The Obama Administration's Proposal to Reform the U.S. Financial Regulatory System

James Hamilton, J.D., LLM.
CCH Principal Analyst

Wolters Kluwer
Law & Business

Introduction

The Obama Administration has proposed to Congress the most sweeping and fundamental regulatory reform of the U.S. financial and securities markets since the New Deal. The proposal's goals are to regulate systemic risk, enhance transparency and disclosure, delink executive compensation from excessive risk, improve investor protection, and prevent regulatory arbitrage. The Administration has set forth detailed recommendations on the regulation of hedge funds and over-the-counter derivatives, including credit default swaps, as well as draft legislation on a new resolution authority to unwind failing securities and commodities firms. The Administration also recommends major corporate governance reforms, such as shareholder advisory votes on compensation and enhanced compensation committees.

The Administration also envisions a completely reformed securitization process playing an important role in the financial markets. The plan also proposes new authority for the SEC to protect investors, improve disclosure, raise standards and increase enforcement. The SEC would be directed to establish a fiduciary duty for broker-dealers offering investment advice and also to harmonize the regulation of investment advisers and broker-dealers. A new independent regulator, the Consumer Financial Protection Agency, would have authority to ensure that consumer protection regulations are written and enforced.

In a bow to international regulatory coordination, the Administration recommends that the Financial Stability Board and national regulators implement the G-20's commitment to international cooperation on the regulation of global financial firms through, for example, the establishment of a college of regulators.

Guiding Principles

Several key principles will guide the effort to overhaul the oversight of financial markets. One such principle is that the nation must devise a financial regulatory regime for the 21st century to replace what is still essentially a 1930s regulatory apparatus. In light of the widespread valuation problems of complex financial instruments such as mortgage-backed securities, another principle of the Obama reforms is enhancing capital requirements and the development and rigorous application of new standards for managing liquidity risk. A further principle is to regulate financial firms for what they do rather than who they are.

An important goal of financial markets reform is to establish a mechanism that can identify systemic threats to the financial system and effectively address them. Financial regulation should identify, disclose, and oversee risky behavior regardless of what kind of financial institution engages in it. This is essentially a regulation-by-objective approach.

Another core principle is 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.

The president recently took a step towards enhancing the SEC's enforcement powers when he signed the Fraud Enforcement and Recovery Act (FERA), which improved the enforcement of securities and commodities fraud and financial institution fraud involving asset-backed securities and fraud related to federal assistance and relief programs. The measure also authorizes additional appropriations for the SEC and other federal agencies to investigate and prosecute fraud. See related white paper on the Fraud Enforcement and Recovery Act.

Another object of the proposed reform is 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 those risks, 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.

Oversight Chairs

Any reform legislation must go through the House Financial Services Committee, chaired by Rep. Barney Frank and the Senate Banking Committee, chaired by Senator Christopher Dodd. In a letter to the President, both oversight Chairs promised that they will work together in a bicameral and bipartisan effort to pass legislation reforming the regulation of the nation's financial markets by the end of this year. Senator Dodd and Rep. Frank said that they would work expeditiously, carefully and deliberately to create a framework for 21st century regulation that will enhance financial stability and protect consumers and investors.

The legislators said that they agree with the Administration's core principles for modernizing financial regulation, including providing for systemic risk regulation, strengthening consumer and investor protection, streamlining prudential supervision, and addressing regulatory gaps, such as with hedge funds and other private pools of capital. In drafting legislation, the leaders will also be guided by the principles of openness, transparency, and plain language.

As part of the reform, the chairs will draft legislation comprehensively reforming corporate governance and executive compensation at financial institutions. They promised to work with the Administration to ensure a new corporate governance framework focused on strict accountability and the promotion of long-term value. One of the most consistent criticisms of current executive compensation is that it favors short-term performance and contributes to excessive risk taking.

While recognizing that the adoption of regulatory rules is a sovereign decision, the chairs want to prevent regulatory arbitrage and thus will consult closely with other major cross-border financial centers in an effort to coordinate legislation.

Systemic Risk Regulator

As financial institutions speculated in increasingly risky products and practices leading to the current crisis, not one federal financial regulator was responsible for detecting and assessing the risk to the system as a whole. The financial sector was gambling on the rise of the housing market, yet no single regulator could see that everyone, from mortgage brokers to credit default swap traders, was betting on a bubble that was about to burst. Instead, each agency viewed its regulated market through a narrow lens, missing the total risk that permeated the financial markets. See Report of the Committee on Capital Markets Regulation (hereinafter Scott Report).

Thus, the Administration proposes the creation of a regulator to police all systemically important firms and markets. This regulator would be authorized to take proactive steps to prevent or minimize systemic risk. Legislation will seek to regulate the financial system as a whole, not just its individual components.

Any financial institution that is big enough, interconnected enough, or risky enough that its distress necessitates government intervention is an institution that necessitates oversight by a federal agency responsible for managing the overall risk to the financial system. In a world where financial innovation is pervasive and where market conditions constantly change, regulators must be authorized to take a holistic view of the playing field, identifying gaps, pointing to unsustainable trends, and raising questions about new kinds of interactions.

The financial crisis has demonstrated that large, interconnected financial firms and markets need to be under a more consistent, and more conservative, regulatory regime. These standards cannot simply address the soundness of individual institutions, but must also ensure the stability of the system itself.

A single regulator would also address the problem of regulatory arbitrage. Major financial institutions cannot be allowed to choose among consolidated regulatory regimes and regulators or avoid consolidated regulation entirely. The plan would create higher standards for all systemically important financial firms, regardless of whether they own a depository institution, to account for the risk that the distress or failure of such a firm could impose on the financial system and the economy.

In identifying systemically important firms, the Administration believes that the relevant characteristics include: the financial system's interdependence with the firm, the firm's size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding, and the importance of the firm as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.

The systemic regulator will also need to impose on systemically important firms liquidity, counterparty, and credit risk management requirements that are more stringent than for other financial firms. For instance, the regulator should apply more demanding liquidity constraints and require that these firms be able to aggregate counterparty risk exposures on an enterprise basis within a matter of hours. The regulator of these entities will also need a prompt, corrective action regime that would allow the regulator to force protective actions as regulatory capital levels decline.

There was fierce debate over whether the systemic risk regulator should be a single regulator, new or existing, or a council of regulators. The Administration proposes that the Federal Reserve Board should be the macro prudential systemic risk regulator, advised by a Financial Services Oversight Council (FSOC), whose members would include Treasury, the Fed, the SEC, the CFTC, the FDIC, and the Federal Housing Finance Authority. Once established, the FSOC would replace the President's Working Group on Financial Markets.

The Fed will regulate systemically significant financial firms, which the plan calls Tier 1 financial holding companies, including the parent company and all its subsidiaries, foreign or domestic. The FSOC will be authorized to: facilitate information sharing and coordination; identify emerging risks; resolve jurisdictional disputes among regulators; and advise the Fed on identifying firms whose failure could pose a threat to market stability and thus would qualify as Tier 1 financial holding companies and be subject to systemic risk regulation.

The FSOC would be authorized to recommend financial firms that would be subject to Tier 1 regulation, but it would be up to the Fed to accept the recommendation. The Fed would have to consult with the FSOC in developing rules to be used to identify Tier 1 firms and in setting standards for Tier 1 firms. The Fed would also have to consult with the FSOC in setting risk management standards for systemically important activities. Further, a subgroup of the FSOC would have responsibility for determining whether to invoke resolution authority for large, interconnected firms.

In order to identify emerging threats to market stability, the FSOC would also be authorized to require periodic and other reports from any U.S. financial firms solely for the purpose of assessing the extent to which the firm's activities threaten market stability.

In order to do its job as a macro regulator properly, the Fed must expand beyond being a "safety and soundness" regulator to regulation of the activities of the firm as a whole and the risks the firm poses to the entire market. The Fed would have to develop new regulatory approaches to do the job of systemic risk regulator.

Concomitant with the establishment of the new systemic risk regulatory regime, the SEC's programs for consolidated supervision should be eliminated. The SEC has already de facto ended its Consolidated Supervised Entity Program under which it regulated large investment banks. The SEC's Supervised Investment Bank Holding Company program should also be eliminated. Investment banking firms seeking consolidated regulation should be subject to Fed regulation.

Definition of Systemically Significant Financial Firm

How Congress defines a systemically important financial institution will be critical to the scope of the systemic risk regulator's authority. If the definition is too broad, the systemic risk regulator could usurp the authority of multiple regulators, including the SEC. The systemic risk regulator should not diminish the role of the SEC, since systemic risk should not trump investor protection.

A G-20 report noted that, in determining the systemic importance of a financial institution, the regulator should consider a wide range of factors, including size, leverage, interconnectedness, and funding mismatches. In addition, the increased integration of markets globally should be taken into account when assessing the systemic importance of any given financial institution, market or instrument given the potential for cross-border contagion.

More specifically, the G-20 report listed three key sets of data that regulators should consider in analyzing the potential risks posed. First, data on the nature of a financial institution's activities should be collected, including, in the example of a hedge fund manager, data on the size, investment style, and linkages to systemically important markets of the funds it manages. Second, regulators should develop common metrics to assess the significant exposures of counterparties on a group-wide basis, including prime brokers for hedge funds, to identify systemic effects.

Third, regulators should also collect data on the condition of markets such as measures on the volatility, liquidity and size of markets that are deemed to be systemically important. It is envisaged that regulators would use a combination of existing information sources, including data collected from key institutions and vehicles. Financial regulators would determine what regulatory, registration or oversight framework would best enable this information collection and subsequent action.

The Administration wants legislation specifying the factors that must be considered in determining if a financial firm poses a threat to market stability. The factors must include the impact of the firm's failure on the entire financial system, the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding, and whether the firm is a critical source of credit for households, businesses, and state and local government, as well as a liquidity source for the financial system. This is a non-exclusive list of factors. Balance sheets should be a factor, but not a determinative factor, else firms would have an incentive to conduct off-balance sheet transactions through off-balance sheet vehicles and we would be right back to firms growing outside the regulatory system.

The Fed, in consultation with Treasury, will adopt rules identifying the Tier 1 firms, but Treasury would have no role in applying the rules to individual firms.

To help the Fed identify firms in need of systemic risk regulation, Congress must authorize the Fed to collect reports from all U.S. financial firms meeting minimum size thresholds. The Fed should also have access to reports submitted to the SEC and other financial regulators. The Fed's authority to require reports and gain access to reports must be limited to those reports that aid in determining if a firm poses systemic risks.

The legislation should also authorize the Fed to examine any U.S. financial firm meeting minimum size thresholds if the Fed is unable to determine if the firm poses systemic market risks based on regulatory reports and discussions with the firm's management. The scope of the Fed's examination authority would be strictly limited to examinations reasonably necessary to enable the Fed to determine if the firm needs systemic oversight.

