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Current Trends In Financial Regulation And Enforcement

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Commentary

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I. Introduction

Frequently, financial and economic regulation is created or increased in response to a crisis. The Securities Act of 1933, our nation's first federal securities law, was enacted (along with other New Deal legislation) in response to the stock market crash of 1929, when the country was in the throes of the Great Depression. One year later, with the passage of the Securities Exchange Act of 1934, the Securities Exchange Commission (SEC) was created to monitor and regulate the securities industry. World War II also caused much economic regulation. The energy crisis of the early 1970s caused such a sharp inflationary spiral that the Federal Reserve had to take measures and Congress passed legislation to help manage the economy through one of the most significant periods of stress since the Great Depression. In 2002, in response to major corporate and accounting scandals such as Enron and WorldCom, Congress enacted the Sarbanes-Oxley Act, establishing more stringent financial accounting and reporting standards for publicly-held companies. And in response to the bursting of the internet bubble in 2001, the SEC and other regulatory bodies commenced a number of investigations and some criminal prosecutions.

In the midst of the current financial downturn, there have been a number of investigations and actions already commenced by various regulatory bodies. Moreover, initiatives are being discussed that call for greatly increased oversight and regulation of the financial industry. The debate over what kind of reform is necessary, and how to go about achieving it, however, is only in the beginning stages. What seems clear is that regulators are very active and it is also likely that there will be change in the current regulatory framework — change that may have widespread impact on the way in which financial institutions are regulated.

This article will provide (1) a discussion of some of the key regulatory investigations/actions stemming from the current economic downturn; and (2) a summary of some of the current proposals to restructure the financial regulatory framework.

II. Select Current Regulatory Enforcement And Criminal Actions

As we have seen markets freeze up and/or deteriorate during the current financial crisis, regulatory activity has picked up considerably, with regulators — civil and criminal — investigating market disruption. These investigations cover a number of areas. For illustrative purposes, we discuss some of those investigations below. In addition to those discussed below, there are a number of other investigations and governmental reviews taking place (*i.e.*, investigations into the practices of rating agencies and investigations into the way certain institutions valued securities).

A. Subprime Lender Investigations: New Century

The first wave of subprime lending investigations began at least as early as in the spring of 2007 when the U.S. Attorney's Office for the Central District of California and the SEC began investigations into the securities trading and alleged "accounting errors regarding allowances for repurchase losses" of major subprime lender, New Century Financial ("New Century").¹ Several of New Century's executives are also being investigated by the Department of Justice (DOJ). A report commissioned by the DOJ, however, concluded that "investigators did not find sufficient evidence to conclude that New Century engaged in earnings management or manipulation, although its accounting irregularities almost always resulted in increased earnings."² In this regard, the SEC is reviewing whether KPMG, New Century's financial auditor, intentionally ignored certain red flags in New Century's accounting processes.³

The 2007 investigations of New Century by the DOJ and SEC presaged the joint DOJ-FBI "Operation Malicious Mortgage," in which over 400 arrests relating to mortgage fraud have been made.⁴

B. Bear Stearns Investigation — New Arrests

In the days leading up to JP Morgan's acquisition of Bear Stearns, the SEC's Division of Enforcement sent a letter to JP Morgan in which it explained the potential for investigation and future inquiry into certain conduct of, and statements made by, Bear Stearns immediately preceding its public announcement of the emergency acquisition.⁵ The SEC's Division of Corporate Finance also wrote a letter to JP Morgan in which it addressed "sales by client accounts managed by JP Morgan and Bear Stearns of the other firm's securities, in view of the control relationship created by the merger agreement."⁶

On a related note, on June 19, 2008, former Bear Stearns employees, Ralph Cioffi and Matthew Tannin, were arrested on SEC charges stemming from the 2007 collapse of hedge funds of which they were managers. According to the press, Cioffi's and Tannin's "arrests are the first from a federal probe of possible fraud by banks and mortgage firms whose investments in subprime loans and securities plunged in

value, causing losses that now total \$396.6 billion."⁷ The SEC's complaint alleges that Cioffi and Tannin "deceived their own investors and certain institutional counterparties about the funds' growing troubles until they collapsed and caused investor losses of approximately \$1.8 billion."⁸

