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Department Of The Treasury Blueprint For A Modernized Financial Regulatory Structure

Introduction

In March 2007, the Department of the Treasury ("Treasury") convened a conference on capital markets competitiveness and commenced a review of the U.S. regulatory structure for financial institutions. In October 2007, Treasury sought public comments on reform of the structure.[1] On March 31, 2008, in the midst of the subprime crisis and the Bear Stearns rescue, Treasury issued its Blueprint for a Modernized Financial Regulatory Structure (the "Report"), which makes a series of short term and intermediate term recommendations. Further, to begin a discussion about rethinking current U.S. regulatory regimes, Treasury also presents a conceptual model for a long term optimal regulatory framework.

Summary

In the short term, Treasury recommends expansion of the President's Working Group on Financial Markets, the creation of a federal Mortgage Origination Commission (to regulate mortgage brokers and others involved in mortgage origination), and greater information sharing among the Federal Reserve, the U.S. Securities and Exchange Commission (the "SEC"), and the Commodity Futures Trading Commission ("CFTC") in connection with the opening of the Federal Reserve's discount window to non-depository institutions.

Treasury's intermediate term recommendations include the abolition of the thrift charter and the Office of Thrift Supervision ("OTS"), introduction of a federal charter and related regulatory system for systemically important payment and settlement systems, creation of an optional federal charter for insurance companies, merger of the SEC and CFTC, modernization of the Investment Company Act of 1940 and creation of a new U.S. global investment company that could market its shares on a global basis, and harmonization of broker-dealer and investment adviser regulation (including the creation of a new self-regulatory organization ("SRO") for investment advisers).

For the long term, Treasury recommends an objectives-based regulatory structure. Specifically, the Treasury proposal is to create three new regulators, with each having responsibility over one regulatory objective (market stability, prudential regulation and business conduct), and to rationalize the federal chartering of financial institutions by creating three new types of federal financial institutions (broadly, depository institutions, insurance companies, and all other types of financial institutions). In addition, Treasury envisions a new federal insurance guarantee corporation that would replace the Federal Deposit Insurance Corporation ("FDIC") and a new corporate finance regulator.

The Treasury proposals are summarized below. We then consider them in greater detail by examining their impact on the mortgage industry,

[1] Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions, 72 Fed. Reg. 58939 (Oct. 17, 2007).

the SEC and CFTC, payment and settlement systems, mutual funds and hedge funds, investment advisers, insurance companies, banking and enforcement. We also briefly report on U.S. industry and political reaction to the Report and compare Treasury's proposed long term optimal structure to the regulation of financial services in the United Kingdom.

Discussion

Short-Term Recommendations

Treasury makes three recommendations for immediate implementation:

- **President's Working Group on Financial Markets ("PWG")**[2] The PWG, created in 1987, acts an inter-agency coordinator for financial market regulation and policy. The Secretary of the Treasury chairs the PWG. Its other members include heads of the Federal Reserve, the SEC, and the CFTC. Treasury recommends expanding the scope of the PWG's activities to focus on the entire financial sector and not just financial markets. In particular, Treasury proposes expanding the PWG's membership to include the heads of the Office of the Comptroller of the Currency ("OCC"), the OTS, and the FDIC. The expanded PWG would seek to facilitate greater inter-agency coordination and communication in the areas of systemic risk mitigation, market integrity, consumer protection, and capital markets competitiveness and would also have the power to consult with other agencies (including foreign regulators).

- **Mortgage Origination Commission**[3] Treasury recommends establishing a federal Mortgage Origination Commission ("MOC") to evaluate, rate, and report on each state's system for licensing and regulating parties involved in the mortgage origination process. Treasury also recommends the enactment of legislation that grants the MOC authority to develop uniform licensing qualification standards for state mortgage market participants, including minimum educational requirements and testing criteria. The Federal Reserve would retain authority to write regulations implementing national mortgage lending laws. Finally, Treasury recommends clarifying the enforcement authority of the various federal and state regulators over mortgage originators that are not depository institutions or subsidiaries of depository institutions.[4]

- **Liquidity – Access to the Federal Reserve Discount Window by Non-Depository Institutions**[5] In March 2008, the Federal Reserve opened its discount window to non-depository institutions for the first time since the 1930s, thereby permitting them to borrow directly from the Federal Reserve. This has raised issues about where the line between overall market stability and expanding the federal safety net should be drawn. Treasury considers the drawing of this line to be a work in progress, to be determined in the course of implementing its long term recommendations and once lessons have been learned from the current period of turmoil.[6] Noting that lending to non-depository institutions should occur only in rare circumstances, Treasury nevertheless recommends certain short-term enhancements. Opening the discount window to non-depository institutions would be "calibrated and transparent."[7] Such lending would be subject to appropriate limitations and conditions (e.g., collateral requirements). Critically, because the Federal Reserve does not have access to non-depository institutions to the same extent as the SEC and CFTC, the Federal Reserve should enter into a collaborative agreement with the SEC and CFTC that would allow the Federal Reserve to access information (particularly information relating to liquidity and funding) about non-depository institutions and should attend SEC or CFTC financial examinations of such institutions. Treasury also recommends that the PWG consider the broader regulatory issues associated with opening the discount window to non-depository institutions.

2 Report at 75-77.

3 Report at 78-83.

4 See further discussion infra, under the heading "Mortgage Origination."

5 Report at 83-86.

6 Report at 85-86.

7 Report at 84.

Intermediate-Term Recommendations

Treasury's intermediate-term recommendations are:

- **Turn Thrifts into National Banks and Close the OTS** Established in 1933, the original federal savings association (commonly known as a thrift) was designed to provide a stable source of funding for residential mortgage lending. Dependence on thrifts to ensure availability of sufficient residential mortgage loans has since decreased, in part because of the increase in mortgage lending by commercial banks and government-sponsored entities such as Freddie Mac and Fannie Mae, to a point where Treasury recommends that, over a two year period, thrifts be converted into national banks and the federal thrift charter be eliminated. The OTS, which regulates thrifts, would close and the OCC, which currently regulates national banks, would assume its functions.[8]

- **Federal Supervision of State-Chartered Banks** Currently, state-chartered banks with federal deposit insurance are supervised at the state and federal level. The Federal Reserve supervises state-chartered banks that are members of the Federal Reserve System. The FDIC oversees non-member state-chartered banks. Treasury recommends conducting a study to examine "the evolving role of Federal Reserve Banks"[9] to determine whether the direct federal supervision of state-chartered banks with federal deposit insurance should be placed entirely with the Federal Reserve or with the FDIC.[10]

- **Payment and Settlement Systems Oversight** Noting the lack of a uniform and overarching regulatory system specifically designed to oversee payment and settlement systems, Treasury recommends creating a federal charter with federal preemption for systemically important payment and settlement systems. The Federal Reserve would have primary oversight responsibilities for the systems, authority to establish standards, and discretion to designate a system as systemically important.[11]

- **Insurance**[12] The insurance industry is regulated primarily by the states. Treasury noted that the "inherent nature" of a state-based regulatory approach makes developing national products more costly and negatively impacts the competitiveness of U.S. insurers.[13] As such, Treasury recommends creating an optional federal insurance charter ("OFC") which would operate alongside the current state-based regulatory system. For those not opting to use the OFC, the current state-based regulatory system would continue to be available. Conversely, states would generally not have jurisdiction over those insurers holding an OFC.[14] No OFC would permit the same insurer to engage in the life insurance business as well as the property and casualty business. Treasury also recommends establishing two new offices within the Department of Treasury. First, a new Office of National Insurance would regulate those engaged in the insurance business pursuant to an OFC. Second, recognizing that certain areas of the insurance industry require immediate attention, a new Office of Insurance Oversight should be established to address international regulatory issues and advise the Secretary of the Treasury on significant domestic and international policy issues.