The legislation should remove the constraints that the Gramm-Leach-Bliley Act imposed on the Fed's ability to require reports from, examine, or impose higher regulatory standards or more stringent activity restrictions on the functionally regulated subsidiaries of financial holding companies.

Collins Bill

A bill introduced by Senator Susan Collins would create a new federal systemic risk regulator to monitor the financial markets and oversee financial regulatory activities. The Financial System Stabilization and Reform Act, S. 664, would create an independent Financial Stability Council to serve as systemic-risk regulator. The Financial Stability Council would be composed of representatives from the Fed, the SEC, the CFTC, the FDIC and the National Credit Union Administration. The council would maintain comprehensive oversight of all potential risks to the financial system, and would have the power to act to prevent or mitigate those risks. The draft legislation would also regulate investment banks for safety and soundness and close the gap that has allowed credit default swaps and other financial instruments to escape federal regulation.

The new Financial Stability Council would be led by a chair nominated by the president and confirmed by the Senate, with the responsibility for the day-to-day operations of the council. The chair would have to appear before Congress twice a year to report on the state of the country's financial system, areas in which systemic risk are anticipated, and whether any legislation is needed for the Council to carry out its mission of preventing systemic risks.

The bill rejects the idea of a single regulator being given systemic powers in favor of a body made up of the key federal financial regulators. This type of collaborative systemic risk oversight is gaining a following in Congress and at the SEC. SEC Chair Mary Schapiro favors a college of regulators for systemic risk rather than a single systemic risk regulator. Senator Dodd has also endorsed a council of regulators for systemic risk. Given the regulatory failures leading up to this crisis, Senator Dodd has concerns about systemic risk authority residing exclusively with any one body. For example, there have been problems with regulated bank holding companies where they have not been well-regulated at the holding company level. That is why the Banking Committee chair is intrigued by the idea of a council approach to addressing systemic risk.

Senator Dodd said that the SEC should have a role in systemic risk regulation; and has advised the SEC Chair Mary Schapiro to "kick down the door" to make sure the Commission has input. There are many types of risk, said the senator. Just as there are many aspects of the financial system, he explained, systemic risk itself has many parts as well. One is the regulation of practices and products that pose systemic risks, from subprime mortgages to credit default swaps.

Under the bill, whenever the Financial Stability Council believes that a risk to the financial system is present due to a lack of proper regulation, or by the appearance of new and unregulated financial products or services, it would have the power to propose changes to regulatory policy, using the statutory authority provided to existing federal financial regulators. The Council would also have the power to obtain information directly from any regulated provider of financial products and, in limited form, from state regulators regarding the solvency of state-regulated insurers.

The Council would also be able to propose regulations of financial instruments that are designed to look like insurance products, but that in reality are financial products that could present a systemic risk. But the legislation does not preempt state law governing traditional insurance products.

The measure empowers the Council to address the "too big to fail" problem by adopting rules designed to discourage financial institutions from becoming too big to fail or to regulate them appropriately if they become systemically important financial institutions.

Under the legislation the Council would help make sure financial institutions do not become too big to fail by imposing different capital requirements on them as they grow in size, raising their risk premiums, or requiring them to hold a larger percentage of their debt as long-term debt. The Council's power is not meant to restrict financial institutions from growing in size, but rather from becoming risks to the system as a whole.

The bill also authorizes the Council to address regulatory gap created by new and imaginative financial instruments that do not fall within the jurisdiction of any federal financial regulator. Credit default swaps are an example of this problem. Prior to 2000, credit default swaps existed in a regulatory limbo. Neither the SEC nor the CFTC were willing to exert authority over the credit default swap market. As a result, they fell through the jurisdictional cracks. Congress then compounded the problem by explicitly exempting credit default swaps from regulation under the Commodity Futures Modernization Act of 2000.

The draft legislation specifically addresses the credit default swap problem by repealing the exemption from regulation that Congress created for these instruments in 2000, and by setting up a government-regulated clearinghouse.

Finally, the bill would apply safety and soundness regulation to investment bank holding companies by assigning the Federal Reserve this responsibility. The SEC would be able to regulate the broker-dealer operations. Under the draft legislation, the Council's role as the systemic-risk regulator would support the critical importance of the Federal Reserve's safety and soundness duties.

European Union

The European Commission has proposed a European Systemic Risk Council to monitor risks to the entire financial system. The Commission envisions that this macro-prudential regulator will provide early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks. The creation of the ESRC would address one of the fundamental weaknesses highlighted by the financial crisis, which is the exposure of the financial system to interconnected, complex, and cross-sector systemic risks.

The Commission envisions that the European Central Bank will have a prominent role on the Risk Council. The governors of the central banks of the members will be on the Council, as will national securities regulators.

Hedge Funds and Private Equity

The Obama Administration has asked Congress to pass legislation requiring SEC registration of advisers to hedge funds and other private pools of capital, including private equity funds and venture capital funds, with assets under management over a certain threshold. All such funds advised by an SEC-registered investment adviser should be subject to investor and counterparty disclosure requirements and regulatory reporting requirements.

The rules should require reporting, on a confidential basis, of 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 the funds with the entity responsible for oversight of systemically important firms, which would then determine whether any hedge funds could pose a systemic threat and should be subjected to the prudential standards administered by the systemic risk regulator.

The legislation should require the SEC to share the reports it receives from hedge funds with the Fed so that the Fed can determine if the funds or fund families pose a systemic risk and thus become subject to Tier 1 financial holding company regulation.

The Administration's proposal is broadly in line with proposals advanced by the G-20 and the Scott Report, which recommended the adoption of a confidential reporting requirement pursuant to which each hedge fund would have to register and provide a regulator with information relevant to the assessment of systemic risk. Confidential reporting would involve information addressing, among other things, a fund's liquidity needs, leverage, return correlations, risk concentrations, connectedness, and other relevant sensitivities.

However, the regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively. The regulator also would have limited authority to take prompt action in extreme situations where a hedge fund poses a clear and direct threat to market stability.

Hedge funds that fall within certain exemptions of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 do not have to register with the SEC or disclose publicly all their investment positions.

The Administration's proposal was not written on a blank slate. The SEC took the first step in this direction with the issuance of a rule requiring hedge fund managers to register with the Commission as investment advisers pursuant to the Investment Advisers Act, but a federal appeals court later vacated the rule. In a 2006 a panel of the District of Columbia Circuit Court of Appeals declared arbitrary an SEC rule requiring hedge fund managers to register with the SEC if they had 15 or more clients and managed a specific amount of assets. The Investment Advisers Act exempts from registration those investment advisers with fewer than 15 clients. The court 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. That decision effectively ended all registration of hedge funds with the SEC, unless and until Congress acts. *Goldstein v. SEC* (CA DofC 2006), Fed. Sec. L. Rep. ¶93,890 [ip access user].

Currently, there is pending legislation in Congress designed to close the loophole created by the Investment Advisers Act, which exempts hedge fund advisers from registering with the SEC if they have less than 15 clients. The Hedge Fund Adviser Registration Act, HR 711, would require anyone who manages hedge funds to register with the SEC. A companion bill in the Senate, the Hedge Fund Transparency Act, S. 344, would impose registration and periodic disclosure requirements on hedge funds essentially the same as the regulation of traditional investment companies.

The Hedge Fund Transparency Act would require hedge funds to register with the SEC, file an annual public disclosure form with basic information, and cooperate with any SEC information request or examination. Public disclosures under the Act would include a listing of beneficial owners, a detailed explanation of the fund's structure, an identification of affiliated financial institutions, as well as the number of investors and the fund's value and assets under management.

European Union

The European Commission favors identifying hedge funds that are of systemic importance and imposing on them reporting requirements that provide a clear ongoing view of the strategies, risk structure and leverage of these systemically-important funds. In the UK, the Turner report, by the Financial Services Authority Chair Adair Turner, similarly highlights the need to gather much more extensive information on hedge fund activities in order to understand overall macro prudential risks.

Anticipating similar legislation in the U.S., and in a move that could prevent regulatory arbitrage, the European Commission proposed the broad regulation of managers of hedge funds and all private equity funds with 100 million euros of assets under management. The Directive on Alternative Investment Fund Managers is designed to create a comprehensive and effective regulatory framework for European hedge and private equity fund managers.

The proposed directive will provide robust and harmonized regulatory standards for all alternative investment funds within its scope and enhance the transparency of the activities of the funds towards investors and public authorities. This will enable member states to improve the macro-prudential oversight of the sector and to take coordinated action as necessary to ensure the proper functioning of financial markets. The proposed regulations would require extensive disclosure of risk-management procedures and other aspects of fund governance.

There had been some confusion over whether just hedge funds, and not private equity funds, would be included in the proposed Directive. In the end, the Commission opted for the broad regulation of all alternative investment funds over a certain minimum asset management level. The Commission was loath to attempt to define hedge funds, fearing that many systemically relevant funds may fall through a regulatory gap. The proposed Directive parallels the proposal presented by the Obama Administration to Congress, which would federally regulate both hedge funds and other private equity funds. Fully acknowledging the need for harmonized fund regulation, the Commission anticipates similar U.S. legislation later this year.

In order to operate in the European Union, all hedge funds and private equity funds will have to be authorized by their home state regulator. They will have to demonstrate that they are suitably qualified to provide fund-management services and will have to provide detailed information on the planned activity of the fund, the identity and characteristics of the assets managed, and the governance of the fund, including arrangements for the delegation of management services and for the valuation and safe-keeping of assets. The alternative investment funds would also have to hold and retain a minimum level of capital.

To ensure effective risk management of hedge fund activities, the funds will be required to satisfy their regulators of the robustness of their internal risk management procedures, in particular liquidity risks and additional operational and counterparty risks associated with short selling. They will also have to set forth procedures for the management and disclosure of conflicts of interest and the fair valuation of assets.

Disclosure is a centerpiece of the proposed regime. Hedge and private equity funds would have to disclose to investors their investment policy, including descriptions of the type of assets and their use of leverage. They would also have to disclose their redemption policy in both normal and exceptional circumstances, as well as their fees and expenses. The funds would have to disclose their risk management and valuation procedures. In addition, the funds would have to disclose to regulators the principal markets and instruments in which they trade, as well as their principal exposures, performance data and concentrations of risk.

The SEC and Investor Protection

The Administration endorses the SEC as an experienced federal regulator with comprehensive responsibilities for protecting investors against fraud and abuse. To further the SEC's mission, the Administration proposes legislation modernizing the financial regulatory structure and improving the SEC's ability to protect investors, focusing on principles of transparency, fairness, and accountability.

Legislation should authorize the SEC to require that certain disclosures (including a summary prospectus) be provided to investors at or before the point of sale, if the Commission finds that these disclosures would improve investor understanding of the particular financial products and their costs and risks. Currently, most prospectuses (including the mutual fund summary prospectus) are delivered with the confirmation of sale, *after* the sale has taken place. Without slowing the pace of transactions in modern capital markets, the SEC should require that investors receive adequate information to make informed decisions.

