

Treasury’s Rules of the Road for Regulatory Reform

March 30, 2009

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It has been obvious for some time that the outdated US system of financial regulation is badly in need of reform. There have, however, been limited opportunities to unblock the political obstacles to reform, despite valiant attempts by the Paulson Treasury to spur debate with its *Blueprint for a Modernized Financial Regulatory Structure* and also by many other groups, private, public and academic. The silver lining in the financial crisis may be that at least some elements of reform can now be achieved. Secretary Geithner’s carefully calibrated announcements last week—timed to become public just in advance of the G-20 meetings scheduled in London this week—are an attempt to stage regulatory reform in such a way that those elements where there is the deepest consensus are treated first before more divisive proposals. The need for increased systemic risk regulation and the need for resolution authority for a wide range of systemically important financial institutions are among those priority proposals.

In announcing his new “rules of the road,” Secretary Geithner identified four major axes of reform: addressing systemic risk, protecting consumers and investors, eliminating gaps in the regulatory structure and fostering international coordination. The most detailed elements of the reform package involved systemic risk, including proposed legislation for the resolution of systemically important financial institutions. More detailed frameworks for the other three areas are promised in the coming weeks.

This memorandum describes Treasury’s framework for regulatory reform, focusing on the comparatively more detailed proposals for addressing systemic risk, and sets forth some of the issues the government and the private sector may consider as the details are hammered out. A companion memorandum discusses Treasury’s proposed legislation for resolution authority. See Davis Polk & Wardwell’s memorandum entitled [Treasury’s Proposed Resolution Authority for Systemically Significant Financial Companies](#) dated March 30, 2009.

Davis Polk & Wardwell will continue to monitor new developments and issue further newsflashes and memoranda as further details become available.

Outline for Comprehensive Regulatory Reform

» Addressing systemic risk

- Single independent regulator with responsibility over all systemically important firms and critical payment and settlement systems
- Higher capital and risk management standards for systemically important firms
- Registration of all hedge fund advisers with assets under management above a certain threshold
- Comprehensive framework of oversight, protections and disclosure for the OTC derivatives market
- New requirements for money market funds to reduce the risk of rapid withdrawals
- Proposed legislation to provide resolution authority over systemically significant financial companies

» Protecting consumers and investors

» Eliminating gaps in regulatory structure

» Fostering international cooperation

Systemic Risk Regulator

Reflecting the deep consensus among policymakers that the US financial regulatory architecture needs a systemic regulator, the centerpiece of Treasury's proposal involves the creation of "a single independent regulator with responsibility over systemically important firms and critical payment and settlement systems." At

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to both of these questions is currently subject to intense debate and political wrangling, and like the Paulson Blueprint before it, the current Treasury proposal deliberately stays at a level of generality on these two politically charged points.

Who Will Be Regulated?

Treasury avoided proposing specific criteria to determine which financial firms would be considered "systemically important," *i.e.*, whose failure would pose a potential risk to the stability of the financial system, and therefore would be subject to regulation by the systemic risk regulator. Instead, Treasury has committed to work with Congress to craft a definition, and has suggested as relevant considerations:

- » the financial system's interdependence with the firm;
- » the firm's size, leverage (including off-balance sheet exposures) and degree of reliance on short-term funding; and
- » the firm's importance as a source of credit for households, businesses and governments and as a source of liquidity for the financial system.

Treasury cited the "limited oversight on a consolidated basis" of various non-bank financial institutions as a "fundamental cause" of the current financial crisis. Treasury's proposal would consolidate supervision of systemically important firms into a "single entity," and thereby prevent cherry-picking where "major financial institutions ... choose among consolidated supervision regimes and regulators or ... avoid consolidated supervision entirely."

Possible Systematic Risk Regulators

» Federal Reserve

- The Paulson Treasury took this position in its Blueprint for a Modernized Financial Regulatory Structure

» Council of Regulators

- Senate Banking Chairman Christopher Dodd recently said that Congress may consider establishing a council, consisting of the Federal Reserve, the FDIC and other federal regulatory agencies, to jointly oversee systemic risk
- Senator Susan Collins introduced a bill calling for the establishment of a financial stability council of regulators to be headed by an independent chairman

The proposal is clearly designed to capture financial firms, including hedge funds, insurance companies, payment systems, OTC dealers and possibly private equity firms, that grow so large as to become “systemically important” and to subject them to the regulation of the systemic risk regulator.

