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Regulatory Changes: The President's Picks Speak

Over the past weeks, there have been several Senate committee confirmation hearings and other appointments for posts that will clearly shape the future of the financial services industry as well as the overall economy. Discussed below are the confirmation hearings for Mary Schapiro as Securities and Exchange Commission Chair, Timothy Geithner as Treasury Secretary, Daniel Tarullo as a member of the Federal Reserve Board of Governors, and appointees to the Council of Economic Advisors.

Mary Schapiro – SEC Chair

On January 15, 2009, the Senate Committee on Banking, Housing and Urban Affairs ("Banking Committee"), led by Chairman Senator Christopher Dodd (D-CT) and ranking member Senator Richard Shelby (R-AL), held the confirmation hearing for Mary Schapiro, President Obama's nominee for Chair of the Securities and Exchange Commission ("SEC"). In her statement, Ms. Schapiro set forth several top priorities: (i) to re-invigorate enforcement (here, she pointed out that the SEC will need resources from Congress to accomplish this goal); (ii) to "re-engage the SEC" with the persons it serves—from individual investors to the largest firms; and (iii) to deepen the SEC's commitment to transparency, accountability, and disclosure.

At the hearing, Ms. Schapiro defended her record at the Financial Industry Regulatory Authority ("FINRA") where she served as Chair and CEO since 2006, promised more aggressive enforcement by the SEC, and foreshadowed a much broader role for the SEC in the regulation of securities markets. In speaking to enforcement, she pledged to "go with full force against anyone who violates investors' trust, large or small." She noted that one of her first initiatives would be to remove the obstacles to aggressive enforcement erected during the previous administration, including a requirement that the Division of Enforcement receive approval from the Commission to propose or accept settlements on behalf of the Commission before imposing penalties on its behalf.

Members of the Banking Committee questioned her commitment to rigorous investigation of companies, suggesting FINRA had been negligent under her watch in its investigation of Bernard Madoff's brokerage business. Ms. Schapiro stated that FINRA had no authority to investigate Madoff's investment advisory activities, where the criminal activity was alleged to have occurred. She criticized the "stovepipe" nature of regulation that allows parts of an institution to fall outside the jurisdiction of some of the regulators. She advocated for more cooperation among the different state, federal, and self-regulatory bodies, which she said are often plagued by jealousy and competition. When further questioned as to whether she had the temperament to police financial institutions,

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Ms. Schapiro replied that she “can be as aggressive an enforcer as anybody has ever been at the head of the SEC.”

Ms. Schapiro also supported the expansion of the breadth of the SEC’s regulatory authority, and that of federal regulators as a whole, in the financial markets. She advocated registration of hedge funds, federal regulation of insurance, and federal regulation of all swaps, including a central exchange for their sale. She also noted that she would consider whether to revive the “uptick” rule, rescinded by the SEC in 2007, which bans short-sellers from trading in shares when their price is falling. In regard to the registration of hedge funds, Ms. Schapiro indicated she would work to develop an appropriate disclosure regime for such funds to ensure greater transparency in their management. She further noted that if legislation was necessary in order to proceed with the registration of hedge funds, she would not hesitate to request that Congress enact such legislation. In regard to swaps, she noted that she would support federal regulation of swaps to ensure greater transparency in the swaps market, minimize counterparty risk, and ensure that institutions maintain sufficient collateral positions.

Ms. Schapiro not only supported a broader reach for SEC regulatory authority, but also suggested the SEC could explore an approach to protecting investors whereby new products would require SEC approval before being sold. Rather than simply enforcing a disclosure regime, she said she would be open to SEC evaluation of the social utility of products. She suggested that such evaluation might involve the application of two criteria: (i) the risk such products pose to the financial system as a whole; and (ii) the “implications” for investors.

She addressed questions about credit rating agencies and how to avoid potential conflicts of interest in a system where the rating agencies are paid by the very same entities whose securities are being evaluated. She stated that the current structure gives the appearance that “things are for sale in the markets.” She suggested that a possible solution might be for exchanges to pool money collected from listing fees to pay rating services. Alternatively, she suggested that a regulatory body could collect fees paid by companies for compensating rating agencies. This way, the issuers would not themselves be directly paying the rating agencies.

On January 22, 2009, Ms. Schapiro’s appointment as the new SEC Chair was approved by the Senate and she was sworn in on January 27.

Timothy Geithner – Treasury Secretary

On January 21, 2009, the Senate Committee on Finance, led by Chairman Senator Max Baucus (D-MT) and ranking member Senator Chuck Grassley (R-IO), held the confirmation hearing for Timothy Geithner, President Obama’s nominee for Secretary of the Treasury.

In his statement, Mr. Geithner emphasized that the markets alone cannot solve all problems, and in order to begin to address the current economic crisis, we need well-designed and strongly enforced financial regulations. He stated that President Obama is planning to go before Congress in the coming weeks to present a comprehensive plan for recovery. Mr. Geithner noted that the government must act with strength, speed, and care to get the economy back on track, and that any future recovery plan should address the problems on four separate fronts:

- **Quick action to provide support for economic recovery and restore the flow of credit.** Mr. Geithner stated that such action cannot be tentative and must evidence a clear commitment to do what is necessary to fix the economy. He warned that if action is not swift, the costs will be greater. He noted that the American Recovery and Reinvestment Plan (“Plan”) is now before the Congress and that the Plan would meet this test. Mr. Geithner stated that the Plan is a critical part of the solution, but must be accompanied by aggressive actions to address the housing crisis and frozen credit markets. He further stated that last year’s passage of the Troubled Asset Relief Program (“TARP’), a program designed to strengthen the financial sector through government purchases of assets and equity from troubled financial institutions, helped prevent a financial catastrophe and that he and President Obama believe that TARP needs reform. He acknowledged the serious concerns that have been expressed regarding transparency and accountability for the monies expended under the TARP.

