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Administration Plan for Financial Services Regulatory Reform

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 26-09
BROKER/DEALER ADVISORY COMMITTEE No. 34-09
OPERATIONS COMMITTEE No. 12-09
TRANSFER AGENT ADVISORY COMMITTEE No. 46-09 RE: ADMINISTRATION PLAN FOR
FINANCIAL SERVICES REGULATORY REFORM

On June 17, the Obama Administration issued a white paper outlining its plan for financial services regulatory reform. [\[1\]](#) The paper includes recommendations that are designed to meet five key objectives: (1) promote robust supervision and regulation of financial firms; (2) establish comprehensive supervision of financial markets; (3) protect consumers and investors from financial abuse; (4) provide the government with the tools it needs to manage financial crises; and (5) raise international regulatory standards and improve international cooperation. The summary below seeks to highlight recommendations that may be of particular interest to Institute members.

I. Promote Robust Supervision and Regulation of Financial Firms

Financial Services Oversight Council

The Administration proposes creating a permanent Financial Services Oversight Council (Council) chaired by the Treasury Secretary. The other members of the Council would be the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, the Chairman of the Commodity Futures Trading Commission, the Chairman of the Federal Deposit Insurance Corporation, the Director of the Federal Housing Finance Agency, and the Directors of two new proposed agencies discussed below, the Consumer

Financial Protection Agency and the National Bank Supervisor. The Council, which would be housed within the Treasury Department, would have a permanent staff.

The paper recommends that the Council replace the President's Working Group on Financial Markets (PWG) and be responsible for: (1) facilitating information sharing and coordination among the principal federal financial regulators regarding policy development, rulemakings, examinations, reporting requirements, and enforcement actions; (2) providing a forum for discussion of cross-cutting issues among the principal federal financial regulators; and (3) identifying gaps in regulation and preparing an annual report to Congress on market developments and potential emerging risks.

To enable the Council to monitor for emerging threats that activities in the financial markets may pose to financial stability, it would have the authority to require reports from any U.S. financial firm solely for this purpose. The paper states that, in the case of federally regulated firms, the Council should, wherever possible, rely on information that is already being collected by members of the Council in their role as regulators. The Council would have the responsibility for referring emerging risks to the attention of regulators with the authority to respond.

The Council would advise the Federal Reserve on the identification of financial holding companies (FHCs) whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (referred to as Tier 1 FHCs). The Federal Reserve would be required to consult with the Council in developing rules for the identification of, and in setting material prudential standards for, Tier 1 FHCs.

Heightened Consolidated Supervision and Regulation of Tier 1 FHCs

The Federal Reserve would have authority to supervise and regulate Tier 1 FHCs, regardless of whether the firm owns an insured depository institution. The proposed criteria for identifying such firms would include: the impact the firm's failure would have on the financial system and the economy; the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. The paper indicates that the Federal Reserve should be allowed to consider other relevant factors and exercise discretion in applying the specified factors to individual firms.

The paper recommends that Congress authorize the Federal Reserve to collect from all U.S. financial firms that meet certain minimum size thresholds reports containing information reasonably necessary to determine whether the firm is a Tier 1 FHC. It states that in the case of federally regulated firms, the Federal Reserve should have access to relevant reports submitted to other regulators, and its authority to require reports should be limited to information that cannot be obtained from reports to other regulators. The paper

recommends that the Federal Reserve also have examination authority over U.S. financial firms meeting certain minimum size thresholds, but only if the Federal Reserve is unable to determine whether the firm's financial activities pose a threat to financial stability based on regulatory reports, discussions with management, and publicly available information. It indicates that such examination authority should be limited to examinations reasonably necessary to enable the Federal Reserve to determine whether the firm is a Tier 1 FHC.

Tier 1 FHCs would be subject to stricter and more conservative capital, liquidity, and risk management standards than those applicable to other financial firms. The paper recommends that consolidated supervision of a Tier 1 FHC extend to the parent company and all subsidiaries. While regulated subsidiaries would continue to be supervised and regulated primarily by their functional or bank regulator, the paper recommends removing constraints under the Gramm-Leach-Bliley Act that impede the Federal Reserve's ability, as a consolidated supervisor, to obtain information from or impose prudential restrictions on regulated subsidiaries of a bank holding company, including SEC-registered broker-dealers, investment advisers, and investment companies. The paper further recommends that all FHCs be required to meet certain capital and management requirements, which currently apply only to subsidiary depository institutions, on a consolidated basis.

Money Market Funds

The paper recommends that the SEC move forward with plans to strengthen the money market fund regulatory framework and that the SEC consider, in particular: (1) requiring money market funds to maintain substantial liquidity buffers; (2) reducing the maximum weighted average maturity of money market fund assets; (3) tightening the credit concentration limits applicable to money market funds; (4) improving the credit risk analysis and management of money market funds; and (5) empowering money market fund boards of directors to suspend redemption in extraordinary circumstances to protect the interests of fund shareholders. The paper further proposes that the PWG prepare a report by September 15, 2009 considering fundamental changes to address systemic risk more directly. It states that those changes could include, for example, eliminating the ability of a money market fund to use a stable net asset value or requiring money market funds to obtain access to reliable emergency liquidity facilities.

