DAVIS POLK & WARDWELL

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To: Interested Persons

Re: Paulson Proposes Financial Regulatory Overhaul

Treasury Secretary Henry M. Paulson, Jr. has proposed a sweeping overhaul of the U.S. financial regulatory system that, for the first time, would bring insurance companies, hedge funds, private equity funds, venture capital funds and mortgage originators under direct federal supervision. The proposals, contained in a *Blueprint for Financial Regulatory Reform* officially released on March 31, would also reorganize the existing financial regulatory infrastructure in ways more fundamental than the United States has seen since the enactment of the Glass-Steagall Act of 1933 and the Securities Exchange Act of 1934.

Although some commentators are suggesting that the details of the *Blueprint* reflect an effort to limit the federal government's role in the financial markets, the fact that these proposals have been put forward by a Republican administration in the middle of a financial crisis in the last months of its tenure may indicate that a shift of thought has occurred among federal policymakers. In addition, the Administration can expect both the Federal Reserve and Democratic members of Congress to insist that the Federal Reserve have a broader and more permanent regulatory role with respect to the activities and capital requirements of any groups that have access to the discount window.

The *Blueprint* contains a series of proposals divided into "short term" recommendations, "intermediate term" recommendations and a "conceptual model for an 'optimal' regulatory framework." These are briefly described below.

Short-term recommendations

The short-term recommendations comprise a series of proposals to address the current market crisis, some of which can be accomplished without new legislation. According to Treasury, these are designed to "focus on taking action now to improve regulatory coordination and oversight in the wake of recent events in the credit and mortgage markets."

Short-term recommendations include:

- *Enhanced inter-agency coordination* – Expanding the membership and mandate of the President's Working Group on Financial Markets (PWG), an inter-agency coordinating body first established following the 1987 market break. PWG membership would be expanded from the heads of the Federal Reserve, Treasury, SEC and Commodity Futures Trading Commission (CFTC), to include the heads of the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Office of Thrift Supervision (OTS). PWG's mandate would be expanded from focusing on financial markets to mitigating systemic risk to the financial system, enhancing financial market integrity, promoting consumer and investor protection, and supporting capital markets efficiency and competitiveness.

- *Mortgage industry oversight* – Forming a Mortgage Origination Commission (MOC) composed of representatives from the Federal Reserve, OCC, OTS, FDIC, the National Credit Union Administration, and the Conference of State Bank Supervisors. MOC would oversee uniform minimum licensing qualification standards for state mortgage market participants. MOC would also evaluate, rate and report on the adequacy of each state's system for licensing and regulation of participants in the mortgage origination process.

- *Liquidity provisioning by the Federal Reserve* – Formalizing the process by which non-depository institutions can access the Federal Reserve's discount window to ensure that "the process is calibrated and transparent; appropriate conditions are attached to lending; and information flows to the Federal Reserve through on-site examination or other means as determined by the Federal Reserve are adequate."

Intermediate-term recommendations

Most of Treasury's intermediate-term recommendations would require Congressional action to implement, but could be accomplished without a major realignment of the existing federal financial regulatory infrastructure. As explained by Treasury, the intermediate recommendations "focus on eliminating some of the duplication of the U.S. regulatory system, but more importantly try to modernize the regulatory structure applicable to certain sectors in the financial services industry (banking, insurance, securities, and futures) within the current framework."

Intermediate-term recommendations include:

- *Federal regulation of the insurance industry* – Creating a dual state-federal regulatory system for the insurance industry similar to the dual regulatory system for banks by establishing an optional federal insurance charter (OFC). Treasury proposes the near-term creation of an Office of Insurance Oversight (OIO) that would serve as a vehicle for asserting greater federal pressure over the state-run National Association of

Insurance Commissioners; the functions of OIO would eventually be assumed by an Office of National Insurance (ONI) that would regulate all insurance companies holding an OFC.

- *Rationalizing the regulation of securities and futures* – Merging the SEC and the CFTC to provide unified oversight of the futures and securities industries. Treasury proposes the creation of a joint SEC-CFTC task force with equal representation from both agencies that would be responsible for both the structural and philosophical aspects of the merger. While the *Blueprint* plainly favors the CFTC's principles-based approach over the SEC's rules and enforcement-based approach, there is likely to be substantial opposition to any sort of lighter regulatory touch traditionally favored by the CFTC.

- *Investment Company Act reform* – Encouraging the SEC to use its exemptive authority to permit the public trading of non-U.S. collective investment vehicles "already actively trading" in foreign jurisdictions.

