# Center for Financial and Accounting Literacy

## New Era of Financial Regulation:
## Lessons Learned from the 2008/2009 Financial Crisis

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In December 2009, the House of Representatives passed a 1,279-page bill that would establish a council of regulators to monitor systemic risks and establish a system of oversight for the derivative market. The Senate is working on a separate bill that will need to be reconciled with the House bill before any of the reforms are signed into law. Sweeping overhauls like these take time. The US Treasury Department provided a foundation for future reforms in June 2009 when it laid out a comprehensive regulatory reform plan to modernize the US financial system. The plan is described in a white paper on "Financial Regulatory Reform, A New Foundation." The reforms outlined in this paper will have the most direct effects on companies in the financial services industry, but they will also affect directors and shareholders in other industries.

**Areas affected by reforms**

The proposed reforms are complex, and the full package may not be approved. But, clearly, financial regulatory reform is a high priority now while the recent financial crisis is fresh in everyone's minds. Basically, the reforms seek to modernize systems that failed to keep pace with decades of financial innovation, resulting in unforeseen risks and forcing the government to take extraordinary measures to revive the economy after the financial crisis. The Treasury Department expects that the proposed changes will help investors and consumers avoid unpleasant surprises like those experienced in 2008 and 2009.

**Areas of Reform**

There are five key areas for which reforms are being considered. Below are the areas and the current status and/or major milestones reached in each area.

**(1) Financial firms**

The Treasury Department has suggested a series of reforms designed to strengthen the foundation for supervision and regulation of financial institutions and other firms in the financial services sector. These reforms include: (1) establishing a new Financial Services Oversight Council to identify emerging systemic risks and improve interagency cooperation, (2) granting more authority to the Federal Reserve Board to supervise all firms that could pose a threat to financial stability, and (3) introducing a number of other changes, such as creating a new National Bank Supervisor for all federally chartered banks, eliminating the Office of Thrift Supervision, and empowering the SEC to require registration of advisers of hedge funds and other private pools of capital.

Major Milestones:

(a) New Financial Services Oversight Council

> In July 2009, the Treasury Department introduced several bills that will help the government better manage what has become known as systemic risk. The bills include the "Financial Services Oversight Council Act of 2009," which would establish a Financial Services Oversight Council. The new oversight council will include the chairman of the US Securities and Exchange Commission (SEC). Its role will be to facilitate coordination of financial regulatory policy and resolution of disputes and to identify emerging risks in financial markets.

(b) Other steps to manage systemic risk

> Other proposed laws would provide for supervision and regulation by the Federal Reserve of all of the largest, most interconnected firms. All these firms will be subject to the nonfinancial activities restrictions of the Bank Holding Act, regardless of whether they own insured depository institutions. These largest firms will also be subject to stricter and more conservative prudential standards than those that apply to other bank holding companies, including higher standards of capital, liquidity and risk management. In addition, steps would be taken to strengthen firewalls between banks and their affiliates, to close loopholes and gaps in the bank regulatory system and to strengthen oversight of systematically important payment, clearing, and settlement systems.

(c) Private Fund Investment Advisers Registration Act of 2009

In July 2009, the Treasury Department introduced the "Private Fund Investment Advisers Registration Act of 2009." This proposed law would require all advisers to hedge funds and other private pools of capital, including private equity and venture capital funds, to register with the SEC and comply with record-keeping, reporting, and other requirements established by the SEC. The Treasury Department notes that this would help protect investors because it would enable the government to collect the kinds of reliable comprehensive data necessary to monitor funds' activity and assess potential risks in the market. The lack of such data constituted a significant regulatory gap that hindered the government from responding appropriately at several points during the recent financial crises.

(d) Oversight of Brokers, Dealers and Investment Advisers

In July 2009, the US Treasury Department introduced a bill known as the "Investor Protection Act of 2009." This proposed law is designed to strengthen the SEC's authority to protect investors. Among other things, the proposed legislation would improve the controls over transactions by broker-dealers and investment advisers. Key provisions would allow the SEC to establish consistent standards for broker-dealers and investment advisers. This provision could result in the establishment of fiduciary responsibilities based on activities performed, regardless of legal classification, and it could lead to prohibitions on certain types of compensation arrangements when the products are not in the investors' best interest. The Act would also allow the SEC to regulate the quality and timing of certain disclosures by funds. For example, the SEC might require a concise summary prospectus and a simple disclosure showing the costs of a fund prior to the completion of a sale. (Currently these disclosures are typically not made until after a transaction is complete).

