

## Treasury Department Proposes Reform of Financial Regulation Affecting Banks, Broker-Dealers and Commodities Firms

April 4, 2008

On March 31, 2008, the Department of the Treasury released its "Blueprint for a Modernized Financial Regulatory Structure" (the "Blueprint"). Unlike many other proposals currently being discussed, the Blueprint does not focus on resolving issues relating to subprime mortgages.<sup>1</sup> Rather, its principal concern is with regulatory efficiency as an economically desirable goal for the US financial system. Despite this focus, some of the Blueprint's proposals could have an effect on the resolution of some of the questions that have arisen as a result of the subprime crisis.

The emphasis on devising an efficient regulatory regime for the financial services sector leads to an emphasis on the concept of optimality and to a discussion that is unusual in its abstractness and breadth. The Blueprint covers in one way or another substantially all of the financial services provided in the US, not just areas of the economy or governmental agencies for which the Department of the Treasury is directly responsible. For example, it makes proposals regarding the responsibility of the Federal Reserve Board as well as the structure of the national insurance business. It discusses the structure of these services less in terms of specific problems that need to be resolved and more in terms of how different styles of regulation might be more efficient and what the consequences for the US regulatory system would be if the style favored by the Blueprint were implemented.

### Basic Assumptions of the Blueprint

The fundamental premise of the Blueprint is that financial services providers and financial products are converging. Because the existing regulatory system is organized basically along industry lines (for example, insurance products and insurance companies are regulated primarily by state insurance regulators), jurisdictional problems arise when products combine elements of insurance, banking, securities and futures. It can become unclear who is responsible for regulating a particular product or its provider, whether the product is regulated by anyone, or even whether the product can be offered at all in the US. Referring to the current US regulatory style as "functional,"<sup>2</sup> the Blueprint describes it as exhibiting

...several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor

<sup>1</sup> The President's Working Group, however, released a proposal recently that is intended to respond to the subprime crisis.

<sup>2</sup> In the somewhat misleading sense made popular by the Gramm-Leach-Bliley Act.

Americas

Europe

Russia/CIS

Asia Pacific

Africa

Middle East

[www.dl.com](http://www.dl.com)

systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. In addition, the inability of any regulator to take coordinated action throughout the financial system makes it more difficult to address problems related to financial market stability.<sup>3</sup>

Another purported inadequacy of the functional approach is its tendency to hamper product innovation by making jurisdictional disputes among regulators nearly inevitable. The examples given of such disputes are "the prolonged process surrounding the development of US Basel II capital rules, the characterization of a financial product as a security or a futures contract, and the scope of banks' insurance sales."<sup>4</sup> Finally, functional regulation allegedly results in a failure to capture similarities across institutions in terms of monitoring capital requirements and providing consumer protection.

### **Short-Term Recommendations**

To overcome these inadequacies, the Blueprint recommends short-term, intermediate-term and long-term changes. For the short term, the Blueprint recommends further study of the system by a wider group of agencies and the establishment of a group to study problems in mortgage origination. The mortgage origination study is clearly related to the current situation in the financial markets and may have continued validity even if Congress passes measures for immediate financial relief for homeowners and others. One other short-term proposal also is of immediate relevance, namely that work begin on making the process by which the Federal Reserve makes loans to non-depository institutions more rule-governed, transparent and based upon better access to information about such institutions.<sup>5</sup>

### **Intermediate-Term Recommendations**

For the intermediate term, the Blueprint recommends phasing out the federal thrift charter and the separate federal regulator of thrifts; eliminating overlapping responsibility for the oversight of state banks; making the regulation of payment systems in the US more uniform; establishing a parallel system of federal insurance regulation;<sup>6</sup> merging the Securities and Exchange Commission (the

---

<sup>3</sup> Blueprint, p. 4.

<sup>4</sup> Blueprint, p. 5.