Payment and Settlement Systems. In light of the fact that weaknesses in the settlement systems for overnight and short-term lending markets and over-the-counter (“**OTC**”) derivatives can exacerbate financial distress, Treasury has stated that there should be a single entity with “broad and clear” authority over systemically important payment and settlement systems and activities. Otherwise, Treasury has not yet suggested criteria for determining which payment and settlement systems will be deemed systemically important, although we expect an expansive definition that includes many of the existing systems.

OTC Dealers. Treasury has suggested that *all* dealers in OTC derivative markets would be systemically important firms and thus subject to enhanced regulation. See below for discussion of the implications of Treasury’s proposal on OTC dealers.

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Who Will Be the Regulator?

Many commentators and policy makers have long thought that the Federal Reserve is the only institution that has the experience and capacity to be the systemic risk regulator, and we believe that the chances are still high that the Federal Reserve will take the lead role in this area. The Paulson Treasury took this position in its *Blueprint for a Modernized Financial Regulatory Structure*, stating that “[t]he Federal Reserve should assume this role in the optimal framework given its traditional central bank role of promoting overall macroeconomic stability.”

There have been dissenting voices recently, however, driven in part by fears that the Federal Reserve would be unaccountable and also, on the part of some, by criticisms of the Federal Reserve’s role in the financial crisis. Indeed, Senate Banking Chairman Christopher Dodd recently said that Congress may consider establishing a council, consisting of the Federal Reserve, the Federal Deposit Insurance Corporation (“**FDIC**”) and other federal regulatory agencies, to jointly oversee systemic risk. Senator Susan Collins introduced a bill on

Counter-Cyclical Capital Buffers

» **Counter-cyclical capital buffers will require certain firms to build additional capital buffers during economic upturns to mitigate the consequences of downturns**

» **Counter-cyclical capital buffers have recently become a popular topic of discussion for regulators and accounting standard setters worldwide**

- The Bank of Spain implements such a regime through its form of statistical “dynamic provisioning” for expected loan losses

» **Potential alternatives**

- It is not clear whether Treasury would endorse a capital regime that varies required capital ratios throughout the economic cycle
- An alternative would be to maintain constant capital ratios and create a buffer as a reserve, akin to the approach taken by the Bank of Spain, though it is not well settled how such a reserve would be calculated

March 23, 2009 calling for the establishment of a financial stability council of regulators to be headed by an independent chairman. Such a proposal raises unanswered questions about how an interagency task force would function as a systemic risk regulator, including how it would interact with other agencies and who would staff such a council. As a result, Secretary Geithner has carefully followed a path of not expressing a view on who ought to be the systemic regulator, instead expressing an intention to work with Congress on deciding this important issue later on.

Many questions remain with respect to the overall scope of the systemic risk regulator’s authority and how it will be integrated into the current regulatory framework. Secretary Geithner stated that the authority of existing federal regulators should be preserved and the systemic risk regulator should consult and coordinate with those regulators. He also stressed the importance of “appropriate checks and balances,” however, suggesting a regime where the systemic risk regulator may

need to obtain the concurrence of existing functional regulators in certain circumstances. The concept of “checks and balances” was also a key

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theme of his testimony regarding the resolution authority. Treasury’s outline, however, suggests that the systemic risk regulator would have primary authority to supervise, examine and set prudential requirements for at least certain systemically important firms.

Capital and Risk Management Standards

Treasury has provided an aspirational, if incomplete, answer to the question of what it foresees as the systemic risk regulatory agenda: tougher standards, primarily in the form of more stringent capital requirements, consolidated supervision and expansion of the prompt corrective action regime to include systemically important financial institutions as well as insured depository institutions.

