Analysis&Perspective

REGULATORY REFORM

Securities Regulation Under the Obama Plan

BY STEPHEN J. CRIMMINS

The Treasury Department's "Financial Regulatory Reform" proposal, introduced by President Obama just over a week ago, spans the full breadth of the financial services regulatory landscape and spends much of its energy on steps needed to control systemic risk. However, the proposal also lays out in some detail the Administration's intended course for remaking important areas of securities regulation through legislation and rulemaking over the months ahead.[1]

This article focuses on the particular proposals that securities practitioners will likely find important as the Administration presses forward with its "new foundation" for financial services regulation. Some of the items will find broad support, while others will be controversial, but whatever the outcome on particular proposals, the pressure of the current financial crisis will undoubtedly assure a more comprehensive and considered reappraisal of securities regulation than we have seen in decades.

A. The SEC's Resurgence.

The Securities and Exchange Commission clearly has the Administration's confidence and appears a winner in the opening phase of financial services regulatory reorganization. Just months after some were placing much of the blame for the financial crisis on the SEC's shoulders and questioning whether it was up to the task of fixing things, the Treasury Proposal now praises the SEC as "an experienced federal supervisor" and, as discussed below, assigns it substantial new responsibilities.[2]

The SEC's resurgence is thanks in large measure to initiatives and leadership by its new Chairman, Mary Schapiro. The Treasury Proposal notes that following "scandals associated with the current financial crisis, including . . . the Madoff affair," the SEC has already taken steps to "strengthen and streamline" enforcement, and squarely endorses a number of Schapiro's initiatives. In particular, the Treasury commends the SEC for expediting the process for granting its staff subpoena power to pursue particular investigations; for beginning to revamp its technology and internal processes for evaluating the hundreds of thousands of tips it gets each year concerning possible investment frauds; and for building expanded enforcement resources into its FY2010 budget.[3]

B. OTC Derivatives.

The Treasury Proposal calls for amendments to the securities and commodities laws to require clearing of all standardized over-the-counter derivatives through regulated central counterparties and to authorize the SEC and the Commodity Futures Trading Commission, "consistent with their respective missions," to take appropriate regulatory actions.[4] The Treasury notes that the Commodity Futures Modernization Act of 2000 explicitly exempted OTC derivatives, including credit default swaps, from regulation and resulted in a largely unregulated market. As the financial crisis grew, firms that had offered credit default swap protection against declines in asset backed securities were overwhelmed, institutions were left with losses they thought had been protected against, and regulators lacked information to mitigate the systemic threat.[5]

Among other things, the Treasury Proposal calls for the SEC and CFTC to put in place "robust" margin re-

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[1] "Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, June 17, 2009 ("Treasury Proposal"), available at www.treasury.gov.

[2] Treasury Proposal, p. 70. The proposal reduces other agencies' roles – for example, creating a new "National Bank Supervisor" to take over prudential supervision and regulation responsibilities from the Office of the Comptroller of the Currency and the Office of Thrift Supervision, and a new "Consumer Financial Protection Agency" to undertake a consumer protection role that edges into the Federal Trade Commission's domain. Notably, the proposal explicitly provides that the SEC should maintain its current responsibilities as a market regulator, and that the new CFPA's jurisdiction should not extend to "investment products and services already regulated by the SEC." Treasury Proposal, pp. 4, 32, 55.

[3] Treasury Proposal, pp. 32, 70.

[4] Treasury Proposal, pp. 47-48. On June 22, 2009, SEC Chairman Schapiro told the Senate Banking Committee that the SEC should take primary responsibility for securities-related OTC derivatives, including credit default swaps, and that the CFTC would cover all other OTC derivatives. "SEC Chairman Outlines Plan Giving Agency Control Over Securities Derivatives," BNA Daily Report for Executives, June 23, 2009 [*see related report in this issue*].