- **Merger of CFTC and SEC**[15] In general, the securities industry is regulated by the SEC and the futures industry is regulated by the CFTC. When the federal securities laws and the Commodity Exchange Act were enacted in the 1930s, the securities and futures markets were distinct. In the 1970s, when futures trading began to expand beyond agricultural futures, the distinction became harder to draw and has resulted in jurisdictional disputes between the SEC and CFTC. Over time, product and market participant convergence, market linkages and globalization have continued to blur the distinction and Treasury has concluded that the current regulatory bifurcation is "untenable, potentially

8 Report at 8, 96-99.

9 Report at 9. Treasury does not specify who would conduct the study.

10 Report at 8–9, 99–100.

11 Report at 9, 102-106.

12 Report at 9-11, 126-133.

13 Report at 165.

14 Holders of an OFC would still need to comply with certain state laws, including those regarding state taxes, coverage for workers' compensation and required participation in a state's residual risk mechanisms and guarantee funds. Report at 10.

15 Report at 106-118.

harmful, and inefficient."[16] Treasury thus recommends merging the SEC with the CFTC.

The road to the merger would involve two steps. First, noting the difference between the rules-based approach of the SEC and the principles-based approach of the CFTC and wishing to preserve the latter, Treasury recommends that the SEC take several preliminary steps to facilitate a "more seamless" merger with the CFTC.[17] These steps would include: (1) adoption by the SEC of core principles governing clearing agencies and exchanges (the core principles would be modeled on the core principles applied by the CFTC to futures exchanges and clearing organizations); and (2) issuance by the SEC of a rule that streamlines and expedites the rule-making process for SROs.

Second, the merger itself, which would only be possible if legislation is enacted, would have to result not only in a structural merger of the two regulators but also in a merger of "regulatory philosophies."[18] This would require a substantial harmonization of laws and regulations. In particular, Treasury recommends that: (1) the new agency adopt regulatory principles based on investor protection, market integrity, and overall financial system risk reduction; (2) all clearing agency and market SROs be permitted to self-certify all rulemakings, other then those regarding corporate listing and market conduct standards, so that such rules become effective on filing; and (3) a joint CFTC-SEC task force, with equal agency representation, work to harmonize laws and regulations (including rules dealing with margin, asset segregation, insider trading, customer suitability, short sales, SRO mergers, and implied rights of action).[19]

- **Exemptive Rulemaking to Modernize the Investment Company Act**[20] The SEC granted exemptive orders under the Investment Company Act of 1940 (the "Investment Company Act") to individual entities (to take an example) of exchange traded funds for nearly 15 years, but only proposed general exemptive rules for such funds in 2008. Individual exemptions are subject to a time consuming SEC application process and may be relied upon only by the entities to whom the exemptions are granted. On the other hand, exemptive rules of general applicability do not involve any SEC application process and may be relied upon more broadly. Favoring general exemptive rule-making over individual exemptive orders, Treasury recommends that the SEC undertake general exemptive rule making under the Investment Company Act consistent with investor protection standards, to permit the trading of products already trading in the U.S. or in foreign jurisdictions under individual exemptions.

- **New Global Investment Company**[21] Recognizing that the U.S. fund industry has difficulty in marketing shares of U.S. mutual funds on a global basis (because, for example, the U.S. taxes an investor on his or her gains even if the investor has not redeemed his or her shares whereas other jurisdictions do not impose a tax until redemption), Treasury recommends that the SEC propose changes to Congress that would expand the Investment Company Act to permit registration of a "global" investment company.[22] Treasury does not outline the features that such an investment company would need in order to overcome existing hurdles to the global marketing of U.S. mutual fund shares, nor does it specifically discuss tax law changes that would be required. Treasury does, however, recommend that a global investment company provide investor protections that are the same as those currently available under the Investment Company Act.

16 Report at 11.

17 The CFTC adopted the principles-based model after passage of the 2000 Commodity Futures Modernization Act.

18 Report at 115.

19 See further discussion infra, under the heading "CFTC and SEC Merger."

20 Report at 113-115.

21 Report at 114-115.

22 Report at 106 and 115.

- **Harmonizing Regulation of Broker-Dealers and Investment Advisers – Investment Adviser SRO**[23] According to a report commissioned by the SEC and released in January 2008, one of the reasons that most retail investors do not differentiate between investment advisers and broker-dealers is that they appear to provide very similar services to investors.[24] Indeed, Treasury believes that the "differences have largely disappeared."[25] The SEC itself is currently examining the regulatory structures that deal with investment advisers and broker-dealers. Treasury recommends statutory changes to harmonize regulation and oversight of broker-dealers and investment advisers that offer similar services to retail investors. Investment advisers should also be subject to an SRO regime similar to that of broker-dealers.[26]

Long Term Optimal Regulatory Structure – An Aspirational Model[27]

Replacing the Current System with an Objectives-Based Structure

The current system for regulating financial institutions in the United States is an "institutionally based functional system."[28] In other words, there are different regulators for different types of financial institutions. For example, at the federal level, five separate agencies are charged with regulatory and examination authority (often overlapping) over depository institutions (such as commercial banks, thrifts and credit unions).[29] Mutual funds and registered investment advisers are regulated by the SEC. Broker–dealers are regulated by the SEC and the Financial Industry Regulatory Authority, Inc. ("FINRA"), a self-regulatory organization, and others. Many of these types of businesses are also regulated at the state level, as is most of the insurance industry. Regulation of the futures markets is the exclusive preserve of the CFTC.

In the eyes of Treasury, the current system has the advantage of allowing for specialization among regulators. Treasury's assessment, however, is that the current system is not designed to deal with the convergence of financial service providers and financial products, leads to regulatory turf battles and duplicative requirements, presents opportunities for regulatory arbitrage and adversely impacts the ability of the U.S. to compete with foreign capital markets.[30] In addition, the most serious failings of the current system are that "no single regulator possesses all of the information and authority necessary to monitor systemic risk, and the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected."[31]

To address these inadequacies, Treasury recommends the creation, in the long term, of an "objectives-based" regulatory system that focuses on three key objectives:[32]

- market stability regulation to address overall conditions of financial market stability that could impact the real economy;
- prudential financial regulation to address issues of limited market discipline caused by government guarantees; and
- business conduct regulation (linked to consumer protection regulation) to address standards for business practices.

What would this objectives-based optimal regulatory structure look like? Treasury proposes to create three new regulators, with each having responsibility over

23 Report at 118-126.

24 Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (Rand Corporation, 2008) (http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf).

25 Report at 123.

26 Report at 118-126.

27 See Ch. VI of the Report.

28 Report at 139.

29 Report at 32. The five agencies are the Federal Reserve, the OCC, FDIC, the OTS, and the National Credit Union Administration (the "NCUA").

30 See Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform, March 31, 2008 (http://www.treasury.gov/press/releases/hp897.htm), and Report at 139-140.

31 Report at 139.

32 Report at 13.

one of the objectives referred to above, and to rationalize the federal chartering of financial institutions by creating three new types of federal financial institutions. In addition, Treasury envisions a new federal insurance guarantee corporation that would replace the FDIC and a new corporate finance regulator.