C. Investigations Into Auction Rate Securities

There has been significant disruption in certain aspects of the auction rate securities ("ARS") market. The North American Securities Administrators Association (NASAA), the SEC, the Financial Industry Regulatory Authority (FINRA) as well as individual states including the New York Attorney General are investigating aspects of the ARS business. Several class action lawsuits have also been filed in the United States District Court for the Southern District of New York against several firms that issued these securities. Other investors have filed arbitration claims relating to these failed securities.

D. CFTC Oil Market Investigation

Responding to concerns that speculators may be responsible for driving up the price of crude oil, the Commodity Futures Trading Commission (CFTC) has announced that it has been investigating "practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivative contracts."⁹ With no concrete evidence that speculators have manipulated prices, however, the CFTC's "investigation" is more akin to a "market study" aimed at determining the cause(s) of the dramatic rise in the crude oil prices. Although this is not the first time that the CFTC has investigated potential price manipulation in the commodities markets, the CFTC's disclosure of its investigation to the public is what makes this current action unusual.¹⁰ CFTC Acting Chairman Walt Lukken and Commissioners Michael Dunn, Jill Sommers and Bart Chilton issued the following statement on May 29, 2008:

In addition to the CFTC's ongoing examination of the role of fundamental economic forces and new investors in the recent commodity market price increases, the agency continues to pursue one of its primary missions — to deter, detect, and punish futures market manipulation.¹¹

In pursuit of this mission, the CFTC is forming a task force, "which includes staff representatives from the CFTC, the Federal Reserve, the Department of the Treasury, the [SEC], the Department of Energy, and the Department of Agriculture, [that] will examine investor practices, fundamental supply and demand factors, and study the role of speculators and index traders in the commodity markets."¹² "The bottom line," says CFTC Commissioner Bart Chilton, "is we need to investigate."¹³ Chilton and Lukken, however, have stated that they have yet to see any evidence that the sharp rise in oil prices is attributable to anything other than increased demand. Lukken has also emphasized that Congress has now closed the "Enron loophole," which exempts from U.S. regulation over-the-counter oil trading through foreign exchanges such as the Intercontinental Exchange (ICE), and that the CFTC is now "ratcheting up its scrutiny of traders using an alternate exemption called the 'swaps loophole' to avoid limits on excessive commodities speculation."¹⁴

III. Proposals For Regulatory Reform

A. Fed-Level Reform

1. Treasury Secretary Paulson's Plan For Regulatory Consolidation

Treasury Secretary Henry Paulson has proposed a regulatory reform plan that would essentially create a "Super-Fed," *i.e.*, a Federal Reserve that would continue its current lending role, but regulate the whole financial industry as well. Paulson's proposal involves the creation of three regulators: (1) a market stability regulator; (2) a prudential regulator; and (3) a conduct of business regulatory agency (CBRA). The Super-Fed would, under the proposal, assume many of the functions of the SEC and CFTC.

The market stability regulator would serve a macro-regulatory role, monitoring the entire financial industry and countering systemic risk to the stability of the financial markets. This macro-regulator would "collect information from commercial banks, investment banks, insurance companies, hedge funds, [and] commodity pool operators," and would have the authority to investigate individual firms whose activities may pose a threat to the health of the financial markets.¹⁵ Paulson's proposal would create a single prudential regulator out of the many federal bank regulators. The prudential regulator would primarily be concerned with the viability of federally-guaranteed

institutions, serving a role, Paulson says, similar to that of the Office of the Comptroller of the Currency. Finally, the CBRA would take on many of the roles of the SEC and CFTC, enforcing regulations to protect consumers and investors.

