CONGRESSIONAL HEARINGS EXPLORE PROPOSALS FOR NEW OR MODIFIED FINANCIAL REGULATION

INTRODUCTION

Two committees of the House of Representatives (the "House") held hearings last week focused on weaknesses in the U.S. financial regulatory system that have contributed to the current economic turmoil. The committees also solicited recommendations from government, industry, and academic experts for changes to that regulatory system. The timing of these hearings was unusual, since Congress has otherwise been out of session to allow Members to campaign for reelection. Additional hearings are scheduled and we expect the findings from all the hearings to form the basis of legislation that will be considered by the new Congress and the new Administration next year to reform, and potentially expand, federal regulation of financial services. This legislation and other proposals for regulatory reforms are likely to have a significant impact on financial services firms, markets, and products, and we will be carefully monitoring the unfolding process.

The hearings focused on three broad areas:

- The structure of proposed financial reform;
- Discussion of regulated entities; and
- Discussion of certain types of financial instruments.

This memorandum provides a brief description of the hearings and a summary of the recommendations with respect to financial reform in general and the specific entities and instruments that were discussed.

OVERVIEW

On Tuesday, October 21, the House Financial Services Committee, chaired by Rep. Barney Frank (D-MA), held a hearing on "The Future of Financial Services Regulation." This hearing featured testimony from a panel of economists, most of whom have held senior economic positions in previous Democratic Administrations, including: Alice Rivlin (Brookings Institution); Joseph Stiglitz (Columbia University); Joel Seligman (University of Rochester); and Manuel Johnson (JohnsonSmick International). The Committee also heard from a panel of heads of financial services industry trade associations, including: Steve Bartlett (Financial Services Roundtable); Edward Yingling (American Bankers Association); T. Timothy Ryan, Jr. (Securities Industry and Financial Markets Association) and Mike Washburn (Independent Community Bankers of America). This hearing was significant because the Financial Services Committee has primary jurisdiction over most financial services regulation. The witness testimony from this hearing may be found at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr102108.shtml.

On Wednesday and Thursday, October 22 and 23, the House Oversight and Government Reform Committee ("Oversight Committee"), chaired by Rep. Henry Waxman (D-CA), held two hearings. Although this Committee has no direct jurisdiction over financial services regulation, it has a broad mandate to review the efficiency and effectiveness of government programs and also has direct jurisdiction over legislation to reorganize agencies within the executive branch of government.

The Oversight Committee's October 22 hearing focused on "Credit Rating Agencies and the Financial Crisis." Testimony was heard from two panels. The first panel included Jerome Fons, a former Moody's Corporation executive; Frank Raiter, a former Standard & Poor's executive; and Sean Egan, Managing Director of Egan-Jones Ratings, a small credit ratings agency. The second panel consisted of the chief executive officer (the "CEO") of each of the three largest credit rating agencies, including Deven Sharma, president of S&P; Raymond McDaniel, CEO of Moody's; and Stephen Joynt, CEO of Fitch. The witness testimony from this hearing may be found at http://oversight.house.gov/story.asp?ID=2250.

The October 23 hearing addressed the role of the financial regulators in the current financial crisis. The Oversight Committee heard from former Federal Reserve Chairman Alan Greenspan, current Securities and Exchange Commission ("SEC") Chairman Christopher Cox, and former U.S. Treasury ("Treasury" or the "Treasury Department") Secretary John Snow. The Committee's questioning of the panelists and the related discussion were directed to the failure of the financial regulatory agencies to anticipate and address the factors that caused the financial crisis, and possible new measures that may be required to address those failures. Witness testimony from this hearing may be found at http://oversight.house.gov/story.asp?ID=2256.

Members of both Committees favorably discussed the option of having the House form a bipartisan special committee to draft comprehensive legislation incorporating various proposals to reform the current financial regulatory structure. There appeared to be a consensus that a single House committee could overcome the jurisdictional rivalries that have delayed or prevented such legislation in the past.