Higher Standards for Capital

Recent events have drawn into much sharper focus the need for robust capital standards that contain adequate cushions to better withstand cyclical variations. Indeed, Secretary Geithner stressed in his Congressional testimony that a key

Financial Industry Risk Management Reports

- » ***Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007-2008, Institute of International Finance (July 2008)***
- » ***Containing Systemic Risk: The Road to Reform—The Report of the CRMPG III (August 2008)***
 - The Counterparty Risk Management Policy Group has made a number of recommendations regarding risk management standards. Their most recent report was released in August 2008

component of systemic risk regulation would be “capital, capital, capital.” Treasury’s proposal calls for more “conservative” and “robust” capital requirements for systemically important firms than for other financial firms, in order “to be effective in a wider range of deeply adverse economic scenarios than is typically required.” Treasury also suggested that the capital requirements be “less pro-cyclical” so that systemically important firms build “substantial” capital buffers during economic upturns to “avoid deleveraging in cyclical downturns.” See sidebar on prior page for a discussion of counter-cyclical capital buffers. Not explicitly stated was the important fact that neither Treasury nor any US regulator controls the agenda when it comes to the reform of capital requirements. Basel I, initiated in 1987, was the first major attempt at harmonization of standards across banks, and the setting of capital standards has been an international activity since then. International efforts are already underway to amend the capital standards through the Basel Committee and the Financial Stability Forum.

Higher Standards for Risk Management

Along with more stringent capital requirements, Treasury’s proposal broadly calls for “stricter liquidity, counterparty and credit risk management requirements” on systemically important firms. These requirements could require such firms “to aggregate counter-party risk exposures on an enterprise-wide basis within a matter of hours.” Increasing risk management standards has already been identified by the financial sector as an important task. Stricter liquidity and counterparty standards, imposed by the industry itself last fall, represent a significant improvement to current standards that heretofore have been more aspirational than real.

Prompt Corrective Action Regime

Treasury proposes to give the systemic regulator prompt corrective action powers over systemically significant financial institutions, similar to those currently enjoyed by the federal banking regulators with respect to insured depository institutions. Whereas capital requirements are a preventative measure, a prompt corrective action regime would be a first line of defense should the financial or operational health of a systemically important institution begin to decline. If exercised properly, such prompt corrective action has the potential to stop any further downward spiral of the firm’s financial or operational health and thereby avert the need to exercise proposed resolution authority powers.

Moral Hazard / “Too Big to Fail”

Concern regarding systemic risk regulation has centered around the concept of moral hazard. Commentators have argued that identification of particular firms as “systemically important” will mean that these firms are “too big to fail,” thus incentivizing them to engage in risky behavior and unfairly lowering their capital costs, as any future

losses would likely be subsidized by the government. Secretary Geithner acknowledged this risk, but contended that stringent capital requirements would restrict firms’ ability to engage in such risky behavior and

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thereby temper moral hazard concerns. This argument does not address the parallel concern that systemically important firms may enjoy greater access to capital through a naturally lower cost of debt, as market participants might infer that debt raised by such firms is essentially guaranteed by the government or at least subject to significant risk oversight by the government.

More generally, Secretary Geithner suggested that the purpose of Treasury’s regulatory reform proposals is precisely to avoid “too big to fail” situations. He said, “the critical test for any system should be: is our system strong enough that we can handle failure, even of the largest institutions. That is a critical objective that’s underpinning everything we do.” Secretary Geithner also argued that more robust capital requirements would be a natural limiting factor on the development of firms that are “too big to fail” and thereby help curb the need for future bailouts.

Secretary Geithner was careful to note that the proposal would not impose capital requirements on hedge funds generally, although he did leave the door open to possible future regulation should a hedge fund or other entity cross the “systemically important” threshold. See below for discussion of the implications of Treasury’s proposal on hedge funds.

Proposed Private Fund Regulation

- » **Mandatory registration with the SEC for advisers with assets under management over a certain threshold**
- » **Disclosure to the SEC of investors and trading partners**
 - Not clear whether this disclosure would be made public
- » **Confidential disclosures to the SEC to determine whether fund is “systemically important”**

Regulation of Private Funds

Registration Requirement

Treasury’s proposal would require all advisers to hedge funds and other private pools of capital, such as private equity funds and venture capital funds, with assets under management

over a certain as yet unspecified amount to register with the Securities and Exchange Commission (“SEC”). This would likely be accomplished by eliminating the so-called

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private adviser exemption from registration under the Investment Advisers Act of 1940 currently relied on by investment advisers with fewer than 15 clients. There is already a pending House bill that would eliminate this exemption. In her recent Congressional testimony, SEC Chairman Mary Schapiro said that the SEC is “considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves.”

