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TREASURY PROPOSAL FOR REGULATORY REFORM

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On March 31, 2008, the U.S. Department of the Treasury ("Treasury") released a Blueprint for Financial Regulatory Reform ("Blueprint"), a proposal to revamp the structure of oversight of the financial services industry.

The Blueprint is the latest attempt to modernize the financial regulatory structure of the federal and state supervision and examination of financial institutions. It was released against a dramatic background of events in the financial markets, including increased mortgage related defaults, significant tightening in the credit markets, and the near failure (and resulting fire sale) of Bear Stearns.

Previous attempts to reorganize and modernize the financial regulatory structure have largely been unsuccessful, with the limietd exception of the Gramm-Leach-Bliley Act of 1999. Many past proposals focused on reform of the structure of depository institution supervision, including the 1993 Clinton administration proposal to form a Federal Banking Commission, the 1991 G.H.W. Bush administration proposal "Modernizing the Financial System: Recommendations for Safe, More Competitive Banks, and the 1984 Reagan administration proposal "Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services". The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have negotiated several turf agreements over new products containing securities and futures. Countless other proposals were published and some versions were introduced into Congress without passage.

The result of these failures is that the overall supervisory structure for financial services is almost entirely the same as when enacted in the 1930s and 1940s, notwithstanding the fact that the financial markets and financial institutions subject to those schemes are largely unrecognizable from those existing at that time.

The Blueprint appears to have several purposes. First, it is intended to more rationalize the regulation and supervision of financial services in the U.S. from the "alphabet soup" of agencies now responsible for pieces of the entire picture. Second, it attempts to move regulation from a rules based outlook to a more objectives or principles based regulation in order to permit the U.S. financial services industry to better compete internationally. Third, it is intended to plug holes and gaps in the regulation of financial services that have sprung up in the 75 years since most of the architecture was put in place. Finally, it looks to both de-regulate certain areas of finance now subject to heavy regulation while also beginning to cover certain areas not now subject to federal regulation.

However, the Blueprint also largely ignores parallel debates on related topics now underway in Congress, including discussion of the appropriate regulation of the Government Sponsored Enterprises ("GSEs"), mortgage relief actions, industrial loan companies, and other regulatory relief bills. Further, the Blueprint is a summary document at best; large topics are

omitted or barely mentioned, such as CFTC regulation of energy and other non-financial products.

The Blueprint

1. General Description

The Blueprint is a comprehensive proposal to modernize the regulation of the financial services industry. Even when issued it had little chance of being enacted, in that the U.S. would elect a new President in seven months. It was somewhat out-of-date even upon its release, given the fast moving events of the first few months of 2008. However, it can play a meaningful role in framing the inevitable debates on the proper role of regulation in financial services.

The Blueprint offers short-term, intermediate-term and long-term recommendations. Most of the short-term recommendations can be instituted without significant federal legislation. These recommendations are meant to enable existing institutions to react more effectively to current events. It is not clear that these proposals would accomplish any meaningful change from more effective use of the current structure, nor do they include any mention of the current legislation in Congress to provide relief for mortgage holders or lending institutions.

The intermediate-term recommendations would require significant federal legislation to implement. These recommendations would fundamentally alter the current distribution of supervision of federal thrifts, state-chartered depository institutions, payment and settlement systems, insurance companies, and futures and securities companies, exchanges and self-regulatory organizations. These recommendations are meant to finally settle many longstanding disputes among regulatory agencies and to rationalize regulatory structures so as to end regulatory arbitrage.

Finally, the long-term recommendations propose to replace the current U.S. financial regulatory structure of functional regulation with an "objectives-based regulatory approach." This type of financial regulation would significantly and materially alter the types of financial institutions in the U.S. and how they are regulated. It would subject to federal regulation entities engaged in financial services that are not currently so regulated in the U.S., such as hedge funds and commodity pool operators. Objectives-based regulatory systems are in place in the Netherlands and Australia. Some of the long-term recommendations appear to be in conflict with some of the intermediate-term recommendations.

2. Bureaucratic Turf Wars

The Blueprint wades into significant and complex areas of disagreement among the financial services regulators and the institutions they monitor. These fights have long help stymie any fundamental reform. The Blueprint proposes:

- Merging the SEC and the CFTC into one agency, implementing a more "principles" based regulatory philosophy, and streamlining the self-regulatory organization ("SRO") and the 1940 Investment Company Act ("40 Act") rulemaking process

- Eliminating the thrift charter, and merging thrifts into national banks and the Office of Thrift Supervision ("OTS") into the Office of the Comptroller of the Currency ("OCC")
- Eliminating or significantly limiting the direct supervisory and examination responsibilities of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the Federal Deposit Insurance Corporation ("FDIC")
- Greatly reducing most federal regulation of the holding companies of financial institutions
- Eliminating any restriction to commercial ownership of financial institutions
- Creating an optional federal insurance charter
- Ultimately creating three distinct regulators to manage market stability, prudential financial issues, and business conduct and replace almost every federal financial supervisor
- Enabling the Federal Reserve as "super" regulator and supervisor of all significant financial institutions, including investment banks, insurance companies and presently unregulated financial participants
- Eliminating much of the effective differences between State-chartered banks and national banks, and essentially dismantling the "dual banking" system
- Greatly diminishing the authority of the States

3. The Blueprint

a. Short-term recommendations

The suggestions in this section of the Blueprint are intended to strengthen market stability in light of the recent events in the credit and mortgage markets, and as a useful transition to the intermediate-term recommendations.