The SEC can better evaluate the effectiveness of investor disclosures if it can meaningfully engage in consumer testing of those disclosures. The SEC should be better enabled to engage in field testing, consumer outreach and testing of disclosures to individual investors, including by providing budgetary support for those activities.

New legislation should also bolster investor protections and bring important consistency to the regulation of these two types of financial professionals, brokers and advisers, by: requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers; providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and prohibiting conflict of interests and sales practices that are contrary to the interests of investors.

Currently, investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective.

Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor. Current regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers can give incidental advice in the course of their business pursuant to an exemption in the Investment Advisers Act, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.

Thus, the Administration proposes legislation allowing the SEC to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest.

Mandatory Arbitration

Broker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, the Administration believes that mandating a particular venue and up-front method of adjudicating disputes, and thereby eliminating access to courts, may unjustifiably undermine investor interests.

Thus, legislation should authorize the SEC to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. The legislation should also provide that, before using such authority, the SEC would need to conduct a study on the use of mandatory arbitration clauses in these contracts. The study must consider whether investors are harmed by being unable to obtain effective redress of legitimate grievances, as well as whether changes to arbitration are appropriate.

Historically, claims for violations of the federal securities laws were considered to be non-arbitrable based on the doctrine enunciated by the U.S. Supreme Court in *Wilko v. Swan* (U.S. Sup. Ct. 1953), 1952-56 CCH Dec. ¶90,640 [ip access user]. In *Wilko*, the Court held that an agreement to arbitrate claims under Section 12(2) of the Securities Act was not enforceable. However, as arbitration gained increasing judicial favor, the Court began to chip away at the *Wilko* doctrine and in 1989 expressly overruled it. The Court ruled that a pre-dispute agreement to arbitrate an investor's securities claims against a brokerage firm was enforceable in view of the strong federal policy favoring arbitration. *Rodriguez v. Shearson/American Express, Inc*. (U.S. Sup. Ct. 1989), 1989 CCH Dec. ¶94,407 [ip access user].

Whistleblower Protection

Legislation should authorize the SEC to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. Currently, the SEC has the authority to compensate sources in insider trading cases, but that authority should be extended to compensate whistleblowers that bring well-documented evidence of fraudulent activity. The Administration supports the creation of this fund using monies that the SEC collects from enforcement actions that are not otherwise distributed to investors.

Sanctions

Noting that improved sanctions would better enable the SEC to enforce the federal securities laws, the Administration proposes legislation authorizing the SEC in pursuing enforcement to impose collateral bars against regulated persons across all aspects of the industry rather than in a specific segment of the industry. The interrelationship among the securities activities under the SEC's jurisdiction, the similar grounds for exclusion from each, and the SEC's overarching responsibility to regulate these activities, all argue in favor of imposing collateral bars.

Liability Standards

The legislation should also amend the federal securities laws to provide a single explicit standard for primary liability to replace various federal circuit courts of appeal formulations of different tests for primary liability.

Investment Advisory Committee

The SEC recently established an Investor Advisory Committee, made up of a diverse group of well-respected investors, to advise on the SEC's regulatory priorities, including issues concerning new products, trading strategies, fee structures, and the effectiveness of disclosure. The Administration proposes legislation making the Investor Advisory Committee permanent.

Financial Consumer Coordinating Council

Similarly, in order to address potential gaps in investor protection and to promote best practices across different markets, the Administration proposes the creation of coordinating council composed of the heads of the SEC, the FTC, the Department of Justice, and the new Consumer Financial Protection Agency. The Coordinating Council should meet at least quarterly to identify gaps in consumer and investor protection across financial products and to facilitate coordination of consumer-protection efforts.

Congress should help ensure the effectiveness of the Coordinating Council for the benefit of consumers by empowering the Council to establish mechanisms for state attorneys general, consumer advocates, and others to make recommendations to the Council on issues to be considered or gaps to be filled. Legislation should also require the Council to report to Congress and the SEC and other member agencies semi-annually with recommendations for legislative and regulatory changes to improve consumer and investor protection, and with updates on progress made on prior recommendations. The Council should also be authorized to sponsor studies or engage in consumer testing to identify gaps, share information and find solutions for improving consumer protection across a range of financial products.

Consumer Products Safety Commission

The Administration also proposes the creation of a single regulatory agency, the Consumer Financial Protection Agency (CFPA), with the authority and accountability to make sure that consumer protection regulations are written fairly and enforced vigorously. The CFPA should reduce gaps in federal supervision and enforcement; improve coordination with the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products.

SEC and CFTC: Harmonizing Securities and Futures Regulation

The Administration decided not to propose a merger of the SEC and CFTC. Instead, the SEC and CFTC are directed to make recommendations to Congress for changes to their statutes and regulations that would harmonize the regulation of futures and securities. The SEC and CFTC are directed to blend their rules-based and principles-based approaches to regulation into a combined approach more precise than the principles-based approach while still allowing flexible innovation.

The Administration noted that the broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency. Although differences exist between securities and futures markets, many differences in regulation between the markets are no longer justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

Many of the instruments traded on the commodity and securities exchanges and in the OTC markets may fall within the purview of both regulatory agencies. One result of this jurisdictional overlap has been that economically equivalent instruments may be regulated by two agencies operating under different and sometimes conflicting regulatory philosophies and statutes. For example, many financial options and futures products are similar. Under the current federal regulatory structure, however, options on a security are regulated by the SEC, whereas futures contracts on the same underlying security are regulated jointly by the CFTC and SEC.

In many instances, the result of these overlapping yet different regulatory authorities has been numerous and protracted legal disputes about whether particular products should be regulated as futures or securities. These disputes have consumed significant agency resources that otherwise could have been devoted to the furtherance of the agency's mission.

Uncertainty regarding how an instrument will be regulated has impeded and delayed the launch of exchange-traded equity, equity index, and credit event products, as litigation sorted out whether a particular product should be regulated as a futures contract or as a security. Eliminating jurisdictional uncertainties and ensuring that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction, would remove impediments to product innovation.

Arbitrary jurisdictional distinctions also have unnecessarily limited competition between markets and exchanges. Under existing law, financial instruments with similar characteristics may be forced to trade on different exchanges that are subject to different regulatory regimes. Harmonizing the regulatory regimes would remove these distinctions and permit a broader range of instruments to trade on any regulated exchange.

In the Administration's view, permitting direct competition between exchanges also would ensure that plans to bring OTC derivatives trading onto regulated exchanges or regulated transparent electronic trading systems would promote rather than retard competition. Greater competition would make these markets more efficient, which would benefit users of the markets, including investors and risk managers.

In short, there must be greater coordination between the SEC and CFTC going forward. The Commodity Exchange Act currently provides that funds trading in the futures markets register as commodity pool operators (CPO) and file annual financials with the CFTC. Over 1,300 CPOs, including many of the largest hedge funds, are currently registered with and make annual filings with the CFTC. The CFTC must maintain its enforcement authority over these entities as the SEC takes on important new responsibilities in this area.

The CFTC currently uses a principles-based approach to regulation, while the SEC follows a rules-based approach. The Administration said that efforts at harmonization should seek to build a common foundation for market regulation through agreement by the two agencies on principles of regulation that are significantly more precise than the CEA's current core principles. The new principles need to be sufficiently precise so that market practices that violate those principles can be readily identified and subjected to enforcement actions by regulators.

At the same time, the principles should be sufficiently flexible to allow for innovations by market participants. For example, the CFTC has indicated that it is willing to recommend adopting as core principles for clearing organizations key elements of international standards that are considerably more precise than the current CEA core principles for CFTC-regulated clearing organizations.

Harmonization of substantive futures and securities regulation for economically equivalent instruments also should require the development of consistent procedures for reviewing and approving proposals for new products and rulemaking by self-regulatory organizations. Here again, the agencies should strike a balance between their existing approaches. The SEC should recommend requirements to respond more expeditiously to proposals for new products and SRO rule changes and should recommend expansion of the types of filings that should be deemed effective upon filing, while the CFTC should recommend requiring prior approval for more types of rules and allowing it appropriate and reasonable time for approving such rules.

The harmonization of futures and securities laws for economically equivalent instruments would not require eliminating or modifying provisions relating to futures and options contracts on agricultural, energy, and other physical commodity products. There are important protections related to these markets that must be maintained, and in certain circumstances enhanced, in applicable law and regulation.

The Administration directs the CFTC and the SEC to file a report with Congress by September 30, 2009, identifying all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explaining why those differences are essential to achieving underlying policy objectives for investor protection, market integrity, and price transparency, or recommending changes that would eliminate the differences. If the two agencies cannot reach agreement on the explanations and recommendations by September 30, 2009, their differences should be referred to the new Financial Services Oversight Council. The Council should have to address these differences and report its recommendations to Congress within six months of its formation.

OTC Derivatives

The financial crisis revealed that massive risks in derivatives markets went undetected by both regulators and market participants. In 2000, the Commodity Futures Modernization Act (CFMA) explicitly exempted OTC derivatives, to a large extent, from regulation by the CFTC. Similarly, the CFMA limited the SEC's authority to regulate certain types of OTC derivatives. As a result, the market for OTC derivatives has largely gone unregulated.

This lack of regulation led to disastrous consequences. Many institutions and investors had substantial positions in credit default swaps, swaps tied to asset-backed securities, complex instruments whose risk characteristics proved to be poorly understood even by the most sophisticated of market participants. At the same time, excessive risk taking and poor counterparty credit risk management by many banks saddled the financial system with an enormous unrecognized level of risk.

When the value of the asset-backed securities collapsed, the danger became clear. Individual institutions believed that these derivatives would protect their investments and provide return, even if the market went down. But, during the crisis, the sheer volume of these contracts overwhelmed some firms that had promised to provide payment on the swaps and left institutions with losses that they believed they had been protected against. Lacking authority to regulate the OTC derivatives market, regulators were unable to identify or mitigate the enormous systemic threat that had developed.

Thus, the Administration proposes, for the first time, the federal regulation of the markets for OTC derivatives. The legislative draft sets forth a comprehensive regulatory framework for over-the-counter derivatives, which under current law are largely excluded or exempted from federal regulation. The draft is designed to achieve four broad objectives in the regulation of the OTC derivatives markets: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. To achieve these goals, it is critical that similar products and activities be subject to similar regulations and oversight.

In order to contain systemic risks, the Commodity Exchange Act and the federal securities laws would be amended to require the clearing of all standardized OTC derivatives through regulated central counterparties (CCPs). To ensure that this measure is effective, regulators would need to ensure that CCPs impose robust margin requirements and other necessary risk controls and that customized OTC derivatives are not used solely as a means to avoid using a central counterparty. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared. All OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential regulation.