Treasury’s proposal to require all hedge fund advisers with assets under management over a certain threshold to register with the SEC was expected. Although hedge funds are not widely thought to be a cause of the current financial crisis, the lack of transparency into their operations and their capacity to cause systemic risk, as demonstrated by the losses incurred by Long Term Capital Management in the late 1990s, has drawn scrutiny and persistent calls from Congress, foreign supervisors, and the public to require hedge fund advisers to register. Moreover, hedge funds have become direct competitors with banks and securities firms in many aspects of their businesses.

More controversial is Treasury’s proposed extension of the registration requirement to private equity funds and venture capital funds with assets under management over a certain threshold. Proponents of venture capital funds in particular argue that they play a crucial role in financing new technology companies, and that additional regulation would impede their critical role in fostering entrepreneurship. Private equity firms argue that they also play an important role in the economy that additional regulation would encumber and that their investment strategies do not raise the same transparency and systemic risk concerns as hedge funds. It is important to note, however, that as the

private equity and hedge fund asset classes have converged over the last several years, attempts to define their differences have been more difficult, and it is likely that Congress will take a broader approach to registration requirements.

A significant but as of yet unspecified factor is the threshold of assets under management that would trigger the registration requirement. Legislation recently introduced in the Senate would require hedge funds, rather than their advisers, to register with the SEC if they had over \$50 million in assets. This figure struck many in the investor community as surprisingly low, but could reflect an impulse to require almost all funds to be subject to SEC oversight.

It is also important to note that state securities regulators appear eager to increase regulation of private funds. It is likely that there will be few, if any, gaps between state and federal registration requirements. As a result, most advisers will be required to be registered with either the SEC or an appropriate state regulator.

Disclosure Requirements

Under Treasury's proposal, funds advised by an SEC-registered adviser would be required to disclose their investors and trading partners. Such funds would also be subject to new regulatory reporting requirements that would require them to provide the SEC with information to assess whether a fund or a fund family is so large or highly leveraged that it could pose systemic risk.

Treasury's proposal that all registered advisers would be subject to investor and counterparty disclosure requirements could represent a significant change for investment advisers and investors, although the proposal provides no detail as to the scope of disclosure required or whether the information would be made public. SEC-registered advisers are not currently required to disclose the names of their investors or their counterparties, so Treasury's proposal would

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be a marked change for both currently registered and newly registered advisers. Several concerns are raised by the required disclosure of investor information, including investor privacy concerns and, particularly for funds of funds, insight into their proprietary investment strategies. Wide disclosure of investor names should be thought through very carefully. Many investors are wary of their

privacy and may view disclosure negatively, potentially harming the US fund industry—a risk that is compounded by the concern that increased regulation of investment advisers and upcoming tax changes are likely to push some US hedge funds, private equity funds and investment advisers offshore. While some disclosure seems necessary, we think that wide disclosure may be too blunt a tool. In addition, mutual funds and other publicly traded companies are not required to disclose their investors, so the requirement for funds to disclose their investors would be disproportionate. Moreover, because of the bare-bones nature of the proposal, it is unclear what counterparty disclosure would entail. At one end of the spectrum, disclosure of a fund’s prime broker would not likely be controversial for most advisers. At the other end, trade-by-trade disclosure of counterparties could be much more complex, burdensome and expensive for many advisers.

Systemic Risk Regulation

In his Congressional testimony, Secretary Geithner noted that the Administration does not intend to regulate all hedge funds similarly to banks or to impose minimum capital requirements on all hedge funds. But he also indicated that if a systemic risk regulator determined that a fund did pose a systemic risk, the fund should be subject to a “fully elaborated set of capital requirements, [and] requirements on liquidity [and] on risk management that are applied and enforced on a consolidated basis by a competent authority.” While it is more likely that a hedge fund would be deemed systemically important than its adviser, it is possible that both could be brought within the oversight of the systemic risk regulator.