President's Working Group on Financial Markets ("PWG")

The PWG was established by the President in 1988 and includes the heads of the Treasury Department, the Federal Reserve, the SEC and the CFTC. The Blueprint proposes that (i) the PWG's focus be broadened to include the entire financial sector (rather than just financial markets); (ii) the PWG focus on improving inter-agency coordination and communication; (iii) its membership be expanded to include the heads of the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS") and the Federal Deposit Insurance Corporation ("FDIC"); and (iv) the PWG should be able to proactively issue reports, rather than waiting to be requested to do so.

Mortgage Origination Commission

The Blueprint proposes to create a Mortgage Origination Commission ("MOC") that would set uniform minimum licensing standards for State mortgage lenders and bankers and grade each State's licensing, supervision and enforcement systems. The membership of the MOC would consist of the federal regulators and a representative from the Conference of Bank Supervisors ("CSBS"). This proposal appears to be an extremely modest response to reports of widespread mortgage origination fraud occurring at lenders not regulated on a federal level, and is somewhat duplicative of a project already underway through the CSBS.

The Blueprint also notes confusion about which federal body enforces mortgage lending laws, and recommends that this authority be clarified. The authority to enact federal mortgage lending regulations would continue to be managed by the Federal Reserve. The Blueprint does not comment on criticism levied at the Federal Reserve for failure to more aggressively exercise these powers over the last five years.

Federal Reserve as Lender of Last Resort

The Blueprint notes that the Federal Reserve recently invoked powers granted to it under the Federal Reserve Act to lend to non-depository institutions in emergency circumstances. The Treasury suggests that this power should be enhanced to ensure that the process is transparent, appropriate conditions are attached to lending, and information flows to the Federal Reserve from the borrowers through on-site examinations and other reports. The PWG should also consider the long-term implications of access to discount window functions by non-depository institutions.

Intermediate-term recommendations

These proposals are intended to be implemented within the next two to eight years, accordingly to press reports.

Elimination of the Thrift Charter and the OTS

The Blueprint recommends phasing out and transitioning the thrift charter to the national bank charter, and eliminating the OTS and folding its duties into the OCC. The federal thrift charter was established in 1933 as a method of promoting real estate lending. This specific charter does not appear to be as necessary in the present (and normally) liquid markets for real estate finance. State thrift charters would be apparently be unaffected.

Federal Supervision of State-chartered Banks

State chartered banks are supervised and examined federally by either the Federal Reserve (for State member banks) or the FDIC (for State non-member banks). This distinction, which is rooted in the membership of some banks in the Federal Reserve System, has lost significance over time and creates duplication and confusion. The Blueprint recommends a study to determine the appropriate federal regulator.

Payment and Settlement Systems

The Blueprint would formalize the role informally played by the Federal Reserve as the primary federal regulator of all payment and settlement systems, including those for large-value and retail payments, as well as settlement systems for securities and other financial institutions. The Treasury proposes a federal charter for such systems that would preempt inconsistent State laws. The Federal Reserve would designate federally important systems, and would have full regulatory powers over them.

Federal insurance charter

Traditionally, insurance companies largely have been regulated by the States. The Blueprint proposes to create an Office of Insurance Oversight within the Treasury to focus on international issues and act as an advisor to the States. Treasury would also establish an optional federal charter through a new Office of National Insurance for insurers that would provide for a system of federal chartering, licensing, regulation and supervision for insurers, re-insurers and insurance producers.

Securities and Futures regulation

The Blueprint proposes to merge the SEC and the CFTC to reflect the growing convergence of the products, exchanges and markets regulated by each agency. Notably, the Blueprint is silent as to areas where the agencies do not cover, such as agricultural products, metals and energy. This SEC/CFTC merger has been proposed many times in the past, and recognizing certain bureaucratic and administrative difficulties, the Blueprint proposes several steps to mitigate these difficulties: (i) the SEC should adopt "core principles" for securities regulation to conform to the CFTC model for futures exchanges and clearing organizations; and (ii) the SEC should issue rules streamlining (A) the SRO rulemaking process to reflect the more competitive marketplace (and the lack of need for SEC review of all proposals), (B) the securities product approval process to keep U.S. securities firms competitive with non-U.S. firms, and (C) streamline the '40 Act rulemaking process.

