Committee on Capital Markets Regulation Releases Plan for Regulatory Reform

On May 26, 2009, the Committee on Capital Markets Regulation (Committee) released *The Global Financial Crisis: A Plan for Regulatory Reform*. The Committee is an independent, nonprofit research organization comprised of representatives from the investor, business, finance, legal, and academic communities. The Committee’s report, which outlines a detailed plan for capital markets regulatory reform, adds to the rapidly growing body of literature released in recent months in response to the financial crisis. The Committee’s ongoing empirical research on capital markets issues has received considerable attention in the past.

**Recommendations**

In its report, the Committee attributes the failure of the financial system to inconsistent regulation across products and services, insufficient transparency, fragmented supervision, and lack of internationally coordinated regulation. The Committee puts forth four regulatory reform principles aimed at correcting these problems: (1) create a coordinated, streamlined regulatory system; (2) reduce systemic risk through more effective regulation; (3) increase disclosure to investors; and (4) increase international regulatory coordination.

The Committee expands on the principles through a series of specific recommendations for capital markets regulatory reform. The report’s significant recommendations include:

1. **Building a Coordinated and Unified Regulatory System**: The U.S. should have only two or three independent regulatory bodies overseeing the financial system: (1) the Federal Reserve, which would serve as the new systemic risk regulator; (2) a newly-created agency, similar to the U.K.’s Financial Services Authority (FSA), which would regulate all aspects of the financial system; and (3) possibly a new investor and consumer protection agency.

2. **Reducing Systemic Risk**
   
a. **Credit Default Swaps and Other Derivatives**: The credit default swaps (CDSs) market should be reformed by mandating centralized clearing, adopting a TRACE-like system for transaction reporting, and requiring listing and trading of certain standardized, high-volume CDSs on exchanges. The report also recommends that policymakers work toward establishing one or two international derivatives clearing facilities to improve netting capabilities.

   b. **Hedge Funds**: The Committee recommends adoption of a confidential reporting requirement, under which each hedge fund would be required to register and provide the regulator (temporarily the Federal Reserve) with information to assess the fund’s systemic risk.
c. Private Equity: The Committee recommends limiting regulation of private equity funds only to information collection and suggests relaxing the bank acquisition standards that currently apply to private equity funds.

d. Money Market Mutual Funds (MMMF): Procedures should be put in place to enhance MMMF transparency, risk evaluation and monitoring, and crisis management. In addition, the report recommends consideration of possible government or self-funded guarantees to support MMMF shareholder accounts.

e. Capital Regulation: The Committee recommends strengthening leverage ratios, adopting counter-cyclical capital ratios, and requiring higher solvency standards for larger financial institutions, but suggests leaving overall bank capital requirements unchanged pending further study.

f. Resolution Process for Failed Financial Institutions: A single insolvency regime should be established that is applicable to all financial companies. Ad hoc, enhanced resolution powers should be available to the designated regulator if a financial company poses systemic risk.

3. Increasing Disclosure to Protect Investors and Stabilize the Market

a. Credit Rating Agencies (CRAs): The Committee recommends continuing to allow CRAs to develop their own rating methodologies, but requiring increased disclosure of CRA practices. The Committee suggests vesting CRA regulation authority at the federal level and international coordination of regulatory standards. The report also advises that policymakers review the use of credit ratings in regulatory frameworks.

b. Enhancing Accounting Standards: The Committee recommends that FASB supplement the FAS 157-4 fair value standard by requiring preparers to disclose two additional balance sheet presentations, enabling investors to distinguish the influence of credit and market value.

c. Incentives of Originators: Regulators should prescribe rules that restrict high-risk mortgage products and lending practices, including prohibiting such products and practices from entering into the securitization market. The Committee also recommends exploring minimum risk retention and enhanced disclosure of the retained interest, including the ability and intention of the originator to hedge this interest and the fees to be earned by the originator, in order to better align economic interests of originators and investors and allow investors to assess the level of alignment with originators.