The paper advises the SEC and PWG to "carefully consider ways to mitigate any potential adverse effects of such a stronger regulatory framework for [money market funds], such as investor flight from [money market funds] into unregulated or less regulated money market investment vehicles or reductions in the term of money market liabilities issued by major financial and non-financial firms."

Hedge Funds and Other Private Pools of Capital

The paper recommends requiring SEC registration of investment advisers to hedge funds and other private pools of capital, including private equity funds and venture capital funds, whose assets exceed a "modest" threshold. It proposes that all investment funds advised

by an SEC-registered adviser [2] be subject to recordkeeping requirements; requirements with respect to disclosures to investors, creditors, and counterparties; and regulatory reporting requirements. It states that regulatory reporting requirements for such funds should require reporting on a confidential basis of the amount of assets under management, borrowings, off-balance sheet exposures, and other information necessary to determine if a fund or fund family meets the Tier 1 FHC criteria and therefore should be supervised and regulated as such.

Executive Compensation / “Say on Pay”

The paper recommends that federal regulators issue standards and guidelines to better align financial firms’ executive compensation practices with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. It indicates that the Administration will support legislation requiring all public companies to hold “non-binding shareholder resolutions” on the compensation packages of senior executive officers, as well as new requirements to make compensation committees more independent.

Fair Value Accounting

The paper recommends that accounting standards setters review fair value accounting rules with the goal of identifying changes that could provide users of financial information with both fair value information and greater transparency regarding the cash flows that management expects to receive by holding investments.

Other

Other noteworthy recommendations designed to promote robust supervision and regulation include:

- Creation of a new “National Bank Supervisor” that would replace the OCC and the Office of Thrift Supervision to supervise and regulate national banks and federal branches and agencies of foreign banks; and
- Establishment of a new “Office of National Insurance” to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.

II. Protect Consumers and Investors from Financial Abuse

Consumer Financial Protection Agency

The paper proposes the creation of a new, independent federal agency that would have broad jurisdiction to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.

According to the paper, the CFPB would not have jurisdiction over investment products and services that are already regulated by the SEC or CFTC. Rules promulgated by the CFPB would serve as a floor, not a ceiling. States would be able to adopt and enforce stricter consumer protection laws and would have concurrent authority to enforce federal law.

Point of Sale Disclosure

The paper recommends authorizing the SEC to require that “certain disclosures (including a summary prospectus) be provided to investors at or before the point of sale, if it finds that such disclosures would improve investor understanding of the particular financial products, and their costs and risks” (emphasis added). The paper notes that currently, “most prospectuses (including the mutual fund summary prospectus) are delivered with the confirmation of sale, after the sale has taken place.” It states that “[w]ithout slowing the pace of transactions in modern capital markets, the SEC should require that adequate information is given to investor [sic] to make informed investment decisions.” The paper recommends that the SEC engage in consumer testing to evaluate the effectiveness of investor disclosures and that budgetary support be provided for such efforts.

Investment Adviser/Broker-Dealer Regulation

The paper recommends establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers. It states that the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors’ best interest. The paper expresses support for legislation to bolster investor protection and increase consistency in the regulation of investment advisers and broker-dealers by: (1) requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers; (2) providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and (3) prohibiting certain conflicts of interest and sales practices that are contrary to investors’ interests.

Financial Consumer Coordinating Council

The paper proposes the establishment of a Financial Consumer Coordinating Council made up of the heads of the SEC, Federal Trade Commission, Department of Justice, and Consumer Financial Protection Agency, or their designees, to address potential gaps in consumer and investor protection and to promote best practices across different markets. It recommends that the Investor Advisory Committee recently established by the SEC to provide advice on regulatory priorities be made permanent by statute.

Retirement Security

The paper recommends that Congress enact an “Automatic IRA” for individuals whose

employers do not offer a retirement plan and a modified saver's credit that would be deposited directly in an individual's qualified retirement plan account or IRA for families earning less than \$65,000. The paper states that employee-directed workplace retirement plans should be transparent, simple, fair and free from conflicts of interest that could harm employees. It indicates that plan sponsors and service providers should be accountable and subject to appropriate oversight, and that high-quality plans should be accessible to all workers.

The paper notes that other critical issues in the area of retirement security that need to be addressed include: (1) exploring ways to encourage the use of automatic features to improve saving and investment behavior in 401(k) plans and restore more lifetime income throughout the retirement system; (2) aiming to reduce costs, such as investment fees; (3) investigating how to reduce "leakage" from retirement plans; and (4) exploring means of strengthening the defined benefit plan system.

