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# GlobalNote®

## U.S. Treasury Proposes Plan For Financial Regulatory Reform

**TO: Clients and Friends<sup>1</sup>**  
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On June 17, 2009, the United States Department of the Treasury (“Treasury”) published a wide-ranging set of proposals to improve oversight and regulation of the U.S. financial system, titled “Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation” (referred to herein as the “Proposal”).<sup>2</sup> This GlobalNote summarizes those aspects of the Proposal we believe to be most relevant to our clients and reviews Treasury’s recommendations from an industry-by-industry perspective. This GlobalNote also discusses the impact of the Proposal on market participants and their primary regulators.

The Proposal is premised on the idea that reforming the financial system, its institutions and its participants is necessary to better identify systemic risks and to prevent problems from threatening the stability of the U.S. financial system. To minimize such risks, the Proposal’s recommendations are intended to meet the following objectives: (1) promoting robust supervision and regulation of financial firms; (2) establishing comprehensive supervision of financial markets; (3) protecting consumers of financial products; (4) providing the government with additional tools to manage financial crises and (5) raising international standards and increasing international cooperation.

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<sup>1</sup> This GlobalNote® memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information, please see the firm’s website: [www.thshlaw.com](http://www.thshlaw.com).

<sup>2</sup> A copy of the Proposal, its accompanying fact sheets and public statements by President Barack Obama, Treasury Secretary Timothy Geithner and National Economic Council Director Lawrence Summers can be obtained online at: <http://financialstability.gov/roadtostability/regulatoryreform.html>.

## **I. General Overview**

The Proposal suggests both *structural* and *regulatory* reforms of the U.S. financial system.

### **A. Structural Reforms**

Among the more significant structural reforms the Proposal recommends is the creation of a committee of financial regulators called the Financial Services Oversight Council (“FSOC”) that would replace the President’s Working Group on Financial Markets. It would be responsible for identifying emerging systemic risks and improving cooperation and information sharing among different agencies. The FSOC would identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks.

The Proposal also recommends the creation of two new federal agencies. A new agency called the National Bank Supervisor would be responsible for federally chartered banks. Also, the Consumer Financial Protection Agency (“CFPA”) would be a new independent agency dedicated to consumer protection in credit, savings, and payments markets and to preventing against unfair, deceptive and abusive practices. It also would be charged with ensuring that consumer protection regulations are written fairly and enforced vigorously. The goals of CFPA would be to 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.

In addition, the Office of Thrift Supervision and the Federal Thrift Charter would be eliminated while some existing agencies’ regulatory authority would be expanded. Notably, Treasury will have an expanded role in the regulation of the insurance industry, will have right of approval over decisions by the Federal Reserve to extend credit in unusual and exigent circumstances and will have the chairmanship of and house the FSOC. These and other structural reforms are discussed more fully in Section II below.

### **B. Regulatory Reforms**

The Proposal recommends a variety of regulatory changes, including strengthening oversight of the banking and insurance industries, regulating and monitoring OTC derivatives such as credit default swaps (“CDS”) and associated counterparty risks, increasing transparency and integrity in the valuation and rating of asset backed securities (“ABS”), tying executive compensation to performance and protecting consumers of financial products.

The following is a summary of certain key structural and regulatory reforms contained in the Proposal as they apply to major industries in the financial sector.

## **II. Summary of the Proposal's Effect on Major Industries and Market Participants**

### **A. Managers of Hedge Funds and Other Private Funds**

#### **1. Mandatory Registration**

The Proposal recommends the mandatory registration of advisers to hedge funds and other private funds with the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940, as amended. In addition, the Proposal recommends that all investment funds advised by SEC-registered investment advisers be subject to recordkeeping and disclosure requirements and regulatory reporting requirements.

The Proposal comes one day after a bill introduced in Congress by Senator Jack Reed of Rhode Island requiring all hedge fund and other private pool advisers that manage more than \$30 million in assets to register as investment advisers with the SEC (whereas smaller advisers would continue to fall under state oversight). In Sen. Reed's bill, the SEC would be authorized to collect information from the hedge fund industry and to require hedge funds and other investment pools to maintain and share with other federal agencies any information necessary for the calculation of systemic risk. The bill also seeks to clarify the SEC's authority to oversee registered investment advisers.