<sup>5</sup> This reference to non-depository institutions is hard to reconcile with the apparent limitation of data gathering to depository institutions in the discussion of the role of the Federal Reserve as market stability regulator.

<sup>6</sup> See our Client Alert, **TREASURY'S BLUEPRINT ADDS TWIST ON ITS MARCH TO OFC: AN INTERIM "OFFICE OF INSURANCE OVERSIGHT" TO ADDRESS INTERNATIONAL REGULATORY AND**

"SEC") and the Commodity Futures Trading Commission (the "CFTC");<sup>7</sup> harmonizing the regulation of broker-dealers and investment advisers; improving aspects of the way in which exchanges and self-regulatory organizations are supervised; speeding up product approval under the Investment Company Act of 1940; and authorizing a new type of global investment company. Some of these intermediate-term recommendations have a clear bearing on regulatory efficiency and can be justified (or opposed) on the basis of something less than a general theory of optimal regulation. Unless the wording of any final rule adopting such changes would for some reason have the effect of permitting the sale of products whose abuse could cause a financial crisis,<sup>8</sup> the kinds of issues raised by these recommendations, no matter how interesting, have little to do with those raised by the subprime crisis. Except for the organizational consequences of merging the SEC and the CFTC, they would also represent largely incremental changes in the current system of regulation.

### **Long-Term Recommendations**

Unlike its short- and intermediate-term recommendations, the Blueprint's long-term recommendations expressly aim to create an optimal regulatory system. The discussion proceeds by first comparing the existing functional regulation to a "functional-based" system which has separate regulators for the different activities in which an entity engages; a single-regulator system as in the United Kingdom; and an "objectives-based" approach as practiced in Australia and The Netherlands.

#### *Styles of Regulation*

The Blueprint implicitly rejects the existing system of functional regulation as too obviously flawed to require much discussion of the value of incremental change. It rejects "functionally-based" regulation as raising definitional questions (what are the boundaries of a function?), inviting jurisdictional disputes and blurring responsibility for the health of the system as a whole. That these kinds of problems could arise in such a system (as well as the one we have now) seems clear.

---

**OTHER POLICY ISSUES**, dated April 2, 2008, for further information on the insurance component of the Blueprint.

<sup>7</sup> In this and one or two other contexts, the Blueprint mentions the possible superiority of "principles-based" regulation. Any effort to adopt this regulatory style in the US based on experience in other jurisdictions should consider the extent (if any) to which the apparent success of that style in other jurisdictions is dependent on special characteristics of those jurisdictions, such as the relationship between regulator and regulated, attitudes toward government, the extent to which the failure to disclose compliance violations can be the object of private litigation and the general level (or lack) of private litigiousness. Of course, significant efforts to implement principles-based regulations have already been made in the US. Regulation AB of the SEC is one example.

<sup>8</sup> For example, by inadvertently encouraging a form of investment structure that could be exploited to create a new type of market risk.

What is less clear is the persuasiveness of the Blueprint's arguments against a single regulator. These arguments are largely what might be called psycho-bureaucratic: the regulator might neglect one of its tasks at the expense of another; synergies might be limited; resources might not be allocated correctly; the regulator might try to focus on everything as opposed to areas with greatest risk to the market, namely abuse of government guaranties; the regulator might not get along with the central bank (i.e., the Federal Reserve). In addition, the Blueprint expresses concern that in the US a single regulator would have to be too big to be tolerated. This last argument might well explain the reason our present system of regulation has been so stable. The psycho-bureaucratic arguments can, unfortunately, probably be raised in one form or another against any system of regulation.