(e) Statement of SEC's Priorities

Speaking before the Senate Subcommittee on Financial Services and General Government on June 2, 2009, SEC Chairman Mary Schapiro described the specific areas on which the Commission will focus on in 2009. The areas that affect financial firms include:

- *Strengthening risk-based oversight.* The Commission is working on a risk-based oversight methodology that will improve its risk-based oversight of broker-dealers, investment advisers, and mutual funds.
- *Improving transparency.* In addition to working with the FASB on improvements in accounting standards, the SEC is focusing on the effectiveness of controls put in place for broker-dealers and investment advisers to prevent the spreading of false information. Additional reforms are expected in 2009 to address investments in municipal securities and harmful pay-to-play practices by investment advisers to public pension funds.
- *Filling regulatory gaps.* Some of the gaps affect firms; others affect markets. For example, the areas that are likely to be subject to more regulation include credit default swaps, hedge funds and other unregulated private pools of capital. Other gaps likely to be addressed relate to differences in the regulations that apply to broker-dealers and investment advisers.

(f) Proposed responses to the Madoff swindle

In the wake of the Madoff swindle, as well as other recent Ponzi schemes and abuses involving investment advisers, the SEC is proposing several reforms. One proposed solution involves a requirement for annual "surprise exams" of investment advisers by independent public accountants to better assure the safekeeping of investor assets. For more information, see the Center's separate report available at http://www.fincenter.org/Madoff_Surprise_Audits.htm.

(g) National bank supervisor

In July 2009, the US Treasury Department introduced a bill known as the "Federal Depository Institutions Supervision and Regulation Improvements Act of 2009." This proposed law would create a national bank supervisor through the consolidation of the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC), and it would make other changes that would affect the regulatory fees assessed on banks.

(h) Authority resolution for governmental agencies

In July 2009, the US Treasury Department introduced bills known as the "Resolution Authority for Large, Interconnected Financial Companies Act of 2009, and the "Payment, Clearing, and Settlement Supervision Act of 2009." Together, these proposed laws are designed to provide a regulatory regime that can adequately respond to a financial crisis so that, in the future, the government will not need to choose between bailouts and financial collapse. For example, the bills would give the Treasury Department the authority to appoint the FDIC or the SEC as a conservator or receiver for a failing firm. The conservator or receiver would have the authority to take control of the operations of the firm and sell or transfer any part of the assets of the firm.

## (2) Financial markets

The Treasury Department has suggested that the regulation of financial markets could be strengthened through added requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans. Other potential reforms include comprehensive regulation of over-the-counter derivatives (including credit default swaps), and empowerment of the Federal Reserve Board to oversee payment, clearing, and settlement systems.

Major Milestones:

(a) Introduction of "Over-the-Counter Derivatives Markets Act of 2009"

In August 2009, the Obama Administration introduced proposed legislation known as the "Over-the-Counter Derivatives Markets Act of 2009." Under this Act, the financial markets for credit default swaps (CDS) and other over-the-counter (OTC) derivatives would be comprehensively regulated for the first time. The rapid growth and level of innovation in these markets are believed to have contributed to the risks and stresses that caused the financial crisis of 2008 and 2009. If enacted as proposed, the provisions of this legislation would:

- Require central clearing of standardized OTC derivatives by a clearing organization regulated by the Commodities Futures Trading Commission (CFTC) and central trading by a securities clearing agency regulated by the SEC.
- Move more OTC derivatives into central clearing and exchange trading. This would be done by broadening the definition of standardized OTC derivatives and imposing higher capital and margin requirements for non-standardized derivatives.

- Require transparency of all OTC derivative markets. Aggregate information would be available to the general public, and certain federal agencies would have access on a confidential basis to the transactions and open positions of individual market participants.
- Regulate all OTC derivative dealers and other major market participants for the first time by federal agencies. The CFTC and SEC would oversee business conduct, reporting and record-keeping requirements for these entities.
- Prevent market manipulation, fraud and other market abuses. This too would be overseen by the CFTC and SEC.
- Protect unsophisticated investors, such as individual investors and small municipalities, by tightening the definition of eligible investors that can engage in OTC derivative transactions.