As noted above, Treasury also proposes requiring registered advisers to provide information to the SEC on a confidential basis to allow a determination of whether the fund or funds they advise pose a systemic risk to financial stability. The SEC would be required to share this information with the systemic risk regulator, which would determine whether a fund’s size, complexity, extent of leverage and other characteristics pose a systemic threat such that the fund or the fund’s family of funds should be subject to the capital, leverage and risk standards required for systemically important firms discussed above. There are currently no details available regarding what information would be required to be disclosed or what criteria would be employed to determine if a fund is a systemically important firm. Potential criteria could include the amount of a fund’s assets under management, its notional exposure or its participation in a particular market or a range of markets. As the proposal is debated and developed, we expect that many in the industry will push for clear criteria for

Treasury's Framework for Regulating CDS and Other OTC Derivatives

- » All OTC dealers are “systemically important”
- » Mandatory use of central counterparties for all “standardized” OTC derivatives
- » Mandatory use of data repositories and transparency on the part of the repositories
- » Encouragement of exchange trading
- » Other requirements
 - Eligibility requirements
 - Recordkeeping and reporting requirements
 - Possible disclosure and suitability requirements

when a systemic risk regulator can step in and subject a fund or fund family to the applicable prudential standards.

Regulation of CDS and Other OTC Derivatives

Treasury's proposal calls for the government “for the first time” to regulate the markets for credit default swaps (“CDS”) and other OTC derivatives. This is driven, in part, by the role that CDS played in AIG's problems and the fear that they could bring down other systemically important firms as well. Treasury's proposals deem all OTC dealers to be “systemically important” firms. Treasury's proposal that all OTC dealers are “systemically important” and therefore subject to regulation by the systemic risk regulator, regardless of how small or large, would represent a sea change for OTC dealers. This also raises the question of why Treasury proposes to treat OTC dealers differently from hedge funds, which are not all deemed to be systemically important. We note that unlike hedge funds, there was no reference in Treasury's proposal to a functional regulator for these entities. Treasury is not alone in calling for federal regulation of OTC derivatives. See the sidebar on the next page for highlights of other proposals.

Although Treasury has not provided details on the specific role that different regulators might play, it has previously discussed several components of the proposed regulatory agenda. Like the House Agriculture Committee bill, discussed in the sidebar on the next page, Treasury's proposal would make mandatory for all OTC derivatives certain structural elements that the CDS industry has already started moving toward.

Central Counterparties

Treasury's proposal would require all standardized OTC derivatives contracts to be cleared through “appropriately designed” central counterparties. A central counterparty is an entity that acts as the buyer to market sellers and as the seller to market buyers on the same transaction, eliminating counterparty risk.

Following a memorandum of understanding signed by the Federal Reserve, the CFTC and the SEC to support the development of central counterparties, both IntercontinentalExchange and the Chicago Mercantile Exchange moved quickly to launch US-based central counterparties for CDS. Treasury's proposal implies that existing central counterparties will need to be expanded—or new ones will need to be created—to handle not only more varieties of CDS, but all

Other Proposals for Regulation of OTC Derivatives

» **Bills introduced in the Senate in 2008:**

- One bill would have created a regulatory regime specifically for CDS
- The other would have placed all OTC derivatives under the oversight of the CFTC
- See the Davis Polk client memorandum entitled [Credit Default Swap and Regulatory Restructuring Bills Proposed by Senator Harkin and Senator Collins](#) dated December 1, 2008

» **House Agriculture Committee bill introduced:**

- In February 2009, the House Agriculture Committee approved a bill that would give regulatory authority over OTC derivatives markets to the CFTC
- Following the introduction of that bill to the House, it was widely reported that Chairman Barney Frank of the House Financial Services Committee opposed the bill and would be supporting a bill of his own to regulate these markets

types of OTC derivatives that cannot currently be cleared through existing central counterparties.