### *Objectives-Based Regulation*

In any event, the Blueprint's preferred regulatory regime is the "objectives-based" system. Regulatory organizations would be established to pursue a chosen set of objectives: market stability, prudence (in financial structure), and business conduct (including consumer protection). Creating regulators around these objectives would establish environments for "natural synergies" and focus efforts on "key types of market failures."<sup>9</sup> Why a single regulator would be incapable of organizing itself in this manner is not articulated. One potential drawback of objectives-based systems is, however, discussed: heightened difficulty in ensuring effective communication among regulators who are focused on their own specific sets of objectives. Why this problem would not be ideally resolved by having a single regulator is not, however, touched upon. The issue of communication returns in various guises throughout the rest of the Blueprint, since each objectives-based regulator must be assured sufficient access to information in the hands of the other regulators in order to reach its objective.

### *Market Stability*

After having chosen to recommend an objectives-based approach, the Blueprint proceeds to sketch how such a system might look. The Federal Reserve would become the regulator responsible for general market stability. A single regulator would be established to supervise the prudence with which firms benefiting from a government guaranty structure their finances. Another new regulator would oversee the manner in which financial firms interact with one another and their customers and would also be responsible for licensing.<sup>10</sup> At this level of generality, several issues would appear to need resolution. Why should the

---

<sup>9</sup> Blueprint, p. 142. What kinds of market failures are being referred to is unclear.

<sup>10</sup> However, the discussion of prudential regulation also covers the creation of new types of banking and insurance licenses. It remains unclear from the wording of the Blueprint itself whether the prudential regulator would license banks and the business conduct regulator would license other financial services institutions (other than insurers), or whether the business conduct regulator would license everyone (other than insurers). The former distribution of authority presumably makes more sense than the latter and presumably was intended.

regulator responsible for market stability not also be the prudential regulator? What does it mean to limit concern for market stability to situations in which dislocations might "spill over" into the "overall economy"?<sup>11</sup> Why should prudential supervision be applicable only to firms benefiting from government guaranties? What do licensing and the definition of permissible activities have to do with sales practices?

None of these questions receives the level of treatment it will ultimately require if any large-scale changes are to be made to the US regulatory system. For example, the Blueprint discusses the role of the Federal Reserve as market-stability regulator in terms of collateralized debt obligations. That role is characterized largely as gathering and disseminating data, followed, if necessary, by some sort of corrective action. Gathering data will certainly be important in such situations; it will probably be even more important to determine what kinds of data might be necessary and which types of data need to be kept confidential by the Federal Reserve because they would reveal the competitive strategies of individual firms.

However, an important part of understanding what (if anything) could or should be done about structured investments<sup>12</sup> - and what type of prudential oversight might be appropriate to avoid or meliorate the types of problems we are seeing today - might conceivably also involve more than collecting data. For example, the market-stability regulator might conclude that adjustments are necessary to the manner in which banks and other institutions structure their retained involvement in some investments of that kind. Making any such adjustments would presumably be a type of prudential regulation. This is likely to be particularly true for special purpose investment vehicles with continuing liquidity requirements. Such vehicles could perhaps be described as bank clones or "bankoids," intermediation vehicles that match long-term and short-term exposures like banks but do not undergo the same type of on-going regulation and supervision to which banks are subject.

In addition, determining the point at which action should be taken would require the ability to establish where the overall (as opposed to the merely financial) economy begins. Given the salience of the financial economy in modern societies and the extent of even individual, consumer involvement in that economy, the phrase "overall economy" is more likely to be something like a synonym for "serious," rather than an objective indicator. Finally, the seriousness of the subprime crisis and manner in which anxiety spread did not appear to be directly correlated with the existence or absence of government guaranties. Consequently, although the presence of such a guaranty may call for heightened concern, it does not seem to be a criterion sufficient to define the limits of prudential regulatory supervision.

---

<sup>11</sup>.Blueprint, p. 146.

<sup>12</sup> Of which collateralized debt obligations are just one type.

