U.S. Treasury Announces Plans
For Regulatory Reform

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The Current Regulatory Oversight of the U.S. Financial System

The system and agencies that are responsible for the oversight and regulation of the U.S. financial system were largely put in place as part of the New Deal in the 1930s. It is a patchwork system that, over the years, has had little meaningful updating in light of the growth in complexity of different securities and our capital markets.

In essence, the Comptroller of the Currency oversees federally chartered banks while state chartered banks are regulated by each state’s bank regulator. Insurance companies are regulated on a state basis and have no federal oversight. The National Association of Insurance Companies (NAIC) is a self-regulating organization that makes recommendations for state governance and lobbies on behalf of the insurance industry.

Depending on their size and type of business, Registered Investment Advisors are regulated by either the Securities and Exchange Commission (SEC) or individual state regulators. Hedge funds, private equity firms and venture capital firms are not regulated. And, securities firms are regulated by the SEC as well as self-regulatory agencies including the Financial Industry Regulatory Authority (FINRA).

With respect to securities, generally securities that are offered for sale to the public are required to be registered with the SEC. Yet, because they are typically not structured as securities, interests in hedge funds and private equity funds are exempt from registration. Derivatives transactions are largely unregulated.

The New Regulatory Proposal

At this point, the proposal offers limited details but addresses regulatory reforms in four major areas: Limiting “systemic risk” which could threaten the economy, enhancing protection for investors and consumers, closing gaps in regulatory oversight and coordinating financial regulation globally.

Create an “Independent” Risk Regulator

American International Group (AIG) was one of the world’s largest financial conglomerates whose operations spanned businesses in aircraft leasing, insurance, and complex derivatives. Because of its intertwined use of derivatives within the financial system, its collapse would have resulted in the collapse of many other financial firms which could have taken our entire financial system down. Yet, one of the problems with the collapse and subsequent government assistance of AIG is that it didn’t fall clearly under the regulatory umbrella of any one regulator who could step in and take decisive action.

Treasury Secretary Geithner has proposed setting up an “independent agency” to monitor major institutions or payment systems whose failure could present a destabilizing effect on the economy. While we are not sure what the “independent” structure is driving toward, the objective clearly is to attempt to limit systemic risk such that no one firm could take down our entire financial system. The plan proposes giving the power to this independent agency to step in and take over failing institutions that are a threat to our capital markets and economy.

The plan also calls for increased capital requirements for financial firms as well as better risk management policies within these firms.

Hedge Funds Would be Required to Register with the SEC

A hotly debated issue since the collapse of Long Term Capital Management in 1998 has been the requirement that hedge funds register with the SEC. With outsized returns that only a bull market can provide, hedge funds, including fund-of-funds structures, have been the fastest growing entity in our financial system over the past decade. Yet, they are not required to register with the SEC. This plan calls for hedge funds over a certain size to register with the SEC. Large hedge funds would have to provide portfolio and transaction data on a private basis to the SEC. The goal is to identify and monitor which hedge funds could represent a threat to the capital markets and the economy.

Comprehensive Oversight of Derivatives Transactions

One of the most significant risks to our financial system remains the counter party risk associated with over-the-counter (OTC) derivative transactions, such as credit derivative swaps and forward transactions. OTC derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Products such as credit swaps and forward rate agreements are traded in this way. The OTC derivative market is the largest market for derivatives, and is largely unregulated with respect to disclosure of information between the parties. Unlike options and futures, OTC derivative transactions are negotiated contracts between a sophisticated buyer and seller. While progress has been made over the years to standardize and stream line these transactions, currently they are non-standardized with each firm monitoring the nuances of each transaction and collateral manually. In order to make good on the delivery of that transaction, both parties need to remain solvent. If one party fails, such as Lehman Brothers and AIG did last September, the entire system is placed in jeopardy.

Treasury Secretary Geithner's plan is to regulate these instruments and require that they trade through a centralized clearinghouse or exchange. Such transparency would allow the markets and investors to see with better clarity which firms are taking on what level of risk.

Further Regulation of Money Market Mutual Funds

Money market mutual funds are considered one of the safest investments in the market. Money market funds, under Rule 2-a-7 of the Investment Act of 1940, can price their assets at amortized cost under certain circumstances. As a result, they have a high level of certainty at being priced with a one dollar net asset value.

However, with the collapse of Lehman Brothers and AIG last year, their commercial paper declined in value which resulted in several money market funds being priced at an NAV of less than one dollar. Compounding matters, the growing deterioration in investor confidence resulted in a wave of redemption activity from money market funds which couldn't be managed. As investors attempted to pull their money, widespread disruption and illiquidity resulted in many money funds freezing redemptions.

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