The central counterparty requirement only applies to “standardized” contracts. The CDS industry has worked to develop a standard contract. Counterparties expect to begin using it in April 2009, but its use will not be mandatory. Treasury could also view other types of contracts as “standardized.” Without identifying which contracts would be deemed “standardized,” Secretary Geithner’s testimony made clear his belief that there has been enough maturation across the OTC derivative market that requiring “standardized” contracts to trade through central counterparties would take a significant amount of risk out of the financial system. OTC derivatives contracts that it views as non-standardized would not be required to be cleared through central counterparties, but would still need to be reported to data repositories, as discussed below. Financial institutions and other traders may have commercial reasons for seeking to resist an expansive definition of “standardized” contracts, and the attendant central counterparty clearing requirement.

Although nine European dealer firms have committed to using EU-based central counterparties to clear CDS referencing EU-based entities, no such commitment has been made by US market participants. However, the industry has generally been supportive of central counterparty development.

Data Repositories

Treasury’s proposal would require all non-standard derivatives contracts to be reported to data repositories. The most likely choice would be The Depository Trust & Clearing Corporation (“DTCC”) Deriv/SERV Trade Information Warehouse. The Trade Information Warehouse is commonly used by derivatives market participants for post-trade processing, and a group of major CDS dealers already have voluntarily committed to Treasury’s proposal would require all non-standard derivative contracts to be reported to data repositories Treasury to using it for all eligible products, and to backload it with existing contracts, by fall 2009. It would need to expand to accommodate all kinds of derivatives contracts, or else new players would need to enter.

Treasury’s plan would also require data repositories to make a limited amount of aggregate data available to the public. DTCC Deriv/Serv has been doing this for CDS on a weekly basis since November 2008. The plan would further

increase transparency by requiring repositories to make individual counterparty data available on a confidential basis to federal regulators.

These reporting requirements would also apply to central counterparties. To date, central counterparties have not indicated any plans to make market data on their use available to the public, even on an aggregate basis. On the other hand, currently operating central counterparties are required to make data on individual trades available to the SEC under the terms of their respective exemptive orders. The extent and nature of the public data disclosure envisioned is far less than the public data stream that is currently mandated in the US equity, options and fixed-income markets. Given the mostly institutional character of the OTC derivatives market, the proposal reflects a moderate approach to market data, which may yield some greater level of transparency in the OTC derivatives market without unduly compromising the interest of the trading community in maintaining a degree of confidentiality with respect to trading strategies.

Other Treasury Initiatives

In addition to mandating use of central counterparties and data repositories, Treasury's proposal promises to introduce several new key initiatives to the regulatory framework.

Exchange Trading. Treasury's proposal would not mandate exchange trading for all OTC derivatives, as some reformers would prefer, but would "encourage" greater use of exchange-traded instruments. One way to accomplish this would be through more favorable margin and/or capital requirements for exchange traded instruments, although to date Treasury has not discussed the form it intends such encouragement to take.

Treasury's proposal would not mandate exchange trading for all OTC derivatives . . . but would "encourage" greater use of exchange-traded instruments

Proponents of exchange trading note that it increases price transparency and provides order protection mechanisms, while opponents argue that exchange trading leaves no room for customized contracts. Even where contracts are not customized, exchange trading has not always been successful. The Chicago Board Options Exchange, for instance, has been trading products modeled on CDS since June 2007, but trading volume has been fairly insignificant.

Eligibility Requirements. Treasury's proposal promises to strengthen eligibility requirements for trading in OTC derivatives and "will subject all dealers in OTC derivative markets to a strong regulatory and supervisory regime of systemically important firms." The proposal to treat all dealers in OTC derivatives as systemically important and to increase their regulation, while not shocking in the overall context, has not been previously widely discussed and the form it would take is

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unknown. Most likely, eligibility requirements would take the form of capital and margin requirements, akin to the prudential regulation proposed for systemically important firms discussed above.

Capital and margin standards are already imposed by central counterparties on their members for risk management purposes and these requirements have been accepted by the regulators of the central counterparties. Treasury's proposal may or may not impose more conservative capital and margin requirements, but in any case would likely extend such requirements to market participants whose contracts are not cleared through a central counterparty.

Recordkeeping and Reporting Requirements. Treasury's proposal includes recordkeeping and reporting requirements, which have been included in almost every government program introduced to date. Such requirements have already been imposed on central counterparties through the orders issued by the SEC exempting them from certain requirements of the Securities Exchange Act of 1934. IntercontinentalExchange and the Chicago Mercantile Exchange must maintain records for five years and must allow the records to be inspected by the SEC.