The issue of government guaranties also plays another role in the Blueprint's allocation of responsibilities. The existence of guaranties is treated as creating the possibility of moral hazard (the taking of unmotivated risk because of the protection offered by the guaranties). This risk is, in turn, seen as undermining market discipline (without much consideration of the extent of the guaranties). The Blueprint also treats prudential regulation as undermining such discipline, because market participants would allegedly rely on the regulator rather than on their own wits. In this regard, the Blueprint would appear to under-emphasize the extent to which guaranties and prudential regulation make complex financial markets possible in the first place.<sup>13</sup> In addition, it would appear to undervalue any increase in the kinds of non-market powers that could be necessary for the effective operation of a market-stability regulator, given at least some views of the subprime crisis.

By focusing on guaranties, the Blueprint also misses the opportunity to consider the salience of certain firms or activities in the network of the marketplace, rather than the presence of guaranties, as a potentially crucial factor in the need for a market-stability regulator. The notion of salience already receives some attention when implicit guaranties and the existence of entities that are "too big to fail" are discussed. However, salience could in some instances be more important than, and different from, size.

As the Blueprint proceeds from this general conceptual position, it proposes numerous, more specific regulatory changes that it treats as following from it. As market stability regulator, the Federal Reserve would continue to make monetary policy, serve as lender of last resort and oversee the payment and settlement system. In addition, it would become a "macro-prudential regulator." As a macro-prudential regulator, the Federal Reserve would need access to more types of information than it can currently obtain. The Blueprint seems<sup>14</sup> to limit this information to the kinds that can be obtained from institutions regulated by the prudential or the business conduct regulator. Unless essentially all financial institutions are regulated by those agencies, this restriction (if actually intended) on the availability of information would appear to ignore some of the lessons of the subprime crisis. It could be necessary in some situations to demand information from entities not otherwise subject to regulation. As market-stability regulator, the Federal Reserve would also publish, or require the publication of, data it deemed useful for the purpose of allowing market participants to correctly understand the degree and distribution of risk inherent in the market.

### *Financial Prudence*

The role of the prudential financial regulator is introduced by the discussion of two new charters,<sup>15</sup> one for federally insured depository institutions and one for

---

<sup>13</sup> The value of deposit insurance is, however, mentioned on p. 158 of the Blueprint.

<sup>14</sup> Third paragraph, p. 147.

<sup>15</sup> Or licenses. Given the discussion in the Blueprint of the shifts in regulatory responsibilities and the reductions in restrictions on the choice of entity types used for banking and other financial

federal insurance institutions. Establishing a federal license for all types of depository institutions purportedly would "create a level playing field where competition among financial institutions can take place on an economic basis, rather than on the basis of regulatory differences."<sup>16</sup> In terms of banking powers, however, this more or less "level playing field" has existed for some time, since the powers of national banks serve as the general standard for everyone. The permissible activities recommended by the Blueprint for depository institutions are, in fact, those of national banks. A principal advantage of the new federal license would presumably be a version of preemption. The Blueprint discusses what powers would be left to the states. Federal deposit insurance would be available only to institutions with the new federal license; those institutions would be subject to prudential regulation. The role of federal depository institutions within a holding company structure receives some attention, particularly with respect to affiliate transactions. The Blueprint briefly considers the possibility that depository institutions not be allowed to engage in affiliate transactions at all.<sup>17</sup> Ultimately, the Blueprint seems to favor a rather free holding company structure, including one that eliminates the current general prohibition on mixing commercial and financial activities. If that prohibition were removed, a substantial portion of the differential treatment accorded to certain foreign banks, which have a long tradition of mixing finance and commerce, could disappear. However, the Blueprint contains no explicit discussion of the regulation of foreign banks in the United States.

The Blueprint treats the Federal Deposit Insurance Corporation (the "FDIC") as being only an insurer, rather than as a prudential regulator, since its role as supervisor of state banks that are not members of the Federal Reserve System would disappear. Explaining how the FDIC would obtain the data and experience it needs to be an effective insurer requires, as mentioned in a more general context above, that the lines of demarcation drawn by objectives-based theory be partially ignored. How this arrangement would affect the FDIC's ability to resolve insolvencies is also not discussed.

