Statement to Economic and International Trade Transition Team Regarding Regulation of Financial Services

The Association of the Bar of the City of New York

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Although the government has not yet commissioned a comprehensive study into the factors that led to the current economic crisis, regulatory failures are seen to have contributed significantly to the magnitude, and perhaps to the cause, of the crisis in the U.S. Decentralization and segregation of oversight responsibilities among a number of different regulators, without a framework for coordination among them, led to gaps in regulation. Duplicative and inefficient regulation and competition among regulators served as incentives to financial services providers to move their businesses abroad and to structure products and services in a manner so as to avoid U.S. regulation.

Financial products and services provided to U.S. retail investors and consumers are overseen by multiple regulators imposing overlapping requirements, based on outdated rules that were established largely in the 1930s and 1940s. In contrast, products and services provided to institutional investors are often not subject to any regulatory reporting and structured in such complex ways that it is difficult for regulators and investors to understand the systemic and investor risks that the products present. In general, the U.S. regulatory system was not designed to deal with the dynamic growth of the financial services industry has experienced over the past 80 years and, as currently structured, is not well-positioned to address the challenges facing our marketplace both at present and in the future.

The depth of the crisis provides an opportunity to look at regulation of financial services in a new way and address the problems that led to deterioration of the current system. As the Obama Administration begins its evaluation of the current financial regulatory framework, the Association of the Bar of the City of New York urges the Obama Administration to seek a new model for regulation of financial services and markets which ensures that the U.S. will continue to be the strongest, most important capital market in the world.

The Association of the Bar, founded in 1870, has over 23,000 members. While most practice law in the New York area, the Association’s membership includes lawyers from around the nation and in 50 foreign countries. The Association regularly reports on legislative and regulatory issues with regard to the financial sector.

In the hope that this Association can be of assistance in helping the Administration to think through a new approach, 10 of the Association's committees that address financial services issues and related fields have developed the following recommendations for the Administration to consider.

Regulatory Structure

1. *Regulation Based on Substance.* The regulatory approach should evolve from one based on form to one based on economic substance (e.g., swaps, forwards and futures should be overseen by the same regulator applying the same principles). Regulation of product distribution and creation would also be handled in a coordinated fashion, with the goal of avoiding gaps and redundancies contained in the current structure, which have led to the breakdown of regulatory oversight in a number of areas. Such an approach would encourage regulators to understand better the underlying economics of a product and its distribution, address valuation issues and, thereby, design an appropriate regulatory framework.

2. *Consolidation of Regulation and Centralization in a Federal Forum.* Consideration should be given to consolidating regulatory responsibilities into fewer federal agencies, to gain efficiencies and in recognition of the overlap of financial services and the integration of financial services companies. Given the increasing national and global aspect of the financial sector, consideration should be given to whether effective federal regulation would be a better approach than state-by-state regulation in the financial services area. The new structure should ensure that regulators have sufficient funding as well as appropriate independent oversight.

3. *Enhancing Disclosure and Transparency.* Any new regulatory paradigm should include an improved approach to disclosure and transparency which would feature:

a. More user-friendly disclosure to consumers, including disclosure of potential risk, so they can better grasp the risk/reward balance and other implications of the various financial products they are considering. Such an approach might well include consumer acknowledgement of that disclosure before purchase of the relevant financial product;

b. Enhanced reporting requirements for all products, to provide greater insight into the marketplace and transactions for investing professionals and the regulators;

c. Leveraging of available technology to deliver information efficiently and quickly, acknowledging the importance of the new speed of communication.

4. *Best Practices and Improved Communications Between Industry and Regulators.* In formulating the regulatory framework and regulating specific functions, the various financial industries should be brought into the process from the initial stages. Industries should be encouraged to advance "best practices" and make other recommendations in a continuing dialogue. We believe the regulations will be more effective with such collaboration, and those being regulated would better understand what is expected of them. The new paradigm would create a more cooperative relationship between the regulators themselves (both globally and in the U.S.) and between the regulators and the industry and enhance the flow of information between the industry and the regulators.

Regulatory Guideposts

Regulation of the financial sector should maintain the essential balance between protecting consumers and investors, on the one hand, and encouraging investment and capital formation on the other. The regulatory framework should promote efficiency, encourage innovation and promote stability in financing and investment.