The New Federal Charters[33]

Treasury envisions three new federal charters for three new types of federal financial institutions:[34]

- **FIDIs** A federal insured depository institution ("FIDI") charter would be established for all depository institutions with federal deposit insurance. This charter would replace the charters for national banks, federal savings associations (to the extent the intermediate-term proposal to abolish thrifts is not implemented), and federal credit unions. Any depository institution seeking federal deposit insurance would be required to be a FIDI. To limit the risks to the federal deposit insurance scheme, activity limits would be placed on FIDIs similar to today's limits on the activities of national banks (e.g., general banking, fiduciary services and certain securities activities).

- **FIIs** A federal insurance institution ("FII") charter would be established for insurers offering retail products where some type of government guarantee exists (whether in the form of the possible Federal Insurance Guarantee Fund discussed below and/or existing state guarantees).

- **FFSPs** A federal financial services provider ("FFSP") charter would be established for all other types of financial services providers, including broker-dealers, futures firms, hedge funds, private equity funds, venture capital funds, mutual funds, providers of investment management and investment advisory services and providers of general insurance products that are not guaranteed (i.e., insurers who are not FIIs).

33 Report at 159-160, 166-168 and 176-178.

34 Treasury notes that each such institution should have "field preemption" over state laws. See, for example, Report at 178.

The New Regulators

Treasury's proposal calls for the Federal Reserve to be given new powers and for the creation of new regulators as follows:

- **Federal Reserve as market stability regulator**[35] The Federal Reserve, in addition to its current monetary policy and lender of last resort responsibilities, would acquire expanded powers as market stability regulator charged with understanding the risks that financial institutions pose to the overall financial system and taking corrective action (in other words, the Federal Reserve would undertake "macro-prudential" regulation).[36] The Federal Reserve would not directly concern itself with the financial health of any particular financial institution, but would focus instead on common exposures across financial institutions. As market stability regulator, the Federal Reserve would have certain powers, including the authority to:

  - obtain detailed information about FIDIs, FIIs and FFSPs (in particular financial reports and examination reports) through, among other things, an information-sharing arrangement with the Prudential Financial Regulatory Authority ("PFRA"'), the new proposed regulator of FIDIs and FIIs (further discussed below);

  - examine FIDIs, FIIs, and FFSPs jointly with PFRA or the Conduct of Business Regulatory Authority ("CBRA"), the new business conduct and consumer protection regulatory agency (further discussed below);

  - disclose information about peer group financial exposures;

  - mandate additional disclosures for publicly-traded federally-chartered financial institutions;

  - provide input on certain areas of PFRA and CBRA regulation, such as capital adequacy requirements, liquidity risk management, and counterparty risk management; and

35 Report at 146-156.

36 Report at 147.

- order corrective action (generally across financial institutions or asset classes) if it determines that there are overall risks to the financial system or economy.

- **The new Prudential Financial Regulatory Authority (PFRA)**[37] PFRA, a new regulator, would be charged with the prudential regulation of financial institutions that benefit from government guarantees, namely FIDIs (which would benefit, as current depository institutions do, from federal deposit insurance) and FIIs.[38] Prudential regulation aims to safeguard the financial health of individual financial institutions through the imposition of capital adequacy requirements, limitations on business activities and investments, on-site risk management supervision and other techniques. In relation to depository institutions, PFRA would assume the functions performed today by regulators such as the OCC and OTS.[39]

- **The new Conduct of Business Regulatory Agency (CBRA)**[40] CBRA, a new regulator, would be the licensing and chartering authority for FFSPs and would regulate the relationship between all types of financial firms and retail customers (individuals or small businesses) in the areas for which it would be responsible. Specifically, CBRA would be responsible for business conduct and consumer protection regulation of FIDIs, FIIs, FFSPs, and all other types of financial firms (including state-chartered firms). CBRA's role in this area would be wide and broad, replacing the related rule writing, compliance and enforcement functions of the SEC, the CFTC, the Federal Reserve, other regulators of insured depository institutions, state insurance regulators and others. If necessary, CBRA could elect to employ an SRO model in the performance of its mission.

  CBRA would focus on establishing disclosure standards for customers across all types of financial products and services. It would seek to ensure that financial firms do not engage in unfair, deceptive or discriminatory business practices. Through its ability to grant and revoke FFSP charters, CBRA would seek to create national "fit and proper" requirements for FFSPs (such as having appropriate financial and managerial capacity initially and on an on-going basis).[41] CBRA would have full rule-making and enforcement powers in these areas.

  In relation to any given FFSP, the scope of activities specifically regulated by CBRA would additionally depend on the FFSP's business. For example, for broker-dealers, CBRA would also focus on net capital requirements and compliance, operational ability, professional conduct, testing and training, best execution and customer suitability. For mutual funds, CBRA would additionally focus on disclosures, valuation methodologies, and governance standards.

- **Reconstitute FDIC as FIGC**[42] Treasury envisions reconstituting the existing FDIC as the Federal Insurance Guarantee Corporation ("FIGC") to not only administer (as FDIC does now) federal deposit insurance, but also to supervise a possible new Federal Insurance Guarantee Fund ("FIGF") that would guarantee certain obligations of FIIs.[43] FIGC would not have any regulatory powers (unlike FDIC, which oversees certain state-chartered banks that have federal deposit insurance) and would act primarily as an insurer.

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37 Report at 157-170.

38 States have established insurance guarantee funds that provide guarantees of some retail insurance products. The Treasury recommendations raise as a soft proposal the possibility of establishing a federal insurance guarantee fund for FIIs, but the matter is ultimately left open. In any event, whatever the nature of the guarantee, PFRA would be responsible for the prudential regulation of FIIs.

39 Recognizing that the regulation of government-sponsored entities such as Freddie Mac, Fannie Mae and Farmer Mac, does not necessarily fit into the optimal structure (because, notwithstanding perceptions to the contrary, the obligations of these entities are not guaranteed by the federal government), Treasury nevertheless recommends that consideration be given to establishing a separate prudential regulator for such entities. Report at 168-170.

40 Report at 170-180.

41 Report at 177.

42 Report at 21 and 168.

43 See supra note 38 as to the soft status of the recommendation to establish the FIGF.

- **Corporate Finance Regulator**[44] Finally, Treasury envisions a corporate finance regulator responsible for oversight in the public securities markets of matters such as corporate disclosures, corporate governance, accounting, and auditing. The corporate finance regulator would fulfill this role in relation to all types of public issuers, including financial institutions that offer shares to the public.

Impact on Specific Industries

Mortgage Origination

The recent high levels of subprime mortgage defaults, delinquencies, and foreclosures highlight the gaps in mortgage origination oversight. In recent years, up to 50% or more of subprime mortgages and a significant percentage of prime mortgages have been originated by mortgage lenders that are not subject to federal supervision. To address these regulatory and supervisory gaps, Treasury has proposed three reforms.

First, Treasury calls for the creation of a new federal commission, the Mortgage Origination Commission ("MOC"), to evaluate, rate, and report on the adequacy of each state's system for licensing and regulating the participants in the mortgage origination process. The MOC should have a Director selected by the President from the mortgage regulatory community or the private sector mortgage market. The Director will chair a seven-member commission consisting of himself and representatives from the Federal Reserve, the OCC, the OTS, the FDIC, the NCUA and the Conference of State Bank Supervisors. The MOC should develop uniform minimum licensing standards for state mortgage market participants, which should include personal conduct and disciplinary history, minimum educational requirements, and appropriate license revocation standards. In addition, the MOC would be responsible for developing criteria to evaluate, rate and report on the adequacy of each state's system for licensing, supervision and enforcement of such participants. These evaluations would be made public and would become a strong incentive for states to address the weaknesses in their respective systems.