Key elements of that regulatory regime must include conservative capital requirements, business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. Counterparty risks associated with customized bilateral OTC derivatives transactions that would not be accepted by a CCP would be addressed by the regime covering derivative dealers.

The OTC derivatives markets would be made more transparent by 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. Certain of those requirements could be deemed to be satisfied by either clearing standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs and trade repositories would have to, among other things, make aggregate data on open positions and trading volumes available to the public and to make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC, SEC, and the institution's primary regulators.

Market efficiency and price transparency would be improved in derivatives markets by requiring the clearing of standardized contracts through regulated CCPs, by moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives and by requiring development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. Further, regulated financial institutions would be encouraged to make greater use of regulated exchange-traded derivatives. Competition between appropriately regulated OTC derivatives markets and regulated exchanges will make both sets of markets more efficient and thereby better serve end-users of derivatives.

Market integrity concerns would be addressed by making whatever amendments to the Commodity Exchange Act and the federal securities laws would be necessary to ensure that the CFTC and the SEC have unimpeded authority to police fraud, market manipulation, and other market abuses involving all OTC derivatives. The CFTC also should have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Central counterparties, trade repositories, and other market participants would have to provide the CFTC, SEC, and the institution's primary regulator with a complete picture of activity in the OTC derivatives markets to assist in detecting and deterring all such market abuses.

Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent. The CFTC and SEC are reviewing the participation limits in current law to recommend how the Commodity Exchange Act and the federal securities laws should be amended to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties, such as small municipalities.

Credit Default Swaps

The Obama Administration proposes, for the first time, the federal regulation of credit default swaps as part of the regulation of OTC derivatives. Credit default swaps are contracts that insure a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade. Naked credit default swaps are those swaps that are merely a wager on the viability of an institution or financial instrument without requiring the corresponding underlying risk from the failure of those institutions or instruments.

Legislation

The Administration's proposal comes against the backdrop of pending legislation in Congress that would regulate OTC derivatives and credit default swaps. Two bills were reported out of the House and Senate Agriculture Committees earlier this year. The House Derivatives Markets Transparency and Accountability Act of 2009 was sponsored by Ag Committee Chair Collin Peterson. The bill was referred to the House Financial Services Committee. Senator Tom Harkin, Chair of the Agriculture Committee, introduced a companion bill in the Senate.

In the wake of the Administration's proposal, Chairman Peterson and House Financial Services Chair Barney Frank said that they would work closely together to pass legislation providing for the strong, comprehensive and consistent regulation of OTC derivatives.

A growing global consensus favors a central counterparty for OTC derivatives, including credit default swaps. Earlier this year, Elizabeth King, SEC Associate Director for Trading and Markets, said that a well-regulated and prudently managed central counterparty for credit default swaps has the potential to significantly reduce counterparty credit risks to market participants. In remarks at the Security Traders Association mid-winter meeting, the SEC official also emphasized that a CCP can also reduce systemic risks by preventing the failure of a single market participant from having a disproportionate effect on the overall market.

Harkin bill—The Harkin legislation would bring all OTC financial transactions and credit default swaps currently traded without federal oversight onto regulated exchanges. The Derivatives Trading Integrity Act, S. 272, would establish stronger standards of transparency and integrity in the trading of swaps and other over-the-counter financial derivatives as a critical step toward restoring confidence in the financial system. The broad goal of the legislation is to establish the standard that all futures contracts trade on regulated exchanges. According to the chair, it will bring these transactions out into the sunlight where they can be monitored and appropriately regulated.

The legislation envisions that the regulated exchanges would work with the CFTC to ensure that trading on the exchange is fair and equitable and not subject to abuses. In calling for the regulation of credit default swaps, former SEC Chair Christopher Cox has told the Senate Banking Committee that the credit derivatives market is a regulatory hole that must be closed by Congress.

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 overly leveraged or dangerously overextended. The Administration wants financial derivatives like credit-default swaps to be traded on a regulated exchange so that regulators can know the value of the contracts, who is trading them, and if the institutions have enough assets to back the contract.

The SEC’s current authority with respect to these instruments, which are generally security-based swap agreements under the Commodity Futures Modernization Act, 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.

Over the years, the CFTC and laws enacted by Congress have allowed instruments that are essentially futures contracts to be privately negotiated without the safeguards provided through exchange trading. In this economic downturn, Congress does not have the luxury to sit back and let the markets work.

The Derivatives Trading Integrity Act will bring more transparency and accountability into the marketplace. Specifically, the bill amends the Commodity Exchange Act to eliminate the distinction between “excluded” and “exempt” commodities and transactions versus commodities and transactions traded or conducted on regulated exchanges. All commodities and transactions of the same nature would be treated the same.

In addition, the bill eliminates the statutory exclusion of swap transactions and ends the CFTC’s authority to exempt these transactions from the general requirement that a contract for the purchase or sale of a commodity for future delivery can only trade on a regulated board of trade. In effect, this means that all futures contracts must trade on a designated contract market or a derivatives transaction execution facility. Virtually all contracts now commonly referred to as swaps fall under the definition of futures contracts and function basically in the same manner as futures contracts.

The bill seeks to eliminate the negative consequences from the lack of price transparency and the failure to properly measure and collateralize the risk in trading over-the-counter derivatives. Similar problems have not been seen in the trading of financial futures on regulated futures markets subject to CFTC oversight.

Peterson bill—The House Agriculture Committee has approved legislation to increase the transparency of and strengthen the oversight of futures, options and over-the-counter (OTC) markets. By voice vote, the Committee approved the Derivatives Markets Transparency and Accountability Act of 2009 as amended, a bill sponsored by Committee Chair Collin Peterson. The bill was referred to the House Financial Services Committee.

The House legislation, H.R. 977, will bring greater transparency and oversight to futures, credit default swaps, and OTC derivatives markets. It toughens position limits on futures contracts for physically-deliverable commodities as a way to prevent potential price distortions caused by excessive speculative trading. An innovative provision authorizes the CFTC to initiate and conduct criminal litigation for violations of the Act if the U.S. Attorney General has declined to bring criminal proceedings. This is a power the SEC does not have.

From October through December 2008, the Committee held a widely publicized series of hearings on the role unregulated OTC financial derivatives have played in causing the present economic meltdown The draft legislation is designed to apply time-tested tools of market regulation to the OTC energy and financial derivatives markets.

The overwhelming message of the testimony presented to the Committee established a consensus that the unregulated OTC markets caused severe systemic shocks because of a lack of transparency to the financial regulators of these private bilateral agreements, and because of inadequate capital reserves set aside by OTC derivative counterparties to underpin the trillions of dollars of financial commitments they made through the OTC transactions in question.

The bill requires all prospective over-the-counter transactions to be settled and cleared through a CFTC-regulated designated clearing organization, unless exempted by the CFTC in accordance with specified criteria. In some cases, the clearing requirement can met through an SEC regulated clearing agency or a properly regulated foreign clearinghouse. The measure gives the CFTC the authority, with the President's consent, to suspend naked credit default swap trading whenever an SEC short selling suspension order is in effect.

Importantly, the measure would close the so-called London Loophole by requiring foreign boards of trade to share trading data and adopt speculative position limits on contracts that trade U.S. commodities similar to U.S.-regulated exchanges. The bill also imposes a clearing requirement on OTC derivatives contracts and empowers the CFTC to suspend trading in naked credit default swaps under certain circumstances. The bill broadens and improves on last year's bipartisan derivatives legislation, which passed the House by a wide margin.

The measure will also limit eligibility for hedge exemptions to bona fide hedgers and improve transparency by requiring the CFTC to disaggregate and separately report the trading activity of index funds and swap dealers in agriculture and energy markets. It also calls for new, full-time CFTC employees to police manipulation and prevent fraud.

The bill also authorizes the CFTC to take corrective action if it finds disruption in over-the-counter markets for energy and gas. A manager's amendment by Chairman Peterson, by voice vote, contains technical and clarifying corrections, and changes regarding position limits and authorizes the CFTC to suspend credit default swaps trading.

Section 4 of the bill requires the CFTC to issue a proposed rule defining and classifying index traders and swap dealers for data reporting requirements and setting reporting requirements for transactions in designated contracts markets, derivatives transaction execution facilities, foreign boards of trade, and electronic trading facilities with respect to significant price discovery contracts. The statute also requires the CFTC to disaggregate and publicly provide the number and total value of positions of index funds, and other passive, long-only and short-only investors in all regulated markets, and data speculative positions relative to their bona fide physical hedgers.

The bill also authorizes the CFTC to suspend trading in credit default swaps, with the concurrence of the President. The measure provides that credit default swaps traded or cleared by registered entities will not be considered a federal security except as necessary for enforcing insider trading prohibitions of the Securities Exchange Act.

The draft legislation provides for tailored and limited exemptions that may be granted by the CFTC from the mandatory clearing requirements for individually negotiated derivatives. The precise standards assure that the exemption will only be granted when systemic risks will not be posed. The draft legislation is a reasonable compromise that accommodates individually negotiated contracts that cannot be cleared. By contrast, Senator Harkin's legislation flatly bans exceptions from this requirement that all OTC contracts be exchange traded, not merely cleared.

Money Market Funds

In the wake of Lehman Brothers' bankruptcy, the Administration learned that even one of the most stable and least risky investment vehicles, money market mutual funds, was not safe from the failure of a systemically important institution. These funds are subject to strict regulation by the SEC and are billed as having a stable asset value such that a dollar invested will always return the same amount.

But when a major prime money market fund "broke the buck" and lost money the event sparked sharp withdrawals from prime money market funds. Those withdrawals resulted in severe liquidity pressures, not only on prime money market funds, but also on companies that relied significantly on such funds for financing. In response to this increasing spread of systemic risk, the Treasury Department decided to guarantee the accounts of shareholders in money market funds existing on the date the guarantee was issued.

The vulnerability of money market funds to breaking the buck and the susceptibility of the entire money market fund industry to sharp withdrawals in those circumstances remains a significant source of systemic risk.

In addition, the widespread run on money market mutual funds underscored the dangers of institutions with no capital and no safety net operating as large pools of maturity transformation and liquidity risk. These have been compounded by provision of transaction account services, with withdrawals on demand at par, mimicking the services of regulated commercial banks.

Thus, the Administration proposes that the SEC strengthen the regulatory framework around money market funds in order to reduce the credit and liquidity risk profile of individual funds and make the money market fund industry as a whole less susceptible to runs. Specifically, the SEC should require money market funds to maintain substantial liquidity buffers and reduce the maximum weighted average maturity of fund assets. SEC rules should tighten the concentration limits applicable to money market funds and improve the credit risk analysis and management of money market funds. The SEC should also empower the fund boards of directors to suspend redemptions in extraordinary circumstances to protect the fund shareholders.