POSSIBLE REFORM ISSUES DISCUSSED AT THE HEARINGS

The "Blueprint for Regulatory Reform," released by the Treasury Department in March 2008 (the "Blueprint"), was a reference point for several of the witnesses. Among other proposals, the 212-page Blueprint, which may be found at http://www.treas.gov/offices/domestic-finance/regulatory-blueprint/, recommended that the current regulatory structure be replaced by three regulators: one with oversight of "market stability" throughout the financial sector; another with jurisdiction over the safety and soundness of financial institutions that are supported by federal guarantees; and a third authorized to protect investors and consumers. While the new Administration that will assume office in January 2009 will almost certainly have its own proposals for financial regulation, some elements of the Blueprint will probably be included because the Blueprint was the product of extensive work with the financial services industry and federal regulators. Many of the witnesses characterized the Blueprint as a good starting point while nonetheless suggesting that it is incomplete and making a number of additional recommendations, as summarized below.

1. Overall Structure of Financial Regulation

There appeared to be a general consensus among the Financial Services Committee witnesses that some kind of "super regulator" should be established to monitor the entire financial system and, potentially, have authority to mobilize and coordinate a comprehensive federal response to a financial emergency by the regulators which have functional regulatory authority over the separate types of financial institutions. This super regulator would act as a "financial markets stability regulator" or a "systemic oversight regulator." Alternatively, such authority could be vested in the Federal Reserve Board, which would be given authority to supervise "significant financial institutions."

Many (but not all) of the witnesses also supported consolidation of functional financial regulation into fewer agencies with more resources, including merger of the SEC with the Commodity Futures Trading Commission (the "CFTC") and possible unification of the five agencies that currently regulate depository institutions. Rep. Paul Kanjorski (D-PA), who chairs the Financial Services Committee's Subcommittee on Capital Markets, called for fewer agencies with more flexibility and adequate resources under a regime that fosters "cooperation rather than competition" among regulators.

In the Oversight Committee's hearing on the crisis, witnesses and members agreed that failings in the existing financial regulatory structure either led to or exacerbated the current financial crisis. Former Treasury Secretary Snow took the position that the current crisis could have been mitigated if there had been one financial regulatory agency that had authority over all financial markets and could have seen the whole picture. Snow called on Congress to adopt the proposal in Treasury's Blueprint for a consolidated financial regulator – bringing the SEC and the CFTC under the umbrella of the Federal Reserve.

SEC Chairman Cox argued that a consolidated financial regulator would be less effective and instead suggested that the CFTC and the SEC should be combined, but otherwise kept independent of the Federal Reserve. Former Federal Reserve Chairman Greenspan appeared to support keeping the SEC and the Federal Reserve separate but disagreed that combining the agencies would result in a regulator with more information or better decision-making ability. Oversight Committee members did not express opinions on which of these options they supported, though it did appear from reactions to the panelists' testimony that there was general agreement that some restructuring of the financial regulators is needed.

2. Specific Regulatory Issues (Arranged Alphabetically)

Accounting Standards

At the Financial Services Committee hearing, the American Bankers Association ("ABA") noted the "critical importance" of accounting policy, asserting that accounting standards (including mark-to-market accounting) have a "profound impact" on the financial system and must be part of any "systemic risk calculation." The ABA recommended establishing an accounting oversight board chaired by the chairman of the "systemic" or "stability" regulator that would include the SEC

Chairman. Accounting standards would continue to be developed by a private sector body, but the board would have oversight authority.

Banks and Bank Holding Companies

Much of the discussion of bank regulation during the October 23 Oversight Committee hearing focused on the effectiveness of the Federal Reserve's oversight of banks. Former Secretary Snow called for the federal government to provide guarantees of interbank loans, as has been recently undertaken in the United Kingdom. With respect to bank holding companies, several witnesses at the Financial Services Committee hearing proposed more extensive regulation of bank holding companies, generally through expanded authority for the Federal Reserve.

Credit Default Swaps

In the Financial Services Committee hearing, there was substantial support for federal regulation of credit default swaps ("CDS"), both among Committee members and some of the witnesses. Although there was no uniform consensus as to what agency should be empowered to regulate CDS, there appeared to be an inclination toward the SEC. However, some witnesses suggested that specific regulatory proposals be deferred until Congress has a chance to assess the success of the credit-swaps clearinghouse being coordinated by the Federal Reserve Bank of New York.

