Razor Alert

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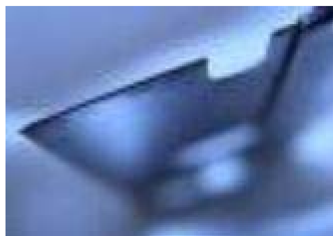

Issues to Consider in Treasury White Paper on Regulatory Reform

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On June 18th, 2009, the U.S. Treasury issued a White Paper proposing a new financial regulatory regime. This article highlights the legal issues and challenges implementation will face. This article is not intended as a summary.

The White Paper's approach to establish comprehensive supervision of the financial markets raises implications for: (1) the conduct and profitability of the capital markets, (2) the products (loans, investments, etc.) sold to businesses and individuals which are then securitized, (3) the insolvency regimes, and (4) cross border business, regulation, markets and products.
This article covers central counterparty clearing – OTC standard derivatives, asset securitization of off-balance sheet items, credit rating agencies, international issues, compensation, Treasury role on the FSOC, hedge funds, accounting issues, and consumer products.

Central Counterparty Clearing – OTC Standard Derivatives

- The proposed requirement to establish central counterparty clearing entities to trade standardized over the counter derivatives needs to be integrated with ("CCP") non-US efforts to do the same so that cross margining, netting, and settlement actions

between clearing organizations are harmonized to avoid possible default and uncovered exposures.

- The establishment of CCP's should be considered in the context of ensuring that where trades have a non-US component[i], or are entirely outside the US, the intended goals are met. These goals include minimizing the impact of counterparty default, ensuring the ultimate trade settlement, and enabling regulators to address market manipulation arising from the incentives inherent in short positions.

- The White Paper proposes to deal with the originate to distribute model in various ways that pose conflicts and challenges. The efforts to protect consumers should be coordinated with the efforts to increase disclosure about the securitization of products sold to customers. The data on the consumer protection side should be consistent with the information about underlying assets produced for investors.

- The White Paper does not focus sufficiently on customized over the counter derivatives since not all transactions can be forced on to a CCP or an exchange. Some form of netting, margin requirements, disclosure to regulators, and disclosure to the market should be imposed on participants in a transaction. There is no legal mechanism that could be fashioned to prohibit such customized derivatives, as some Congress members have proposed.

Asset Securitization of Off-Balance Sheet Items

- The proposal to require the originator to retain some un-hedged part of securitized risk may not always achieve the desired goal of aligning the originator's interests with those of the investor because many originators in the crisis did retain some risk. Moreover the capital requirements associated with risk retention tend to stimulate more conservative behavior only when an individual transaction may require more capital than what is available at the originator at that moment.

- Supporting the FASB proposal for banks to recognize income and losses during the life of a product is a positive development and regulators should require that compensation be tied to the recognition of income and losses.

- Retention of the first loss position could negatively impact the true sale of the assets and capital deployment. There might be alternative approaches to the risk retention requirement in order to ensure due diligence in underwriting standards and avoid misalignment of incentives and some are addressed in the White Paper itself.

- Congress should also focus on the proposed FASB rules which change the consolidation treatment of securitization vehicles.

- The White Paper proposes an asset securitization requirement that originator retain 5% risk. The Fed and other bank regulators already have many rules on the subject (the recourse rules, for example). Moreover, there are similar accounting and Sarbanes Oxley requirements. The idea that the 5% must remain un-hedged forever may put an originator in a precarious position later by restricting its ability to

rebalance its portfolio. Of course, the 5% risk retention requirement may moderate the incentives and behavior of bankers and banks to be more careful about what they originate and later securitize. The 5% risk retention requirement might support the argument that the vehicle is not off balance sheet as far as the originator is concerned. What would that mean for disclosure and risk assessment purposes? Shouldn't there be changes to the bankruptcy law to make sure that the originator has really conducted a true sale.

