

MEMO# 22392

April 3, 2008

Treasury Department Blueprint for a Modernized Financial Regulatory Structure

[22392]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 11-08
CEOS CLOSED-END INVESTMENT COMPANY MEMBERS No. 9-08
EQUITY MARKETS ADVISORY COMMITTEE No. 16-08
FEDERAL LEGISLATION MEMBERS No. 4-08
INTERNATIONAL MEMBERS No. 3-08
INVESTMENT ADVISER MEMBERS No. 6-08
OPERATIONS MEMBERS No. 4-08
PRIMARY CONTACTS - MEMBER COMPLEX No. 2-08
PUBLIC COMMUNICATIONS COMMITTEE No. 1-08
SEC RULES MEMBERS No. 30-08
SMALL FUNDS MEMBERS No. 19-08
TAX MEMBERS No. 7-08
UNIT INVESTMENT TRUST MEMBERS No. 6-08 RE: TREASURY DEPARTMENT BLUEPRINT
FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE

On Monday, the U.S. Treasury Department issued a blueprint for reform of the regulatory structure for U.S. financial institutions. [\[1\]](#) This is the latest in a series of initiatives to improve the competitiveness of our capital markets and follows from Treasury's request for public comment last fall. The blueprint contains: (1) short-term recommendations intended to improve regulatory coordination and oversight in the wake of recent market events; (2) intermediate-term recommendations intended to minimize duplication of the U.S. regulatory system and modernize the regulatory structure applicable to the securities, futures, banking, and insurance sectors; and (3) a conceptual model for instituting an objectives-based, regulatory framework for the long term.

For the investment company industry, one of the most significant issues is the potential impact of the proposed merger of the Securities and Exchange Commission and the Commodity Futures Trading Commission. In addition, consistent with the Institute's submission to Treasury in December, the blueprint calls for the SEC to propose legislation establishing a new form of registered investment company for the global marketplace. Set forth below is a brief, high-level summary of the recommendations in the blueprint that may be most relevant to the fund industry. [\[2\]](#)

Proposal to Merge the SEC and CFTC

The blueprint states that “[p]roduct and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient.” It recommends that the SEC and CFTC be merged in order to provide unified oversight and regulation of the securities and futures industries.

The blueprint recognizes that the two agencies take very different approaches to regulation and specifies a distinct preference for the CFTC's principles-based philosophy. In order to “preserve the market benefits achieved in the futures area,” the blueprint recommends that, prior to any merger of the agencies, the SEC take several steps to modernize its regulatory approach, including under the Investment Company Act. The recommended steps include the following:

- **Fund Model for the Global Marketplace** – The SEC should propose to Congress legislation to expand the Investment Company Act to permit registration of a new form of “global” investment company. The blueprint remarks on the inability of the U.S. fund industry to market fund shares on a global basis because of a variety of issues, including significant tax impediments, and concludes that this limits investor choice and the growth and competitiveness of the U.S. fund industry. It expressly recommends that the SEC develop the legislation “in consultation with retail and institutional investors, other domestic and international regulators, the asset management industry, academics, tax professionals, and other market participants.” The blueprint also specifies that the new form of investment company “should provide investor protections equivalent to the current U.S. investment company regulatory framework, such as a robust governance system, fee disclosures, and other disclosures.”
- **Modernizing Investment Company Regulation** – The SEC should adopt rules under the Investment Company Act “to permit the trading of those products already actively trading in the U.S. or foreign jurisdictions,” such as exchange-traded funds, so that sponsors can introduce new funds under the same terms and conditions as set forth in previously issued exemptive orders. The blueprint cites favorably to a recent speech by Alan Beller, former head of the SEC's Division of Corporation Finance, suggesting that the SEC could use its exemptive authority to modernize the Investment Company Act, as it did in achieving far-reaching reform of the rules for capital formation under

the Securities Act.

- Regulation of Securities Clearing Agencies and Exchanges – The SEC should adopt core principles for securities clearing agencies and exchanges. These principles should be modeled on those currently applicable to futures exchanges and clearing organizations under the Commodity Futures Modernization Act.
- Reform of the SRO Rulemaking Process – The SEC should update and streamline the rulemaking process for self-regulatory organizations. Among other things, the SEC should consider adopting a firm time limit for the SEC to publish SRO rule filings, expanding the types of rules deemed effective upon filing, and streamlining the approval for securities products common to the marketplace.

