



THE VOLCKER ALLIANCE  
*Working for Effective Government*



# Reshaping The Financial Regulatory System

**LONG DELAYED, NOW CRUCIAL**

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This paper is the product of the Volcker Alliance project on Reform of the Federal Financial Regulatory Agencies. It is an important goal of the Alliance to produce reports that contain ideas, proposals and recommendations for dealing in new ways with persistent governance problems based on independent research and analysis supporting constructive solutions. To stimulate this process and maintain project independence to make such conclusions and recommendations as they deem to be appropriate, these Alliance projects are commissioned to proceed without the requirement of approval of their conclusions and recommendations by the Board of Directors collectively, or by individual members of the Board of Directors. The current project, led by Chairman Paul Volcker, supported by the Alliance Staff and outside independent consultants, is the first of the projects completed under this policy.



## ABOUT THE ALLIANCE

THE VOLCKER ALLIANCE was launched in 2013 by former Federal Reserve Board Chairman Paul A. Volcker to address the challenge of effective execution of public policies and to help rebuild public trust in government. The non-partisan Alliance works toward that broad objective by partnering with other organizations – academic, business, governmental, and public interest.

The Alliance aims to be a catalyst for change – encouraging our public and educational institutions to give sustained attention to excellence in the execution of public policies at the federal, state and local level in the US and abroad. Our efforts will be reflected in meaningful research, well-supported proposals for action, and initiatives that ultimately produce better outcomes and accountability. We will work closely with the professional schools preparing people for public service and other organizations, always in the interest of restoring trust and pride in the way our public institutions implement policy.

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## PREFACE

THE VOLCKER ALLIANCE, which I founded with some interested colleagues a couple of years ago, has an ambitious mandate: strengthening government performance both by improving education for public service and by enhancing the framework for the effective execution of public policy.

Our mantra is taken from an axiom of Thomas Edison: “Vision without execution is hallucination.”

While our focus is by no means limited to finance, the massive financial crisis of recent years has encouraged attention to the long-standing disarray in the federal system for regulating financial institutions and financial markets. Legislation, notably the Dodd-Frank act of 2010, has addressed the substance of regulation. But it has done little with respect to the fragmentation, overlaps, and glaring gaps in regulatory and supervisory authority.

In one sense, it’s an old story. Numerous attempts at reform over decades have been frustrated.

Now, with the massive impact on the economy of the financial breakdown, passivity in making necessary changes cannot reasonably be accepted. This report is part of an effort to stimulate needed debate and congressional action.

The recommendations offered in this report lay out a strong framework for reform. We recognize differing particular proposals could be consistent with this framework. What we do insist is that Congress, the administration, existing regulatory agencies, and financial institutions themselves step up to the needed debate and set out an agreed program for reform suitable for the 21st century.

I would be remiss without recognizing the leadership of the Alliance’s director of financial regulation, Gaurav Vasisht, and the special contributions of Alliance board members Michael Bradfield and Anthony Dowd.

PAUL A. VOLCKER

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## OVERVIEW

THE SYSTEM FOR REGULATING FINANCIAL INSTITUTIONS in the United States is highly fragmented, outdated, and ineffective. A multitude of federal agencies, self-regulatory organizations (SROs), and state authorities share oversight of the financial system under a framework riddled with regulatory gaps, loopholes, and inefficiencies. Never coherently designed, the regulatory framework developed in a piecemeal fashion over the past 150 years, as Congress established a plethora of new agencies and eliminated others primarily in response to financial panics and periods of economic instability.<sup>1</sup> Notably, while the regulatory structure has seen some modification in recent decades, its foundational elements have been in place since the 1930s.

