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Tussle begins over US market reforms

Hard times prompt calls for quick action, and the US regulatory agencies are ready to move. But, says Maureen Nevin Duffy, it seems that not all stakeholders have been locked into the process. Get ready as industry giants, the US Fed, the SEC, Treasury and Congress battle for ultimate oversight of the financial markets

July 7, 2008 just may go down in US financial history as the date investors and regulators declared their independence over the capital markets.

On that one day the US Federal Reserve's Ben Bernanke and the Securities and Exchange Commission's exiting chairman Christopher Cox issued their Memorandum of Understanding agreeing to share power and secret data as the two agencies unite to reform financial markets. The Certified Financial Analysts (CFA) Institute Center issued survey results attacking credit rating agencies and declared its intention to respond to the SEC's proposals; and the Securities Industry and Financial Markets Association (SIFMA) declared it would form a global, joint working group to "enhance market discipline and transparency".

It was also the week that Vanity Fair magazine hit the news stands with a story on the fall of Bear Stearns, whose meltdown initially lit this fire. The writer, author of the iconic 1980's book Barbarians at the Gate that chronicled the leveraged buyout mania of that decade, is an authoritative and incisive commentator on the state of the US financial sector. His new observation is that sea changes in regulatory structures are being proposed when the vultures haven't even finished picking over the bones of dead firms.

Pressure to act

The US has just witnessed the first run on, and the first major bail out, of an investment bank. The Federal Reserve, which supplied that money, now has to clarify its future role. Rhetoric abounds and the path ahead is littered with dire predictions. Sunday talk shows discuss the possibility that the US faces the worst economy since the Great Depression. The economy is hurting and the US public is seeking relief, fast.

But risk walks with change. Robert Armott, chairman of California-based Research Affiliates, which has $35 billion under management for clients who include CalPERS and Pimco worries that negative real interest rates are driving an intense desire for action at Congress. "That combination is dangerous. It can

wind up fueling an alternative bubble somewhere else in the economy. And it can create an environment of ratcheting up regulations."

He feels the big risk now is over-hasty action. "Government should play a role of not introducing new layers of moral hazard, not introducing bail outs of those who contributed to the current problems. And I do worry a great deal about Congressional over-reaction."

Myriad proposals for regulatory reform had formed by early June. But Harvard Professor Lawrence Summers told one newspaper: "So far, missing from the debate has been a set of principles describing the properties of any desirable regulatory regime, against which proposals can be evaluated."

Detailed proposals from the US Treasury, headed by former Goldman Sachs chairman Hank Paulson, offer a format to recognize the different needs of consumers and businesses relating to government protections or "guarantees". The Blueprint, as it is known, envisions an optimal regulatory structure consisting of a federal insurance guarantee corporation and a corporate finance regulator, and three new regulators focused exclusively on financial institutions. These are:

The Market Stability Regulator, to be assumed by the Federal Reserve, would be responsible for implementing monetary policy and providing liquidity to the financial system through traditional channels, as before. A recast role would also grant specific authority to collect "appropriate information from financial institutions, disclosing information, collaborating with other regulators on rulemaking, and taking corrective actions when necessary in the interest of overall financial market stability."

The Prudential Financial Regulator would focus on financial institutions with some type of explicit government guarantees associated with their business operations. Regulation would apply to individual firms and operate like the current regulation of insured depository institutions and cover such subjects like capital adequacy requirements.

A Business Conduct Regulator would be responsible for conduct across all types of financial firms, to address specific consumer protections such as disclosures, business practices and the licensing of some firms.

The Federal Insurance Guarantee Corporation would insure institutions supervised by the prudential financial regulator, set risk-based premiums, charge ex-post assessments, and act as receiver for failed prudentially regulated institutions.

The Corporate Finance Regulator would handle general issues related to corporate oversight in public securities markets; such as corporate disclosures

and corporate governance. Under this optimal structure, the Securities and Exchange Commission would continue jurisdiction over this area.

The US Treasury is also considering four broad conceptual options which it compares with the function-based system it has now, and to a more functional system, which would regulate the activities of firms as opposed to industry segments. Also on the table is a move to a single regulator for all financial services, similar to the UK system, or an objectives-based regulatory approach, used by Australia and others.

Paulson's blueprint also presents the pros and cons for each strategy. For example, a single consolidated regulator would eliminate the role of the central bank in financial institution regulation, but preserve its role in determining monetary policy. It also would allow for a consolidated, and hopefully clearer, view of overall risks to the system. However, it might also lead to less market discipline, since the same regulator would regulate all financial institutions.

The July 7 MOU between the SEC and the Federal Reserve Board was aimed at combining the powers of both, but seems to ignore the US Treasury. Throughout the 10-page agreement, which can be rescinded by either party on 30 days notice, are descriptions of the type of information, gathered from the parties under each institution's authority, which is to be shared with the other. There is emphasis on protecting access to the information by other than these two. But it raises the question of whether a future Hank Paulson might have trouble keeping a handle on what's going on with the banks and the broker dealers they serve if such restrictions are in place.

Take for example section C of the MOU, which deals with coordination regarding capital, liquidity and funding. The SEC and the Fed will "cooperate in obtaining (including through visitations reports and other means), analyzing and evaluating information regarding the capital, liquidity and funding position and resources and associated risk management systems and controls of CSEs (Commission Supervised Entity) and Primary Dealers."

There is no mention of sharing findings or reporting to the Treasury, which responded, on its website, with the apparently composed comment: "The MOU finalized between the SEC and the Federal Reserve is consistent with the long-term vision of Treasury's Blueprint for a Modernized Regulatory Structure and should help inform future decisions as our Congress considers how to modernize and improve our regulatory structure."

However, a former Treasury counsel official, quoted by Bloomberg news agency, might provide a glimpse of real sentiment. The only reason for the Fed to have an interest in how investment banks are doing, is if it intends to step in and provide access to the discount window in more normal times, said Peter

Wallison. "Once that idea gets established then market discipline essentially disappears.''

In June, senators Christopher Dodd and Richard Shelby, two senior members of the US Senate Banking Committee objected in a letter to Bernanke and Cox at the progression of the MOU before Congress had had a chance to comment. Dodd and Shelby also noted that Congress has yet to give the Fed permanent authority to lend to securities dealers. Congress planned to hold its own meetings on financial regulations later in July.

"It is my hope that the MOU will result in improved supervision of investment banks and bank holding companies, and strengthen our financial markets for investors and our nation's economy," reads a release from Dodd. "It is important to note that the MOU does not grant any new authority to either agency, nor does it affect the ability of the Congress and the Senate Banking Committee to oversee regulated institutions and markets. I am pleased that the MOU seeks to achieve its important objectives while leaving consideration of any broader reforms to our financial regulatory landscape to Congress-- issues that the Senate Banking Committee will begin to examine in greater detail over the coming weeks and months."

Market commentators say that is a polite way of telling the US Fed and the SEC to get back in line. But will they? This could be the calm before a long overdue regulatory storm.

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