(b) Statement of SEC's Priorities

Speaking before the Senate Subcommittee on Financial Services and General Government on June 2, 2009, SEC Chairman Mary Schapiro described the specific areas on which the Commission will focus on in 2009. The areas that affect financial markets include:

- *Improving money market and mutual fund regulation.* The SEC is considering proposals to strengthen the money market fund regulatory regime, to determine whether more regulation is needed over so-called "target date funds," and to assess whether changes are needed to Rule 12b-1 which permits mutual funds to compensate broker-dealers and other intermediaries for distribution and servicing expenses.
- *Combating abusive short-selling.* Already, the Commission has proposed two approaches to placing restrictions on short sales. These approaches were discussed at a roundtable held in May 2009.

(c) Improved oversight of credit rating agencies

In July 2009, the Treasury Department introduced a section of the Investor Protection Act that is designed to strengthen the SEC's authority over credit rating agencies and to help investors become less reliant of these agencies that in the past have failed to accurately describe the risk of rated products. The bill proposes that credit rating agencies be barred from consulting with any company that they rate. It would also impose a number of new requirements, including documentation of rating policies and procedures, disclosures about the risks measured when rating a security, use of a special symbol to identify the risks associated with structured finance products, registration with the SEC, and compliance with annual reporting requirements and other rules established by the SEC.

(d) Asset-backed securitization process

Another section of the Investor Protection Act would improve the asset-backed securitization process by requiring that the securitizer of an asset-backed security retain 5 percent of the credit risk of the underlying assets. It would also expand the SEC's authority to require loan-level disclosure for asset-backed securities in a standard format to enhance the ability of investors to perform their own due diligence.

## (3) Investors and consumers

Several reforms are designed to help investors and consumers by promoting simplicity, fairness, and accountability. These include: (1) creation of a new Consumer Financial Protection Agency to protect consumers from unfair, deceptive, and abusive practices, (2) enactment of stronger regulations for consumer and investor products, and (3) a more level playing field and higher standards for ALL providers of consumer financial products and services, regardless of whether they are part of a bank.

Major Milestones:

(a) Consumer Financial Protection Agency Act of 2009

In June 2009, the US Treasury Department introduced a bill known as the "Consumer Financial Protection Act of 2009. This proposed law would create an agency with a balanced mission of protecting consumers and promoting access to financial products. In this role, the agency will be expected to encourage concise and clear information about financial products or services (such as loans) that consumers can understand and use and to protect consumers from unfair and deceptive practices, while at the same time promoting access to financial services in fair, efficient, and innovative financial services markets. This new agency will implement and enforce the new credit card bill signed into law by President Obama and Congress, and it will have the authority needed to combat the worst abuses in mortgage markets.

(b) Statement of SEC's Priorities

The SEC will continue its mission of protecting investors. In the aftermath of a year in which trillions of dollars of wealth were destroyed, the SEC is stepping up its efforts to protect and strengthen the rights of shareholders. Speaking before the Senate Subcommittee on Financial Services and General Government on June 2, 2009, SEC Chairman Mary Schapiro described the specific areas on which the Commission will focus on in 2009. The areas that affect investors include:

- *Reinvigorating the SEC's Enforcement Division.* Led by a new Enforcement Director, the SEC staff will be allowed more latitude in the use of subpoenas to obtain documents and testimonies from witnesses.
- *Strengthening shareholder rights.* In response to significant investor support, the SEC is considering allowing shareholders some proxy access to nominate directors, as well as requiring some expanded corporate disclosures that will provide more insights into why a board has chosen a particular leadership structure and how a company's board of directors manages risks. The Commission will also consider whether more disclosures are needed about executive compensation.

(c) Formation of Investor Advisory Committee to the SEC

In June 2009, SEC Chair Mary Schapiro announced the formation of an Investor Advisory Committee to give investors a greater voice in the Commission's work. The committee will provide input into the SEC's rule-making initiatives, including the 21st Century Disclosure project and the effectiveness of disclosures in general as well as issues involving new products, trading strategies, and fee structures. This committee would be made permanent by the Investor Protection Act of 2009 introduced by the Treasury Department in July 2009.

(d) Shareholder vote on executive compensation disclosures (Say on pay)

The Investor Protection Act of 2009 is designed to strengthen the SEC's authority to protect investors. Among other things, this Act would require that all public companies include a non-binding shareholder vote on executive compensation as disclosed in the proxy for any annual meeting held after December 15, 2009. It would also mandate a separate vote on golden parachutes in the case of a merger or acquisition with a clear and simple disclosure of the amounts executives will receive.

(e) Independence of compensation committees

The Investor Protection Act of 2009 would also require independence of compensation committees similar in some respects to that required for audit committees. This would meant hat compensation committees would need to meet new standards of independence, that any compensation consultants and legal counsel they hire must be independent from management, and that they must have the authority and funding to hire independent compensation consultants, outside counsel and other advisors as needed to ensure that executive compensation packages are in the best interests of shareholders.

