of the benefits and efficiencies of the integrated approach, while at the same time addressing the inherent conflicts that may arise from time to time between the objectives of safety and soundness regulation and consumer protection and transparency. The twin peaks approach is currently used in the Netherlands and Australia.

The twin peaks approach embodies the principle of regulation by objective under which one agency's objective is prudential supervision, while the other agency focuses on business conduct and consumer protection. The Treasury blueprint, which promotes regulation by objective approach, differs from existing twin peaks models on that it advocates a business conduct regulator separate from the transparency and markets regulator. The Treasury blueprint proposes that the transparency and market regulator be the SEC.

Current twin peaks jurisdictions link investor protection with market fairness and transparency mandates and have a single regulator in charge of all three mandates. Since most securities regulators have deep experience with business conduct regulation, this role has usually been given to the securities regulators in jurisdiction using twin peaks regimes. The report points out that the business conduct regulator is not limited to rulemaking, but can also develop arbitration and mediation systems.

The Volcker report clearly views the current U.S. regulatory structure as an exception to the four standard regimes. The anomalous U.S. regulatory structure is a creature of historical precedent, politics and culture. The U.S. system is functional with institutional aspects, said the report, with the added complexity of state-level agencies and actors. Although the current structure is quite complex, it soldiered on until the current crisis exposed its weakness and the need for structural reform.

The report says that the institutional approach is largely based on a business model that no longer exists. Many large financial firms are involved in a cross-section of products and services rather than in the monoline activities of the past. This approach also suffers from potential inconsistencies in applying regulations by disparate regulators.

A major drawback of functional regulation, said the report, is that it can be extremely difficult to distinguish which activity comes within the jurisdiction of which regulator. A problem with the integrated approach is that if the universal regulator fails to spot an issue there is no other regulator to fill the void.

© 2008, CCH. All rights reserved.

Sen. Dodd's Principles for Reform

For his part, Senate Banking Committee Chair Christopher Dodd issued a statement outlining his principles for reforming financial regulation. Noting that he will remain chair of the Banking Committee in the upcoming 111th Congress, Senator Dodd said that the first order of business will be to erect a new financial regulatory regime in order to restore investor confidence in the securities markets. As part of this legislative effort, the committee will execute an ambitious schedule of meetings, briefings and hearings to understand the strengths and weaknesses of the current regulatory system. The committee's inquiry and deliberations, assured Mr. Dodd, will be guided not by pre-conceived notions but by core principles that must be reflected in any comprehensive reform effort.

One core principle is that regulators must be strong cops on the beat, rather than turn a blind eye to reckless practices. As SEC Chairman Cox said earlier, voluntary regulation has failed and it is now clear that the financial markets alone cannot be entrusted to police themselves. The consequences for taxpayers are just too great, said Sen. Dodd, to allow significant market actors to carry out their activities in an unregulated or under regulated environment.

Another element of reform is the need to remove negative incentives for regulators to compete against each other for "clients" by weakening regulation. The new financial regulatory system cannot encourage regulatory arbitrage, charter-shopping or a regulatory race to the bottom in an attempt to win over institutions. Regulators should not have to fear losing institutions, and thus the source of their funding, by being good cops on the beat.

Reform legislation must also ensure that regulators are aware of risks that the institutions they supervise are taking and effectively control them, so that they do not imperil the financial system. All institutions that pose a risk to the financial system must be carefully and sensibly supervised. This responsibility could reside with a single regulator or multiple agencies, he noted, but in either case communication and information-sharing among agencies must be streamlined and improved.

Another key principle is the need for more transparency in the financial system. Market participants need information about the risks they are taking. And, it is not acceptable to have regulators in the dark about the risks posed to and by the institutions under their watch.

Finally, an important principle is that investor protection must be placed on an equal footing with regulations ensuring the safety and soundness of the financial system. It is now clear that investor protection and economic growth are not in conflict but, on the contrary, are inextricably linked. The crisis teaches that a failure to protect investors can wreak havoc on the financial system.

© 2008, CCH. All rights reserved.