The SEC must carefully consider how to mitigate any potential adverse effects of a stronger regulatory regime for money market funds, such as investor flight from money funds into less regulated investment vehicles or reductions in the term of money market liabilities issued by major firms.

The Administration proposes that the President’s Working Group on Financial Markets prepare a report on fundamental changes to money market fund regulation that will more directly deal with systemic risk., including how to move away from a stable net asset value for money market funds or how to require such funds to obtain access to reliable emergency liquidity facilities from private sources. For liquidity facilities to provide money market funds with meaningful protection against runs, they should be reliable, scalable and designed so that drawing on them to meet redemptions would not disadvantage remaining fund shareholders. The report would be due by September 15, 2009.

Clearing and Settlement Systems

A key determinant of the risk posed by the interconnectedness of financial institutions is the strength or weakness of arrangements for settling payment obligations and financial transactions between banks and other financial institutions. Where those arrangements are strong they can help guard against instability in times of crisis. Where they are weak they can be a major source of financial contagion, transmitting a financial shock from one firm or market to many other firms and markets.

Further, when major financial institutions come under significant financial stress, weaknesses in settlement arrangements for financial transactions are a source of contagion. For several years prior to 2008, the Fed had worked with other regulators and market participants to strengthen those arrangements. In the case of OTC derivatives, significant progress was achieved, notably the cessation of unauthorized assignments of trades, reductions of backlogs of unconfirmed trades, and efforts to compress portfolios of outstanding trades. But progress was slow and insufficient.

Thus, the Administration proposes legislation broadly defining the characteristics of systemically important payment, clearing, and settlement systems and sets objectives and principles for their oversight. The legislation should direct the Federal Reserve, in consultation with the FSOC, to identify clearing and settlement systems and set risk management standards for their operation.

The legislation would define a covered system as a payment, clearing, or settlement system the failure or disruption of which could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the financial system.

Congress should authorize the Fed to collect information from any payment, clearing, or settlement system for the purpose of assessing whether the system is systemically important. In the case of a system that is subject to comprehensive regulation by the CFTC or the SEC, the market regulator will remain the primary regulator of the system. The Federal Reserve should first seek to obtain the information it needs from the SEC and CFTC, but may request additional information directly from the system if it is determined that the information is not currently collected by or available to the primary regulator.

The risk management standards imposed by the Federal Reserve on covered systems should require the systems to have consistent policies and practices for ensuring timely settlement by the systems across a range of extreme but plausible scenarios. The standards for these systems should be reviewed periodically by the Fed, in consultation with the FCOS, and should take into account relevant international standards.

A covered system should be subject to regular, consistent, and rigorous on-site safety and soundness examinations as well as prior reviews of changes to its rules and operations in order to ensure that the amended rules and operations meet the applicable risk management standards. If a system is subject to comprehensive regulation by the SEC or CFTC, then the SEC or CFTC should lead those exams and reviews. The Federal Reserve should have the right to participate in the exams, including in the determination of their scope and methodology, and should be consulted on rule changes that affect the system's risk management. The Federal Reserve and the SEC or CFTC should regularly conduct joint assessments of the system's adherence to the risk management standards.

If a covered system's risk management policies and practices do not meet the standards, the Federal Reserve should be authorized to compel corrective actions. If a covered system is subject to comprehensive regulation by the CFTC or SEC, then the SEC or CFTC should have primary authority for enforcement. If the Federal Reserve concludes that corrective actions are necessary, it should recommend those actions to the SEC or CFTC. If the Federal Reserve and the SEC or CFTC cannot agree on the need for enforcement action, the Federal Reserve should have emergency authority to take enforcement action but only after consultation with the FSOC, which should attempt to mediate the agencies' differences.

The Federal Reserve should also be authorized to require a covered system to submit reports for the purpose of assessing the risk that the system's operations pose to the financial system. In the case of a covered system that is subject to comprehensive regulation by the SEC or CFTC, the Federal Reserve should have access to relevant reports submitted to the SEC or CFTC, but its authority to require reports should be limited to information that cannot be obtained from reports to the SEC or CFTC.

Resolution Authority for Systemically Significant Financial Companies

The federal government's responses to the impending bankruptcy of Bear Steams, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of securities firms and other non-bank financial firms, including affiliates of banks or other insured depository institutions. In the absence of such a framework, the government's only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve's lending authority. And this mechanism was insufficient to prevent the bankruptcy of Lehman Brothers, an event that served to demonstrate how disruptive the disorderly failure of a non-bank financial firm can be to the financial system and the economy.

These market events demonstrated the weaknesses of financial company insolvency regimes. According to the Scott Committee, certain insolvencies have had a far greater systemic effect than others, partially because the law that governs the insolvency of a financial company depends on the company's form of organization. For example, the insolvency of banks insured by the FDIC is governed by the Federal Deposit Insurance Act. The insolvency of SEC-registered broker-dealers is governed by the Securities Investor Protection Act. And the insolvency of most other financial companies is governed by the Bankruptcy Code. One significant aspect of the Federal Deposit Insurance Act, as compared to the Code, is that it permits the transfer of certain derivatives and other qualified financial contracts to third parties, thus eliminating the downward spiral of prices that can result from a rush to liquidate collateral. See Scott Committee Report.

In particular, noted the Scott Committee report, neither the Code nor SIPA are structured to effectively resolve large families of financial companies. An insolvent holding company frequently has solvent subsidiaries. However, under the Code and SIPA, there is no analog to the Federal Deposit Insurance Act's bridge bank authority that would enable a quick sale of solvent subsidiaries to a federally chartered entity to preserve their value and stabilize markets. A parent's insolvency frequently leads to insolvency proceedings in respect of its subsidiaries, either because of defaults under parent guarantees or financing arrangements or because of a loss of confidence in the subsidiary. The resolution methods available under the Code and SIPA unnecessarily limit regulators' options.

Thus, the Administration asks Congress to pass legislation allowing the government to take control and unwind non-bank financial institutions such as securities and commodities firms. The new resolution regime would to allow for the orderly resolution of failing bank holding companies, including Tier 1 financial holding companies in situations where the stability of the financial system is at risk.

A federal regulator would manage the resolution of the firms efficiently and effectively in a manner that limits systemic risk with the least cost to the taxpayer, in conjunction with the primary regulator of the affected institution.

According to Treasury, the lack of a federal regulatory regime and resolution authority for large systemic non-bank financial institutions contributed to the financial crisis and, unless addressed with legislation, will constrain a federal response to future crises. As demonstrated by AIG, severe distress at large global non-depository financial institutions can pose systemic risks to the financial markets just as distress at banks can. The Administration asks for legislation authorizing federal regulators to use the same set of tools for addressing distress at non-bank financial institutions as they currently posses to deal with distressed banks. Institutions covered by the proposed legislation would include holding companies that control broker-dealers, insurance companies, and futures commission merchants.

This resolution regime should not replace bankruptcy procedures in the normal course of business. Bankruptcy is and will remain the dominant tool for handling the failure of a bank holding company unless the special resolution regime is triggered because of concerns about financial stability.

The proposed resolution regime is modeled on the systemic risk exception contained within the existing FDIC resolution regime. This exception allows the FDIC to depart from the least cost resolution standard, when financial stability is at risk. Like that authority, the authority proposed here would be only for extraordinary times and would be subject to strict governance and control procedures.

The Administration proposes a formal process for deciding whether use of this special resolution regime is necessary for a particular firm and determining the form that the resolution process for the firm should take. The process could be initiated by Treasury or the Federal Reserve. In addition, the process could be initiated by the FDIC, or, by the SEC, when the largest subsidiary of the failing firm is a broker-dealer or securities firm.

The authority to decide whether to resolve a failing firm under the special resolution regime should be vested in Treasury, which could invoke the authority only after consulting with the President and only upon the written recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the members of the FDIC Board. But, if the largest subsidiary of the firm, measured by total assets, is a broker-dealer, then FDIC Board approval is not required and two-thirds of the commissioners of the SEC must approve. If the failing firm includes an insurance company, the Office of National Insurance within Treasury will provide consultation to the Federal Reserve and FDIC Boards on insurance specific matters.

To invoke this authority, Treasury must determine that: (l) the firm is in default or in danger of defaulting; (2) the failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy; and (3) use by the government of the special resolution regime would avoid or mitigate these adverse effects.

The authority to decide how to resolve a failing firm under the special resolution regime should also be vested in Treasury. The tools available to Treasury should include the ability to establish conservatorship or receivership for a failing firm. The regime also should provide for the ability to stabilize a failing institution (including one that is in conservatorship or receivership) by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm. The Administration proposes that, in choosing among available tools, Treasury should consider the effectiveness of an action for mitigating potential adverse effects on the financial system or the economy, the action’s cost to the taxpayers, and the action’s potential for increasing moral hazard.

Treasury generally should appoint the FDIC to act as conservator or receiver, in cases where it has decided to establish conservatorship or receivership. But Treasury should also have the authority to appoint the SEC as conservator or receiver when the largest subsidiary of the failing firm, measured by total assets, is a broker-dealer or securities firm. The conservator or receiver should coordinate with foreign authorities that may be involved in the resolution of subsidiaries of the firm located in foreign jurisdictions. The existing customer protections provided to insured depositors, customers of broker-dealers and futures commission merchants, and insurance policyholders under federal or state law should be maintained.

The conservator or receiver of the firm should have broad powers to take action with respect to the financial firm. For example, it should have the authority to take control of the operations of the firm or to sell or transfer all or any part of the assets of the firm in receivership to a bridge institution or other entity. That should include the authority to transfer the firm's derivatives contracts to a bridge institution and thereby avoid termination of the contracts by the firm's counterparties (notwithstanding any contractual rights of counterparties to terminate the contracts if a receiver is appointed). The conservator or receiver should also have the power to renegotiate or repudiate the firm's contracts, including contracts with its employees.

The entity acting as conservator or receiver should be authorized to borrow from Treasury when necessary to finance exercise of the authorities under the resolution regime, and Treasury should be authorized to issue public debt to finance any such loans. The costs of the loans should be paid from the proceeds of assessments on bank holding companies. These assessments should be based on the total liabilities other than liabilities that are assessed to fund other federal or state insurance schemes. In addition, in light of the FDIC's role in the proposed special resolution regime for bank holding companies, the FDIC should have the authority to obtain any examination report prepared by the Fed with respect to any such company and should have back-up examination authority over them.

Securitization

There is a growing consensus that securitization must and should survive the financial crisis since it remains essential to the global financial markets despite its role in the subprime crisis. As these legislative overhauls get underway, it is becoming clear that the global financial system has crossed the Rubicon and there will be no return to the world of Glass-Steagall and the days of originate and hold before securitization.

In many ways, the financial crisis was at root a crisis of securitization. Thus, complex structured securitization must be reformed. While traditional securitization was a successful tool for bundling loans into asset-backed securities, 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 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. See remarks of French Central Bank Chair Christian Noyer.