Second, Treasury recommends that the Federal Reserve retain the sole authority to write regulations for national mortgage lending laws through its rulemaking authority granted under the Truth in Lending Act ("TILA"). In particular, Treasury suggests that it may be necessary to amend the TILA to ensure that it appropriately covers both mortgage lenders and mortgage brokers.

Third, Treasury recommends that the process of enforcing federal mortgage laws be clarified. For those mortgage originators that are affiliates of depository institutions within a federally regulated holding company, it should be made clear that enforcement authority rests with the Federal Reserve with respect to bank-holding companies and the OTS with respect to thrift-holding companies. For those independent mortgage originators that are not part of a federally-regulated holding company, Treasury recommends that it be made clear that state agencies responsible for licensing and regulating participants in the mortgage origination process have clear authority to enforce federal mortgage laws, including TILA.

CFTC and SEC Merger

Treasury recommends that the U.S. should combine the regulatory system for futures and securities and harmonize the regulatory approach in ways that are more like the current philosophy for regulating futures.

Treasury observes that, although the futures and securities markets were originally quite different, the development of financial futures has caused the two markets to converge. Treasury believes that continued "regulatory bifurcation of the futures and securities markets [is] untenable, potentially harmful, and inefficient."[45] The Report notes that the legal ambiguity as to the definition of "security" and "future" has "spawned a history of jurisdictional disputes, which critics claim have hindered innovation, limited investor choice, harmed investor protection, and encouraged product innovators and their consumers to seek out other, more integrated international markets, engage in regulatory arbitrage, or evade regulatory oversight altogether."[46] For example:

- Dual SEC-CFTC oversight of single stock futures and narrow-based securities indices has been

[44] Report at 138, 145 and 175.

[45] Report at 106.

[46] Report at 107.

cumbersome and hindered development of these products.

- The absence of a single regulator hinders the ability of regulators to have a single, unified assessment of risk concentration.

- Lack of coordination over clearance and settlement processes may increase risk and raise costs.

- A bifurcated regulatory system makes it more difficult to operate internationally. For example, it is more difficult for two agencies to negotiate with foreign regulators than for one. Similarly, the CFTC has embraced mutual recognition, while the SEC is just beginning to adopt that approach.

Legislation to resolve these jurisdictional disputes has been only partially effective.

Treasury outlines a number of steps that it recommends to "improve and modernize the process of SEC."[47] In general, Treasury expresses the view that the CFTC's approach to regulation is preferable to the SEC's approach. Treasury points to the Commodity Futures Modernization Act of 2000 ("CFMA") and its establishment of "core principles" for regulating derivative clearing organizations and contract markets as examples.[48] Such entities must demonstrate their compliance with the relevant core principles. Although the SEC had adopted a similar approach for the registration of clearing agencies, it has not adopted an approach that requires exchanges to comply with core principles.[49]

47 Report at 109.

48 Report at 110.

49 Registration of exchanges, clearing agencies, and a securities association is a process that can take years at the SEC and entail tremendous expense. For example, Nasdaq, (and the affiliated NASD) was already regulated as a securities association under Section 15A of the Securities Exchange Act of 1934 and as a securities information processor under Section 11A thereof. Nonetheless, Nasdaq filed Form 1 to register as a securities exchange under Section 6 thereof on March 15, 2001. The SEC granted Nasdaq's petition nearly five years later, after numerous amendments. In the Matter of the Application of The Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Release No. 34-53128, File No. 10-131 (January 13, 2006).

Treasury believes that the core principles adopted for contract markets under the CFMA should also be adopted for securities exchanges, with appropriate modifications. These principles should allow exchanges to adapt their operations, internal control system, and risk management practices to the dynamic market environment, thus enhancing investor protection and market integrity.[50]

The Report also makes recommendations with respect to the SEC's process for approving SRO rule changes. The Report discusses the requirements of Section 19 of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires SROs to file proposed changes with the SEC. Although some changes may take effect upon filing, the more significant filings (other than those relating to fees) generally do not take effect until the SEC affirmatively approves them. Treasury notes in the Report that the delay associated with the approval process hinders the competitiveness of U.S. exchanges when compared to their foreign counterparts that can act more swiftly.[51]

The SEC has sought over the years to streamline this process, without compromising its responsibilities under Section 19. Treasury urges the SEC to take further actions to speed up this process, including:

- establishing a firm time limit for the SEC to publish SRO rule filings;

- defining more clearly and expanding the type of rules deemed effective upon filing; and

- streamlining of approval for any securities products "common to the marketplace," citing rapid approval in 1998 of new derivative securities products.[52] Treasury cautions that the "core principles relating to the listing of contracts not readily susceptible to market manipulation and position limits should not apply in the securities context, but the other core principles are compatible with the operations of securities exchanges."[53]

50 Report at 111.

51 Report at 112-113.

52 Report at 113.

53 Report at 111 (footnote omitted).

The SEC's SRO review process has been the subject of discussion for decades, as the Report suggests. The SEC considered some SRO rule proposals for months or years, but exchanges' competitors, such as Alternative Trading Systems, or foreign exchanges, are not subject to such reviews and can act with much greater speed. On the other hand, the Exchange Act grants substantial governmental authority to the SROs, which argues for a careful review process. As the Report notes, the SEC is well aware of these challenges and has sought to address them, although with limited success.

The recommendation for establishing a firm time limit for the SEC to publish SRO filings would address a longstanding concern about SEC staff actions in delaying or refusing to publish SRO rule proposals while staff comments and concerns are negotiated. The discussions between the SEC staff and the SRO pending the publication of a proposal or amendment are entirely opaque. A particularly vexing practice occurs when the staff and the SRO discuss and agree in private to amendments to a proposal that has been previously published for comment. In this situation, the SRO then submits an amended proposal, and the SEC approves the proposal on an accelerated basis, and asks for comment at that time. The public's opportunity to comment is essentially meaningless, since commentators would be submitting their views with respect to a *fait accompli*.

Although a unified U.S. futures and securities regulator would present a more familiar structure to UK firms doing business with the U.S., whether the merger would ultimately be welcome from a UK perspective will depend on how it impacts other substantive issues, some of which are not specifically addressed in the Report, such as the extent of the merged regulator's extraterritorial reach and whether it might offer UK licensed firms any increased freedom to operate in the U.S.[54]

Payment and Settlement Systems[55]

The Report has generated substantial attention for its sweeping recommendations for banking, brokerage, insurance, and other financial service providers. But overlooked in this discussion is a substantial recommendation for changing the regulatory framework for payment and settlement systems.

Most significantly, Treasury recommends the creation of a mandatory federal charter for certain payment and settlement systems. The characteristics of the federal charter include the following:

- The charter would be limited to those payment and settlement systems having systemic importance to the U.S. financial system and economy. Retail payment systems would not be included.[56]
- The Federal Reserve would be required to charter, regulate, and supervise any payment or settlement system that it determines to be systemically important. It should have broad discretion to designate payment and settlement systems as systemically important.
- The charter "should incorporate" federal preemption.[57]
- If the Federal Reserve has not required a federal charter for a particular system, "existing state charters would continue to remain an option."[58]
- The charter would provide lead authority to the Federal Reserve, with responsibility to coordinate with other federal or state agencies.
- The Federal Reserve would have the authority to establish regulatory standards to ensure the safety and efficiency of the systemically important payment and settlement systems. For example, those standards may include finality of settlement, mitigation of credit and liquidity risks, certainty of settlement, segregation of funds, permissible investments for such funds, and operational safeguards. The Report asserts that the Federal Reserve as the regulator should establish the standard rather than having the standard established by statute.
- As the lead regulatory agency, the Federal Reserve would have the authority to conduct ex-

54 See infra under the heading "The Current UK System" for a discussion of that system.

55 Report at 8 and 100-106.

56 Accordingly, it appears that Report would exclude money transmitters, such as PayPal, from the federal charter requirement.