House Leaders' Principles for Reform

In recent House hearings on the future of financial regulation, leaders of the Financial Services Committee set forth principles for the complete overhaul of the regulatory regime. Rep. Paul Kanjorski, a senior committee member, listed several such principles. For example, complex financial products require greater transparency. Hedge funds and private equity firms must disclose more about their activities. The markets for credit default swaps and other derivatives must also operate more openly and under regulation. Banking and securities must be separate, he continued, and all financial institutions must soundly manage their risks. In his view, regulators must be consolidated into fewer agencies, while enforcement is enhanced at the same time.

There is also a growing consensus for a Financial Products Safety Commission, patterned after the Consumer Products Safety Commission, to vet financial products for investors. Rep. Jackie Spier suggested that, rather than create a new agency; the SEC could be transformed into something capable of protecting investors from overly-risky financial products. Rep. Ron Klein stated that a new, evolving version of the SEC, CFTC, or combination of the two—or an entirely new Financial Product Safety Commission—could give confidence to investors on novel, complex financial products. But in any event, there is a need to rethink and implement a regulatory organization that promotes good business practices and gives clear information to consumers so they can make informed investment decisions.

Securitization Reforms

According to senior officials, this market crisis is at root a crisis of securitization. But, almost all policymakers and regulators agree that, having crossed the Rubicon into the land of asset-backed securities under an originate-and-distribute model, there is no returning to the land of originate-and-hold. Thus, complex structured securitization must be reformed.

In recent remarks, Federal Reserve Board Chair Ben Bernanke strongly emphasized that securitization must be reformed. In his view, the ability of financial intermediaries to sell the mortgages they originate into the broader capital market by means of the securitization process serves two important purposes: First, it provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits; and second, it substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks associated with holding mortgages to maturity, thereby reducing the overall costs of providing mortgage credit.

Although traditional securitization was a successful tool for bundling loans into asset-backed securities, recently noted French central bank head Christian Noyer, in the last decade it morphed into the short-term financing of complex illiquid securities whose value had to be determined by theoretical models. The inherent fragility of this new securitization model was masked by the actions of market intermediaries, particularly

© 2008, CCH. All rights reserved.

credit rating agencies. The collapse of structured securitization revealed the ugly reality that, far from managing and dispersing risk, it had increased leverage and concentrated risk in the hands of specific financial institutions.

Echoing these sentiments, new U.K. Financial Services Authority Chair Adair Turner remarked that securitization morphed into something much more complex, opaque and risky. Securities were packaged and structured and sliced. Derivatives were used to lay off risks, with huge unsettled counterparty exposures. And, even more defeating to the original idea, a large proportion of the securities were not in fact passed through to end hold-to-maturity investors but held and traded on the balance sheets of banks and on the off balance sheets of banks through conduits and in the highly leveraged balance sheets of investment banks.

But, agreeing with many U.S. and EU regulators, the FSA chair emphasized that securitization will survive the current market crisis, but the process must be reformed back to the original idea of securitizing assets on bank balance sheets for sale to investors in transparent simple instruments held to maturity. Also, there must be fewer layers of intermediation and trading. In recent remarks at the International Banking Seminar in Washington, he said that the original reason for securitization remains valid, namely taking accumulating credit assets off bank balance sheets and distributing them directly to end investors who can select desired risk return combinations and thereby reduce the concentration of risks on particular intermediary balance sheets.

In a seminal address that may serve as a blueprint for the reform of mortgage securitization, Fed Chair Bernanke set forth three alternative ways to reform securitization so that mortgage-backed securities can regain the confidence of investors: privatize Fannie Mae and Freddie Mac, tie them closer to the federal government, or introduce covered bonds.

Privatization of Fannie Mae and Freddie Mac would solve several problems associated with the current GSE model, he said. For example, it would eliminate the conflict between private shareholders and public policy and likely diminish systemic risks as well. Other benefits are that private entities presumably would be more innovative and efficient than a government agency, and could operate with less interference from political interests. However, he questioned whether the GSE model is viable without at least implicit government support.

A greater concern with fully-privatized GSEs is whether mortgage securitization would continue under highly stressed financial conditions. It may be advisable to retain some means of providing government support to the mortgage securitization process during times of turmoil. One possible approach is to create a government bond insurer, analogous to the FDIC. This new agency would offer, for a premium, government-backed insurance for any form of bond financing used to provide funding to mortgage markets. For example, debt and mortgage-backed securities issued by the privatized GSEs and mortgage-backed bonds issued by banks would be eligible for the guarantee.