The Administration proposes to reform securitization by changing the incentive structure of market participants; increasing transparency to allow for better due diligence; strengthening credit rating agency performance; and reducing the incentives for over-reliance on credit ratings.

One of the most significant problems in the securitization markets was the lack of sufficient incentives for lenders and securitizers to consider the performance of the underlying loans after asset-backed securities were issued. Lenders and securitizers had weak incentives to conduct due diligence regarding the quality of the underlying assets being securitized. This problem was exacerbated as the structure of those securities became more complex and opaque. Inadequate disclosure regimes also exacerbated the gap in incentives between lenders, securitizers and investors.

Thus, the proposal would direct the federal banking agencies to adopt regulations requiring loan originators or sponsors to retain five percent of the credit risk of securitized exposures. The regulations should prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these regulations. This is critical to prevent gaming of the system to undermine the economic tie between the originator and the issued asset-backed securities. The federal banking agencies should also be authorized to specify the permissible forms of required risk retention, for example, first loss position or pro rata vertical slice, and the minimum duration of the required risk retention.

The agencies also should be authorized to provide exceptions or adjustments to these requirements as needed in certain cases, including authority to raise or lower the five percent threshold and to provide exemptions from the no hedging requirement that are consistent with safety and soundness. The agencies should also have authority to apply the requirements to securitization sponsors rather than loan originators in order to achieve the appropriate alignment of incentives contemplated by the proposal.

The securitization process should provide appropriate incentives for participants to best serve the interests of their clients, the borrowers and investors. To do that, the compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process should be linked to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products.

Thus, U.S. GAAP should be changed to eliminate the immediate recognition of gain on sale by originators at the inception of a securitization transaction and instead require originators to recognize income over time. The proposed changes should also require many securitizations to be consolidated on the originator’s balance sheet and their asset performance to be reflected in the originator’s consolidated financial statements.

Similar performance-based, medium-to-long term approaches to securitization fees should enhance incentives for market participants to focus on underwriting standards. For example, 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. Sponsors of securitizations should have to provide assurances to investors, in the form of strong, standardized representations and warranties, regarding the risk associated with the origination and underwriting practices for the securitized loans underlying asset-backed securities.

The SEC is currently working to improve and standardize disclosure practices by originators, underwriters, and credit rating agencies involved in the securitization process. The Administration urges the SEC to continue those efforts. To strengthen those efforts, the SEC should be authorized to require robust ongoing reporting by asset-backed securities issuers.

Moreover, investors and credit rating agencies should have access to the information necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of asset-backed securities. In particular, the issuers of asset-backed securities should have to disclose loan-level data broken down by loan broker or originator.

Issuers should also have to disclose the nature and extent of broker, originator and sponsor compensation and risk retention for each securitization. The Administration urges the industry to complete its initiatives to standardize and make transparent the legal documentation for securitization transactions to make it easier for market participants to make informed investment decisions. With respect to residential mortgage-backed securities, the standards should include uniform rules for servicers to modify home mortgage loans under appropriate circumstances, if such modifications would benefit the securitization trust as a whole.

Also, the SEC and the Financial Industry Regulatory Authority (FINRA) should expand the Trade Reporting and Compliance Engine (TRACE), the standard electronic trade reporting database for corporate bonds, to include asset-backed securities.

Credit Rating Agencies

Essentially, the current financial and securitization crisis was partially caused because the credit rating agencies failed investors by awarding their highest ratings to complex debt instruments that were undeserving of investment grade status.

Many investors in mortgage-backed securities and collateralized debt obligations relied heavily on the credit ratings in making their investment decisions and in communicating risk appetites to their investment managers, rather than undertaking their own independent credit analysis on these complex instruments. When it became apparent that even AAA tranches of asset-backed securities could face large write downs, investors lost faith in the ratings of a broad range of complex structured products. And, no longer willing to rely on ratings and unable to perform their own credit analyses, investors simply pulled back from a wide range of structured product markets.

The SEC has adopted rules reforming the credit rating agency process. The Administration has directed the SEC to continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise promote the integrity of the ratings process.

Differentiation is a key concept in the reform of credit rating agencies. This means that credit rating agencies should differentiate the credit ratings that they assign to structured credit products from those they assign to unstructured debt. They should also publicly disclose credit rating performance measures for structured credit products in a manner that facilitates comparisons across products and credit ratings and that provides meaningful measures of the uncertainty and potential volatility associated with credit ratings.

Credit rating agencies should also publicly disclose, in a manner comprehensible to the investing public, precisely what risks their credit ratings are designed to assess, such as the likelihood of default and loss severity in event of default, as well as material risks not reflected in the ratings. This disclosure should highlight how the risks of structured products, which rely on diversification across a large number of individual loans to protect the more senior investors, differ fundamentally from the risks of unstructured corporate debt.

Credit rating agencies should also disclose sufficient information about their methodologies for rating structured finance products, including qualitative reviews of originators, to allow users of credit ratings and market observers to reach their own conclusions about the efficacy of the methodologies. Credit rating agencies should also disclose to the SEC any unpublished rating agency data and methodologies.

The Administration also urges regulators to reduce their use of credit ratings in regulations and supervisory practices, wherever possible. Where regulators use credit ratings in regulations and supervisory practices, they should recognize the potential differences in performance between structured and unstructured credit products with the same credit rating.

Moreover, risk-based regulatory capital requirements should appropriately reflect the risk of structured credit products, including the concentrated systematic risk of senior tranches and re-securitizations and the risk of exposures held in highly leveraged off-balance sheet vehicles. They should also minimize opportunities for firms to use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk.

The SEC adopted a set of new requirements focusing heavily on the complex structured products whose ratings were at the center of the financial crisis. The SEC thus embraces the doctrine of differentiation, which is also being adopted by the European Commission in its reform of credit rating agencies. The changes are designed to improve the quality of credit ratings by fostering accountability, transparency, and competition in the credit rating industry, particularly with respect to credit ratings for structured and asset-backed financial products. Release No. 34-59342 (SEC 2009).

The Commission has enhanced the disclosure of credit ratings performance measurement statistics; increased the disclosure of information about the assets underlying structured finance products; required more information about the procedures and methodologies used to determine structured finance ratings; and addressed conflicts of interest arising from the structured finance rating process.

Exchange Act Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO using Form NRSRO, and requires that a credit rating agency provide certain public information. Form NRSRO is also the means by which NRSROs update the information they must publicly disclose.

The SEC amended the instructions to Exhibit 1 to Form NRSRO to require NRSROs to provide more detailed performance statistics and, thereby, make it easier for users of credit ratings to compare the ratings performance of the NRSROs. In addition, these amendments will make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients.

One change to the Exhibit 1 instructions would require an NRSRO when generating the performance statistics to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Another change would require that the class-by-class disclosures be broken out over 1, 3 and 10-year periods.

Yet another change to the Exhibit 1 instructions would clarify the type of ratings actions that are required to be included in these performance measurement statistics. Specifically, it would change the instruction requiring that the performance statistics show down-grade and default rates with an instruction that they show ratings transition and default rates. The switch to ratings transition rates from downgrade rates was designed to clarify that upgrades (as well as downgrades) should be included when generating the statistics.

The SEC also amended the instructions to Exhibit 2 of Form NRSRO to provide greater clarity around three areas of the NRSROs' rating processes that have raised concerns in the context of the recent credit market turmoil: (1) the level of verification performed on information provided in loan documents; (2) the quality of loan originators; (3) and the on-going surveillance of existing ratings and how changes made to a model used for initial ratings are applied to existing ratings.

This additional information will assist users of credit ratings in making more informed decisions about the quality of an NRSRO's ratings processes, particularly with regard to structured finance products.

The rating agency must disclose information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction relied on in determining credit ratings. The Commission believes this disclosure will benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings.

NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (*e.g.*, value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired. Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification will be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by inaccurate information about the assets underlying a rated structured finance product.

The rating agency will also have to disclose whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings. Originators of assets were key players in the originate-and-distribute securitization process that contributed to the financial crisis.

The Commission believes that certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance.

Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSROs' procedures and methodologies.

The SEC also requires rating agencies to disclose how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

On a more macro level, The Commission believes that these enhanced disclosures in the Exhibits to Form NRSRO will make it easier for market participants to select the NRSROs that are performing well and have the highest quality processes for determining credit ratings. The Commission expects that providing market participants with enhanced disclosures will lead to increased competition and the promotion of capital formation through a restoration of confidence in credit ratings.

Rule 17g-2 requires an NRSRO to make and keep current certain records relating to its business and requires an NRSRO to preserve those and other records for certain prescribed time periods The SEC amended Rule 17g-2 to provide greater documentation of the ratings process to assist Commission staff in their examination function as well as to provide greater information to users of issuer-paid credit ratings about the performance of an NRSRO's issuer-paid credit ratings.

The additional records will be: (1) a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating for a structured finance product; (2) a record showing the history and dates of all previous rating actions with respect to each outstanding credit rating; (3) a record, to be made publicly available, showing the history and dates of a 10-percent random sample of issuer-paid credit ratings, for each ratings class for which an NRSRO is registered and has issued 500 or more issuer-paid credit ratings, of all previous rating actions with respect to each outstanding credit rating; and (4) any written complaints regarding the performance of a credit analyst in determining credit ratings. These records will assist in monitoring whether an NRSRO is operating consistently with the methodologies and procedures it establishes to determine credit ratings and its policies and procedures designed to ensure the impartiality of its credit ratings, including its ratings of structured finance products.

In addition, changes to Rule 17g-2(d) will require an NRSRO to make publicly available a random sample of 10% of the issuer-paid credit ratings actions histories, in an XBRL format and with a six-month grace period, for each ratings class for which it has issued 500 or more issuer-paid credit ratings. This XBRL disclosure requirement will allow the marketplace to better compare the performance of different NRSROs that determine issuer-paid credit ratings, since it will shift the source of data formatting from end-users to NRSROs submitting interactive data, thus eliminating the need for end-users to make interpretive decisions on how to compare data fields across NRSROs' reported rating histories. This additional disclosure also may make NRSROs more accountable for their issuer-paid credit ratings by enhancing the transparency of their ratings performance.

The Commission believes the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs because it will require them to present the information in a standard format. Making the information available in an XBRL format will facilitate the process of creating better and more useful means to analyze how a given NRSRO performed in a certain class of issuer-paid credit ratings and compare that broader performance across

NRSROs subject to the public disclosure rule, increasing the transparency of the results of their rating processes and encouraging competition within the industry by making it easier for users of issuer-paid credit ratings to judge the output of the NRSROs.