Unlike the regulatory system, however, the financial system has experienced significant transformation in the past few decades. Notably:

- Banking system assets have become concentrated in a handful of extremely large, exceedingly complex, globally active, and highly diversified institutions, with huge trading books and even, in some cases, ownership of industrial assets such as coal mines, oil tankers, and power plants;<sup>2</sup>
- The less regulated market outside the traditional banking system, or shadow banking, has emerged as a bigger part of the whole financial system, with increased reliance on potentially unstable forms of short-term funding that create the risk of contagion and fire sales (notably, nonbank financial institutions hold two-thirds of all credit-market assets);<sup>3</sup>
- Financial products have rapidly and fundamentally changed, becoming exceedingly complex and substantially increasing the opacity of the financial system;<sup>4</sup>
- Alternative investment funds, such as hedge funds and private equity funds, have become highly leveraged, including through the use of derivatives transactions;
- Assets under management have grown dramatically and become concentrated in the largest fund complexes;<sup>5</sup> and
- Equities markets have become fragmented, more complex, and less transparent, in part as a result of technological advances, with increasing participation from unregulated entities, such as high-frequency trading firms.<sup>6</sup>

The transformation of the financial landscape placed the outmoded and fragmented regulatory framework under significant strain in the run-up to the financial crisis, exposing

its shortcomings. For example, gaps in the regulation of the markets for mortgages, short-term funding, and over-the-counter (OTC) derivatives allowed significant risks to build in the financial system and ultimately contributed substantially to its collapse. In addition, interagency jurisdictional conflicts often resulted in delays or inaction on critical matters, including the promulgation of rules and interagency guidance on subprime lending. Moreover, no single agency had a comprehensive understanding of the risks in the financial system, as each agency remained focused only on its area of supervision. Finally, increased opportunities for regulatory arbitrage—particularly in the supervision of large thrift institutions such as American International Group (AIG) and Countrywide Financial, and in the now-extinct large, stand-alone investment banks, including Lehman Brothers and Bear Stearns—allowed systemic risks to multiply.<sup>7</sup>

In describing how the regulatory structure contributed to the financial crisis, former Secretary of the Treasury Timothy Geithner wrote in his memoir, *Stress Test: Reflections on Financial Crises*:

... [Our] weak and disjointed regulatory system, riddled with gaps and evasion opportunities, cried out for reform. Government oversight just hadn't kept up with the fast-growing and fast-changing frontiers of finance, from the exotic innovations in mortgage markets to the explosion of complex derivatives. The financial cops weren't authorized to control the system's worst neighborhoods, and they weren't aggressive enough about using the authority they had. While we clearly needed better safeguards against systemic risk in these new frontiers outside the traditional banking system, we also needed to make sure individual Americans were not left vulnerable to predation and abuse there.<sup>8</sup>

Secretary Geithner's predecessor, Henry M. Paulson, Jr., similarly wrote in his memoir, *On the Brink*:

Regulatory reform alone would not have prevented all the problems that emerged. However a better framework that featured less duplication and that restricted the ability of financial firms to pick and choose their own, generally less-strict, regulators—a practice known as regulatory arbitrage—would have worked much better. And there is no doubt in my mind that the lack of a regulator to identify and manage systemic risks contributed greatly to the problems we faced. We need a system that can adapt as financial institutions, financial products, and markets continue to evolve.<sup>9</sup>



In her 2010 testimony before the Financial Crisis Inquiry Commission (FCIC), a body established by Congress to examine the causes of the financial crisis, then-Vice Chair of the Federal Reserve Board Janet Yellen spoke of delays in issuing guidance for commercial loan underwriting standards in the run-up to the financial crisis. She said:

This kind of process that I think we have had where it takes six different regulators [...] to negotiate in what I gather is an excruciating process over many years, to do something in the end that is probably too little too late. To my mind, that process fails.<sup>10</sup>

The main focus of the Dodd-Frank act was to strengthen and expand the scope of regulation, not to rationalize the regulatory framework. As a result, many of the structural deficiencies highlighted by the financial crisis remain substantially unaddressed. Notably:

- Important parts of the financial system remain insufficiently regulated or unregulated and not well understood;<sup>11</sup>
- Significant forms of risk have migrated and continue to migrate to less-regulated or unregulated parts of the financial system;<sup>12</sup>
- The regulatory system remains insufficiently forward-looking and equipped to identify and address emerging threats to financial stability in a timely manner;
- The locus and effectiveness of prudential supervision for certain large market participants, such as broker-dealers and derivatives clearing organizations (DCOs), remains uncertain;
- Some agencies remain under-resourced even as their responsibilities have grown exponentially;<sup>13</sup> and
- The multiagency framework continues to fuel interagency tension; cause communication and coordination problems at home and abroad; foster a lack of accountability (with everyone involved but sometimes no one in charge); impede timely response to critical matters; and disperse the available talent, training, and resources of the regulatory system across a multitude of agencies.<sup>14</sup>

That the regulatory system needs fixing should not be news. Its reform has been on the public agenda for many decades. There have been more than 25 official reform proposals since World War II, spanning Democratic and Republican administrations; virtually none have met with significant success.<sup>15</sup> Opposition from various stakeholders that benefited from the status quo impeded these historic reform efforts.