[5] Treasury Proposal, p. 47.

quirements, other risk controls, and recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Additionally, regulated central counterparties used for clearing (and regulated trade repositories) would be required to make publicly available aggregate data on open positions and trading volumes. The regulated central counterparties would also be required to make individual trading and position data available on a confidential basis to the SEC and CFTC. Moreover, the Treasury wants the securities and commodities laws amended to ensure that the SEC and CFTC have "clear, unimpeded authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives," as well as to protect "less sophisticated counterparties such as small municipalities."[6]

C. Hedge Funds and Other Private Pools.

The Treasury proposes SEC registration under the Investment Advisers Act for all investment advisers to hedge funds, private equity funds and venture capital funds whose assets under management exceed "some modest threshold."[7] The Treasury notes that, during the period leading up to the present financial crisis, "[h]edge funds and other private pools of capital operated completely outside of the supervisory framework."[8]

Under the Treasury Proposal, the funds managed by these SEC registered advisers would be subject to (i) recordkeeping requirements; (ii) requirements for disclosures to investors, creditors and counterparties; and (iii) regulatory reporting, on a confidential basis, of the amount of assets under management, borrowings, off-balance sheet exposures, and other information to assess whether the fund or fund family "is so large, highly leveraged or interconnected that it poses a threat to financial stability." The funds would be subject to "regular, periodic examinations" by the SEC to assure compliance.[9] The SEC would be expected to share the reports it receives from the funds with the Federal Reserve.[10]

D. Money Market Funds.

The Treasury notes that when a single money market fund "broke the buck" following the Lehman Brothers failure last fall, it sparked a run on the entire money market mutual fund industry that was only stopped by the Treasury's Temporary Guarantee Program and new Federal Reserve liquidity facilities. To reduce this risk in the future, the Treasury Proposal favors having the SEC move forward with plans to strengthen the regulatory framework for money market funds, with particular attention given to maintaining substantial liquidity buffers, reducing the maximum weighted average maturity of fund assets, tightening credit concentration limits, improving credit risk analysis, and allowing fund boards to suspend redemptions in extraordinary circumstances.[11]

The Treasury Proposal would also require the President's Working Group on Financial Markets, which includes the SEC and other financial regulators, to complete a study by September 15, 2009, that would consider further changes for money market mutual funds to address systemic risk. These changes could include moving away from a stable net asset value, and requiring the funds to obtain access to reliable emergency liquidity facilities from private sources.[12]

E. Securitization Markets.

Enhanced Disclosure. Noting the SEC's ongoing work to improve disclosure practices in connection with the securitization process, the Treasury Proposal suggests additional authority for the SEC to require "robust ongoing reporting" by issuers of asset backed securities. Among other things, the proposal calls for disclosure of loan-level data broken down by loan broker or originator, and disclosure of the nature and extent of compensation and risk retention of brokers, originators and sponsors. The proposal also calls on the SEC and FINRA to expand the TRACE trade reporting database for corporate bonds to include asset backed securities.[13]

Credit Rating Agencies. The Treasury Proposal calls for credit rating agencies – already subject to SEC jurisdiction[14] – to have policies and procedures to manage and disclose conflicts, to differentiate ratings for structured versus unstructured debt, to clearly disclose the risks their ratings are designed to assess versus material risks not reflected in the ratings, and to publicly disclose their ratings methodologies for structured products, including qualitative reviews of originators. The proposal also requires credit rating agencies to disclose any unpublished data and methodologies to the SEC. Finally, the proposal calls on regulators to reduce their use of credit ratings in regulations and supervisory practices.[15]

F. Investor Protection.

Brokers Treated As Fiduciaries. The Treasury Proposal notes that brokers are permitted to give "incidental" investment advice to customers even though they are merely agents and not fiduciaries for the customers. Investment advisers, on the other hand, are held to the fiduciary standard. The Treasury Proposal would eliminate this disparate treatment with legislation requiring broker-dealers who provide investment advice to have

[6] Treasury Proposal, pp. 47-49.
[7] Treasury Proposal, p. 37.
[8] Treasury Proposal, p. 19.
[9] Treasury Proposal, p. 37.
[10] Treasury Proposal, p. 38. The Treasury Proposal urges other nations to adopt legislation this year that will put in place commitments the G-20 nations made at their April 2009 summit in London to require registration of hedge funds or their managers (subject to threshold limits), and to require hedge fund disclosure to facilitate systemic risk disclosure. Treasury Proposal, p. 85.