4. Facilitating International Regulatory Cooperation: In addition to recommending strengthened international regulatory dialogues, the Committee endorses the establishment of the Financial Stability Board to harmonize regulation of international finance and supports enabling the IMF to play an early warning role.

Growing Body of Financial Crisis Literature

The Committee’s report adds to the growing list of recommendations, some conflicting, that have been offered as the capital markets regulatory reform effort gains momentum. Significantly, the Committee rejects the systemic risk regulation approach advocated by FDIC Chairman Sheila Bair and SEC Chairman Mary Schapiro, which would create a council comprised of the federal regulators to monitor and regulate systemic risk. Instead, the Committee’s recommendation, consistent with the Treasury Department’s March 2008 Blueprint for a Modernized Financial Regulatory Structure and the G30’s January 2009 Financial Reform: A Framework for Financial Stability, would authorize the Federal Reserve to act as a systemic risk regulator.

The Committee’s recommendation to expand the Federal Reserve’s role, in conjunction with its recommendation to establish a new U.S. agency modeled after the U.K. ’s FSA and charged with regulation of the entire financial system, is similar to a framework currently under consideration by the Obama Administration. Administration officials have indicated they are contemplating a single bank
regulator and merger of the current responsibilities of the FDIC, Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). The Obama Administration is also considering a merger of the SEC and the CFTC, although it is not clear whether the Administration would go so far as to combine bank regulation with the traditional SEC and CFTC functions. The Administration’s proposal is still under development, and an announcement is expected in a few weeks.

The Committee’s endorsement of a third regulatory agency to protect consumers and investors is another proposal that has been gaining favor in recent months. At a Senate Banking Committee hearing this month, Treasury Secretary Timothy Geithner noted that Treasury is considering the creation of a financial products safety commission, a concept proposed by Elizabeth Warren, Chair of the TARP Congressional Oversight Panel. In March, Assistant Senate Majority Leader Dick Durbin (D-IL) introduced S. 566, a bill that would create such a commission (see the K&L Gates Alert Fifty Ways to Need a Lawyer: Congress Proposes to Establish Financial Services Watchdog Agency). Congressmen Bill Delahunt (D-MA) and Brad Miller (D-NC) introduced H.R. 1705, a House companion bill that mirrors the Senate version.

The Committee calls for a regulatory framework for credit default swaps and other over-the-counter derivatives similar to that proposed by the Treasury Department earlier this month (see the K&L Gates Alert Comprehensive Regulatory Framework for OTC Derivatives Proposed as a Prelude to Reform of the U.S. Financial System). The report takes a less far-reaching approach in terms of regulation of other financial products. Notably, the Committee recommends imposing only a confidential reporting regime on hedge funds, and not public disclosure and capital, liquidity, counterparty, and credit risk management requirements suggested by the G30 and the Treasury Department in its March 2009 Framework for Regulatory Reform. In addition, the Committee advocates only limited regulation of private equity funds.

K&L Gates Forms Capital Markets Reform Group

The Committee report reinforces the likelihood that the pending legislative reforms will be unprecedented in scope. In the past, it was sufficient for financial services industry participants to focus on policy developments relating only to specific business sectors. However, it is clear that such an approach will be insufficient in the weeks and months ahead because the reforms will occur at a macro level and will impact all financial services interests. Therefore, K&L Gates has established an internal Capital Markets Reform Group that consists of designated partners in each of the firm’s relevant practice areas across the full spectrum of capital markets issues. These practice areas include: broker-dealer/securities trading; commodities/futures; depository institutions; derivatives/securitization; hedge funds; insurance/annuities; investment banking; investment management; mortgage banking/consumer finance; and public policy. By coordinating across all of these disciplines, K&L Gates will be able to provide unequalled service and insights to firm clients as these new laws and implementing regulations are written.