57 Report at 9.

58 Report at 104.

aminations of and obtain reports from systemically important payment and settlement systems. The Federal Reserve also would have broad regulatory authority, including the authority to require such systems to adhere to applicable law by imposing cease and desist orders, monetary penalties, and bars on individuals from service in federally chartered payment and settlement systems.

The proposed change is a substantial departure from the current regulatory framework for securities clearing agencies. Under the Exchange Act, an entity that constitutes a "clearing agency" as defined in Section 3(a)(23)(A) (and not exempted by subsection (B) of that section) must register with the SEC under Section 17A.[59] The Exchange Act provides that the SEC must coordinate regulatory activities with a bank regulator when it is the "appropriate regulatory authority" for a clearing agency.[60] Nonetheless, Congress determined that the SEC should have the primary rulemaking and regulatory authority over securities clearing agencies. Accordingly, the proposed changes in the regulation of securities clearing agencies constitute a substantial departure from the status quo.

- Federally-chartered payment and settlement systems would pay a portion of the costs associated with their supervision and regulation. They should not pay so much as to retard their ability to develop or use new technologies.

- The Federal Reserve would license systemically important payment and settlement systems that are based abroad but that operate in the U.S. The arrangement should ensure that effective risk mitigation and procedures exist between U.S. and foreign regulators.

  Although the Report proposes to require foreign payment and settlement systems to register with U.S. authorities, it suggests an alternative regulatory arrangement that seems more analogous to a mutual recognition regime.

Treasury recommends that "a study should be performed of whether all systemically important payment and settlement systems, including those the Federal Reserve Banks currently operate, are subject to comparable risk management and efficiency standards, taking into account the finality, customer base, and other attributes associated with each system."[61]

The Report does not specify what entity should perform the study. It seems unusual to make such detailed recommendations for regulating payment and settlement systems without the benefit of the information that such a study would produce.

Mutual Funds and Hedge Funds

The Report does not deal with mutual funds in great depth. As noted above, Treasury recommends that the SEC propose changes to Congress to create a global investment company that can be sold across different jurisdictions and codify existing exemptive orders to permit the trading of products already trading in the U.S. or in foreign jurisdictions (e.g., ETFs). In addition, the Report proposes the applicability of the FFSP charter to mutual funds, hedge funds and private equity funds and other providers of investment management and investment advisory services that are not guaranteed.

While the stringent rules-based regulatory approach of the Investment Company Act is not inherently consistent with Treasury's proposal (which relies on a principles-based approach), the Report glosses over this inconsistency, focusing instead on various big picture recommendations. If the proposals outlined in the Report move forward, the tension between the current requirements of the Investment Company Act and the principles-based approach outlined in the Report would need to be reconciled.

With respect to private funds, there is little specific discussion other than the application of the FFSP charter to a variety of private funds (hedge funds, private equity funds, venture capital funds). The applicability of the FFSP charter to these funds would not provide day-to-day regulation of these entities, but would subject them to a greater degree of oversight than is currently the case in situations where the fund's adviser is not currently registered with the SEC.

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59 Section 17A(b)(7) provides certain exceptions for security futures.

60 See Section 3(a)(34)(B) and Section 19(b)(4) of the Exchange Act.

61 Report at 106.

In addition, these entities would also be subject to the requirements of the CBRA which would likely fall somewhere in between the requirements of the Investment Advisers Act of 1940 (the "Advisers Act") for registered investment advisers and the application of a voluntary "best practices" regime that currently exists for unregistered private fund managers.

Investment Advisers

As discussed, the main focus of Treasury's proposal regarding investment advisers is to promote a convergence in the regulation of investment advisers and broker-dealers, including the establishment of an SRO. While this type of convergence is clear at the retail level where financial planners, financial advisors, and old-fashioned "stockbrokers" often wear both a salesman's and portfolio manager's hat, this convergence is less an issue with respect to institutional investment advisers who clearly focus on the portfolio manager role. Without a clear delineation between the duty of the SEC and the SRO, firms that serve this role are unlikely to view the addition of SRO regulation on top of Advisers Act requirements as an advancement. Accordingly, in applying these recommendations to registered investment advisers, the challenge will be in transitioning to an SRO-based approach without duplicating the requirements of the Advisers Act or creating a parallel regulatory structure of the type that currently has proven problematic to dual registrants (e.g., registered investment advisers and broker-dealers).

Insurance

The Report calls for reform of traditional state regulation of insurance on the grounds that insurance is a national and a global industry and that state regulation can lead to inefficiencies and undue regulatory burden that slows innovation and limits insurers' ability to compete nationally and internationally. Significantly, the Report states that, "under the current U.S. state-based insurance system, no regulatory official at the federal level can speak for the interests of U.S. regulators of insurers."[62]

- **Optional Federal Charter** To address these concerns, Treasury endorses the establishment of a federal regulatory structure in the intermediate term through the creation of an optional federal charter ("OFC") for insurers. This would allow insurers the choice of being regulated at the national level pursuant to an OFC or continue to be regulated by the states. An OFC has long been advocated by life insurance industry interests, including the American Council of Life Insurers, and has been the subject of congressional proposals that have never been enacted.[63] These initiatives are sometimes opposed by small insurers and agent groups. Treasury identifies certain core concepts that should be incorporated in the establishment of the federal regulatory structure including:
  - safety and soundness;
  - enhancement of competition among insurers in international and national markets;
  - increased efficiency;
  - promotion of rapid technological change;
  - reduction of regulatory costs; and
  - consumer protection.
- **Office of National Insurance** Treasury proposes the creation, in the intermediate term, of an Office of National Insurance ("ONI") within Treasury and headed by a Commissioner of National Insurance ("CNI") which would regulate those engaged in the business of insurance (i.e., insurers, reinsurers, brokers and agents). ONI would be self-funded by assessments imposed upon federally charted insurers and subject to oversight by the appropriate congressional committees. Treasury suggests that the federal regulatory powers of the CNI should be comparable in scope and force to those of other world-class financial supervisors, including specified regulatory, supervisory, enforcement, and rehabilitative powers to oversee the organization, incorporation, operation, regulation, and supervision of national insurers and national agencies.
- **Office of Insurance Oversight** Recognizing that the Congressional debate on the OFC is difficult and ongoing, Treasury offers recommendations for immediate action. Treasury recommends that Congress create a national Office of Insur-

62 Report at 71.

63 In 2006 and 2007, Senators John Sununu (R-NH) and Tim Johnson (D-SD) introduced "National Insurance Acts" that would have provided for an OFC under a newly-created federal regulatory authority.

ance Oversight ("OIO") within Treasury, which could ultimately be rolled into the ONI/OFC federal regulatory regime after Congress passes significant insurance regulatory reform. Treasury envisions that the OIO would focus immediately on key areas of federal interest in the insurance sector and advise the Secretary of the Treasury on major domestic and international policy issues.

- **Conduct of Business Regulatory Agency and Insurance** Treasury also proposes CBRA have authority to regulate insurance business conduct issues associated with disclosures, business practices, and discrimination. Additionally, Treasury suggests that the CBRA should have primary responsibility for developing standard disclosures so that consumers can compare an insurance policy's pricing and coverage options.