(f) Proposed changes in proxy access

In June and July 2009, the SEC released the text of its controversial proposed rules on proxy access and disclosures.

- *Proxy access.* The proposed proxy access rules would allow shareholders to nominate directors (provided the shareholders meet certain ownership requirements), and companies would need to include the names of the candidates nominated by the shareholders in the proxy materials (subject to certain state law prohibitions).
- *Proxy disclosures.* The proposed proxy disclosure rules would require that companies make disclosures about the qualifications of directors (both incumbent and nominated) and executives, about how their compensation polices relate to risk, and about any potential conflicts of interest involving compensation consultants.

For more information, see the Center's separate report available at http://www.fincenter.org/Proxy_Access.htm

(g) Proposed changes to Regulation Z (Truth in Lending)

In July 2009, the Federal Reserve Board proposed changes in Regulation Z (Truth in Lending) to protect borrowers against certain kinds of lending practices that may have contributed to the initial stages of the financial crisis. The Fed's proposed rules would require lenders to:

- Provide additional disclosures to mortgage applicants and home-equity loan applicants, including a one-page Q&A document explaining risky features of a loan (such as balloon payments in adjustable-rate mortgages), a revised annual interest rate that includes most fees and costs, and a graph showing borrowers how their rates compare with rates of borrowers with excellent credit.
- Provide clearer information to loan applicants about costs, including costs of title insurance.
- Notify borrowers of home-equity loans 45 days before changing the terms of a loan.

- Prohibit the making of side payments (known as yield-spread premiums) to mortgage brokers or loan officers in exchange for steering borrowers to higher-cost or riskier loans.

### (4) US government

The Treasury Department has suggested that more tools could be made available to help the government manage any future crises. Most notably, a new regime could be established for addressing potential failures of nonbank financial institutions.

### (5) International cooperation

Recognizing that financial crises spread quickly around the world, the paper released by the Treasury Department includes a section on raising international regulatory standards and improving international cooperation. The stated objectives are to reach international consensus on how to best improve oversight of global financial markets, enhance crisis management tools, strengthen the capital framework, and coordinate supervision of internationally active firms.

Buried on the final pages of the Treasury Department's white paper are a few broad recommendations for accounting standards. Specifically, the paper suggests that the FASB and IASB should strive to do the following by the end of 2009: (1) clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, (2) improve accounting for loan loss provisioning, and (3) make substantial progress toward the development of a single set of high-quality global accounting standards. The paper mentions, but does not specifically endorse, the SEC's proposed roadmap to adopt IFRS. The Commission plans to consider the comments received on that proposal.

## Background Reports and Recommendations

Important events and papers leading up the new era of financial regulation include the following:

March 31, 2009. US Treasury Secretary Timothy Geithner outlined a framework for regulatory reform to address the lessons learned from the financial crisis.

March 29, 2009. Two former SEC Chairmen testified at a Senate Banking Committee hearing on the steps needed to respond to the financial crisis. Their comments generally favor greater transparency in financial reporting and reforms in the area of corporate governance to make boards of directors more accountable and better protect investors.

October 6, 2008. The Advisory Committee on the Auditing Profession issued its final report. Former Treasury Secretary Henry Paulson established this blue ribbon panel to examine the state of the auditing profession. The profession and its audits are a critical element to the effectiveness and efficiency of the US capital markets where 100 million people invest their savings and retirement assets.

March 31, 2008. The US Treasury Department released a blueprint for an improved regulatory structure. This Blueprint was a key part of then Treasury Secretary Henry Paulson's initiative to improve the competitiveness of the US capital markets in the increasingly global marketplace and to allow the US to more effectively protect investors and consumers in times of market disruptions. Paulson's recommendations included a new federal commission to oversee mortgage originations, modernization and elimination of duplication in the financial regulatory system, and creation of a new system to incorporate a market stability regulator, a prudential regulator and a business conduct regulator with a focus on consumer protection.

### Related Reports and Commentary

April 20, 2009. The G20 released a "Declaration on "Strengthening the Financial System." Among other things, it asks accounting standard-setters to improve standards for: (a) the valuation of financial instruments within the framework of fair value accounting, (b) the recognition of loan loss provisions, and (c) accounting for off-balance sheet exposures.

January 29, 2009. The Congressional Oversight Panel of the TARP released a special report on regulatory reform.