[11] Treasury Proposal, p. 38. On May 5, 2009, the SEC filed litigation against entities and individuals who operated the Reserve Primary Fund, the fund that "broke the buck" last September. SEC Litigation Rel. 21025 (May 5, 2009), available at www.sec.gov.
[12] Treasury Proposal, pp. 38-39.
[13] Treasury Proposal, p. 45.
[14] In September 2006, the Credit Rating Agency Reform Act gave the SEC jurisdiction over the rating agencies. Securities Exchange Act § 15E, 15 U.S.C. § 78o-7. Rating agencies must register with the SEC and disclose their procedures and methodologies for determining credit ratings; their policies for dealing with material nonpublic information and conflicts of interest; and on a confidential basis, the 20 largest issuers and subscribers using its services. On June 5, 2007, the SEC adopted final implementing rules. Exchange Act Rules 17g-1 through 17g-6, 17 C.F.R. §§ 240.17g-1 through 240.17g-6.
[15] Treasury Proposal, p. 46.

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the same fiduciary obligations as registered investment advisers. The Treasury observes that retail customers, as a practical matter, seek the same sort of advice about the wide array of available investment products from both brokers and investment advisers, and that both should be subject to the same legally enforceable duties to customers.[16]

Broker Compensation and Sales Practices. In connection with raising brokers' obligations in providing advice to the fiduciary level of investment advisers, the Treasury Proposal suggests eliminating certain forms of incentive-based compensation for all intermediaries, including both brokers and investment advisers. Specifically, it suggests giving the SEC the power to ban those forms of compensation that encourage intermediaries to put investors into products that, while profitable for the intermediary, are not in the investors' best interest. The Treasury Proposal also calls for legislation to ban certain conflicts of interest and sales practices deemed contrary to investors' interests, but what these would be is left for future definition.[17]

Possible End to Mandatory Arbitration. The Treasury Proposal questions whether investors should be required to agree at account opening to commit to arbitration of all future disputes and to waive access to the courts. Instead, the proposal suggests legislation that would let the SEC restrict or entirely ban the use by broker-dealers and investment advisers of mandatory arbitration clauses. However, the SEC would have to conduct a study on the impact of mandatory arbitration clauses before determining to restrict or limit such clauses.[18] In a similar vein, the Treasury suggests allowing the new Consumer Financial Protection Agency to study and then possibly restrict or ban the use of mandatory arbitration clauses for the financial products within its purview.[19]

Investor Advisory Committee at SEC. The Treasury Proposal commends the SEC for recently creating an Investor Advisory Committee composed of a diverse group of investors to advise the SEC on such topics as new products, trading strategies, fee structures and the effectiveness of disclosures.[20] The Treasury Proposal also includes the SEC in what would be a new "coordinating council" with the FTC, the Justice Department, the CFPA, and other federal and state agencies to identify regulatory gaps and make recommendations concerning consumer and investor protection.[21]

G. Disclosure and Accounting.

Point of Sale Disclosures. To promote investor understanding of particular products and their costs and risks, the Treasury Proposal calls for legislation authorizing the SEC to require delivery of summary prospectuses and other specified disclosures "at or before the point of sale." Currently prospectuses are delivered after the sale, along with the confirmation. The proposal also calls for additional appropriations for the SEC to engage in "consumer testing" of the effectiveness of disclosures through field tests and other forms of consumer outreach.[22]