- **Federal Insurance Institution and Federal Insurance Institution Charter.** Treasury found parallels between federal deposit insurance enjoyed by banks and other depository institutions and the system of state guarantee funds that pay policyholder claims upon the insolvency of an insurer (which generally does not cover variable products). Treasury suggests the creation, as part of the long-term optimal regulatory framework, of a new federal insurance institution (FII) charter for insurers offering retail products where some type of government guarantee is present, which would be similar to a FIDI charter. Treasury states that a state-level guarantee system could be explicitly maintained in this framework. Treasury suggests a uniform and consistent federally established guarantee structure in the long run. Specifically, Treasury proposes the establishment of a Federal Insurance Guarantee Fund (FIGF) to create a federal guarantee system.

Banking

The Report's long-term recommendations to reform the bank regulatory system are truly sweeping and would transform the financial services regulatory structure. By contrast, the intermediate-term proposals for the banking industry, while significant, are much more modest in scope and incremental in nature.

Apart from the payment and settlement systems proposals discussed above, which would effect significant substantive changes to the current regulation of clearing agencies and other payment and settlement systems, Treasury's banking-related recommendations are limited to (i) a calling for a study of whether the FDIC or Federal Reserve would be the better federal supervisor of state chartered banks, and (ii) phasing out and transitioning the thrift charter to a national bank charter, with a corresponding merger of the OTS into the OCC. Neither of these latter two recommendations are particularly novel or far-reaching. Rather, the banking industry has been discussing variations of these proposals in some form or another for many years. Indeed, the Report cites a 1997 Treasury proposal to unify bank and thrift regulation as providing the basis for elements of the proposal.

- **Federal Supervision of State-Chartered Banks** Under the current regulatory structure, the Federal Reserve is the primary federal supervisor of those state-chartered banks that are members of the Federal Reserve System. While this is not always the case, state-chartered member banks tend to be the larger state-chartered banks. The FDIC, on the other hand, is the primary federal supervisor of all state-chartered non-member banks (the deposits of which are insured by the FDIC) which typically, but not always, are the smaller state-chartered banks. Treasury recommends making this regulatory structure more efficient, and thus competitive, by making one of these agencies responsible for the federal supervision of all state-chartered banks. The arguments in favor of the Federal Reserve focus on the importance of having a role in bank supervision to the Federal Reserve's monetary policy and discount window lending functions. Conversely, the arguments in favor of the FDIC focus on the breadth of the FDIC's experience in supervising small community banks and the importance of that experience to the FDIC's responsibilities as insurer of deposits.

- **Thrift Charter** Treasury's recommendation to phase out the thrift charter reflects both (i) the evolution of the federal thrift charter from its origins as a very specialized financial institution focused principally on accepting deposits and making residential mortgage loans with a parallel but separate regulatory structure to today's environment where thrifts more closely resemble, compete directly with, and operate under a regulatory structure that is very similar to, and in many cases directly overlaps with, the regulatory structure applicable to commercial banks; and (ii) an assessment, based on developments in asset securitization, the decreasing residential mortgage market share held by thrifts, and other regulatory developments "that the thrift

charter is no longer necessary to ensure sufficient residential mortgage loans are made available to U.S. consumers."[64]

- Specific elements of Treasury's recommendation include:
  - A two-year transition period during which (i) all federally chartered thrifts would convert by operation of law into national banks, and (ii) the OTS would merge into the OCC.
  - At the end of the two-year period, all state-chartered thrifts would be treated as state-chartered banks for all federal bank regulatory purposes.
  - Thrift holding companies would become bank holding companies subject to the Federal Reserve's regulation under the Bank Holding Company Act of 1956 ("BHC Act").
  - Unitary thrift holding companies grandfathered under the Gramm-Leach-Blilely Act of 1999 would remain exempt from the BHC Act's activity limitations, provided that they continued to meet the qualified thrift lender tests, enhanced firewall and other conditions of existing thrift law on the conversion date.
  - Each banking agency would institute a program to accommodate voluntary specialization in housing finance.
  - Congress should transfer federal supervision and regulation of state-chartered thrifts to the FDIC.

The Implications for the Government's Enforcement Program

Some commentators have detected an anti-enforcement bent in Treasury's proposal, both in terms of the emphasis on principles rather than rules and in terms of the reorganization and repositioning of the various regulatory agencies. The proposal has been the subject of a critical op-ed piece by former SEC Chairmen whose tenures were marked by vigorous enforcement programs.[65] These criticisms are particularly pointed given recent market dislocations and Congressional expressions of concern that regulatory toothlessness may have been a contributing factor.

It is true that the structure no doubt affects the implementation of a regulatory regime, and principles-based regulation provides more latitude if a regulator decides to be de-regulatory. (The "light-handed" prudential approach that has defined EU regulators is an example.) Despite these concerns, an argument may be made that the manner in which the pieces fit together is less important than the philosophy that animates the regulators. Under this view, the vigor of an enforcement program reflects primarily the attitudes of those who are called upon to administer it and, regardless of whether a regulatory regime is rules- or principles-based, regulatory agencies will pursue investigations and prosecutions if the will exists to do so.

As discussed above, the proposals call for a merged SEC/CFTC to adopt "overarching regulatory principles focusing on investor protection, market integrity, and overall financial system risk reduction."[66] It is easy to see how an enforcement-minded regulator could fit most of the major enforcement actions brought by financial regulators over the past few years within the rubric of such principles. Moreover, most of the recent major actions brought by the SEC involve allegations (or at least intimations) of intentional, reckless, or highly negligent conduct, even if the terms on which particular cases were settled did not describe such conduct specifically. There have been few SEC actions that have involved merely "technical" rules violations, as that concept is narrowly understood, and most actions could have been brought under either a rules or principles-based structure (this may be less true of CFTC actions). Finally, the "rules vs. principles" debate is inapplicable to the Department of Justice and state authorities, whose jurisdiction is unaffected by the proposals. It also is inapplicable to whatever SRO (self-regulation being an important part of the model reflected in the proposals) emerges.

One area in which the proposed structure could affect enforcement lies in the potential overlap among the agencies identified as components of the "optimal regulatory structure." As noted above, the proposals contemplate a regulatory authority, CBRA, that would

64 Report at 96.

65 William Donaldson, Arthur Levitt Jr. and David Ruder, Muzzling the Watchdog, April 29, 2008, available at http://www.nytimes.com.

66 Report at 115.

consolidate the "consumer protection" aspects of current regulatory agencies, including "disclosure, sales and marketing practices...and anti-discrimination laws...operational ability, professional conduct, testing and training, fraud and manipulation, and duties to customers (e.g. best execution and investor suitability.)"[67] The proposals also contemplate the establishment of a corporate finance regulator as well as a market stability regulator (a function that, as noted above, would reside in the Federal Reserve). Under this scenario, the Federal Reserve would have the authority to collect information from financial institutions and to make judgments concerning disclosure of such information. One can foresee situations in which the Federal Reserve decides that disclosure of certain information would destabilize the financial markets. Yet, to the extent that the institutions involved were public companies (or subsidiaries of public companies), the corporate finance regulator could decide that the companies had an obligation to disclose the information and the CBRA could decide that the companies' failures to disclose such information constituted a fraud on consumers. The tenor of the proposals suggests that the principle of market stability would take precedence. Assuming that this were so, any enforcement mechanism available to the CBRA or to the corporate finance regulator would be restrained by the Federal Reserve.