Paulson's proposal "advocates a separation of responsibilities between a regulator looking at the system as a whole [the market stability regulator] and another regulator focused on the health of the individual institutions [the prudential regulator]."¹⁶ According to Paulson, having a macro- and a micro-regulator under the auspices of one regulatory agency is wise because "investor protection and market stability are critical elements of competitiveness. . . . Far from being at odds with one another, they are mutually reinforcing."¹⁷

In light of the recent increase in collaboration between the SEC and CFTC, the federal government has also proposed to merge the two regulators, believing that "having one agency responsible for these critically important issues for all financial products should bring greater consistency to regulation where overlapping requirements currently exist."¹⁸ The current regulatory framework is unique in that it separates regulation of commodities and securities. The Paulson proposal suggests that there is overlap in the regulation of these investments and reasons that it would be wise to pool the resources of the SEC and CFTC together. Paulson suggests that an SEC-CFTC merger could well increase the capabilities of the regulatory regime because the two agencies could avoid unnecessary duplication of effort and coordinate enforcement. SEC Chairman, Christopher Cox, has neither endorsed nor rejected the prospect of such a merger. The CFTC, however, seems firmly against the idea.¹⁹

2. SEC-Fed Information-Sharing Agreement

While a merger between the SEC and CFTC is still only in the "proposal" stages, another regulatory change is about to get underway now that the SEC and Federal Reserve have completed their agreement to restructure an aspect of how Wall Street firms are regulated.²⁰ The agreement, which calls for greater cooperation among the two agencies, is designed to facilitate greater inter-agency cooperation in several areas, "including anti-money laundering, bank bro-

kerage activities under the Gramm-Leach-Bliley Act, clearance and settlement in the banking and securities industries, and the regulation of transfer agents.”²¹

The information-sharing agreement, which was announced on July 7, 2008, comes on the heels of the Senate Banking Committee’s attempts to put the breaks on the plan. In a June 27, 2008 letter to Treasury Secretary Paulson, SEC Chairman Christopher Cox, and Federal Reserve Chairman Ben Bernanke, Senator Christopher Dodd, Chairman of the Senate Banking Committee, and Senator Richard Shelby stated:

Given the limited authority of the Fed and the SEC to regulate investment banks with primary dealer status, and Congress’s ultimate responsibility for formulating financial regulatory policy, we ask that no action regarding implementation of the [agreement] be taken before we can determine that it is in the best interests of our nation’s economy and the well being of its citizens.²²

Despite the Senate Banking Committee’s suggestion, however, the Federal Reserve and SEC surged forward with their discussions and reached an agreement that, according to Fed Chairman Ben Bernanke, “formalizes and strengthens the ongoing cooperation between [the] two agencies to enhance the stability of the financial system.”²³ Among other things, the new agreement may have an effect on the SEC’s oversight of investment banks, which are currently monitored under the SEC’s Consolidated Supervised Entity (“CSE”) Program.

As of now, the following four investment bank firms are monitored by the SEC under the voluntary CSE program: Lehman Brothers, Goldman Sachs, Merrill Lynch, and Morgan Stanley.²⁴ SEC Chairman, Christopher Cox, had this to say about the CSE program: There is simply no provision in the law that requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis . . . Because the CSE program is not authorized in statute, it relies on the SEC’s authority under the Securities Exchange Act of 1934 to determine net capital rules for the regulated broker-dealer subsidiaries of investment banks. . . . It provides consolidated supervision to investment bank holding companies

that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. At the same time it achieves the statutory purpose, which is to monitor for financial or operational weakness in the holding company or its unregulated affiliates that might place the U.S.-regulated broker-dealers and other regulated entities at risk.²⁵

The CSE is unusual because it is currently voluntary. Regulatory issues that will likely be addressed include whether the CSE program should become mandatory, thus including many firms that have not voluntarily submitted to the program. Another approach came from Sheila Bair, Chairman of the Federal Deposit Insurance Corp. (FDIC), who has recently called for Congress to provide the FDIC with the authority to shut down failing investment banks through a process basically akin to receivership. Bair’s proposal would involve granting the FDIC “authority to set up bridge banks to take over and sell assets of failed banks.”²⁶ Paulson has described Bair’s investment bank plan as “dead on.”²⁷

3. Hedge Fund Regulation

Unlike commodities and traditional securities such as stocks and mutual funds, hedge funds are largely unregulated. By and large, hedge funds are not required to register with the SEC, nor are they subject to the reporting requirements of the Securities Exchange Act of 1934. In response to the recent financial downturn, there has been much discussion about the role of regulation in hedge fund markets, with a number of commentators calling for expanded SEC oversight in the largely unregulated industry. Former Senator Paul Sarbanes has recently called for changes that would require hedge funds to register under the Securities Act of 1933.