Disclosure and Suitability Requirements. Finally, Treasury's proposal promises to introduce investor "disclosure and suitability requirements." The role that such requirements might play is unclear. CDS investors are typically sophisticated market participants that may not benefit significantly from enhanced disclosure and suitability requirements. Moreover, much of the controversy surrounding CDS has been attributed to the large sellers of credit protection rather than the purchasers of CDS.

Investment Company Institute Proposal for Money Market Fund Reform

- » Periodic minimum liquidity requirements
- » Stress testing of funds' portfolios
- » Tightening of funds' portfolio maturity limits
- » Raising credit quality standards
- » Enhanced risk disclosure

Resolution Authority

On March 24, 2009, Secretary Geithner proposed in testimony to the House Financial Services Committee that the government have resolution authority with respect to certain non-bank financial institutions. On March 25, Treasury released proposed legislation to grant the government resolution authority over systemically significant financial companies.

Treasury proposals for an enhanced resolution authority for a broad range of financial institutions is covered in a companion Davis Polk & Wardwell memorandum, [Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies](#), also distributed today.

Regulation of Money Market Funds

Treasury's proposal also would strengthen the regulatory framework that governs money market funds, particularly to reduce the credit and risk profile of individual funds in order to make the industry as a whole less susceptible to sharp withdrawals.

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and, in her Congressional testimony, SEC Chairman Schapiro indicated that the SEC staff plans to present proposals this spring aimed at strengthening money market mutual funds by improving credit quality, maturity and liquidity standards.

Since the Reserve Primary Fund "broke-the-buck" in the wake of Lehman Brothers' collapse last September, leading investors to withdraw hundreds of billions of dollars from money market funds, threatening a run on the bank, triggering a collapse in the commercial paper market, and necessitating a temporary Federal Reserve guarantee of money market funds, there has been clear consensus that money market fund regulation must be reformed. Many have questioned whether the mandates of money market funds, a stable net asset value of \$1 and on-demand liquidity, are compatible. The Investment Company Institute, a mutual fund industry group, recently announced the recommendations of a working group dedicated to money market fund reform. See sidebar for details of this proposal. Any or all of these recommendations could be adopted by the SEC staff as it crafts the proposals Chairman Schapiro announced would be forthcoming later this spring.

Other Possible Proposals

» **Weakly Regulated Jurisdictions**

- The Secretary has said that Treasury will launch a new three-pronged initiative to address prudential supervision, tax havens and money laundering issues in weakly regulated jurisdictions

» **Executive Compensation Proposals**

- Treasury has suggested that there should be standards for executive compensation practices across all financial firms which encourage prudent risk taking, incentivize long-term performance of the firm rather than short-term profits and create incentives that do not overwhelm risk management frameworks, but has not yet put forth a specific proposal

Other Regulatory Reform Proposals

Apart from systemic risk regulation, Treasury’s proposal included a broad call for reform in three other areas: protecting consumers and investors, eliminating gaps in the regulatory structure and fostering international coordination. Treasury said it will release more details on these regulatory reform initiatives in the coming weeks. In addition, Treasury has said it will launch an initiative to address weakly regulated jurisdictions and that there should be standards for executive compensation, but has not yet put forth specific proposals.

Protecting Consumers and Investors

Treasury’s proposal will seek to “simplify financial decisions for households and . . . protect people from unfair and deceptive practices.” One consumer protection initiative gaining traction in Congress is the creation of a Financial Products Safety Commission. Bills have been introduced in both the House and the Senate to create such a commission, which would be modeled after the Consumer Products Safety Commission. The commission would investigate predatory or deceptive practices relating to products such as mortgages, credit cards and retirement savings accounts. In his Congressional testimony, Secretary Geithner indicated that he was aware of the proposals, but that Treasury has not yet taken a position on the concept of a Financial Products Safety Commission or

either of the bills introduced in Congress. A new, separate regulator in this area, however, may be inconsistent with the goals

One consumer protection initiative gaining traction in Congress is the creation of a Financial Products Safety Commission

of consolidating regulatory functions and avoiding further regulatory fragmentation.