© 2008, CCH. All rights reserved.

A securitization device widely used in other countries is the covered bond, which is a debt obligation issued by financial institutions and secured by a pool of high-quality mortgages or other assets. Covered bonds are the primary source of mortgage funding for European banks. These instruments are subject to extensive statutory and supervisory regulation designed to protect the interests of covered bond investors from the risks of insolvency of the issuing bank.

Legislation typically specifies the types of collateral permitted in the cover pool, defines a minimum over-collateralization level, provides certainty of principal and interest payments to investors in the case of insolvency, and requires disclosures to regulators or investors or both. In addition, the government generally provides strong assurances to investors by having bank supervisors ensure that the cover pool assets that back the bonds are of high quality and that the cover pool is well managed.

Covered bonds also help to resolve some of the difficulties associated with the originate-to-distribute model. The on-balance-sheet nature of covered bonds means that the issuing banks are exposed to the credit quality of the underlying assets, a feature that better aligns the incentives of investors and mortgage lenders than does the originate-to-distribute model of mortgage securitization. The cover pool assets are typically actively managed, he noted, thereby ensuring that high-quality assets are in the cover pool at all times and providing a mechanism for loan modifications and workouts. Also, the structure used for such bonds tends to be fairly simple and transparent.

Currently, the U.S. does not have the extensive statutory and supervisory regulation designed to protect the interests of covered bond investors that exists in European countries. To this end, the recent introduction of the FDIC policy statement on covered bonds and the Treasury covered bond framework were constructive steps. Finally, the cost disadvantage of covered bonds relative to securitization through Fannie and Freddie is increased by the greater capital requirements associated with covered bond issuance.

A third approach, besides privatization and covered bonds, would be to tie Fannie and Freddie even more closely to the government. In doing so, the choice must be made whether to continue to allow an element of private ownership in these organizations. A public utility model offers one possibility for incorporating private ownership.

In such a model, the GSE remains a corporation with shareholders but is overseen by a public board. Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return to shareholders. If private shareholders are excluded, several possibilities worth exploring remain. One approach would be to structure a quasi-public corporation without shareholders that would engage in the provision of mortgage insurance generally.

© 2008, CCH. All rights reserved.

Say on Pay: Advisory Vote on Executive Compensation

Another almost certain reform will be legislation requiring public companies to allow a non-binding advisory shareholder vote on corporate executive compensation plans. A bill requiring just that, HR 1257, passed the House of Representatives by a vote of 269-134 in the 110th Congress. Importantly, on the day of passage, then Sen. Barack Obama introduced a companion bill in the Senate, S 1181, requiring a shareholder advisory vote on executive compensation.

Specifically, the legislation builds on the SEC's executive pay disclosure rules to require that companies include in their annual proxy to investors the opportunity to vote on the company's executive pay packages. Last year, the SEC took a major step forward by requiring that companies significantly improve their executive compensation disclosures to shareholders. Financial Services Committee Chair Barney Frank believes that the Act is needed because the SEC-mandated disclosure, while important, is incomplete.

The Shareholder Vote on Executive Compensation Act (HR 1257) also contains a separate advisory vote if a company gives a new, not yet disclosed, golden parachute to executives while simultaneously negotiating to buy or sell a company. This rare second vote is designed to empower shareholders to protect themselves from senior management's natural conflict of interest when negotiating an agreement to buy or sell a company while simultaneously negotiating a personal compensation package.

The Act is designed to ensure that shareholders have an opportunity to give their approval or disapproval on the company's executive pay practices. As such, the bill represents a market-based approach empowering shareholders to review and approve their company's comprehensive executive compensation plan. In that spirit, the bill does not establish any artificial restrictions on executive compensation, nor does it seek to set any form or measure of executive compensation. Similarly, the committee has emphasized that the shareholder vote is advisory in nature, which means that a company's board and CEO can ignore the will of the shareholders if they so choose.

According to Rep. Frank, the Act in no way intrudes Congress or the SEC into the process of setting management compensation. That said, the House financial services chair does believe that boards of directors are not likely to disregard an advisory opinion from the shareholders.

As a matter of sound corporate governance, observed Rep. Frank, Congress believes that the advisory vote is important input that the board should have. The chair rejected the argument that the Act unduly interferes with the company's affairs, noting that corporations do not exist in nature. They are the creations of positive legislative action, he reasoned, and have no powers except those the government gives them.