Fair Value Accounting. The Treasury observes that the "interpretation and application of fair value accounting standards" during the present crisis raised significant "procyclicality" concerns – meaning that fair value accounting tended to "amplify" the business cycle. The Treasury urges the SEC to work with other accounting standard setters to identify changes to fair value accounting rules that could provide investors with both fair value information and "greater transparency regarding the cash flows management expects to receive by holding investments."[23]

Loan Loss Reserves at Financial Services Firms. Also on the subject of accounting, the Treasury suggests that the SEC and other accounting standard setters require financial firms to employ "more forward-looking" loan loss provisioning practices. Treasury proposes that financial firms consider factors that would cause loan losses to differ from recent historical experience, which would likely cause the firms to recognize higher provisions earlier in the credit cycle.[24]

H. Executive Compensation.

Compensation at Financial Services Firms. The Treasury expects the SEC to join with other federal financial regulators in setting standards for compensation at financial firms. The standards would then be "fully integrated into the supervisory process." The standards would align compensation with the interests of shareholders and with sound risk management, and such items as golden parachutes and supplemental retirement packages would come under particular scrutiny.[25]

"Say on Pay" Provisions for Public Companies. The Treasury Proposal supports legislation specifically authorizing the SEC to issue so-called "say on pay" rules that would require all public companies to include on their proxies a nonbinding shareholder vote on executive compensation. The Treasury notes that such requirements exist in many other countries, and that they build investor trust through enhanced shareholder participation and board accountability.[26]

Independent Compensation Consultants. Additional proposed legislation would allow the SEC to set rules requiring that compensation committees have the responsibility and resources to hire independent compensation consultants and outside counsel. The SEC would also set standards to ensure the independence of compensation consultants, to assure that compensation committees get expert advice that is objective.[27]

I. SEC Enforcement.

[16] Treasury Proposal, pp. 71-72. The SEC Chairman applauded the proposal to subject brokers to fiduciary standards, and commented that "[i]t is time that the regulatory regime for financial service providers reflects 21st century realities, rather than 1930s-era distinctions that are no longer relevant in today's market place." Remarks of SEC Chairman Mary L. Schapiro, June 18, 2009, to the New York Financial Writers Association, available at www.sec.gov.

[17] Treasury Proposal, pp. 71-72.

[18] Treasury Proposal, p. 72.

[19] Treasury Proposal, pp. 62-63. The new CFPA would deal with an array of non-securities financial products like credit cards and mortgages. Treasury Proposal, p. 55.

[20] On June 3, 2009, the SEC announced creation of its Investor Advisory Committee. SEC Press Release, June, 3, 2009, available at www.sec.gov.

[21] Treasury Proposal, pp. 73-74.

[22] Treasury Proposal, pp. 70-71.

[23] Treasury Proposal, pp. 30-31.

[24] Treasury Proposal, pp. 30-31.

[25] Treasury Proposal, pp. 29-30.

[26] Treasury Proposal, pp. 30, 73.

[27] Treasury Proposal, p. 30.

Paying for Tips. Each year, the SEC receives hundreds of thousands of tips concerning possible violations of the securities laws. Where tipsters present the SEC with "well-documented evidence of fraudulent activity," the Treasury Proposal would allow the SEC to pay a bounty that would be funded from money recovered in other SEC cases that is not distributed to investors.[28]

Industry-Wide Bars. The Treasury Proposal would allow the SEC to impose industry-wide (or "collateral") bars on individuals found to have engaged in serious violations.[29] The SEC presently can bar individuals only from the particular areas of the securities industry where they were working at the time of a violation. Thus, if an individual commits a violation while associated with a broker-dealer, the SEC can bar the individual from association with a broker-dealer but generally not from association with another regulated entity, such as an investment adviser. The SEC previously imposed collateral bars,[30] but the collateral bar remedy became unavailable after a 1999 decision holding that the SEC lacked statutory authority to impose such bars.[31]