What is clear today that may not have been evident years ago is that despite the continu-

ing good faith efforts of our professional and skilled regulatory agencies, failure to reorganize the regulatory structure will contribute to the buildup of systemic risk and make us more vulnerable to the next financial crisis. Given the lessons of the last crisis, the toll it continues to take on American households and the economy at large, and the resulting loss of public trust and confidence in our regulatory system and once-venerated financial institutions, this is a result we can ill afford.

This report details the need to reorganize the current regulatory system. The aim is a simpler, clearer, more adaptive, and more resilient regime that would have a mandate to deal with the financial system as it exists now and would be capable of keeping pace with the evolving financial landscape. In making its recommendations, the report remains true to certain core organizational principles that are designed to ensure a balanced, comprehensive, independent, and effective regulatory framework aimed at achieving sustained financial system stability. These guiding principles are as follows:

- The Federal Reserve, as the nation's central bank, must retain primary responsibility for—and have the tools to enhance—financial stability. However, regulatory authority must not become overly concentrated or centralized in a single agency, not only because such responsibility would be too large for any one agency to undertake effectively, but also because it would fail to provide adequate checks and balances.
- The secretary of the Treasury, as the representative of political and executive authority and broad economic policy, should be kept well-informed of developments in the financial system and remain able to intervene promptly in crises requiring governmental action. However, the secretary should not be involved in regulation and supervision in an ordinary, continuing way or otherwise encroach on the independence of the regulatory agencies.
- The regulatory system must have broad competence, with the ability to identify, monitor, and address in a timely manner systemic risks as they develop throughout the financial system, especially all activities and practices that may pose a threat to financial stability.
- The regulatory system must contain effective safeguards to help ensure the independence of the responsible agencies; reduce the risk of groupthink; and guarantee a broad perspective in governance and decision-making, including arrangements to spur corrective action when necessary.
- The regulatory system should recognize and appreciate that not all financial institu-

tions need the same intensity of oversight. For example a true community bank that recycles its deposits in the form of loans to the community it serves should not be subjected to the regulatory framework for institutions engaged in a broader range of risky activities.

- Each agency must be able to rely on independent financial resources to appropriately fund its operations while remaining subject to effective congressional oversight.
- Expertise and experience must be infused in the professional staffs of regulatory and supervisory agencies, recognizing the need for appropriately attractive compensation practices and engaging with colleges and universities to offer more coursework and degree programs to enhance the stature of the profession.

Informed by these guiding principles, the recommendations in this report can be categorized under three broad, objectives-based rubrics: (1) oversight and surveillance; (2) supervision and regulation; and (3) investor protection and capital market conduct. The report assumes no change in respect to consumer protection, which would remain an important objective of the reconfigured regulatory system. The insurance and mortgage markets, likewise, are beyond the scope of this report but remain an important area of concern for public policy. Importantly, the recommendations highlighted are consistent with preserving the dual banking system that has provided an element of checks and balances, consistent with the nation's strong federalist roots.

Our key recommendations are set out below in general terms. Each is supported by detailed analysis later in the report.

In setting out these specifics, we recognize that alternative approaches to reform and the specific proposals will be debated in developing needed legislation. What we insist on is that the status quo is not satisfactory and that the considerations set forth above are relevant to any reform.

## **Oversight and Surveillance**

*Enhance independence, authority, breadth of perspective and overall effectiveness*

■ The Financial Stability Oversight Council (FSOC) would continue its role as a coordinating council and designation authority of systemically important financial institutions (SIFIs) and remain chaired by the secretary of the Treasury. However:

- The FSOC **would establish a Systemic Issues Committee (SIC)** composed of the

chairman of the Federal Reserve, the chairman of the Federal Deposit Insurance Corporation (FDIC), the director of the Federal Housing Finance Agency (FHFA), the director of the Consumer Financial Protection Bureau (CFPB), the chair of a newly created Investor Protection-Capital Market Conduct Regulator (see below), the director of the Office of Financial Research (OFR), and a state insurance commissioner designated by the state insurance commissioners.