© 2008, CCH. All rights reserved.

Indeed, he believes that the Act embodies good governance by letting the shareholders who own the company vote on information that the SEC has already required the company to put forward as to whether they approve or disapprove. The chair similarly rejected arguments that the Act will be burdensome, noting that it requires simply that corporations add to the proxy a box that says "I approve/I disapprove," and shareholders can check it as appropriate. The sole corporate expense is the ink in printing "approve" or "disapprove," and the tallying along with the other tallying. There is no additional paperwork. And shareholders can say "yes" or "no" to the proposed executive compensation without diminishing or interfering with the board's legal authority.

The House Financial Services Committee has published a committee report (110-088) to accompany the bill. The report states that, in addition to requiring an advisory shareholder vote on executive compensation disclosure, the Act requires an additional advisory vote if the company awards a new golden parachute package while simultaneously negotiating the purchase or sale of the company. The report explains that the rare second vote was added out of a fear that CEOs may be willing to sell the company for less or pay more for another if they personally receive a larger package, thereby reducing shareholder value. The report clarifies that this provision would not apply to long-disclosed change in ownership agreements; and would only apply to new provisions added while negotiating the sale/purchase.

The report also states that the annual nonbinding advisory vote is designed to give shareholders a mechanism for supporting or opposing a company's executive compensation plan without micromanaging the company. Knowing that they will be subject to some collective shareholder action will help give boards more pause before approving a questionable compensation plan. As is the case in other countries that require shareholder advisory votes on executive pay, the committee expects this tool will improve dialogue between management and shareholders on compensation and make compensation a more efficient tool for improving and rewarding management performance. Indeed, in the view of Rep. Carolyn Maloney, the underlying purpose of this bill is to allow shareholders to have a vote on a link between pay and performance

Shareholder advisory votes on executive compensation are mandated in the United Kingdom and other EU jurisdictions. The U.K. Companies Act requires a shareholder advisory vote on the directors' remuneration report. According to Rep. Albio Sires, in the U.K. and Australia, which have similar systems, granting shareholders a say over executive compensation has improved dialogue between executives and shareholders and has increased the use of long-term performance targets in incentive compensation.

The House rejected a number of Republican amendments to the Act. For example, an amendment exempting issuers from the shareholder advisory vote if they provide the majority of the executive's compensation in the form of nonqualified deferred compensation was rejected. In opposing the amendment, Rep. Frank emphasized that the Act is scrupulously and completely neutral as to how the corporations pay their executives. Congress must not pick and choose what is the right kind of corporate compensation.

© 2008, CCH. All rights reserved.

Financial Services Risk Regulator

Another virtual certainty is that Congress will create a financial stability risk regulator that has market-wide jurisdiction. With markets in turmoil primarily because of a failure to manage the risk of complex securitized financial instruments, House Financial Services Chair Barney Frank has called for the creation of a federal Financial Services Risk Regulator to assess risk across financial markets regardless of corporate form. The new regulator would be expected to act when necessary to limit risky practices or protect the integrity of the financial system. In remarks to the Boston Chamber of Commerce, the chair said that the risk regulator could either be an entirely new entity or an adjunct of the Federal Reserve Board.

In exchange for potential access to the discount window for non-depository institutions, noted Mr. Frank, the new financial risk regulator would have enhanced tools to receive timely market information from market players, and inspect institutions. The risk regulator would also report to Congress on the health of the entire financial sector. The risk regulator must focus on the substantive regulation of market behavior, and not the form of it. Since the repeal of Glass-Steagall, observed Rep. Frank, a host of new players have emerged and old ones are doing new things. To the extent that anybody is creating credit, he believes that they should be subject to the same type of prudential supervision that now applies only to banks.

In the chair's view, the current market crisis has revealed that consumer protection and systemic risk are intertwined. The crisis has also shown that seemingly well-capitalized institutions can be frozen when liquidity runs dry and particular assets lose favor, leaving many policymakers calling for enhanced liquidity risk management.