The chances for passage of Sen. Reed's bill are not yet known, but we perceive an emerging consensus in Congress supporting the general notion that investor adviser registration is necessary to address perceived weaknesses in the regulation of hedge funds. It is possible that federal regulation and/or registration may extend beyond fund advisers to the funds themselves, as evidenced by the introduction in the Senate of the Hedge Fund Transparency Act in January 2009.<sup>3</sup> In addition, although the Proposal clearly envisions the registration of advisers to funds with an equities-only strategy and advisers to "hybrid" funds trading a mixture of equities and futures, what is not clear is whether operators of commodity pools (i.e., those funds only trading futures or options on futures) will be required to register with the Commodity Futures Trading Commission (the "CFTC"). The Proposal does not contain such a recommendation and merely states in passing that the CFTC should continue to maintain its enforcement authority over the approximately 1,300 commodity pool operators that are currently registered. More details on the mandatory registration of investment advisers, and perhaps commodity pool operators, will become known in the coming months as Congress considers hedge fund-related legislation introduced this year.

#### **2. Harmonization of Futures and Securities Regulations**

Included in the Proposal is a call for the CFTC and the SEC to harmonize their rules relating to derivatives and other financial products. The two agencies' products-

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<sup>3</sup> For more information on the Hedge Fund Transparency Act, which is not addressed in the Proposal but passage of which remains a possibility, see this firm's GlobalNote entitled, "The Hedge Fund Transparency Act" at [http://www.thshlaw.com/Publications/February\\_2008/The\\_Hedge\\_Fund\\_Transparency\\_Act.pdf](http://www.thshlaw.com/Publications/February_2008/The_Hedge_Fund_Transparency_Act.pdf).

based approach to regulation results in jurisdictional overlap and legal disputes over whether a particular product should be regulated as a security or a futures contract. For example, options on a security are regulated by the SEC whereas securities futures are jointly regulated by the SEC and the CFTC. Treasury wants the SEC and CFTC to harmonize their regimes to remove such distinctions for economically equivalent instruments and permit a broader range of instruments to trade on any regulated exchange. In addition, the Proposal highlights the difference between the SEC's "rules-based" approach to regulation within its jurisdiction versus the CFTC's "principles-based approach" and recommends that the agencies come to an agreement on principles of regulation that are more precise than a principles-based approach but sufficiently flexible to allow for innovations by market participants. The CFTC and the SEC are asked to submit a report to Congress by September 30, 2009, identifying all conflicts in statutes and regulations with respect to similar types of financial instruments and recommending changes to eliminate differences.

Although this recommendation falls short of mandating the merger of the SEC and the CFTC, it is not clear to what extent the agencies will be required to integrate their regulatory activities. Certainly, it will be difficult for the agencies to identify all of the differences in their regulatory approach and agree on corrective action in the next three months. It is also not clear whether the agencies will accept the approach recommended by the Proposal as an improvement on the current practice of signing interagency mutual cooperation agreements, such as the memorandum of understanding signed by former CFTC Chairman Lukken and former SEC Chairman Cox in March 2008 relating to dually-regulated products. In any event, there appears to be a mandate for a more robust SEC, and we expect that attempts to significantly remold the CFTC in the SEC's image or to reduce the CFTC's influence will be met with stiff resistance by those at the CFTC and market participants who prefer the CFTC's principles-based approach to regulation.

### **3. Comprehensive Regulation of OTC Derivatives**

In the Proposal, Treasury identifies a lax regulatory scheme over OTC derivatives, particularly credit default swaps tied to asset backed securities, as a contributor to the recent financial crisis. To prevent activities in those markets from causing systemic risk, the Proposal recommends subjecting OTC derivatives markets to comprehensive regulation. OTC derivatives are not currently subject to regulation by the CFTC or the SEC, but Treasury recommends amending the Commodity Exchange Act to require clearing of all standardized OTC derivatives through regulated central counterparties. Such counterparties would be subject to strict margin requirements and other risk controls. The regulatory capital requirements on OTC derivatives that are not centrally cleared would be increased for all banks and bank holding companies, presumably as part of the banking reforms discussed below. Furthermore, the SEC and CFTC would be tasked with imposing recordkeeping and reporting requirements on all OTC derivatives activity, which requirements would be met by clearing through a central counterparty or, in the case of customized derivatives, by reporting such transactions to a regulated trade repository. Other regulations would prevent customized OTC derivatives from being used to circumvent the requirement of using an authorized counterparty. It is

not clear how the dual regulation of OTC derivatives by the SEC and the CFTC fits with the Proposal's recommendation to harmonize regulations between the two agencies, and this is an area where the agencies will need to compromise.