Credit Rating Agencies

- The White Paper proposal for regulating credit rating agencies by requiring disclosure of conflicts should be enhanced by specific requirements to create more competition for rating agencies, lowering the barriers for entry for rating agencies, minimizing liability defenses for rating agencies (since they are the beneficiaries of government imprimaturs), requiring rating agencies to provide advice/reports/ratings of advisers/rating agencies unrelated to the participants or a transaction, and thus encouraging unsolicited ratings. This involves a number of legal and regulatory issues in terms of disclosure of confidential information to other rating agencies and investors, obligations to disclose, and liability of disclosing parties.

International Issues

- Recommendations regarding OTC derivatives, hedge funds, and ratings agencies raise the same issues in an international context.

- Legal and regulatory reforms may be necessary to give U.S. domestic regulators the authority to capture non-U.S. entities or products which pose risks to the U.S. markets or which are non-compliant with domestic regulation; this could take place through different mechanisms and at different levels (for instance, through affiliated entities, U.S. investors, U.S. counterparties).

- The White Paper, in discussing international issues, focuses mainly on firms, while the crisis has shown the systemic risks arising from products held throughout a chain of market players. Supervisory colleges are a mechanism for sharing information among authorities, but they are only institution-oriented. While the White Paper supports the disclosure of appropriate information by hedge funds to assess the systemic risks they pose, it does not spell out any proposal for the exchange of information among authorities (on the contrary, the recent EU proposed legislation, even though it is specific to the EU institutional framework, contains some interesting mechanisms for aggregating and disseminating information on hedge funds risk exposures).

Compensation

- The issue of compensation practices raises a number of challenges in terms of regulatory consistency, scope of regulation, and legal/regulatory implementation mechanisms. There is the risk that compensation practices may lead to arbitrage favoring firms whose compensation practices are not regulated. Alignment of compensation practices with long term risk-taking may also take a place through a variety of legal mechanisms (e.g. contractual, corporate governance, risk management tools, disclosure, capital charges, tax, and accounting treatment), each of which should be carefully evaluated.

Treasury Role on the FSOC

- Treasury is the Chair of the new FSOC, but is currently precluded from involvement in institution-specific matters, as a means of preserving supervisory independence from political influence.

Hedge Funds

- The proposal would require registration of investment advisers for hedge funds and other private pools of capital. It also appears that, though the hedge funds and other private pools themselves are not required to register, they will be subject to examination, reporting, disclosure, and recordkeeping requirements. This seems to impose more direct requirements on the hedge funds than had been previously mentioned.

- The White Paper proposals that hedge funds would not be registered but that they would be subject to regulation, capital requirements, recordkeeping requirements, etc. is odd. One should distinguish between what hedge fund requirements would satisfy systemic objectives rather than consumer protection. Curiously, the White Paper does not mention directly the fact that many hedge funds have agreed with regulators that someone (the regulators or an independent company like an information clearing house) should have access to information about position risk, which could be aggregated and kept away from a particular hedge fund's competitors. The White Paper does suggest that the government would have access to hedge fund information about counterparties.

- The White Paper proposes that some hedge funds be designated as systemic hedge funds, but this will be difficult to capture. There are 5 factors to consider: where the investors are located, where the advisor is located, where the fund is formed, where the fund invests (the assets location or state of incorporation or regulation), and where the fund has counterparties. Size and this determination of location does not mean that a fund is systemically important. One could have a purely European fund that is systemically important. Or a small fund that invests in only one volatile but important asset class that is important. And what if the fund is really just an investment vehicle for one person or family. Does the family need to disclose its

investment positions so that the government can determine whether it is systemically important.

Accounting Issues

- The proposal recommends that accounting standard setters look at requiring more forward-looking loan loss provisioning and at the application of fair value accounting rules. At least in this chapter, there is no mention of possible changes to the rules regarding when off-balance sheet treatment is permitted.

Consumer Products

- The White Paper proposes to empower the SEC to establish a fiduciary duty to govern the relationship between broker-dealers and their customers; at present, while investment advisers are subject to such a duty, broker-dealers are subject only to the lesser requirements of the "suitability" standard, possibly discouraging brokers from providing informed investment advice, and thus deprive customers of information that they presently rely upon.

Links

The White Paper, US Treasury - Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation

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[i] Non-US parties, reference assets, derivatives, and clearing organizations