The Commission also believes that the XBRL format will increase access to information in the financial marketplace and transform the manner in which individual investors, financial intermediaries, analysts, the financial media, and others access, use, and ultimately understand the wealth of available data. Requiring NRSROs to provide this disclosure in a single industry standard format will offer market participants the benefits of simplification, increase transparency, and ease of comparisons.

Rule 17g-3 requires an NRSRO to furnish certain financial reports to the Commission on an annual basis, including audited financial statements as well as other financial reports Changes to Rule 17g-3 will require an NRSRO to furnish an additional annual report to the Commission: an unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) taken during the fiscal year in each class of credit ratings identified in Section 3(a)(62)(B) of the Act for which the NRSRO is registered with the Commission.

The new report is designed to enhance the Commission's oversight by providing the Commission with additional information to assist in the monitoring of NRSROs for compliance with their stated policies and procedures. For example, the proposed new report will allow examiners to target potential problem areas in an NRSRO's rating processes by highlighting spikes in rating actions within a particular class of credit rating.

Changes to Rule 17g-5 prohibit an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate provided recommendations on the structure of the transaction being rated; a credit analyst or person involved in the ratings process participated in fee negotiations; or a credit analyst or a person responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of $25 or less.

The Commission believes that the amendments to Rule 17g-5 will promote the disclosure and management of conflicts of interest and mitigate potential undue influences on an NRSRO's credit rating process, particularly with respect to credit ratings for structured finance products. These amendments will, in turn, increase confidence in the integrity of NRSRO ratings and, thereby, promote capital formation.

European Union

A committee of the European Parliament has reported out legislation providing for the regulation of credit rating agencies under a single EU-wide regulator, the Committee of European Securities Regulators (CESR). Rejecting the European Commission's proposal for national regulation, the Economic and Monetary Affairs Committee designated CESR as the sole registration and supervisory body over EU rating agencies.

Under the draft legislation, CESR would be in charge of registering credit rating agencies, checking their compliance with the rules and ultimately withdrawing an agency's registration should the rules be breached. CESR would inform Member State authorities once all registration steps are accomplished. On an ongoing basis, CESR would also be in charge of monitoring the past performance of rating agencies and publishing statistical data on the reliability of ratings issued. To that end, credit rating agencies must make available in a public central repository, to be established by CESR, information on their historical performance data and information about past credit rating activities.

The committee referred to credit rating agencies as a de facto oligopoly that clearly underestimated the credit risk inherent particularly in structured credit products and did not adapt their ratings when the markets fell. Given this background, the committee concluded that ratings agencies should be subject to strict regulation. The legislative effort signals the failure of voluntary regulation through codes of conduct for rating agencies.

A major issue dealt with in the draft is how to let European investors use non-EU ratings while maintaining the same criteria as for EU ratings. Embracing an equivalence regime, the legislation provides that non-EU ratings would have to be endorsed by an EU credit rating agency and comply with equivalent criteria to those in the EU legislation. A list of third country legislation and regulation considered equivalent to the EU credit rating agency regulatory regime will be prepared by the European Commission and regularly updated by the Commission.

Pending harmonized global rules, stated the committee report, ratings issued by credit agencies not subject to European regulation could be used as long as these ratings are confirmed and endorsed by an agency based within the European Union, in the sense of its assuming responsibility and certifying that the agency that issued the rating is bound by regulation equivalent to that which exists in the EU. The report emphasized that this is an opportune moment to promote healthy competition in the field of credit rating agencies by favoring the establishment of credit rating agencies with a head office in Europe. To this end, Member States will encourage entities to be rated to use agencies that have their head office located in the EU for a proportion of the ratings to be obtained.

The European Commission proposed the strict regulation of credit rating agencies in an effort to restore confidence in the markets. The legislation is designed to ensure that the ratings issued by the agencies are independent, objective, and of the highest quality. The new regime is based on concepts of transparency and independence. According to Commissioner for the Internal Market Charlie McCreevy, the proposed regime for credit rating agencies will ensure that regulators with responsibility for oversight will have at their disposal sufficient resources and expertise to keep up with financial innovation and to challenge the rating agencies in the right areas, on the right issues, and at the right time.

The legislation provides for a rotation mechanism to avoid conflicts of interest. A key goal of the reforms is to avoid conflicts of interest between the agency issuing the rating and the rated organization. The draft requires that a rotation mechanism be implemented to ensure that rating agency analysts who are in direct contact with the rated entity be rotated out after five years. In order to avoid negative effects on rating agency performance, the draft stresses that rotation should be on an individual basis rather than changing the entire team.

Other reforms would require rating agencies to disclose the compensation arrangements with their clients. In addition, compensation and performance evaluation of analysts providing the credit ratings cannot be contingent on the amount of revenue that the credit rating agency derives from the rated entities. Further, analysts and other employees who are directly involved in the credit rating process must not be allowed to participate in negotiations regarding fees or payments with any rated entity.

Incorporating the concept of differentiation, the legislation provides that credit rating agencies should use different rating categories when rating structured finance instruments and provide additional information on the different risk characteristics of these products. They should also indicate when rating a product for the first time and when rating a newly-created product.

Legislation

Legislation passed in May by the House would begin the reform of the securitization process by introducing extensive new requirements for residential mortgage products and lending practices. The Mortgage Reform and Anti-Predatory Lending Act of 2009, H.R. 1728, would encourage a return to sound underwriting practices by prohibiting mortgage lenders from relinquishing all responsibility for the bad loans they make and sell to Wall Street. Under the measure, lenders will now have to keep skin in the game and retain a five percent stake in any home loan they make and sell.

Also, for the first time ever, the large secondary mortgage market will bear responsibility for bad loans they purchase and securitize, bringing accountability back to every level of the mortgage lending chain. The measure is currently being considered by the Senate Banking Committee.

The legislation establishes a simple federal standard for all home loans under which institutions must ensure that borrowers can repay the loans they are sold. Lenders would have to determine that a borrower has a reasonable ability to repay, based on income, credit history, indebtedness and other factors. For refinancing, the bill will require that all loans provide a net tangible benefit to the consumer, barring junk lending driven by fees rather than solid economics.

Under the legislation, participants in the huge secondary mortgage market would for the first time be liable under federal law for ensuring responsible lending. The measure permits consumers to obtain redress directly from firms involved in securitizing mortgages, unless the securitizer provided the borrower with a loan that meets the basic ability to repay and net tangible benefit standards. In recent years, home loans increasingly were sliced and diced by firms that bundled and resold mortgages to investors, making it difficult to track who was ultimately responsible for ensuring the soundness of loans.

To fully encourage responsible underwriting, the legislation mandates strong new federal rules to require creditors to retain an economic interest in a material portion (at least five percent) of the credit risk of each loan that the creditor transfers, sells, or conveys to a third party. Federal banking agencies would have the authority to make exceptions to the risk retention provisions, including form and amount.

Under the measure, lenders and securitizers in the secondary mortgage market who fail to comply with these standards would be held accountable by consumers for rescission of the loan and the consumer's costs for rescission, including attorney's fees.

Corporate Governance and Executive Compensation

The Obama Administration has asked Congress to pass legislation mandating a non-binding shareholder advisory vote on executive compensation. The Administration also seeks legislation ensuring the independence of board of directors compensation committees similar to the manner in which the Sarbanes-Oxley Act provided for independent audit committees.

Broadly, there is a wide consensus that executive compensation incentives, particularly variable compensation such as bonuses, must be aligned with shareholder interests and long-term, firm-wide profitability. Moreover, compensation schemes must become fully transparent. Also, the assessment of bonuses should be set in a multi-year framework in order to spread out the actual payment of the bonus pool through the cycle. Further, bonuses should reflect actual performance and therefore should not be guaranteed in advance.

Congressional oversight chairs quickly expressed support for the legislative proposal. Senate Banking Committee Chair Christopher Dodd said that he strongly supports say-on-pay legislation. More broadly, the senator said that executive compensation has gone completely out of control by rewarding short-term gain and encouraging excessive risk-taking. House Financial Services Committee Chair Barney Frank also supports say-on-pay legislation, but does not think simply mandating independent compensation committees goes far enough. He believes that the legislation should also direct the SEC to set principles preventing companies from providing compensation systems that lead to excessive risk taking.

The legislation would direct all public companies to include in their annual proxy statements a shareholder resolution requesting approval or disapproval of executive compensation as disclosed in the proxy, including the narrative description of the board's compensation decisions in the Compensation Discussion and Analysis and the quantitative disclosure of amounts executives are entitled to receive.

Shareholders would have the right to vote on annual compensation for the top five named executive officers as disclosed in the company's proxy statement. Currently, SEC regulations designate the CEO, CFO and the next three most highly-paid officers other than the CEO and CFO as the five named executive officers whose compensation must be disclosed. The types of compensation shareholders will have the opportunity to evaluate must include salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and non-qualified deferred compensation earnings.

Under the say-on-pay legislation, shareholders will have the opportunity to cast a non-binding vote to approve or disapprove golden parachute compensation disclosed in proxy solicitation materials prepared for shareholder meetings relating to a merger, acquisition, or other transaction that may involve a company change in control.

Although the shareholder vote will be non-binding, experience shows that the prospect of the vote itself can cause directors more carefully to consider shareholder interests when designing executive pay. Moreover, the Administration believes that giving shareholders a way to express their views on executive compensation will allow boards and shareholders to work together to design compensation that gives executives strong incentives to maximize long-term firm value, which is a key reform goal endorsed by the G-20 and the Financial Stability Board.

A shareholder advisory vote on executive compensation will, in the Administration's view, also send a strong message to management and boards and serve to support a culture of performance, transparency, and accountability in executive compensation.

Shareholders are often concerned about large corporate bonus plans in situations in which they, as the company's owners, have experienced losses. Currently, these decisions are often not directly reviewed by shareholders, leaving them with limited rights to voice their concerns about compensation through an advisory vote.

To facilitate greater communication between shareholders and management over executive compensation, public companies should include on their proxies a nonbinding shareholder vote on executive compensation. Legislation authorizing SEC say on pay rules for all public companies could help restore investor trust by promoting increased shareholder participation and increasing accountability of board members and corporate management. It would provide shareholders of all public U.S. companies with the same rights that are accorded to shareholders in many other countries.

Compensation Committee

The Administration believes that many of the compensation practices that encouraged the excessive risk-taking that contributed to the financial crisis might have been more closely scrutinized if compensation committees had greater independence and shareholders had more clarity. In too many cases, compensation committees were not sufficiently independent of management, while companies were not fully transparent in explaining their compensation packages to shareholders.

The proposed legislation would also direct the SEC to adopt rules requiring that companies have independent compensation committees similar to those for audit committee members under Sarbanes-Oxley. The regulations must ensure that compensation committee members will be truly independent when setting executive pay on behalf of shareholders.