#### **4. Credit Rating Agencies and Securitization Markets**

Private fund managers investing in ABS may welcome efforts outlined in the Proposal to improve market discipline in securitization markets. To ensure that lenders and securitizers remain tied to the quality of the underlying assets being securitized, suggested measures include regulations that require loan originators to retain five percent of the credit risk of securitized exposures and to prohibit the originator from hedging or otherwise transferring the risk it is required to retain under these regulations. The SEC would also be given clear authority to require robust reporting by ABS issuers. Finally, the SEC is asked to continue strengthening the regulation of credit rating agencies and to require that agencies have procedures in place to disclose conflicts of interest. The Proposal also suggests that credit rating agencies undertake a different approach to assigning ratings to structured credit products from those assigned to unstructured debt, that they facilitate comparisons across products and credit ratings and disclose uncertainty and volatility associated with credit ratings and the risks their credit ratings are designed to assess as well as material risks not reflected in the ratings.

##### **B. Broker-Dealers**

The Proposal calls for the SEC to establish a fiduciary duty for broker-dealers offering investment advice and to harmonize the regulation of investment advisers and broker-dealers. Broker-dealers and investment advisers currently are subject to different sets of laws. Broker-dealers are regulated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), while investment advisers are subject to the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Often, there is overlap in the functions that these intermediaries fulfill. For example, broker-dealers sometimes render investment advice to their clients. Broker-dealers are exempted from the application of the Advisers Act, provided that they render investment advice solely incidental to their main line of business and so long as "special compensation" is not received for such services. An important difference is that there is no fiduciary relationship between a broker and its customers, whereas an investment adviser is a customer's fiduciary.

Because of the overlapping functions of a broker-dealer and an adviser, Treasury posits that retail customers see the two intermediaries as identical. The Proposal recommends that the SEC set standards of care for all broker-dealers when providing investment advice about securities to retail investors and ban forms of compensation that incentivize intermediaries to promote products that are unsuitable to the investor. Also, the Proposal recommends legislation giving the SEC authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers.

The Proposal calls for a harmonization of broker-dealer and investment adviser regulations with few specifics. This will be a source of controversy. Although broker-dealers do not have a fiduciary relationship with their clients, those broker-dealers who are members of the Financial Industry Regulatory Authority (“FINRA”) are regulated by and subject to FINRA’s conduct rules. FINRA member broker-dealers likely would oppose as unnecessary attempts to subject them to additional legal duties. Meanwhile, it will be interesting to see if Treasury or the SEC recommends, as an attempt at harmonization, the creation of a self-regulatory organization (“SRO”) to govern investment advisers. Investment advisers will likely oppose such legislation and point to their fiduciary obligations as a reasonable substitute for an SRO. However, with mandatory registration for investment advisers on the horizon, there may be a need for an investment adviser SRO to handle the wave of new registrations, to undertake enforcement and disciplinary proceedings with respect to newly registered advisers, to provide continuing education and training, to conduct examinations for competency, to audit registered firms and to provide dispute resolution mechanisms. We anticipate that this will be subject to much debate as more details become available.

## **C. Banking**

### **1. Bank-Sponsored Hedge Funds**

Significantly, the Proposal calls for closing gaps in the existing set of federal restrictions on transactions between banks and their affiliates. The Proposal recommends that regulators place more effective constraints on the ability of banks to engage in OTC derivatives and securities financing transactions with affiliates. Covered transactions between banks and their affiliates would be required to be fully collateralized throughout the life of the transactions. Moreover, the Proposal recommends that existing federal restrictions on transactions between banks and affiliates be applied to transactions between a bank and all private investment vehicles sponsored or advised by the bank. The Federal Reserve and other federal banking agencies are asked to tighten the supervision and regulation of potential conflicts of interest generated by the affiliation of banks and other financial firms, such as proprietary trading units and hedge funds. There are no specifics in the Proposal about the role of the Federal Reserve in governing bank-sponsored hedge funds.

### **2. Expansion of the Federal Reserve’s Role as a Systemic Regulator**

The Proposal recommends that the Federal Reserve identify and monitor large firms whose failure would pose the greatest threat to the financial system and to reassess the regulatory capital framework for banks and Bank Holding Companies (“BHCs”). The Federal Reserve will be tasked with identifying “Tier 1 Financial Holding Companies” or “Tier 1 FHCs”, vaguely defined as large, leveraged and interconnected companies like AIG. Previously, such firms escaped regulation under the Bank Holding Company Act because they owned depository institutions that did not qualify as “banks”. Tier 1 FHCs will be subject to stricter and more conservative risk management, capital and liquidity standards and will be monitored on a consolidated basis. This means that

the subsidiaries of Tier 1 FHCs – whether regulated or unregulated and wherever located, including outside the U.S. – would come under the Federal Reserve’s supervisory jurisdiction in addition to being supervised by their primary functional or bank regulator.