- The SIC would have the ability to designate SIFIs and require **new or enhanced prudential standards and safeguards on all activities and practices that could pose a threat to systemic stability even if conducted outside the present sphere of prudential supervision**. The Federal Reserve would have the responsibility for promulgating the rules for any new or enhanced standards and safeguards required by the SIC, with implementation of these rules by the new Prudential Supervisory Authority (PSA).
- The FSOC would be empowered to **review the rules and regulations** of its member agencies and **recommend** or **require** changes to the extent necessary to help maintain financial stability.

■ The OFR would be **removed from the Department of the Treasury and become an independent entity**, with its director continuing to be appointed by the president and subject to Senate confirmation. The director would be required to testify at least semiannually at congressional oversight hearings.

- The **OFR director would serve as a member of the SIC**.
- The OFR would, as now, have the mandate to collect, compile, and standardize data; regularly publish aggregated data and analysis; have a reinforced emphasis on identifying possible emerging threats to financial stability; and issue reports and **recommendations to the FSOC** on matters of systemic risk.

■ The Federal Reserve, as the central bank responsible for monetary policy and acting as lender of last resort, would maintain its core function of promoting systemic stability. It would:

- Monitor **activities, practices, trends, and emerging issues** horizontally across firms and the financial system, **including financial markets not entirely in the sphere of present prudential regulation**, focusing on such things as the interdependence of institutions, trends in leverage and risk management, infrastructure of the markets,

- and significance of new institutions and innovations;
- Utilize available authority to address risks to financial stability. Where it may lack such authority, it would **make recommendations to the SIC** for the designation of systemically risky activities or practices. If the SIC approves the recommendations, the Federal Reserve would have the responsibility for **establishing** new or heightened safeguards for such activities or practices.

### Supervision and Regulation

*Eliminate gaps and overlaps, enhance quality of supervision, and centralize resources while providing an appropriately represented governance structure and congressional oversight*

■ **Establish a new PSA** as an independent agency encompassing the: (1) prudential supervisory functions currently performed by the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC in respect to bank and thrift holding companies, state and federally chartered depository institutions, branches of foreign banking organizations, financial market utilities, and SIFIs; and (2) prudential supervisory functions currently performed by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with respect to broker-dealers, swap dealers, DCOs, clearing members, futures commission merchants (FCMs), and money market funds (MMFs).

■ The PSA would:

- Be **chaired by the vice chairman for supervision of the Federal Reserve, who would be required to testify at least semiannually at congressional oversight hearings.**
- Include on its governing body the **chairman of the FDIC, the chair of the new, combined SEC-CFTC (see below) and two presidentially appointed independent members with staggered seven-year terms.**
- Have a **special division for the supervision of true community banks** to help ensure the appropriately tailored regulatory treatment of these institutions.<sup>16</sup>
- Be **funded either through industry assessments or the Federal Reserve System** while encouraging a system of robust congressional oversight.

■ **The Federal Reserve Board would have authority for prudential rulemaking** with respect to entities, activities, and practices subject to PSA supervision or as authorized by the

SIC. This rulemaking authority would include establishing **prudential standards**, including setting capital, liquidity, and margin requirements. The **PSA would be authorized to propose** any such regulations or guidelines to the Federal Reserve for approval.

■ The Federal Reserve would have ready **access to all supervisory exam reports and data from the PSA and the OFR**, as well as **“backup” examination authority**, with the ability to conduct its own examination of any institution supervised by the PSA and particularly any institution seeking Federal Reserve financial support. The Federal Reserve would retain a team of highly qualified examiners for this purpose.

■ **The FDIC would retain its deposit insurance function and its orderly liquidation authority for receivership and resolution** with respect to insured banks and significant financial institutions.

- The FDIC would have a team of senior examiners and **retain its backup examination authority**, as needed, to discharge its statutory responsibilities with respect to the depositories it insures and the resolution of potentially failing nonbank SIFIs.
- To enhance interagency coordination, **an independent member of the PSA would serve on the board of the FDIC**, replacing the comptroller of the currency.

■ The OCC would be eliminated.