CDS were also identified during the October 23 Oversight Committee hearing as a source of instability in the financial markets and an area of focus for future regulation. These instruments are not now federally regulated and, in fact, were specifically excluded from the regulatory purview of the SEC and the CFTC by the Commodity Futures Modernization Act of 2000.

Both Greenspan and Cox called for a central clearinghouse for CDS settlements. Chairman Cox further advocated statutory authority for the SEC over CDS, suggesting that requiring disclosure and subjecting the instruments to federal antifraud provisions would help the government better understand the CDS market and would facilitate the market's functioning.

Credit Rating Agencies

The Oversight Committee hearing on rating agencies focused largely on their role in the financial crisis, particularly with respect to ratings issued on subprime asset-backed securities and collateralized debt obligations ("CDOs").

Committee members and witnesses (other than the rating agencies' CEOs) criticized issuer-paid credit ratings as fraught with conflicts of interest that the major credit rating agencies failed to manage because it was not in their commercial interest to do so. As a result, issuers engaged in "ratings shopping" – offering business to the agency that would provide the best rating of a security, in some cases allegedly without conducting appropriate due diligence. There was also criticism of the SEC's oversight of the ratings agencies, i.e., that the SEC failed to adopt rules governing the ratings agencies in a timely fashion.

Rating agency CEOs acknowledged flaws in the models and methodologies for rating securities based on subprime loans (particularly in assuming that housing prices would never fall more than a certain percent). They opposed banning issuer-paid ratings but conceded the need for more transparency of data underlying ratings and agreed that the ratings models and methodologies should be updated and made more robust.

Some Oversight Committee members supported additional credit rating agency regulation, probably through the SEC.

Hedge Funds

Several witnesses and members at the Financial Services Committee hearing mentioned hedge fund regulation among the "regulatory gaps" that Congress should fill through enactment of a comprehensive reform measure, but did not suggest any specific provisions.

Insurance Companies

Although there was no lengthy discussion of federal regulation of insurance companies, a few witnesses at the Financial Services Committee hearing called the current regime of state regulation "a vestige of the 19th century" and recommended that it be reexamined.

Investment Banks

During the October 23 Oversight Committee hearing, Chairman Cox answered numerous questions regarding the cancelled Consolidated Supervised Entities ("CSE") program, which, on a voluntary basis, set disclosure and liquidity guidelines for investment banks. Chairman Cox took the position that voluntary standards were insufficient to regulate investment bank holding companies. One member of the Committee recommended that such firms should be subject to capital requirements and greater oversight.

Municipal Issuers

Since state and local governments are not subject to the disclosure requirements in the federal securities laws, there is generally less information available on their debt securities. During the October 23 Oversight Committee hearing, Chairman Cox cited this opacity as a source of uncertainty in collateralized debt markets. Cox recommended amending federal securities laws to require disclosures by municipalities similar to those required of other issuers of securities issued to the public.

Other Derivatives and Complex Financial Instruments

Several witnesses at the Financial Services Committee hearing called for federal regulation of derivatives and other complex financial instruments, possibly as part of a "Financial Product Safety Commission" that would set guidelines and approve the use of a variety of financial products. Reps. Kanjorski and Carolyn Maloney (D-NY), who chairs the Financial Services Committee's

Subcommittee on Financial Institutions, also supported federal regulation of derivatives. However, it was unclear what types of instruments should be covered by additional regulation.

CONCLUSION

Although the new Congress will not convene until January 2009, and will not likely begin substantive work on most major issues until at least March, it is clear that reform of financial regulation will be high on the legislative agenda. Legislation to modify and expand the current regulatory system is expected to be comprehensive and to reach sectors and/or products in the financial services industry that have not heretofore been federally regulated. Therefore, it is important that financial firms monitor the development of this legislation and prepare for potentially momentous changes in government regulation and oversight of financial firms and their activities and products.

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This memorandum was prepared by Russell Smith and Benjamin Haskin. If you have any questions about this memorandum, please contact any of the members of the WF&G New Administration/Congress Task Force listed below or the attorney with whom you regularly work. The New Administration/Congress Task Force has been formed to provide information and targeted advice, and to respond to questions from clients in connection with the legislative, regulatory, and enforcement and compliance initiatives, and potential litigation, that will result from the new U.S. presidential administration and Congress to be elected on November 4, 2008.

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