The criteria for identifying a Tier 1 FHC would include the impact the firm’s failure would have on the financial system and economy, the firm’s size, leverage (including off-balance sheet exposures), degree of reliance on short-term funding and the firm’s criticality as a source of credit for households, businesses and local governments. The Federal Reserve would be responsible for evaluating firms based on such criteria to determine if they are Tier 1 FHCs.

The Proposal articulates certain principles, but few specifics, regarding additional regulations on banks that do not qualify as Tier 1 FHCs. It calls for the formation of a working group to be led by the Federal Reserve to study the regulatory capital framework for banks and BHCs and to recommend changes. These changes may include requiring banks to hold more capital during economic booms to prepare for economic busts; allowing banks and BHCs to issue convertible debt securities to satisfy their regulatory capital requirements and increasing capital requirements on investments and exposures that pose high risks such as equity investments, highly rated ABS and MBS and OTC derivatives that are not centrally cleared. A report on this working group’s findings is due December 31, 2009. The Proposal also calls for a second report by a different working group led by Treasury that reviews and analyzes the need for better banking supervision and regulation, which is due October 1, 2009.

### **3. Executive Compensation**

The compensation practices of financial firms will be monitored as part of the greater emphasis on bank and BHC supervision. The Proposal calls for federal regulators to issue standards that better align executive compensation practices of financial firms with shareholder value and to reduce the incentive for risk-taking. An important comment in the Proposal is the Treasury’s willingness to work with Congress to pass “say on pay” legislation that will require all public companies to offer an annual non-binding vote on compensation packages for senior executive officers. In addition, the SEC may be given power to require that compensation committees are more independent and to create standards on independence.

### **4. Reorganization of Banking Regulators and Expanded Scope of the Bank Holding Company Act**

To close loopholes in bank regulation, the Proposal recommends the creation of a new agency called the National Bank Supervisor (“NBS”), which would be dedicated to the chartering and prudential supervision and regulation of national banks and federal branches and agencies of foreign banks. The NBS would replace the Office of the Comptroller of the Currency and inherit responsibility for institutions supervised by the Office of Thrift Supervision. The NBS would be a separate agency within Treasury and led by a single executive. State-chartered banks would continue to be regulated by the

Federal Reserve and the FDIC. The Proposal also recommends eliminating the federal thrift charter, resulting in all thrift holding companies becoming BHCs and regulated on a consolidated basis. Industrial loan companies, credit card banks, trust companies and “nonbank banks” (companies that control depository institutions but exempted from the BHCA definition of “bank”) also would become BHCs.

#### **D. Insurance**

The Proposal includes support for legislation establishing the Office of National Insurance (“ONI”) within Treasury to regulate the insurance industry at the federal level. The insurance industry traditionally has been regulated at the state level with no federal entity accountable for understanding and monitoring it. ONI would be part of an attempt to develop a modern regulatory framework for insurance and would have an information-gathering and monitoring role. The agency would also recommend to Treasury what insurance companies should be supervised as Tier 1 FHCs. In addition to recommending the creation of a new agency within Treasury, the Proposal articulates a set of principles to modernize and improve the regulation of the U.S. insurance system.<sup>4</sup>

### **III. Conclusion**

To implement the measures contained in the Proposal, Congress and various regulatory agencies must pass enacting legislation and rules. Certainly, there is political will to address gaps and failures in the regulatory framework as well as to register advisers to private funds, but special interests will want to influence the process. As usual, the devil is in the details. It is difficult to predict how successful the Obama Administration will be in pushing through the necessary legislation, and it will be necessary for Congress and the various agencies to produce solutions where the specifics are lacking. It is also unclear what the pace of legislation will be to effect some of the more radical changes to financial institutions included in the Proposal. To assist our clients, this firm will track and issue further GlobalNotes on the legislative and regulatory fallout from the Proposal.

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<sup>4</sup> The Proposal’s insurance recommendations are too lengthy to be covered herein, but interested readers are invited to read pages 39-41 of the Proposal for further detail.