

Regulation and Compliance - Overhaul of Financial Services Oversight

In June, the Obama Administration unveiled a proposal, which, if enacted, would create the most sweeping changes to oversight of the financial services industry since the 1930s. Even with healthcare and the war in Afghanistan stealing the headlines, the House Financial Services Committee, chaired by Congressman Barney Frank, managed to hammer out a bill in November that Congressman Frank plans to send to the floor of the House next month. The Senate Finance Committee, chaired by Senator Chris Dodd, has put together its own draft, which Senator Dodd hopes to continue work on in December. No legislation is expected until next year.

Key Elements

The Administration's proposal is comprehensive and is aimed at addressing the systemic problems that many blame for the near collapse of the economy in 2008. While there are differences among the original proposal, the House version, and the Senate version, there is little doubt that the financial services industry will be more closely regulated in the future.

Here are the key elements.

Too Big to Fail—Although the various versions differ on the details, everyone agrees on government oversight of the economy and the largest financial services firms (banks, insurance companies, hedge funds, and private equity firms) to identify and minimize excessive risk. These large companies, considered “too big to fail,” would pay for the privilege of government intervention and the cost of having one of their members wound down in the event of default or impending failure.

Bank Regulation—Although there are differences in how to go about it, all versions contain provisions aimed at preventing banks from “regulation-shopping.” The Administration would merge the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) and eliminate the thrift charter. The Federal Reserve, which supervises bank holding companies and some state banks, as well as the FDIC, which also regulates some state banks, would be left intact. The House would also merge the OTS and OCC, but would retain the thrift charter. The Senate would do away with the OTS and OCC and take away the FDIC's bank regulatory powers. A single powerful agency would have sole responsibility for bank regulation.

Investor Protection—All versions of the proposed regulation include “investor protection” provisions with both the House and Senate closely aligned with the Administration’s proposal. The current regime, which imposes a requirement of full disclosure on broker-dealers, would be replaced by a fiduciary standard, requiring broker-dealers to put their clients’ interests ahead of their own. In addition, pay structures that incent broker-dealers to sell products that might not be in their clients’ best interests would be banned. And, finally, the current requirement that disputes be resolved by arbitration would be changed to allow law suits by investors.

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Consumer Protection—All versions provide greater consumer protection. The Administration and the Senate would create a new agency to protect consumers from unfair sales practices associated with the sale of a wide variety of financial products including mortgages, credit cards, and auto loans. The Federal Reserve, FDIC, and other Federal regulators currently charged with consumer protection would be stripped of their powers in an effort to centralize accountability. The Administration would also require sellers of consumer financial products to offer “plain vanilla” versions of their products and require sellers to assess consumers’ ability to understand those products. The Senate version exempts lawyers, real estate agents, and certain others from the new consumer protection requirements and would not require sellers to offer low-cost, “plain vanilla” products or assess a consumer’s ability to understand them. The House Committee voted not to preempt tougher state consumer protection laws.

Derivatives—Regulation of derivatives has been one of the more hotly-contested issues. The Administration would require “standardized derivatives” including credit default swaps and other risk management instruments to be traded on a regulated trading platform. Dealers and “corporate end-users” would be required to post collateral and comply with new margin rules, increasing costs, but decreasing risk. “Custom-made derivatives,” those created for a single client would be exempt from trading on a regulated platform, but would be subject to the new capital requirements. The House and Senate Committee largely follow the Administration’s proposal, although the House would exempt corporate end-users and hedge funds from trading, clearing, collateral, and margin requirements. It is estimated that end-users account for less than 15 percent of derivatives trades.

Executive Pay—The public outrage over large bonuses paid to executives of firms receiving government bail-out funds has made this another controversial subject. One thing everyone agrees on is that compensation should not encourage excessive risk

taking. Something else the proposals agree on are *no* mandated dollar limits on executive pay. The Administration would curtail executive compensation arrangements that reward executives “up front” for schemes that later result in loss to shareholders or threaten the economy. One way this is accomplished is to allow shareholders a non-binding vote on executive compensation. The House version essentially follows the Administration version. The Senate would require shareholder “say-on-pay,” but would not require

regulators to ban compensation practices that encourage excessive risk taking.

President Obama would create a national office for regulation of insurance (NOI) within the Treasury to “gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.” Regulation of insurance companies would remain with the states.

Credit Ratings—Many have noted that credit-rating agencies are currently paid by the very companies whose credit-worthiness they assess. Some have charged that this apparent conflict of interest caused credit-rating agencies like Moody's and Standard & Poor's to continue to provide high ratings to firms teetering on the brink of disaster in the recent financial crisis. The Administration would create a new office within the SEC to supervise credit-rating agencies. Credit-rating

agencies would be required to implement “robust policies and procedures” to “manage and disclose conflicts of interest” that “differentiate between structured and other products, and otherwise promote the integrity of the ratings process.” The House and Senate Committee versions go even further, allowing investors to sue credit-rating agencies that mislead them. The Senate Committee would allow the SEC to revoke the registration of credit-ratings agencies that provide misleading ratings.

Two other areas of regulation proposed by the Administration relate to insurance and hedge funds. President Obama would create a national office for regulation of insurance (NOI) within the Treasury to “gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.” Regulation of insurance companies would remain with the states.

The Administration would also require advisors to hedge funds and other private pools of capital (including private equity funds and venture capital funds) whose assets under management exceed some undefined “modest threshold” to register with the SEC as investment advisors under the Investment Advisers Act of 1940. Hedge fund advisors would be required to report such information as “is sufficient to assess whether any fund poses a threat to financial stability.” In addition, funds advised by these advisors would be subject to new record-keeping and reporting requirements, and would be required to

provide new disclosures to investors, creditors, and counterparties. Also, the Administration's white paper of financial services regulation provides that "the Federal Reserve and the federal banking agencies should tighten the supervision and regulation of potential conflicts of interest generated by the affiliation of banks and other financial firms, such as proprietary trading units and hedge funds."

Bottom Line

Enactment of major legislation affecting regulation of the financial services industry is almost a certainty. Broker-dealers and others will be held to higher standards. Investors and consumers are likely to have more avenues for redress open to them. Derivatives will likely be traded in the light of day, executive compensation will be open to shareholder scrutiny, and credit-rating agencies will have to avoid conflicts of interest.

The devil remains in the details and how these changes will impact individual advisors and their one-on-one relationships with clients remains to be seen.

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