Industry Reaction

Industry reaction to the Report has come from many quarters and has included support[68] as well as clear opposition.[69] Many important early remarks have been of a more general nature, indicating agreement on the need for reform of the current regulatory regime but naturally staying away from reacting to the particulars of a Report that is just over 200 pages long.

Chairman Cox of the SEC commented that "financial services regulation in the United States needs to be better integrated among fewer agencies, with clearer lines of responsibility."[70] FINRA's CEO, Mary Schapiro, applauded Treasury Secretary Paulson for raising the issues dealt with in the Report, and supported the general concept of modernizing regulation, stating "[t]oday's increasingly complex financial services landscape and fragmented regulatory environment has made it nearly impossible for the average investor to navigate the marketplace and fully understand the risks they may be exposed to and the protections they are entitled to."[71] The Investment Company Institute's ("ICI") President and CEO, Paul Schott Stevens, noted that the "ICI commends Secretary Paulson on a penetrating examination of our current financial regulatory structure, and on a bold concept of the reforms needed to make that structure more appropriate to today's markets and more effective in protecting consumers and promoting competitiveness."[72] Tim Ryan,

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67 Report at 20.

68 For example, John J. Castellani, president of Business Roundtable, applauded the Report as "a broad effort designed to modernize and improve a patchwork of outdated and overlapping regulations," and went on to say that its recommendations would "increase the competitiveness of our financial markets, provide greater efficiencies for our companies, and therefore increase shareholder value." Business Roundtable Statement on The Department of the Treasury's Blueprint for a Modernized Financial Regulatory Structure, March 31, 2008, available at http://www.businessroundtable.org.

69 For example, the National Association of Federal Credit Unions President, Fred Baker, said that the "NAFCU will continue to be proactive in opposing [the Report]" because the consolidation of federal credit unions in to FIDIs would do away with many of the benefits that federal credit unions provide to borrowers. Treasury Blueprint Unlikely to Become Law Soon, April 1, 2008, available at http://www.nafcu.org. The Consumer Federation of America is also strongly against the proposal. The CFA claims that the Report "fails to tackle the underlying causes of ineffective regulation" and opposed a diminished role for states in the regulation of the financial services industries. In its opposition, the CFA pointed out that "[s]tates play a vital role in overseeing those who do business in their states and in enforcing laws to protect the citizens of their states. Any federal regulatory restructuring plan should not serve as a Trojan Horse to advance Wall Street and the banking industry's preemption agenda." Statement of the Consumer Federation of America in Response to the Department of the Treasury's Blueprint for a Modernized Financial Regulatory Structure, March 31, 2008, available at http://www.consumerfed.org.

70 Statement of SEC Chairman Christopher Cox Regarding Blueprint for Financial Regulatory Reform, March 29, 2008, available at http://www.sec.gov.

71 Statement of FINRA CEO Mary L. Schapiro Regarding Treasury Secretary's Blueprint on Revamping Financial Services Regulation, March 31, 2008, available at http://www.finra.org.

72 ICI President Welcomes Treasury's Blueprint On Financial Regulation, March 31, 2008, available at http://www.ici.org.

President and CEO of the Securities Industry and Financial Markets Association ("SIFMA") called Treasury's plan both thoughtful and sweeping, and commented that "[o]ur present regulatory framework was born of Depression era events and is not well suited for today's environment where billions of dollars race across the globe with the click of a mouse. That fact, teamed with the current market conditions, result in an universal agreement that it is time to modernize and revitalize the current system."[73] As noted above, the Report has been subject to criticism by former SEC Chairmen.[74]

Some additional reactions worthy of special note include the following:

- **CFTC Reaction to Merger of CFTC and SEC** Walt Lukken, acting chairman of the CFTC, recognized that while a new unified regulator for securities and futures may bring efficiencies, a larger regulatory bureaucracy may also jeopardize CFTC's ability to function effectively, which it does now partially because of its small size.[75] He further commented that some of the benefits of a unified regulator could be achieved simply through enhanced coordination and information sharing between the CFTC and the SEC.[76]

- **FPA Reaction to SRO for Investment Advisers** Mark Johannessen, President of the Financial Planning Association ("FPA"), stated that while "structural" reform of the financial services industry is overdue, the FPA "strongly objects to a self-regulatory regime for investment advisers..." He added that the FPA would be receptive to professional regulation that included peer review to ensure competency. But "[i]nvestment advisers shouldn't be penalized for the mortgage industry and Wall Street going berserk" and "[i]mposing a costly, self-regulatory organization on investment advisers is ... flunking someone who gets straight A's *[sic]*. Mr. Paulson is unfortunately confusing Wall Street with Main Street, and fiduciary standards with sales regulation of brokers."[77]

- **Optional Federal Charter** There was mixed reaction by some insurance industry participants to the Report's proposal to create the OFC.[78] On the one hand, National Association of Insurance Commissioners President Sandy Praeger was against the proposal, stating, "We agree that the federal government needs to remodel their financial regulatory house, but they need to leave the insurance 'room' alone! While we certainly support better coordinating and modernizing of their oversight efforts, 'Modern' does not mean 'Federal.' State insurance regulators are marginalized in this report and frankly, for our sector it looks more like a solution in search of a problem."[79] However, Governor Marc Racicot, President of the American Insurance Association, commended the OFC proposal, noting that "[p]roviding insurers with the option of a single regulator for insurance will benefit consumers and will be more efficient, effective and rational given the 'increasing tension' a state-based regulatory system creates."[80]

Political Reaction

The Report has received mixed reviews on Capitol Hill, including criticism from leading Democrats and applause from some Republicans.

House Speaker Nancy Pelosi (D-CA) stated that while the Report may be "a step in the right direction, we need to go further; we must take steps now to . . . help . . . families who are hurting."[81] This sentiment

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73 Treasury's Regulatory Reform Plan 'Thoughtful,' 'Sweeping,' Says SIFMA, March 28, 2008, available at http://www.sifma.org.

74 See supra note 65.

75 Statement of CFTC Acting Chairman Walt Lukken Regarding Department of Treasury's Blueprint for Modernizing the Financial Regulatory Structure, March 31, 2008, available at http://www.cftc.gov.

76 On March 11, 2008, the CFTC and SEC signed a cooperation agreement which addresses cross-agency issues. An announcement of this agreement is available at http://www.cftc.gov.

77 *FPA Statement Opposing SRO for Investment Advisers,* March 31, 2008, available at http://www.fpanet.org.

78 See supra discussion of OFC.

79 *NAIC Response to Treasury Report Statement from NAIC President Sandy Praeger*, March 31, 2008, available at http://www.naic.org.

80 *AIA Applauds Treasury Recommendation of "OFC" Blueprint*, March 29, 2008, available at http://www.aiadc.org.