Hedge Fund Regulation

Another likely scenario is that hedge funds and other private investment vehicles will come under some form of federal regulation. Recently, Senator Charles Grassley said that he would introduce a bill in the 111th Congress to require SEC registration of hedge fund advisers. The bill would require hedge fund advisers to register with the SEC, effectively providing a legislative override of the federal appeals court *Goldstein* ruling. The Hedge Fund Registration Act, modeled on a bill the senator introduced in the 110th Congress, would authorize the SEC to require all investment advisers, including hedge fund managers, to register with the SEC. The bill would, however, exempt investment advisers who manage less than $50 million, have fewer than fifteen clients, do not hold themselves out to the public as investment advisers, and manage the assets for fewer than fifteen investors, regardless of whether investment is direct or through a pooled investment vehicle, such as a hedge fund.

Specifically, the bill would amend Section 203(b)(3) of the Investment Advisers Act [IP access user] to narrow the current exemption from registration for certain investment

© 2008, CCH. All rights reserved.

advisers. This exemption is used by large, private pooled investment vehicles, commonly referred to as hedge funds. According to Sen. Grassley, who is the Ranking Member on the Finance Committee, hedge funds are operated by advisors who manage billions of dollars for groups of wealthy investors in total secrecy. They should at least have to register with the SEC, he emphasized, like other investment advisers do.

Currently, the exemption applies to investment advisers with fewer than fifteen clients in the preceding year and who do not hold themselves out to the public as an investment adviser. The Hedge Fund Registration Act would narrow this exemption and close a loophole in the securities laws these hedge funds use to avoid registering with the SEC and operate in secret.

According to Sen. Grassley, Congress needs to act because of the appeals court decision, which struck down as arbitrary an SEC rule that required registration of hedge fund advisers. The appeals panel rejected the SEC's suggestion of counting the investors in the hedge fund as clients of the fund's adviser within the statute's meaning of clients in order to get over the statutory client level. (*Goldstein v. SEC* (DC Cir. 2006), Fed. Sec. L. Rep. ¶93,890 [IP access user].) That decision effectively ended all registration of hedge funds with the SEC, unless and until Congress acts.

Sen. Grassley explained that the Hedge Fund Registration Act would respond to that court decision by narrowing the current registration exemption and bringing much needed transparency to hedge funds. He views the Act as a first step in ensuring that the SEC simply has clear authority to do what it already tried to do, adding that Congress must act to ensure that federal securities law is kept up date as new types of investments appear. Noting estimates that these pooled investment vehicles account for nearly 30% of the daily trades in U.S. financial markets, the legislator emphasized that Congress must ensure that the SEC knows who is controlling these massive pools of money in order to ensure the integrity and security of the markets.

Sen. Grassley has been making the case for greater transparency requirements for hedge funds since last year, following passage of the Pension Protection Act of 2006. He does not want the pension legislation undone by hedge fund secrecy. He observed that a lot of pension holders are in the dark about their exposure to hedge fund losses because transparency is so inadequate.

The Ranking Member surveyed federal agencies about hedge fund transparency last October. Earlier this year, he joined Finance Committee Chair Max Baucus in requesting a review by the Government Accountability Office of the scope of public and private pension plan investments in hedge funds and what returns and risks are likely for worker retirement funds. Similarly, on the House side, Barney Frank, chair of the Financial Services Committee has expressed concern about the interface between pension funds and hedge funds since hedge funds have become increasingly tied to pension plans.

© 2008, CCH. All rights reserved.

In a letter to Comptroller General David Walker, the senators noted that, since the returns on hedge fund investments are often uncorrelated with returns on equity investments, pension funds can in principle reduce their overall risk exposure through the purchase of hedge funds. However if pension funds lack the expertise to evaluate the complex investment strategies that hedge funds employ, greater risks and losses could result. In that event, sponsors may then be forced to cover these losses through higher contributions.

Until recently, hedge funds were limited in how much pension plan equity they could receive, observed the senators, but the Pension Protection Act effectively eliminated such restrictions with regard to governmental pension assets, raising the prospect of even greater pension asset investment in such funds.