- **Foundation for a stronger economic future.** Mr. Geithner stated that a recovery plan must involve investment in the country’s economic future, including initiatives to modernize the country’s infrastructure, strengthen the skills of its workforce, develop new technologies, expand access to health care and reduce costs, and make strides towards energy efficiency. He stated that tax incentives would be key to this portion of a recovery plan.

- **Clear strategy to return to a sustainable fiscal position.** Mr. Geithner emphasized that a recovery plan must include a mechanism to return the economy to a sustainable position with the unwinding of the current government intervention required to stabilize the economy. He stated that after the massive government intervention has returned liquidity to the markets, Americans must begin living within their means to maintain future economic stability. He continued that this would include the federal government, and that reducing the deficit would become a priority after the stabilization of the economy.

- **Financial reform to prevent a future systemic crisis.** Mr. Geithner called for financial reform that would prevent such a crisis from occurring in the future. He acknowledged that individuals and businesses that were careful and responsible were damaged by the actions of those who were not. He noted the importance of a system that would provide greater protections for investors, and he suggested that reform is necessary in the swap markets and that the framework for regulating futures markets should be re-examined.

In response to questions about transparency of funds spent under the TARP, Mr. Geithner noted that he would ensure that there is more transparency as to how funds are spent, and that the Treasury would have to work closely with the Federal Reserve Board and FDIC. He noted also that coordination with other major financial centers outside the U.S. would help solve the problems on a global level.

When questioned about the current state of the automobile industry, Mr. Geithner noted that he is involved in the process of establishing a team knowledgeable in manufacturing and the automobile industry, and that any financial assistance to corporations should come with conditions to give taxpayers confidence that the automobile industry will be stronger and more viable in future.

Regarding tax reform, Mr. Geithner noted that tax policy plays an important role in creating incentives and that the government must examine the entire framework of the tax code. He explained that he and President Obama believe there is substantial opportunity to reform the entire corporate tax system. He explained that this would not be done immediately and that he and the President hope to receive a working review of a package of reforms. He explained that they will be open to all ideas on how best to reform the code.

On January 26, 2009, Mr. Geithner was approved by the Senate and sworn in as the new Secretary of the Treasury.

Daniel Tarullo – Federal Reserve Board of Governors

On January 15, 2009, the Senate Banking Committee, led by Chairman Senator Christopher J. Dodd (D-CT) and ranking member Senator Richard Shelby (R-AL), held the confirmation hearing for Daniel Tarullo, President Obama's nominee to the Board of Governors of the Federal Reserve System.

In his statement, Mr. Tarullo suggested regulatory changes are needed to prevent future financial crises. Without providing specific details, Mr. Tarullo mentioned, as possible reforms, changes in required capital levels, risk management structures, and the government's capacity to respond to and contain risks.

Expired terms leave two other immediate vacancies for President Obama to fill on the Federal Reserve's Board of Governors. In addition, in 2010 President Obama will have the option of replacing or reappointing Chairman Ben Bernanke and Vice Chairman Donald Kohn. The possibility that President Obama may appoint five of the seven Governors within 18 months after taking office will likely allow the President to influence how the Federal Reserve regulates banks and responds to the economic crisis.

Council of Economic Advisors

On January 15, 2009, the Senate Banking Committee, led by Chairman Senator Christopher J. Dodd (D-CT) and ranking member Senator Richard Shelby (R-AL), held a hearing for President Obama's appointments to the Council of Economic Advisors (the "Council"). While the Council has little political power of its own, its members formulate and recommend national economic policy to the President. The nominees were Dr. Christina Romer, Dr. Austan Goolsbee, and Dr. Cecilia Rouse.

Dr. Romer has been named Chair of the Council. She was previously a professor of economics at the University of California at Berkeley. At the hearing, Dr. Romer stood by her empirical findings that tax increases cause the economy to contract, but did not advocate a specific policy. Indicating her support for government spending, Dr. Romer argued that government policies to increase aggregate demand do indeed increase output and reduce unemployment in the short- and medium-term.

Dr. Goolsbee has been named as a Council member and Economic Recovery Advisory Board director and chief economist. He is an economist at the University of Chicago Graduate School of Business. Dr. Goolsbee is considered a tax expert and is known for his centrism and free-trade views. Dr. Goolsbee stated at the hearing that the government needed to directly confront the foreclosure crisis because the "squeeze" on ordinary Americans is at the root of the financial crisis.

Dr. Rouse has been named as a Council member. She is a labor economist at Princeton University and is known for her work on the economics of educational investments. Her appointment has led to speculation that President Obama will be considering the economic benefits of educational investments as he prepares a stimulus package.

At the hearing, Drs. Rouse, Romer, and Goolsbee argued that accountability standards are needed so that the government and taxpayers know how TARP funds are being used by financial institutions.

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