Global Perspective

Regulation in the United States must be undertaken with an understanding of the increasingly global scope of the financial sector. The U.S. cannot attempt to regulate in a vacuum. This country should not risk losing its regulatory effectiveness or its role as the pre-eminent financial center by driving financial services firms and investors overseas and thus further from our regulatory reach. Nor should a new regulatory paradigm result in a sacrifice of disclosure, accounting and other standards that resulted in the historic preeminence of the United States financial markets. It is important to establish a framework within which regulators in the U.S. and abroad coordinate their enforcement and regulatory programs. This requires a more systematic approach than the current ad hoc establishment of memoranda of understanding by the SEC with foreign regulators and periodic meetings of the International Organization of Securities Commissions. The worldwide economic crisis should prompt international discussions regarding coordination of regulations and oversight (perhaps through a structure similar to the President's Working Group) as well as creation of uniform standards, such as adoption of international accounting standards, and frameworks to facilitate offering of cross-border products and services.

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In addition to these general recommendations, a number of Association committees put forth the following recommendations for your consideration regarding specific aspects of financial regulation:

- *Integrated Regulation of Broker-Dealers and Investment Advisers.*
  The same fair dealing standards would apply to broker-dealers and investment advisers, commensurate with the responsibilities contracted for with the client. Regulation would not change based upon the form of compensation or whether the advice is "incidental" to brokerage. The regulatory framework would include protections against abuses arising from conflicts of interest, including principal trades with an adviser or an affiliate, subject to exceptions or exemptions that would be consistent with investor protection and efficient markets (*e.g.,* blanket customer consent to principal trades would be recognized).

- *Cross-Border Mutual Funds Subject to Mutual Recognition.*
  A mutual/reciprocal recognition program should be developed to allow U.S. mutual funds to be offered abroad and foreign funds to be offered in the U.S. with notice filings in lieu of fund registration. The program would require: (i) funds to opt into certain essential local requirements (*e.g.,* Section 17 of the 1940 Act would be a required opt-in provision for foreign mutual funds); (ii) base level accounting standards and disclosure standards (i.e., provisions ensuring that potential U.S. investors receive full and fair disclosure at least commensurate with current U.S. disclosure standards, including the new summary prospectus rules); (iii) revision of tax, pension, securities and other laws and regulations, as appropriate, to ensure even-handed treatment of U.S. and foreign funds and (iv) cooperative agreements between U.S. and foreign regulators relating to exercise of enforcement powers and oversight authority.

- *Insurance Regulation.*
  Consistent with the over-arching themes of consolidated and coordinated regulation, including cross-border cooperation among regulators, consideration should be given to allowing U.S. regulators to have information and, possibly, some amount of regulatory oversight for foreign reinsurers, including regulation of non-U.S. unauthorized reinsurers (encompassing the concept of granting U.S. insurers credit for reinsurance based on a single U.S. jurisdiction for such reinsurers). In addition, consideration should be given to proposals for insurance company optional federal charters including potential impact on state-based consumer protections, optional vs. mandatory federal charters, coordination of insurance company insolvencies, and coordination of holding company regulation among federal financial services regulators and international insurance regulators. Furthermore, the new Administration should consider commissioning a study of whether more coordinated or unified regulation of insurance in combination with other financial services products is warranted.

- *Office of Insurance Information.*
  The Obama Administration should consider establishing an Office of Insurance Information to (i) gather information on current state insurance regulation including coordination of interstate regulatory initiatives (NARAB, single state authorization for reinsurance credit, Surplus Lines licensing and premium tax); (ii) receive information regarding insurance companies and products affecting the

broader financial markets (e.g., financial guaranty insurance); (iii) study coordination of state regulation of insurance affecting global insurance and reinsurance transactions, international accounting initiatives and global trade issues; and (iv) study the need to provide coordinated examination authority over insurance companies that operate as part of a financial services conglomerate as well as the appropriateness of regulating insurance at the federal level in conjunction with regulation of other financial services providers.

- *Financial Reporting Regulation.*
  Unlike many other areas of financial regulation, there have been extensive changes in the rules and framework of financial reporting over the past several years, and there are many recent studies and developments that call for further refinement of those regulations, in addition to a movement toward global standards. In that vein, we recommend that the new Administration approach with caution making further changes in this framework, at least until the changes in this framework have been consolidated and the move toward global standards has been assessed, as noted below. We commend to the Administration the consideration of the key recommendations developed by the Treasury's Advisory Committee on the Auditing Profession and the SEC's Committee on Improvements to Financial Reporting.