Rep. Frank is also interested in hedge fund regulation. He introduced legislation in 2006, HR 5712, to authorize the registration and monitoring of hedge funds, effectively reversing a recent federal appeals court decision declaring arbitrary an SEC rule requiring hedge funds to register with the SEC if they had more than fourteen clients and managed a specific amount of assets. The bill would give the SEC clear authority to require registration and monitoring. The Investment Advisers Act exempts from registration investment advisers with fewer than fifteen clients. In *Goldstein v. SEC,* cited above, the appeals panel rejected the SEC's suggestion of counting the investors in the hedge fund as clients of the fund's adviser in order to get over the 14-client limit. Specifically, Frank's bill would authorize the SEC to interpret the term "client" to require the registration of advisers to funds that have more than 15 investors.

As Congress examines the role of hedge funds in the ongoing financial crisis, former SEC Chair David Ruder urged Congress to empower the SEC to register hedge fund advisers and require them to disclose hedge fund risks and other activities. In testimony before the House Oversight and Government Reform Committee, Mr. Ruder said that the Commission should also be authorized to monitor and assess the effectiveness of hedge fund risk management systems. As part of any legislation, he continued, the SEC should have to share risk information about hedge funds on a confidential basis with the Federal Reserve Board, which should be given primary responsibility for systemic risk regulation.

Credit Default Swaps

In the wake of a call by SEC Chair Christopher Cox for the regulation of credit default swaps, Senator Tom Harkin will introduce legislation regulating swaps and other financial derivatives that are currently traded with virtually no regulation or transparency. Senator Harkin, chair of the Agriculture Committee, noted that, while swaps contracts function much like futures contracts, they are not regulated as futures contracts because of a statutory exclusion from CFTC authority. Since they do not have to be traded on open, transparent exchanges, it is impossible to know whether credit default and other swaps are being traded at fair value or whether institutions trading them are becoming

© 2008, CCH. All rights reserved.

overly leveraged or dangerously overextended. Financial derivatives like credit default swaps must be traded on a regulated exchange, said the senator, so that regulators can know the value of the contracts, who is trading them and whether they have enough assets to back the contract.

According to Director of Market Regulation Eric Sirri, the SEC has a great interest in the credit derivatives market because of its impact on the debt and cash equity securities markets and the Commission's responsibility to maintain fair, orderly and efficient securities markets. In testimony before the House Agriculture Committee, he said that these markets are directly affected by credit default swaps due to the interrelationship between the swap market and the claims that compose the capital structure of the underlying issuers on which the protection is written. In addition, the SEC has seen credit default swap spreads move in tandem with falling stock prices, a correlation suggesting that activities in the OTC credit default swaps market may be spilling over into the cash securities markets.

The Commission's current authority with respect to these instruments, which are generally security-based swap agreements under the CFMA, is limited to enforcing antifraud prohibitions under the federal securities laws. The SEC is prohibited under current law from promulgating any rules regarding credit default swaps in the over-the-counter market. Thus, the tools necessary to oversee this market effectively do not exist.

OTC credit derivatives emerged in the mid-1990s as a means for financial institutions to buy insurance against defaults on corporate obligations. Credit default swaps are executed bilaterally with derivatives dealers in the OTC market, which means that they are privately negotiated between two sophisticated, institutional parties. They are not traded on an exchange and there is no required recordkeeping of who traded, how much and when. Although credit default swaps are frequently described as buying protection against the risk of default on, for example, corporate bonds, they are also used by investors for purposes other than hedging. Institutions can and do buy and sell credit default swap protection without any ownership in the entity or obligations underlying the swap. In this way, credit default swaps can be used to create synthetic long or short positions in the referenced entity.

In earlier testimony before the Senate Banking Committee, SEC Chairman Cox said that the credit derivatives market is a regulatory hole that must be closed by Congress. The $58 trillion national market in credit default swaps is regulated by no one, he emphasized, and neither the SEC nor any regulator has authority over this market. He described a credit default swap buyer as tantamount to a short seller of the bond underlying the swap. Since credit default swap buyers do not have to own the bond or other debt instrument on which the swap contract is based, they can naked short the debt of companies without restriction. As part of the fundamental reform of the financial system, Congress must provide statutory authority to regulate these products. ❐

© 2008, CCH. All rights reserved.

About the Author

[**James Hamilton**]() is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation, at http://jimhamiltonblog.blogspot.com). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

If you would like to post this white paper on your firm's intranet site, please contact Randy Kaplan at randy.kaplan@wolterskluwer.com or call 212/771-0866.

We welcome any and all inquiries to share or republish this material.

© 2008, CCH. All rights reserved.