### *Business Conduct*

The business conduct regulator proposed in the Blueprint would appear to have the most clearly defined set of responsibilities, insofar as these responsibilities relate to disclosure, business practices and enforcement. The notion of having national, as opposed to state, conduct standards and a more uniform system of enforcement appears intuitively to be correct. The proposed federal financial services provider charter may support this uniformity, although the term charter may somewhat obscure what ultimately goes on. For example, if the "charter" can vary depending on the activities in which the provider is engaged, then the

---

services, it would appear preferable to talk about licenses and permissible activities (or powers), rather than charters.

<sup>16</sup> Blueprint, p. 160.

<sup>17</sup> P. 163, third full paragraph.

term will simply mean that the business conduct regulator can issue a range of activity licenses, each of which is like those that are currently available. The principal result of having a federal charter will, in that case, be to create preemption. Such a result has less to do with objectives-based regulation and more to do with having a single (federal) regulator.

How much licensing authority the Blueprint allocates to this regulator remains unclear, as discussed above, as does the actual transferability of skills between supervision of sales of automobile insurance and sales of wheat futures. Whether having uniform conduct regulation also enhances "competitiveness" is also less than clear in this context. In addition, the passing mention of a "general lending" license in the Blueprint's discussion of the proposed federal charter<sup>18</sup> also leaves open a large range of issues. For example, would all types of lenders (banking and non-banking) need a license? A significant amount of commercial lending in the US currently requires no license or supervision (state or federal) at all, and in many states only certain types of consumer lending require licenses. Finally, the extent to which rules for marketing products can be composed effectively without active involvement in the (prudential) supervision of the relevant entities remains open.

The kinds of institutional reorganization described in the Blueprint and sketched above cannot accommodate all of the activities of the existing regulators under the rubrics "market stability," "financial prudence" and "business conduct." In particular, the SEC's extensive responsibilities for general disclosure, financial reporting and shareholder rights don't fit well. As a result, a new corporate finance regulator is proposed. The Blueprint does not describe the exact duties of this new regulator, nor does it propose any changes in the way the SEC operates in this particular area, even though many of the allegedly counterproductive aspects of US financial regulation have, rightly or wrongly, been attributed to precisely these areas of the SEC's responsibility.

Despite the potential difficulties with the Blueprint's position that have been described above, it is nevertheless useful to have a fairly thorough effort at thinking through what it might mean to consistently apply any one regulatory guiding principle. Except for efforts at incremental change, which can be very important, any other proposal for broad reform will have to be at least as thorough in thinking through and revealing its possible implications. In addition, both the Treasury Department and any other group interested in broad reform should try to articulate how the new structures they are proposing will (or will not) predispose the anticipated new system to its own, new weaknesses.

*This client alert is a publication of Dewey & LeBoeuf LLP and is not intended as legal advice regarding specific transactions or matters. If you have questions respecting the subject matter in this alert, please contact George Williams at +1 212 424 8064 or [gwilliams@dl.com](mailto:gwilliams@dl.com), or Christopher Petito at +1 202 986 8283 or [cpetito@dl.com](mailto:cpetito@dl.com), or*

---

<sup>18</sup> P. 177.

This client alert is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2008 Dewey & LeBoeuf LLP  
All rights reserved.

For further information on Dewey & LeBoeuf, please visit [www.dl.com](http://www.dl.com)  
+1 888 532 6383

*Charles Landgraf at +1 202 986 8067 or [clandgraf@dl.com](mailto:clandgraf@dl.com), or Eileen Bannon at +1 212 259 6190 or [ebannon@dl.com](mailto:ebannon@dl.com), or Christopher DiAngelo at +1 212 259 6718 or [cdiangelo@dl.com](mailto:cdiangelo@dl.com), or your Dewey & LeBoeuf relationship attorney.*