On May 6, 2008, President Bush nominated Troy Parades, a law professor at the University of Washington in St. Louis, to replace Paul Atkins, as SEC Commissioner. Opposed to hedge fund regulation, Parades endorses a voluntary ‘best practices’ approach to regulation of the hedge fund industry.²⁸ The President’s Financial Working Group recently issued a report endorsing the ‘best practices’ approach as well, calling for increased transparency and disclosure, more detailed valuation procedures, more extensive risk management analyses, and methods to address conflicts of interest.²⁹ Furthermore,

a May 15, 2008 article in Forbes Online suggested that approval of hedge fund regulation may be difficult to obtain:

The hedge fund industry as a whole just suffered through its worst-ever first quarter. Yet some leading hedge funds have been wildly successful in currently volatile markets, and others, especially so-called “vulture funds,” are playing a market-stabilizing role. The industry will marshal these facts as powerful weapons in the fight against legislative intervention.³⁰

4. Regulation Of Credit Derivatives

Much like hedge funds, derivatives instruments are largely unregulated as well. Complex financial instruments whose value rises and falls depending on variables defined in the instrument, derivatives are traded via exchanges, or between two parties (“OTC”). Exchange-traded derivatives are regulated by the SEC or CFTC; OTC derivatives, including credit derivatives, are not subject to such regulation:

Congress exempted credit derivatives from regulation in 1974, and the industry has grown largely unfettered under self-regulation. At the end of 2007, there were \$62.2 trillion outstanding in credit-default swaps, up 81 percent from the end of 2006, according to the International Swaps and Derivatives Association.³¹

As Daniel Sorid explains, “credit derivatives have been described as the fastest-growing financial market — a market for buying and selling the risk that an investment will fail, or default.”³² In a move intended to prevent the “domino-like” effects that the failure of a major investment bank might have on the market, the Federal Reserve has proposed creating a “central clearinghouse” for derivatives trading.³³ Consistent with this plan, participants at a June 9, 2008 meeting (which included every major investment bank) convened by Timothy Geithner, President of the Federal Reserve Bank of New York, “agreed to register their trades with a computerized system that would allow for nearly instantaneous recording.”³⁴ Erik Sirri, Director of Trading and Markets at the SEC, has stated that the Fed and the SEC, in addition to discussing information-sharing initiatives, are considering

whether a central clearinghouse for derivatives trading might counter the “negative effects of misinformation and rumors that may occur during high volume periods.”³⁵

Because these derivatives are often complex, they are primarily traded by sophisticated institutional investors, not individual retail investors. Funds, dealers, professional investors and institutions are the “players” in derivatives markets, not the small investor. OTC and credit derivatives have not been subject to regulation to date, and the fact that sophisticated investors trade these instruments should make for different priorities in regulatory goals than in markets where the small investor needs protection.

IV. Conclusion

The recent financial downturn and resultant calls for regulatory reform combined with increasing complexity of financial instruments suggest that the regulatory agencies will not only remain quite active in the future, but may also experience change and expansion of their roles as Congress considers proposals for structural reform. It is inevitable that regulators and agencies will continue to investigate when market disruptions occur. When disruptions occur, there is a tendency to seek to blame someone or something and increase regulation. While, in some cases, there is blame reasonably associated with a disruption, this is not always the case and it is often hard to correctly assess where blame belongs. Similarly, some regulation benefits society and some merely stifles innovation. Investing entails risk, and some investments are both risky and beneficial to the economy. We can only hope that a reasonable balance is struck between regulatory needs and the need for a vibrant and creative securities market.

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