81 Pelosi Statement on Paulson Proposal to Overhaul Regulation of the Financial Markets, March 31, 2008, available at http://speaker.gov/newsroom/pressreleases?id=0584.

was echoed by Senate Majority Leader Harry Reid (D-NV), who is reported to have said that his concern was "about today" and that "the White House should direct its attention to what needs to be done now," such as helping homeowners facing higher mortgage rates and foreclosures.[82]

Senator Christopher Dodd (D-CT), Chairman of the Senate Banking Committee, commented that the Report "will do nothing to end the housing crisis, which is the root cause of the recession we are now experiencing," and "[i]f the President and his advisors really want to help, they should work with those of us in Congress who are trying to reduce foreclosures and end the credit crunch."[83] Senator Dodd turned his attention to the Report's "serious flaws," noting that "[o]n the one hand, it would allow the Fed to examine all financial companies—not just banks—to be sure they are not posing a risk to the overall financial system. On the other hand, it fails to realize that the Fed helped create this crisis by ignoring the red flags as far back as five years ago. It does not make sense to give a bigger shovel to the very people who helped dig us into this hole."[84]

House Financial Services Committee Chairman Barney Frank (D-MA) commented that while Secretary Paulson's plan is "a very constructive step forward . . . the plan goes too far in diminishing the role of the states, and not far enough in conferring needed new powers on the Federal Reserve over non-bank financial institutions for which they now have greater responsibility."[85]

Sen. Charles E. Schumer (D-NY), chairman of the bicameral Joint Economic Committee, stated that while the Report is "a good foundation" for updating regulation, it "does not consolidate redundant agencies enough and a single regulator may be a better approach . . . [a]nd I strongly disagree with the Treasury Secretary when he says the current regulatory framework is not at fault for the unrest troubling our economy. The unregulated corners of our economy did much to contribute to the meltdown in our housing market and the accompanying spillover to our financial markets. The havoc wrought by independent mortgage brokers, who fueled the housing bubble, and credit ratings agencies, who rubber-stamped securities with no questions asked, certainly fueled the economic crisis we have now. The Administration's 'deregulation-above-all-else' attitude helped cause the problems we now face. If we focus only on consolidation—and don't also adopt a careful, but more pro-regulation, approach—then we will have approached this modernizing task with too much of a pre-Bear Stearns mindset."[86]

Among the Republican supporters of the Report is Representative Spencer Bauchus (R-AL), the ranking Republican on the House Financial Services Committee, who is reported to have commended the Report, noting that it was "very comprehensive in its potential impact . . . "[87] At the time of drafting this update, Senator Richard Shelby (R-AL), ranking member of the Senate Banking Committee, had not publicly commented on the Report.

The Current UK System

The UK has operated a unified futures and securities regulatory structure to some degree since April 1988, when the Financial Services Act 1986 (the "1986 Act") came into force. The 1986 Act established a structure modeled loosely on the SEC and NASD, in which a number of sector-specific SROs reported to a central regulator, the Securities and Investments Board ("SIB"). Initially, the regulation of brokers and dealers in futures and in securities was split between two SROs, the Association of Futures Brokers and Dealers ("AFBD") and The Securities Association ("TSA") respectively. In 1991, the AFBD and TSA merged to form a single SRO for securities and futures brokers and dealers, the Securities and Futures Association ("SFA"). A separate SRO, the Investment Management

82 Paulson Unveils Overhaul, Marilyn Greenwax, April 1, 2008, available at http://www.ajc.com/business/content/printedition/2008/04/01/regulation0401.html.

83 Dodd Statement on Treasury's "Blueprint" for Regulatory Reform, March 31, 2008, available at http://dodd.senate.gov.

84 Id.

85 Frank Statement on Paulson Plan, March 29, 2008, available at http://www.house.gov.

86 Schumer on Paulson Plan and Jackson Resignation, March 31, 2008, available at http://www.jec.senate.gov.

87 David Cho, Long Fight Ahead for Treasury Blueprint, March 30, 2008, available at http://www.washingtonpost.com.

Regulatory Organisation ("IMRO"), was responsible for the regulation of investment advisers and funds. However, unlike FINRA and the National Futures Association currently, the SFA, IMRO and the other SROs operated under a common statute and were required to implement various common "core" rules and principles mandated by SIB that included core conduct of business rules and client money regulations.

Shortly after coming into power in 1997, the Labour government proposed the creation of a new "super-regulator" that would regulate all investment business then regulated by the SROs and SIB, as well as banking business regulated by the Bank of England and insurance. This was achieved in stages by transferring all relevant SRO and Bank of England staff to SIB (which was re-named the Financial Services Authority ("FSA")) in 1998 and by enacting new legislation, the Financial Services and Markets Act 2000 ("FSMA"), which came into force in December 2001 along with a new unified FSA rulebook. The structure of futures and securities regulation under FSMA is thus broadly similar to the structure established in 1988 under the 1986 Act, but with the SROs eliminated.

One key difference between the UK regulatory structure and the Report is the "Long-Term Optimal" proposal to create a separate prudential regulator and conduct of business regulator. The FSA regulates both areas. Another difference is, as noted above, that the UK system no longer uses SROs.

While the creation of a unified U.S. futures and securities regulator could make life easier for UK firms by reducing the U.S. regulators they are potentially affected by, of greater concern will be the new U.S. regulator's territorial reach and the new costs and opportunities it may present. For example, UK investment managers will remember the extraterritorial reach of the SEC's hedge fund advisers rules that were ultimately invalidated by the D.C. Circuit in July 2006.[88] Many UK managers were forced to register with the SEC under these rules, but withdrew from SEC registration once the rules were invalidated. Any attempt to re-introduce such a requirement in the new legislation creating the unified regulator would be of great concern to UK hedge fund mangers.

Although a unified U.S. futures and securities regulator would present a more familiar structure to UK firms doing business with the U.S., whether the merger would ultimately be welcome from a UK perspective will depend on how it impacts other substantive issues, some of which are not specifically addressed in the Report, such as the extent of the new regulator's extraterritorial reach and whether it might offer UK licensed firms any increased freedom to operate in the U.S.

Conclusion

We believe that there are many helpful recommendation in the Report. Examples are:

- expansion of the President's Working Group;
- a Mortgage Origination Commission to develop uniform minimum licensing qualification standards for state mortgage participants;
- facilitating the offering of a global U.S. investment company;
- access to Federal Reserve liquidity facilities for non-depository institutions;
- payments and settlements oversight; and
- Optional Federal Charter for insurance companies.

Nonetheless, as discussed above, industry and political comments to the Report were mixed, with strong opposition to some of them. Treasury recognizes that the intermediate and long-term recommendations will not be adopted any time soon.[89] In light of the comments so far, it is unlikely that even the short-term recommendations, except for the PWG recommendation,[90] will be adopted in this or the next calendar year. This is because most government agencies, even if willing, will be required to draft and publish most enacting rules for comments and then consider and respond to those comments. More importantly, most of Treasury recommendations require legislative action, which cannot be expected to occur this year, and

88 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

89 For example, see Report at 89, 100, 137.

90 Report at 75-77. See also discussion supra, under "Short-Term Recommendations."

a new administration taking office in 2009 may elect to modify, defer or altogether shelve Treasury's plan.

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This update was authored by Stephen H. Bier (+1 212 698 3889; stephen.bier@dechert.com), Susan C. Ervin (+1 202 261 3325; susan.ervin@dechert.com), Joseph V. Gatti (+1 202 261 3436; joseph.gatti@dechert.com), David J. Harris (+1 202 261 3385; david.harris@dechert.com), Paul Huey-Burns (+1 202 261 3433; paul.huey-burns@dechert.com), Jeffrey S. Puretz (+1 202 261 3358; jeffrey.puretz@dechert.com); Richard Heffner (+44 20 7184 7665; richard.heffner@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), Jules Baughns (+1 202 261 3445; jules.baughns@dechert.com), and Evan S. Posner (+1 860 524 3922; evan.posner@dechert.com), and Yogesh K. Rai (+1 212 698 3866; yogesh.rai@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/realestate, www.dechert.com/financialservices, or www.dechert.com/whitecollar.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

William K. Dodds
New York
+1 212 698 3557
william.dodds@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

Joseph V. Gatti
Washington
+1 202 261 3436
joseph.gatti@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Richard L. Heffner, Jr.
London
+44 20 7184 7665
richard.heffner@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Paul Huey-Burns
Washington
+1 202 261 3433
paul.huey-burns@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

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