- *Rationalizing the regulation of broker-dealers and investment advisers* – Revisiting the existing statutory distinctions between the regulation of broker-dealers and investment advisers engaged in providing services to retail customers. Treasury also calls for the creation of a self-regulatory framework for investment advisers similar to what currently exists for broker-dealers through the Financial Industry Regulatory Authority (FINRA).

- *Abolishing the OTS* – Eliminating the federal thrift charter and abolishing the OTS in view of the diminished role of thrifts in the current mortgage market. The functions of the OTS would be transferred to the OCC.

- *Supervision of state-chartered banks* – Rationalizing the supervision of state-chartered banks by placing examination authority exclusively with the Federal Reserve, or the FDIC, but not both.

- *Payment and settlement system oversight* – Establishing a federal charter for "systemically important" payment and settlement systems and giving the Federal Reserve primary oversight responsibility.

Conceptual model for an "optimal" regulatory framework

The most sweeping changes are envisioned by Treasury's "optimal" regulatory framework, which reflects an "objectives based" approach modeled on systems currently in effect in Australia and the Netherlands. The framework would focus on three key goals:

- Market stability regulation to address overall conditions of financial market stability that could impact the real economy,

- Prudential (safety and soundness) financial regulation to address issues of limited market discipline caused by government guarantees and

- Business conduct regulation (linked to consumer protection regulation) to address standards for business practices.

Highlights of the "optimal" regulatory framework include:

- *Empowering three regulatory agencies to assume responsibility for the entire financial sector* – A market stability regulator (which would be the Federal Reserve) and two new agencies – a prudential financial regulator (Prudential Financial Regulatory Authority, or PFRA) and a business conduct regulator (Conduct of Business Regulatory Authority, or CBRA) – would largely replace the current alphabet soup of federal and state financial regulatory agencies.

    - *The Federal Reserve*, in its capacity as market stability regulator, would focus broadly on issues that can impact market stability across all types of financial institutions.

    - *PFRA* would focus on common elements of risk management across financial institutions.

    - *CBRA* would focus on achieving consistency in the treatment of financial products, eliminate disputes among regulatory agencies, and reduce gaps in regulation and supervision. CBRA would assume the SEC's current business conduct regulatory and enforcement authority over financial institutions.

- *Creating two additional regulatory authorities* – Treasury's optimal structure also calls for the creation of a federal insurance guarantee fund (FIGF) and a corporate finance regulatory authority (CFRA).

    - *FIGF* would accompany the system of federal oversight of insurance companies offering retail products where some type of government guarantee is present.

    - *CFRA* would have responsibility for general issues related to corporate oversight in public securities markets. This would include the SEC's current responsibilities over corporate disclosures, corporate governance, accounting oversight and similar issues.

- *Requiring all "financial institutions" to hold one of three federal "charters"* – Each "financial institution" – a term that applies broadly to any financial market participant or financial services provider, including banks, insurance companies, broker-dealers, hedge funds, private equity funds, venture capital funds and mutual funds – would become a federally "chartered" entity. Treasury's optimal structure would establish a federal insured depository institution (FIDI) charter, a federal insurance institution (FII) charter and a federal financial services provider (FFSP) charter.

- *FIDI* – the FIDI charter would be held by all depository institutions with federal deposit insurance. FIDIs would be regulated by the Federal Reserve and would continue to have access to discount window funding. The PFRA would be responsible for the financial regulation of FIDIs and the CBRA would be responsible for regulating FIDIs' business conduct.

- *FII* – the FII charter would be held by all insurance companies offering retail products where some type of government guarantee is present. FIGF would establish a uniform and consistent guarantee structure for FIIs. The PFRA would be responsible for the financial regulation of FIIs and the CBRA would be responsible for regulating FIIs' business conduct.

- *FFSP* – the FFSP charter would be held by all financial services providers that are not FIDIs or FIIs, including broker-dealers, hedge funds, private equity funds, venture capital funds and mutual funds. According to Treasury, the FFSP regime would include national standards of financial capacity, expertise and other requirements that must be satisfied to enter the business of providing financial services. FFSPs would have to remain in compliance with applicable standards and provide regular updates on their financial condition to the CBRA, the Federal Reserve, and the public as part of their standard public disclosures.

The *Blueprint* acknowledges the practical hurdles to achieving the "optimal" framework. Factors such as traditional notions of federalism, the existing Congressional committee structure, the agencies' powerful instincts for self-preservation and organized pressure from industry lobbyists, are likely to substantially delay or paralyze any attempt at a fundamental overhaul of the U.S. financial regulatory system.