- *International Financial Reporting Standards.*
  There is a growing movement toward global standards – the International Financial Reporting Standards ("IFRS"). The SEC has proposed to allow some U.S. issuers to adopt IFRS. Adopting this proposal, in a form that encourages issuer participation, would be a very important step forward. We note that the independence of the IFRS standard-setters is crucial to the development of global standards. The federal government (not limited to the SEC) should exert pressure on European regulators to pursue this objective. In allowing U.S. issuers to adopt IFRS standards, the SEC should continue to be mindful of possible enhancements drawn from existing U.S. standards that have provided important investor protections.

- *Regulating Consumer and Mortgage Debt and Assisting Debtors.*
  Amidst the concern over assisting and regulating the financial services industries, careful attention must be paid to consumer mortgage debt and other consumer debt that are major drivers of the current market instability and economic crisis. The Obama Administration should consider establishing some regulatory mechanism with monitoring capabilities which will focus on the consumer debt problem and which can grasp the entirety of the problem. It should be designed to (i) ensure compliance with appropriate lending standards and (ii) develop programs providing different types of relief and education for borrowers who are experiencing difficulties in discharging their mortgage debt or credit card obligations, taking into account the interests of holders of the mortgage or other collateralized debt obligations, such as pension funds that hold interests in the debt through securitizations.

- *Regulation of Predatory Lending.*
  Consistent with increasing regulation in the consumer debt area, consideration should be given to expanding federal regulation of entities engaged in predatory lending and mortgage fraud practices, including allowing for appropriate enforcement powers. For example, federal prosecutors have difficulty prosecuting predatory mortgage lending practices that do not fall under the Bank Fraud Statute's definition of "financial institution," pursuant to 18 U.S.C. §1344. Expanding the definition to include non-FDIC-insured institutions would provide more flexibility to regulators and prosecutors as they deal with the changing landscape of the financial markets. We suggest a review of the scope of regulation over these entities generally, as well as a review of other criminal statutes that may have implications for banking and mortgage lending practices in order to determine whether relatively modest legislative changes can be made to update those statutes to deal with the changing financial landscape.

- *Coordinated Focus on Money Market Mutual Funds and Recognition of the Significant Economic Impact these Funds have on Financial Markets.*
  A task force should be commissioned to evaluate regulation of money market mutual funds, taking into account the complex but important role played by the products in our markets, including providing short-term financing to the capital markets while being looked to as a safe-haven for savings. The task force would consider and, if appropriate, recommend changes to the existing regulatory structure, including consideration of the need for governmental insurance.

- *Securitization Markets in General.*
  The Term Asset-Backed Securities Loan Facility ("TALF") program is a good first step toward reviving the asset-backed and mortgage-backed securitization markets. However, it is fairly limited in scope and has a number of shortcomings; in particular, (i) it does not alleviate a big obstacle to new lending--namely, that potential lenders' existing warehouse facilities and balance sheets are full of previously originated assets that such lenders have not been able to securitize, (ii) the one-year term of a TALF loan may limit its effectiveness in stimulating lending funded by ABS issuance, because most AAA-rated tranches of consumer ABS have a term greater than one year; and (iii) it does not provide liquidity for the subordinate tranches of securitizations it proposes to stimulate. We encourage the Obama Administration to address these issues and consider other ways, consistent with the appropriate level of scrutiny for financial soundness, to revive the securitization sector so as to stimulate lending.

- *President's Working Group (PWG) on Financial Markets.*
  We support the PWG recommendations for credit default swaps as a means to reduce counterparty risk by (i) creating clearinghouses that will facilitate settlement and hold collateral and (ii) increasing transparency to make markets more efficient.

Conclusion

The Association of the Bar and its various committees would be happy to discuss its recommendations and work with members of the transition team, the Obama Administration and Congress in the undertaking of regulatory reform, generally and on specific issues. We thank you for the opportunity to present our views and look forward to this Administration's taking advantage of the opportunity it has been afforded to create a modernized, effective and responsive financial regulatory framework.