J. Supervision of Financial Services Firms.

Resolution of Failing Firms. Where the largest subsidiary of a large financial firm in danger of failing is a broker-dealer, the Treasury Proposal would give the SEC the power to authorize resolution proceedings. Such authorization would require a two-thirds SEC vote, *i.e.* a vote of four of the five SEC commissioners. Additionally, the Treasury could then appoint the SEC as conservator or receiver of the failing firm, with "broad powers" to control the firm's operations, to sell or transfer assets, and to take other steps needed for orderly resolution of the firm's affairs.[32]

Ending CSE and SIBHC Supervision. The Treasury Proposal notes that in Fall 2008 the SEC terminated its voluntary supervision program for "consolidated supervised entities," *i.e.* large securities firms, following the failure or acquisition of three of the major stand-alone investment banks supervised as CSEs. The proposal recommends that the SEC also terminate its parallel program for "supervised investment bank holding companies," which has only one remaining SIBHC under supervision. The proposal takes the position that all investment banking firms seeking U.S. consolidated supervision should be regulated by the Federal Reserve.[33]

K. Paying for a Bulked-Up SEC.

In proposing the new Consumer Financial Protection Agency, the Treasury appears to suggest that it be self-funded, in much the same matter as the federal banking agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The Treasury Proposal calls for the CFPA to have a "stable funding stream, which could come in part from fees assessed on entities and transactions across the financial sector."[34]

With the substantial new responsibilities planned for the SEC – as well as the SEC's need for substantially greater resources to carry out its existing responsibilities – it will be appropriate to consider a similar reliable self-funding model for the SEC, a suggestion that has been made repeatedly over the last 20 years. As noted in recent remarks by an SEC commissioner, self-funding would permit the SEC to respond quickly to unexpected developments and, by freeing the SEC from competing in the appropriations process, facilitate the SEC's ability to engage in "long-range planning" and set "appropriate staffing levels."[35]

L. Conclusion.

In the months leading up to the Treasury Proposal, the SEC was aggressive in pushing a "change" agenda – for example, proposing SEC rules to better protect investor assets under the custody or control of investment advisers; to facilitate shareholder involvement in nominating corporate directors; and to restrict short selling in declining markets.

The SEC's new Chairman has now endorsed the recent Treasury Proposal as "the right course for investors and the capital markets."[36] With this level of SEC activity and commitment, leavened by informed debate over some of the more controversial proposals, we are unquestionably entering one of the most interesting periods in the development of securities regulation in this country.

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[28] Treasury Proposal, p. 72. SEC Chairman Schapiro has already asked Congress to give the SEC the ability to pay for useful tips concerning fraudulent conduct. Testimony of SEC Chairman Mary L. Schapiro before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, March 26, 2009, available at www.sec.gov. Chairman Schapiro noted that the SEC can presently compensate whistleblowers only in insider trading cases, where the SEC can pay up to 10% of penalties recovered to persons "who provide information leading to the imposition of such penalty." Securities Exchange Act, sec. 21A(e), 15 U.S.C. § 78u-1(e).

[29] Treasury Proposal, p. 72.

[30] *E.g. Matter of Westerfield*, Securities Exchange Act Rel. 41126, March 1, 1999 (Opinion of the Commission), available at www.sec.gov.

[31] *Teicher v. SEC*, 177 F.3d 1016, (D.C. Cir. 1999).

[32] Treasury Proposal, pp. 76-78.

[33] Treasury Proposal, pp. 36-37.

[34] Treasury Proposal, p. 58.

[35] Remarks of SEC Commissioner Luis Aguilar, March 18, 2009, to the Committee on Broker-Dealer Regulation and SEC Enforcement, District of Columbia Bar, available at www.sec.gov. Previous proposals for SEC self-funding have suggested that such funding come from the modest user fees the SEC already charges for certain filings and now simply pays into the Treasury. With self-funding, the SEC could set these fees at a level that would realistically meet its funding needs, subject to general Congressional oversight.

[36] Remarks of SEC Chairman Mary L. Schapiro, June 18, 2009, to the New York Financial Writers Association, available at www.sec.gov.

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