

## **Commentary: The Art of the Possible in Financial Regulatory Reform**

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This Wednesday, the Obama administration released its 89-page White Paper entitled “Financial Regulatory Reform: A New Foundation.” Asked whether the proposals were influenced by political considerations, President Obama replied that he was seeking to propose something that could be enacted.

Viewed one way, the question about “political considerations” is silly. After all, the people who would enact these proposals are our elected officials, and every one of them is a “politician.” From a different perspective, and the one President Obama treated seriously, the question and its answer speak volumes about how our system of government will respond to the most severe financial crisis in over 70 years.

The *Wall Street Journal* has been publishing articles from 1934, when various important financial figures decried the need for any sort of regulation of the financial services industry. The trio of legislation consisting of the Glass-Steagall Banking Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934 would, according to these financial sophisticates, remove all liquidity from the markets, terminate industrial progress, and usher in a return to the dark ages.

But things are different now. The plethora of federal agencies that regulate various aspects of the financial services industry are supervised by various Congressional Committees, each of whose members can expect generous campaign contributions from their financial services constituents, none of which are likely to include any of the good people who elected them back in Ohio. So, there is no foolish talk about whether financial services regulation should be eliminated this time around.

Instead, systemically important financial services firms have built their business around financial services regulation. Accordingly, regulation serves a dual role. It protects the public – I am not one who favors the Wild, Wild West – and it also insulates financial services firms from competition by the unregulated. Incidentally, since money is the mother’s milk of politics, it also helps incumbent politicians better deliver their message to the public.

What this means is that the financial services industry is not going to try to derail President Obama’s efforts at regulatory reform. Instead, they will try to shape it in

ways that will favor their business models and, with any luck, see off difficult competitors.

The lynchpin of the President's proposal is the creation of something called a "Tier 1 Financial Holding Company." Any financial institution – a bank, broker-dealer, insurance company or hedge fund – could be placed in this category. Using standards enacted by Congress, the Federal Reserve Board would determine who would belong. Essentially, all systemically significant firms, described in the proposal as any financial firm that poses a threat to our economy's financial stability based on size, leverage or interconnectedness to the financial system, will be classified as a Tier 1 Financial Holding Company.

The SEC will remain intact, as will the CFTC. But, the realm of these agencies will be threatened from the top and the bottom.

At the top, the Fed will regulate the largest investment banks and investment funds. The Fed will also regulate clearing and payment systems, such as the one operated by DTC. It is true that the Fed is supposed to consult with the SEC and, where possible, derive its information from the SEC. But, where that information is not forthcoming, the Fed will have authority to seek that information directly, no matter what the SEC has to say about it. Moreover, the Fed will have the responsibility to determine whether Tier 1 FHCs are "well capitalized" and "well managed." Since these determinations will have a huge impact on the profitability of these firms, not to mention who gets to run them, it should not come as a surprise when they start to pay a lot more attention to the views of the Fed, as compared to the SEC. The old maxim about not being able to serve two masters comes to mind.

At the bottom, there will be a new "Consumer Financial Protection Agency" to protect retail consumers of financial products, and especially consumers of real estate mortgages. In a nod to the power of Congressman Barney Frank, the proposal makes clear that this new agency will not have authority over investment products supervised by the SEC. But, you have to wonder how long it will be before mutual funds belong to this new consumer watchdog. Certainly, not past the first scandal involving these products.

Since the proposal contemplates that most existing agencies will remain intact, although most of them will lose some power to the Fed, something must be done to make them work together. This will be accomplished by an eight-member Financial Services Oversight Council, which will replace the ad hoc President's Working Group. The members of the Council will be the (i) Secretary of the Treasury, who shall serve as the Chair; (ii) the Chair of the Board of Governors of the Federal Reserve System; (iii) the Chair of the CFTC; (iv) the Director of the newly created Consumer Financial Protection Agency; (v) the Chair of the Federal Deposit Insurance Corporation (FDIC); (vi) the Director of the Federal Housing

Finance Agency (FHFA); (vii) the Director of the newly created National Bank Supervisor (NBS); and (viii) the Chair of the SEC. However, the Council's power will be largely advisory. It can recommend that certain firms be considered Tier 1 FHCs, and the Fed is supposed to consult with the Council about the risk-management standards that should be adopted by Tier 1 FHCs. But, in the end, it is the Fed that determines who it should regulate and the means to accomplish its regulatory goals.

Many observers have proposed the merger of the SEC with the CFTC. Recognizing the need to placate the two Congressional committees that independently provide oversight to these agencies, this idea has been abandoned. Instead, the SEC and CFTC will be required to work together, primarily to seek a way for national securities exchanges to trade securities futures. If they can't figure out how to play nice together, their differences will be resolved by the Financial Services Oversight Council. The trading of securities futures is big business for the commodities exchanges and those who work on them and will be an important new source of business for the NYSE and NASDAQ. The dogfight over this business should finance many a political campaign before it is over.

The contest over the securities futures business is replayed over and over in this proposal. As I read it, most businesses in the financial services industry stand to win some and lose some here. It seems designed to provoke well-financed proponents and opponents at every turn. The financial services industry is composed of competitors, and this is a proposal that is bound to get the competitive juices flowing. This situation is, of course, an absolute boon for politicians who can expect "political support" from every side.

There is much, much more in President Obama's proposal. Time would fail me if I tried to describe even a few of the many proposals that will eliminate many business models in the world of commercial banking and the savings industries and provide rich opportunities for others. The proposal will have a dramatic effect on the securitization and derivatives businesses of commercial and investment banks. There will be an effort to restrain executive compensation inside and outside of the financial services industry. Hedge fund advisors will have to register with the SEC and be required to provide information about the funds they advise, which sounds to me a lot like hedge fund registration.

If these were normal times, if President Obama and his staff were not so savvy, there wouldn't be a chance that any of this would clear a Congressional committee. But these are not normal times, and President Obama's staff is chock full of canny political operatives. This is a clever proposal, designed in a realistic way – some would say a cynical way – to divide the financial services industry into its many competitive, quarreling pieces and render it difficult for Congress to oppose. My guess is that very few members of Congress will be forced to choose

between what is best for their country, if that's what you think regulatory reform is all about, and their political future. The President has done all he can to merge these two objectives.

It is not a perfect proposal. Much that should be fixed will not be, and the ultimate outcome will likely impose a lot of unnecessary regulatory cost. But no one knows better than this President that the perfect is the enemy of the good. This is high political art, performed by a master.

For all of these reasons, I think a lot of this will come to pass.