Eliminating Gaps in the Regulatory Structure

Secretary Geithner offered three broad objectives relating to “eliminating gaps in the regulatory structure.” The terminology of “eliminating gaps in the regulatory structure” is a politically astute way to avoid, for now, embroiling the systemic regulator policy choices in the much more fraught issues of combining certain federal regulatory agencies which involve issues of turf in both the federal bureaucracies and among committees on Capitol Hill. Secretary Geithner stressed that “[w]e must end the practice of allowing banks and other financial companies to choose their regulator by changing their

International Regulatory Reform Reports

- » ***The Turner Review: A Regulatory Response to the Global Banking Crisis*, Lord Turner, UK FSA (March 2009)**
- » ***The Tripartite Review: A Review of the UK's Tripartite System of Financial Regulation in Relation to Financial Stability*, James Sassoon (March 2009)**
- » ***The High-Level Group on Financial Supervision in the EU*, Jacques de Larosiere (February 2009)**
- » ***The Road to the London Summit: The Plan for Recovery*, HM Government (February 2009)**
- » ***The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios*, World Economic Forum Report (January 2009)**
- » ***Financial Reform: A Framework for Financial Stability*, Group of Thirty (January 2009)**

charters.” He also proposed closing certain unspecified gaps in regulatory coverage. Finally, though Secretary Geithner argued for clearer assignments of regulatory authority by function to prevent conflicts among regulators over enforcement, he carefully avoided disclosing which model of consolidation he might favor.

Fostering International Coordination

Treasury’s proposals acknowledge the fact that, unlike the era of the Sarbanes-Oxley Act, the audience for regulatory restructuring in the United States cannot be solely domestic but must include international stakeholders as well, particularly the finance ministers who will attend the G-20 summit in London later this week. Even before the financial crisis, there was an active discussion among academics, market participants and policy makers about the need to converge, harmonize and, where possible, for regulators in one country to recognize or defer to the standards of a home country regulator. Indeed, the Basel standards on capital and the International Organization of Securities Commissioners had toiled in relative obscurity for a number of years on such issues. What has changed is that, before the financial crisis, the key risk was one of regulatory competition between countries or financial centers, most notably New York and London, which led to fears of an international regulatory race to the bottom. Secretary Geithner’s comment referring to “the imperative of raising standards globally and encouraging a race to the top . . . rather than a race to the bottom” is a reference to this new reality and a warning to those who might be tempted to return to the old ways of regulatory competition where “light touch” regulation was seen by some as a competitive advantage.

What had not been anticipated before the financial crisis is that, as recently stated by Bank of England Governor Mervyn King, “global banks are global in life, but national in death.”¹ As Secretary Geithner noted, the need for a more effective “globally coordinated approach to the resolution of globally active firms” is an imperative. The risk of inaction is that, as Chairman Bair recently testified, “[i]n this environment, ring-fencing—also known as every man for himself—may simply be the only rational response.”

Numerous international studies have comments on how the international system should be reformed as listed in the sidebar on the previous page. Treasury

¹ Steve Schifferes, *Can Banking Regulation Go Global?*, BBC NEWS (March 18, 2009).

suggests achieving these objectives through the Financial Stability Forum, which Treasury said should be reformed and strengthened “so that it can play a more effective role alongside the original Bretton Woods institutions.” Treasury pointed to steps in that direction that have already been taken, including an agreement to expand Financial Stability Forum membership to all G-20 countries. We expect more information on exactly how the Administration and the other G-20 countries expect to achieve these goals after the G-20 summit.

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References

- » [Treasury's Regulatory Reform Proposal Press Release](#) (March 26, 2009)
- » [Secretary Geithner's Testimony before the House Financial Services Committee on Regulatory Reform](#) (March 26, 2009)
- » [Treasury's Release on Resolution Authority](#) (March 25, 2009)
- » [Treasury's Proposed Legislation on Resolution Authority](#) (March 25, 2009)

For further details on Treasury's proposed legislation to grant the government resolution authority, please see our memorandum entitled [Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies](#).



This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.