According to the blueprint, legislation to merge the SEC and CFTC should involve not only a structural component but also a merger of regulatory philosophies and harmonization of securities and futures regulations and statutes. It states that the merger plan should provide for the following:

- Regulatory Harmonization – A joint SEC-CFTC staff task force should be charged with harmonizing the differences between securities regulation and futures regulation and recommending the structure of the new agency. Areas for harmonization would include margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, suitability, short sales, SRO mergers, implied private rights of action, SRO rulemaking, and the regulator's funding mechanism.
- Adoption of Overarching Principles – The new agency should adopt overarching regulatory principles focusing on investor protection, market integrity, and overall financial system risk reduction.
- Further Reform of the SRO Rulemaking Process – All clearing agency and market SROs should be authorized by statute to self-certify all rulemakings except those involving corporate listing and market conduct standards, thus allowing them to become effective upon filing. The regulator would have the right to abrogate the rulemakings at any time.

Other Recommendations

- SRO for Investment Advisers – The blueprint recommends the establishment of an SRO for investment advisers. It states, among other things, that a self-regulatory system can help to cover gaps in federal regulation, can typically respond to market developments more quickly than federal regulators, and may have greater flexibility to protect investors and encourage innovation in the offering of financial services and products. The blueprint acknowledges that “self-regulation is not free of criticism,” including the potential for redundancies and susceptibility to conflicts of interest. It concludes, however, that many of these potential problems may be addressed by structuring SROs as not-for-profit entities, requiring that a majority of the SRO's board members be independent, and ensuring that consumer and investor interests are well represented.
- Harmonizing Broker-Dealer and Investment Adviser Regulation – The blueprint recommends the adoption of legislation to harmonize the regulation and oversight of broker-dealers and investment advisers that offer similar services to retail investors.
- Payment and Settlement Systems – The blueprint notes that there is a wide array of

payment and settlement systems used to transfer funds and financial instruments between financial institutions and between financial institutions and their customers, but that current regulation of these systems is idiosyncratic. The blueprint recommends the creation of a new federal charter for “systemically important” payment and settlement systems and recommends that the Federal Reserve should have primary oversight responsibilities for such systems.

- Liquidity Provisioning by the Federal Reserve – The blueprint calls for clarifying and enhancing the process by which the Federal Reserve provides temporary liquidity to the financial system, including by ensuring that lending is subject to appropriate conditions. It further recommends that the President’s Working Group on Financial Markets[3] study the broader regulatory issues associated with providing non-depository institutions with access to the Federal Reserve’s discount window.

Conceptual Model for an “Optimal Regulatory Structure”

The blueprint acknowledges that there are many possible options to reform and strengthen the regulation of U.S. financial institutions for the long term, and it notes the various approaches considered by the Department. It then describes in detail the Department’s conclusion that an objectives-based regulatory approach – as has been adopted in Australia [4] and the Netherlands – would be best able to adjust to changes in the financial landscape and have the most potential for establishing the greatest levels of market discipline. In brief, such a financial regulatory system would have three primary regulators focused on three key areas:

- Market stability regulation, to address overall conditions of financial market stability that could impact the real economy, would be under the oversight of the Federal Reserve. Among other things, the Federal Reserve would have the ability to monitor risks across the financial system.
- Prudential financial regulation, to address issues of limited market discipline caused by government guarantees (e.g., federal deposit insurance), would be under the auspices of a new prudential financial regulator that would encompass the current roles of several banking regulators.
- Business conduct regulation, to address standards for business practices and the protection of consumers/investors, would be under the auspices of a new business conduct regulator that would encompass most of the current roles of the SEC and CFTC and some roles of the banking regulators. The blueprint envisions that this regulator would set national standards for a wide range of business conduct laws across all types of financial services providers, and that state business conduct laws directly relating to the provision of financial services would be preempted.

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endnotes

[1] The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (March 2008), available on the Treasury Department’s website at

<http://www.treas.gov/press/releases/reports/Blueprint.pdf>. Other related documents include the Department's press release (<http://www.treasury.gov/press/releases/hp896.htm>), a fact sheet summarizing the blueprint's recommendations (http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf) and remarks by Secretary Paulson (<http://www.treasury.gov/press/releases/hp897.htm>).

[2] The blueprint likewise contains recommendations that could result in significant regulatory changes for the banking and insurance industries (e.g., elimination of the federal charter for thrifts, creation of an optional federal charter for insurers).

[3] The blueprint recommends that the President's Working Group on Financial Markets be broadened to address the entire financial sector, in order to enhance its effectiveness as a coordinator of financial regulatory policy. It further recommends that the group should facilitate better interagency coordination and communication in four distinct areas: (1) mitigating systemic risk to the financial system; (2) enhancing financial market integrity; (3) promoting consumer and investor protection; and (4) supporting capital markets' efficiency and competitiveness.

[4] On March 29, the SEC announced that it has begun formal discussions with Australian regulators to develop a mutual recognition arrangement for the two nations' securities markets. See SEC Chairman Cox, Prime Minister Rudd Meet Amid U.S.-Australia Mutual Recognition Talks (press release issued March 29, 2008), available on the SEC's website at <http://www.sec.gov/news/press/2008/2008-52.htm>.