January 21, 2009. The GAO released a report entitled, "A Framework for Crafting and Assessing Proposals to Modernize the Outdated US Financial Regulatory System."

January 15, 2009. The Group of Thirty released a report on "A Framework for Financial Stability."

### Helpful Links

Legislative status
- House bill
  - http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/Financial_Regulatory_Reform.html
- Senate bill – chairman's mark-up
  - http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf
- Senate bill – manager's amendments
  - http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf

Obama Administration's white paper on "Financial Regulatory Reform"
- Executive summary - http://www.financialstability.gov/docs/regulatoryreform/executive_summary.pdf
- Full report - http://www.financialstability.gov/docs/regs/FinalReport_web.pdf
- Press Release - http://www.financialstability.gov/latest/tg_06172009.html

Investor Protection Act of 2009
- US Treasury Department's press release on the SEC's role, including the investor advisory committee and oversight of brokers, dealers and investment advisers - http://www.ustreas.gov/press/releases/tg205.htm
- US Treasury Department's press release on the regulation of credit rating agencies - http://www.ustreas.gov/press/releases/tg223.htm
- US Treasury Department's press release on the rights of shareholders to vote on executive compensation disclosures (say on pay legislation) - http://www.ustreas.gov/press/releases/tg219.htm
- US Treasury Department's press release on the requirements for independence of compensation committees - http://www.ustreas.gov/press/releases/tg218.htm
- Section of proposed legislation addressing improvements to the asset-backed securitization process - http://www.financialstability.gov/docs/regulatoryreform/07222009/titleIX.pdf

More legislation proposed by the US Treasury Department

- New financial services oversight board and other steps to better manage systemic risk
  - US Treasury Department's press release (provides links to proposed legislation) - http://www.treas.gov/press/releases/reports/title%20i%20fsoc%207222009%20fnl.pdf
- Private Fund Investment Advisers Registration Act of 2009
  - US Treasury Department's fact sheet - http://www.treas.gov/press/releases/tg214.htm
  - Proposed legislation - http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf
- More robust regulation of financial firms
  - Proposed legislation
  - National Bank Supervisor
  - Federal Depository Institutions Supervision and Regulation Improvements Act of 2009
  - Resolution Authority for Large, Interconnected Financial Companies Act of 2009
  - Payment, Clearing, and Settlement Supervision Act of 2009
- OTC Derivatives Markets Act of 2009
  - US Treasury Department's press release - http://www.ustreas.gov/press/releases/tg261.htm
  - Proposed legislation - http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf
- Consumer Financial Services Protection Agency Act of 2009
  - US Treasury press release on the - http://www.ustreas.gov/press/releases/tg189.htm
  - Proposed legislation - http://www.financialstability.gov/docs/CFPA-Act.pdf

Federal Reserve Board's press release and related information on proposed changes to Reg Z (Truth in Lending) - http://www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm

SEC chair's testimony on its priorities for 2009 - http://www.sec.gov/news/testimony/2009/ts060209mls.htm

SEC's press release on Investor Advisory Committee – http://www.sec.gov/news/press/2009/2009-126.htm

Documents published by the Center for Financial and Accounting Literacy

- Special Report on Madoff and Surprise Audits - http://www.fincenter.org/Madoff_Surprise_Audits.htm
- Special Report on Proxy Access and Disclosures - http://www.fincenter.org/Proxy_Access.htm
- Insights on Geithner Plan – http://www.fincenter/CFAL-insight-3-31-09.htm
- Insights of former SEC Chairs – http://www.fincenter/CFAL-insight-3-29-09.htm

Important background papers

- Report of the Advisory Committee on the Auditing Profession to the US Department of the Treasury - http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf
- Paulson's 2008 "Blueprint for a Modernized Financial Regulatory Structure" - http://www.treas.gov/press/releases/reports/Blueprint.pdf
- US Treasury Department's 2008 press release on blueprint - http://www.ustreas.gov/press/releases/hp896.htm
- 2008 Treasury Fact Sheet on blueprint - http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf
- Group of 20 (G20) "Declaration on Strengthening the Financial System" - http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf
- Congressional Oversight Panel (COP) special report on regulatory reform, "Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability" - http://cop.senate.gov/reports/library/report-012909-cop.cfm
- US Government Accountability Office (GAO) report on "A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System" - http://www.gao.gov/new.items/d09314t.pdf
- Group of 30 (G30) report on "Financial Reform: A Framework for Financial Stability" - http://www.group30.org/