Legislation implementing a merger should call for a structural merger, as well as a merger of regulatory philosophies to harmonize securities and futures regulation. Key elements will include: (i) overarching regulatory principles focusing on investor protection, market integrity and overall system risk reduction; (ii) self-certification of all clearing agency and market SRO rule-filings (outside of corporate listing and market conduct standards) which would become effective upon filing; (iii) harmonization of SEC and CFTC rules and regulation; and (iv) continued work towards convergence of broker-dealer and investment advisor regulation (and appropriate statutory changes as needed).

Long-term recommendations

The Blueprint proposes switching the structural underpinnings of the U.S. financial services regulatory sector from "functional regulation" to an "objective-based regulatory approach". The Treasury found that the current system is largely incompatible with today's financial markets and financial products. Among the deficiencies of functional regulation is the lack of a single regulator devoted to monitoring and reducing systemic risk.

In response, the Blueprint proposes a broad realignment focusing on three key goals: (i) market stability regulation to address overall conditions of financial market stability; (ii) prudential regulation to address issues of limited market discipline caused by government guarantees; and (iii) business conduct regulation linked to consumer protection regulation to address standards for business practices.

New regulators. The long-term recommendations propose several distinct regulators:

Market stability regulator

The Federal Reserve would assume a role of monitoring risks across the financial system. It would have the responsibility and authority to gather the appropriate information, disclose information, collaborate with other regulator to write rules, and to take corrective actions when necessary to ensure overall financial market stability. The Federal Reserve would have some level of authority over all presently supervised entities, as well as hedge funds, commodity pool operators and other institutions, though its powers to require corrective action would be limited to periods when overall financial stability is threatened. It would have the authority to join examinations with the prudential and business conduct regulators.

The Federal Reserve would not regulate or supervise financial or bank holding companies or State-member banks. The regulation of State-chartered banks would be done by the Prudential Regulator, as described below. No entity would supervise bank holding companies; the Federal Reserve instead would do so as Market Stability Regulator and would have the authority to gather information through reporting requirements and require corrective action. This change would largely eliminate federal holding company regulation and presumably overturn the present federal limitations on a mixture of banking and commerce. The Blueprint instead notes that affiliate transaction limits would continue in place to protect the insured depository institutions from inappropriate funding in support of their non-bank affiliates.

Prudential regulator

The Blueprint would create a Prudential Financial Regulatory Agency to supervise all financial institutions that have explicit federal government guarantees associated with their businesses, such as depository institutions whose deposits are insured by the Deposit Insurance Fund presently run by the FDIC. This agency would focus on the safety and soundness of these institutions with appropriate authority to deal with affiliate relationship issues. This agency would subsume the FDIC, the OCC, the OTS, the supervisory function of the Federal Reserve, and the National Credit Union Administration.

Prudential regulation would mimic the present regulation of insured depository institutions, including capital adequacy requirements, investment limits, activity limits and direct on-site risk management supervision. All entities accepting insured deposits would be supervised by this regulator. It is unclear whether the Government Sponsored Entities, which operate with implicit federal government guarantees, would be included.

Business conduct regulator

The Blueprint would create a Conduct of Business Regulatory Agency. This agency would monitor business conduct regulation across all types of financial firms, including key aspects of consumer protection, and rulemaking for disclosures, business practices and chartering/licensing of certain financial institutions.

This agency would include most of the present functions of the SEC and CFTC, as well as aspects of the mortgage lending markets and bank consumer regulation. It would also include certain areas now supervised by the Federal Reserve, State insurance regulators and the Federal Trade Commission.

Two other agencies: Federal Insurance Guarantee Corporation and the Corporate Finance Regulator

The Federal Insurance Guarantee Corporation would replace the FDIC to manage the Deposit Insurance Fund and act as receiver of insolvent depository institutions. The Corporate Finance Regulator would take over the SEC functions now handled by the Division of Corporate Finance of oversight of corporate disclosures, governance, accounting and related issues.

New Federal Charters. The Blueprint proposes replacing all federal financial charters with three broad new charters:

- *Federal Deposit Institution*. This charter would be for all federally chartered lenders with deposit insurance, including banks, thrifts and credit unions. It would not replace the State charters though all State chartered entities would be required to obtain this charter and to comply with its restrictions. As all depository institutions with a Federal Deposit Institution charter would benefit from preemption of inconsistent State laws, this change would effectively end the "dual banking" system present in the U.S. since 1864.

- *Federal Insurance Institution*. This charter would be for federal insurance companies offering retail products where some form of federal government guarantee is present.

- *Federal Financial Services Provider*. This charter is for other types of financial services firms, such as broker-dealers.