Other

The paper recommends authorizing the SEC to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial rewards, expanding sanctions available in enforcement actions, and harmonizing liability standards.

III. Establish Comprehensive Regulation of Financial Markets

Credit Rating Agencies

The paper recommends that the SEC continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process. It proposes that regulators reduce their use of credit ratings in regulations and supervisory practices wherever possible.

Asset-Backed Securities

The paper recommends that the SEC continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset-backed securities.

OTC Derivatives

The paper proposes that all OTC derivatives markets, including credit default swap markets, be subject to comprehensive regulation designed to: (1) prevent activities in those markets from posing risk to the financial system; (2) promote the efficiency and transparency of

those markets; (3) prevent market manipulation, fraud, and other abuses; and (4) ensure that OTC derivatives are not marketed inappropriately to unsophisticated parties. It recommends, among other things, requiring all standardized OTC derivatives to be cleared through regulated central counterparties and subjecting all OTC derivatives dealers and other parties whose activities in those markets create large exposures to counterparties to a robust and appropriate regime of prudential supervision and regulation. All OTC derivatives would be subject to recordkeeping and reporting requirements, and the SEC and CFTC would have authority to police abusive practices.

Harmonization of Securities and Futures Regulation

The paper discusses the drawbacks of the current, bifurcated system of regulating securities and futures. It notes in particular that the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the SEC and CFTC. It calls for greater coordination and harmonization between the two agencies and recommends that the agencies complete a report to Congress by September 30, 2009 that identifies regulatory conflicts with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives or recommends changes to eliminate the differences.

Systemically Important Payment, Clearing, and Settlement Systems and Related Activities

The paper proposes giving the Federal Reserve responsibility and authority to conduct oversight of systemically important payment, clearing, and settlement systems, and activities of financial firms. It indicates that this authority should supplement rather than replace the existing authority of regulators of clearing and settlement systems and prudential regulators of financial firms. The paper further recommends that Congress authorize the Federal Reserve to provide systemically important payment, clearing, and settlement systems access to Reserve Bank accounts, financial services, and the discount window.

IV. Provide the Government with the Tools It Needs To Manage Financial Crises

Resolution Regime for Failing Bank Holding Companies, Including Tier 1 FHCs

The paper proposes the creation of a resolution regime to allow for the orderly resolution of failing BHCs, including Tier 1 FHCs, in situations where the stability of the financial system is at risk. The regime would supplement (rather than replace) and be modeled on the existing resolution regime for insured depository institutions. The paper emphasizes that the authority it proposes would be only for extraordinary times and would be subject to very strict governance and control procedures, which it describes. Under the proposal, Treasury would have the authority to decide how to resolve a failing firm under the resolution regime, including by establishing a conservatorship or receivership. The paper indicates that the entity acting as conservator or receiver (the FDIC unless the failing firm's largest subsidiary is a broker-dealer or securities firm, in which case it would be the SEC) should be authorized to borrow from Treasury when necessary to exercise its resolution

authorities. It states that Treasury should be authorized to issue public debt to finance any such loans and that the costs of any such loans should be paid from assessments on all BHCs.

Federal Reserve Emergency Lending Authority

The paper indicates that the Administration will propose legislation to require the prior written approval of the Treasury Secretary for any extensions of credit by the Federal Reserve to individuals, partnerships, or corporations in “unusual or exigent circumstances.” It states that the Federal Reserve currently is authorized to make such loans without the Treasury Secretary’s approval, but that when exercising this authority during the recent financial crisis (e.g., to create liquidity facilities to bolster confidence and liquidity in various sectors, including money market funds), the Federal Reserve has sought and received the Secretary’s approval. According to the paper, subjecting the Federal Reserve’s emergency lending authority to prior written approval by the Treasury Secretary would provide appropriate accountability going forward.

V. Raise International Regulatory Standards and Improve International Cooperation

The paper states that the Administration will use its leadership position in the international community to promote initiatives compatible with the domestic regulatory reforms it is recommending. International efforts will focus on reaching consensus in four core areas: regulatory capital standards; oversight of global financial markets; supervision of internationally active firms; and crisis prevention and management. Among other initiatives, the paper calls for:

- promoting standardization and improved oversight of OTC derivative markets, in particular through the use of central counterparties;
- enhancing supervision of global financial firms through the use of supervisory colleges;
- cross-border resolution of global financial firms;
- identification of foreign financial firms that are Tier 1 FHCs;
- requiring hedge funds or their managers to register and disclose information necessary to assess the systemic risk they pose individually or collectively;
- clarification and consistent application of fair value accounting standards and progress toward development of a single set of high quality global accounting standards; and
- enhanced oversight of credit rating agencies.

Frances M. Stadler
Deputy Senior Counsel

endnotes

[\[1\]](#) The paper, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, is available at

http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] The term “investment funds” presumably refers to hedge funds and other private pools.

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