Just as Sarbanes-Oxley gave audit committees the power to retain and dismiss outside auditors, the new requirements must enable compensation committees to use outside advisers in the process of setting executive pay. Thus, under the proposal, compensation committees would be directly responsible for the appointment, compensation, retention and oversight of the work of any compensation consultants that they retains, and these compensation consultants must report directly to the compensation committee. The compensation committee must also have the authority to engage counsel and other advisers, as it determines necessary to carry out its duties.

The legislation would mandate that each company must provide for appropriate funding, as determined by the compensation committee, to enable the committee to engage and adequately compensate compensation consultants, outside counsel and any other advisors employed by the compensation committee. Further, the legislation would direct the SEC to establish standards for ensuring the independence of compensation consultants and outside counsel used by the compensation committee.

In addition to say-on-pay and enhanced compensation committees, the legislation should also direct federal regulators to adopt standards and guidelines aligning executive compensation practices at financial firms with long-term shareholder value and preventing compensation practices from providing incentives that could threaten the financial institutions. The standards must follow the following principles in aligning compensation with shareholder interests.

Compensation plans must properly reward and measure performance and be structured to account for the time horizon of risks. Compensation practices must be aligned with sound risk management. Golden parachutes and retirement packages must be reexamined to determine if they align the interests of executives and shareholders. Broadly, transparency and accountability must be enshrined in the process of setting compensation.

The SEC should supplement these standards with increased disclosure rules. Treasury will support the efforts of the SEC and other regulators in setting forty standards on compensation at financial firms that are fully integrated into the regulatory process. The FSOC will review and monitor compensation practices, specifically on risk taking, and identify any trends that might be creating risk.

Schumer Bill

Currently, there is already a Senate bill, sponsored by Senator Charles Schumer, requiring say on pay as part of broad shareholder rights reforms. The Shareholder Bill of Rights Act, S. 1074, would require public companies to hold an annual advisory vote on executive compensation policies, as well as require shareholder approval of executive golden parachutes.

G-20

The G-20 recently endorsed major changes in executive compensation. Regulation must ensure that compensation structures are consistent with firms' long-term goals and prudent risk taking. Specifically, firms' boards of directors must play an active role in the design, operation, and evaluation of compensation schemes. Compensation, particularly bonuses, must properly reflect risk; and the timing and composition of payments must be sensitive to the time horizon of risks.

Payments should not be finalized over short periods where risks are realized over long periods, said the G-20, and firms must disclose comprehensive and timely information about compensation. Stakeholders, including shareholders, should be adequately informed on a timely basis on compensation policies in order to exercise effective monitoring. The inclusion of stakeholders portends a role for shareholder advisory votes on executive compensation.

For their part, regulators should assess firms' compensation policies as part of their overall assessment of their soundness. When necessary, regulators should intervene with responses that can include increased capital requirements. The G-20 also wants the Basle Committee to integrate these principles into its risk management guidance.

Financial Accounting

It has been widely recognized that certain aspects of accounting standards have had procyclical tendencies, meaning that they have tended to amplify business cycles. For example, during good times, loan loss reserves tend to decline because recent historical losses are low. In determining their loan loss reserves, the Administration says that firms should have to be more forward-looking and consider factors that would cause loan losses to differ from recent historical experience. This would likely result in recognition of higher provisions earlier in the credit cycle. During the current crisis, such earlier loss recognition could have reduced procyclicality, while still providing necessary transparency to users of financial reports on changes in credit trends. Similarly, the interpretation and application of fair value accounting standards during the crisis raised significant procyclicality concern.

Thus, the Administration states that the accounting standard setters, FASB and the IASB, as well as the SEC, should review accounting standards to determine how financial firms should have to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.

Current accounting for loan loss is procyclical by forcing banks to build reserves when it is most difficult to do so. Current accounting standards for loan loss provisioning are based on the incurred loss model under which a bank can make a provision to the reserve only if it can document that a loss has been incurred, which means that a loss is probable and can be reasonably estimated. The easiest way to document those conditions is to refer to historical loss rates and the bank's own prior loss experience with the type of asset in question. Remarks of Comptroller of the Currency John C. Dugan at the Institute of International Banking.

In a long period of benign economic conditions, it becomes difficult to use acceptable documentation based on history and recent experience to justify significant provisioning. Thus, when bankers were unable to produce acceptable documentation, noted the OCC chief, auditors began to lean on them to reduce provisions or even take the more extreme step of reducing reserves. The result, he said, was that the industry went into the current downturn without adequate reserves to absorb the wave of loan losses that are now being recognized.

The Comptroller noted that a Financial Stability Forum working group, which he co-chairs with SEC Commissioner Kathleen Casey, is exploring a number of questions with respect to reserves. He said that the work of this group will help inform the work of standard setters, regulators, and policy makers in this area.

Some commenters have pointed to the dynamic provisioning model that has been used in Spain to permit more mechanical increases to loan loss reserves based on loan growth rather than measures of projected loss. While the OCC needs more details about how the dynamic provisioning approach actually works in practice, and whether it can really be squared with the fundamental concept of loss recognition, the model has the initial appeal of creating greater reserves earlier in the cycle. Still others have suggested eliminating accrual accounting altogether and moving to fair value accounting for all bank assets as a way to address this issue. While the Comptroller disfavors that approach because it would produce even more pro-cyclicality, he wants to hear all ideas as part of a vigorous debate to improve the current standard.

Fair Value Accounting

GAAP and IFRS define "fair value" in a similar way, which is a price at which an asset and liability can be traded with a willing counterparty in an orderly manner. Both accounting frameworks also provide measurement approaches at differentiated levels. Level 1: prices can be observed on active market, which are used to measure the value of assets and liabilities, a practice called mark-to-market. Level 2: when there is no active market, prices are assessed by using models with observable parameters as inputs, a process called mark-to-model. The measurement approach used on level 3 is similar to the mark-to-model approach, but it involves unobservable parameters and model assumptions as inputs. Both IFRS and GAAP require disclosure of the adoption of fair value approaches and specific assumptions as well as risk exposures and sensitivities.

Several policymakers have identified fair value accounting as a factor that worked to exacerbate the financial crisis. A number of policymakers believe that the problems of fair value accounting have been exposed by the current crisis. Compared with the historical cost approach, fair value accounting intensifies market fluctuations. While the fair value approach can better reflect the real time value of assets and liabilities, it also magnifies the changes in their values and increases the volatility of returns through the profit and loss account as a consequence. As a result of the massive collateralized securities they held, financial institutions registered mounting unrealized losses that actually involved no cash flow under the fair value rule. Though these losses were only meaningful in accounting, he said, such astronomical book losses distorted investors' expectations and formed a vicious cycle of tumbling prices and asset write-downs. See remarks of Zhou Xiaochuan, Governor of the People's Bank of China.

G-20

The G-20 leaders also called on the accounting standard setters to work urgently with regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards. Specifically, the standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons, while reaffirming the framework of fair value accounting. In addition, the standard setters should reduce the complexity of accounting standards for financial instruments and strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information. They must also improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty.

The standards setters should achieve clarity and consistency in the application of valuation standards internationally, working with regulators. Within the framework of the independent accounting standard setting process, they must also improve the involvement of stakeholders, including prudential regulators and emerging markets, through the IASB's constitutional review.

International Aspects

It is axiomatic that the financial crisis has international dimensions. The financial markets are inexorably globally integrated and financial stability must be cross-border in order to ameliorate systemic risk and prevent regulatory arbitrage. Thus, reform legislation must provide for the global monitoring of system stability and the regulation of cross-border systemically important institutions. For the proper regulation of cross-border institutions that can impact systemic risk, there must also be strong international cooperation and clear rules.

At the same time, it is also clear that sovereignty will prevent an international mandatory regulatory regime. But there is still a need for some form of international financial oversight to promote the harmonization of regulations and their consistent enforcement. Treasury Secretary Tim Geithner noted that, because markets are increasingly global, the financial rules of the game at the national level need to converge toward higher standards. Since risk and leverage will always tend to migrate to where the constraints are weakest, he reasoned, we must create a level playing field globally, or the effectiveness of national safeguards against risk will be undermined. See remarks to G-8 Finance Ministers (June 13, 2009).

The Obama Administration and the G-20 have endorsed the Financial Stability Board as the vehicle to monitor the cross-border consistency of financial regulation. The Financial Stability Board, with a strengthened mandate, is the successor to the Financial Stability Forum. The Board is charged with monitoring the cross-border consistency of the national financial regulatory reform legislation.

The Administration also proposes that the international group of banking regulators responsible for setting capital requirements take forward its work on reforming capital ratios to constrain future increases in leverage. More broadly, the Administration calls on the international banking regulators to develop proposals by the end of this year for countries to have the necessary tools to quickly resolve failures of cross-border financial firms.

Tier 1 Firms

The legislation would impose a strict regime of regulation on Tier 1 financial holding companies posing systemic risks to market stability. The G-20 agreed in April that all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation.

Thus, the Federal Reserve should develop rules to identify foreign financial firms as Tier 1 companies based on whether their U.S. operations pose a threat to financial stability. This evaluation should be similar to that used to identify domestic Tier 1 companies. The Federal Reserve could consider applying the criteria to the world-wide operations of the foreign firm. The Federal Reserve could also choose to apply the criteria only to the U.S. operations of the foreign firm or to those operations of the foreign firm that affect the U.S. financial markets.

In determining which foreign firms are subject to the Tier 1 regime, the Fed should give due regard to the principle of national treatment and equality of competitive opportunity between foreign-based firms operating in the United States and U.S.-based firms. The Federal Reserve should also consider the implications of these determinations for international agreements negotiated by the executive branch. Under the proposal, Treasury would play no role in the application of these rules to specific firms.

In addition, the new proposed well-capitalized and well-managed tests for financial holding company status should apply to foreign financial institutions operating in the U.S. in a manner comparable to that of U.S.-owned financial institutions, while taking into account the difference in their legal forms. Under the Gramm-Leach-Bliley Act, a foreign bank that owns or controls a U.S. bank must comply with the same requirements as a domestic bank holding company to achieve financial holding company status, namely, all the U.S. subsidiary banks of the holding company or foreign bank must be well-capitalized and well-managed. A foreign bank that does not own or control a U.S. bank, but instead operates through a branch, agency, or commercial lending company located in the U.S. must itself be well-capitalized and well managed if it elects to become an financial holding company. If a foreign bank operates in the U.S. through branches and subsidiary banks, both the foreign parent bank and its U.S. subsidiary bank must be well-capitalized and well-managed if the foreign bank elects to become a financial holding company.

Although the Administration proposes to change the financial holding company eligibility requirements, it will not dictate the manner in which those requirements are applied to foreign financial firms with U.S. operations. Rather, the Federal Reserve, in consultation with Treasury, should determine how to apply these new requirements to foreign banks that seek financial holding company status. The Federal Reserve should make its determination giving due regard to the principle of national treatment and equality of competitive opportunity. ❒

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.

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