### **Investor Protection-Capital Market Conduct**

*Assure effective and efficient direction of the key responsibilities of investor protection and capital market conduct, reduce interagency friction, enhance market surveillance, and ensure independent and adequate funding of the agency*

■ **The SEC and the CFTC would be merged** to create a new, independent investor protection and capital market conduct regulator (SEC-CFTC).

- The SEC-CFTC would be governed by a board of five members appointed by the president and confirmed by the Senate with relevant experience, who would be appointed to staggered **seven-year terms** without regard to political party affiliation.
- The new agency would combine the current rulemaking authority of the SEC and the CFTC with respect to matters of investor protection, the structure of securities and

derivatives markets, and the integrity of those markets. (The PSA would have responsibility for prudential supervision of broker-dealers, swap dealers, DCOs, clearing members, FCMs, and MMFs.)

- The combined agency would be **funded through fees and assessments**, not including fines and penalties.
- A desirable oversight arrangement may be for the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services to oversee the combined agency, with **concurrent oversight** by the Senate and House Agriculture committees.
- The chair of the SEC-CFTC would **serve on the board of the PSA and as a member of the FSOC**, providing a voice to the agency in prudential supervision of financial institutions, while focusing the agency on its core missions.

## INTRODUCTION

IN SPRING 2014, THE VOLCKER ALLIANCE began the project to promote reorganization of the highly fragmented and antiquated US financial regulatory system. The Alliance chose this reform project for several reasons.

*First*, the need for reform is unambiguously clear!

*Second*, reorganization represents a significant piece of the unfinished business of Dodd-Frank. Indeed, reorganization was considered part of the post-financial crisis reform agenda but was removed from what ultimately became the Dodd-Frank act to ensure passage of the substantive reform measures.

*Third*, reorganization of the regulatory framework is not a matter of substantive regulation but rather of structure and design. Therefore, the issue should not be as ideological or partisan as the many other, more substantive matters Congress is examining.

*Fourth*, despite the long and largely unsuccessful history of efforts to reform the regulatory system, the need for reorganization is more obvious than ever given the difficult lessons of the financial crisis. Indeed, virtually every postmortem of the financial crisis, especially those of former senior regulatory participants in the system, cites the convoluted regulatory system as a contributing factor in the financial meltdown.

*Finally*, successfully implemented reform would have a significant, beneficial effect on the quality of regulation and the stability of the financial system—a benefit that should continue for many years.

The analysis in this report aims to inform serious consideration of an issue of fundamental importance that, if resolved, would help establish and maintain a stronger financial system and foster a vibrant economy. This report should also help inform policymakers about: (1) how the current regulatory framework allows risks to multiply in the financial system; and (2) possible approaches to creating a more robust and resilient regulatory framework.

The recommendations contained in this report required significant study and analysis. In developing the analytical foundation for the recommendations, the Volcker Alliance:

- Conducted the most comprehensive study to date of historic proposals to restructure the regulatory framework, spanning more than 100 years of such reform efforts;
- Evaluated the strengths and weaknesses of the regulatory structures of key foreign jurisdictions—including Australia, Canada, France, Germany, Japan, and the United Kingdom;



- Assessed the flaws in the current structure of regulation of banking, insurance, securities, derivatives, and shadow banking;
- Conducted discussions with former and current regulators, academics, trade associations, consumer advocacy groups, financial institutions, and members of Congress;
- Held various informal colloquia and public programs on issues of relevance to regulatory restructuring; and
- Analyzed existing works, including studies, white papers, treatises, memoirs, and other research memoranda from a wide range of sources, including the Treasury Department, the Federal Reserve Board, the Financial Crisis Inquiry Commission, the Government Accountability Office, the International Monetary Fund, the Financial Stability Board, academic institutions, and not-for-profit organizations.

Reform is typically difficult to achieve, and reshaping the regulatory framework will likely not be the exception. Particular interests are entrenched and will attempt to preserve themselves and their authority. But given the high stakes, where inaction could lead to the next financial crisis, it is imperative that short-term economic and political interests be set aside in favor of the long-term stability of our financial system and the future growth of our economy. The path of reform may be difficult, but it would be *more* difficult to bear the consequences of not doing anything. Political wisdom may in fact warn us that reform is not possible, but the stakes are simply too high to allow that notion to stand unchallenged.

## THE NEED FOR REFORM

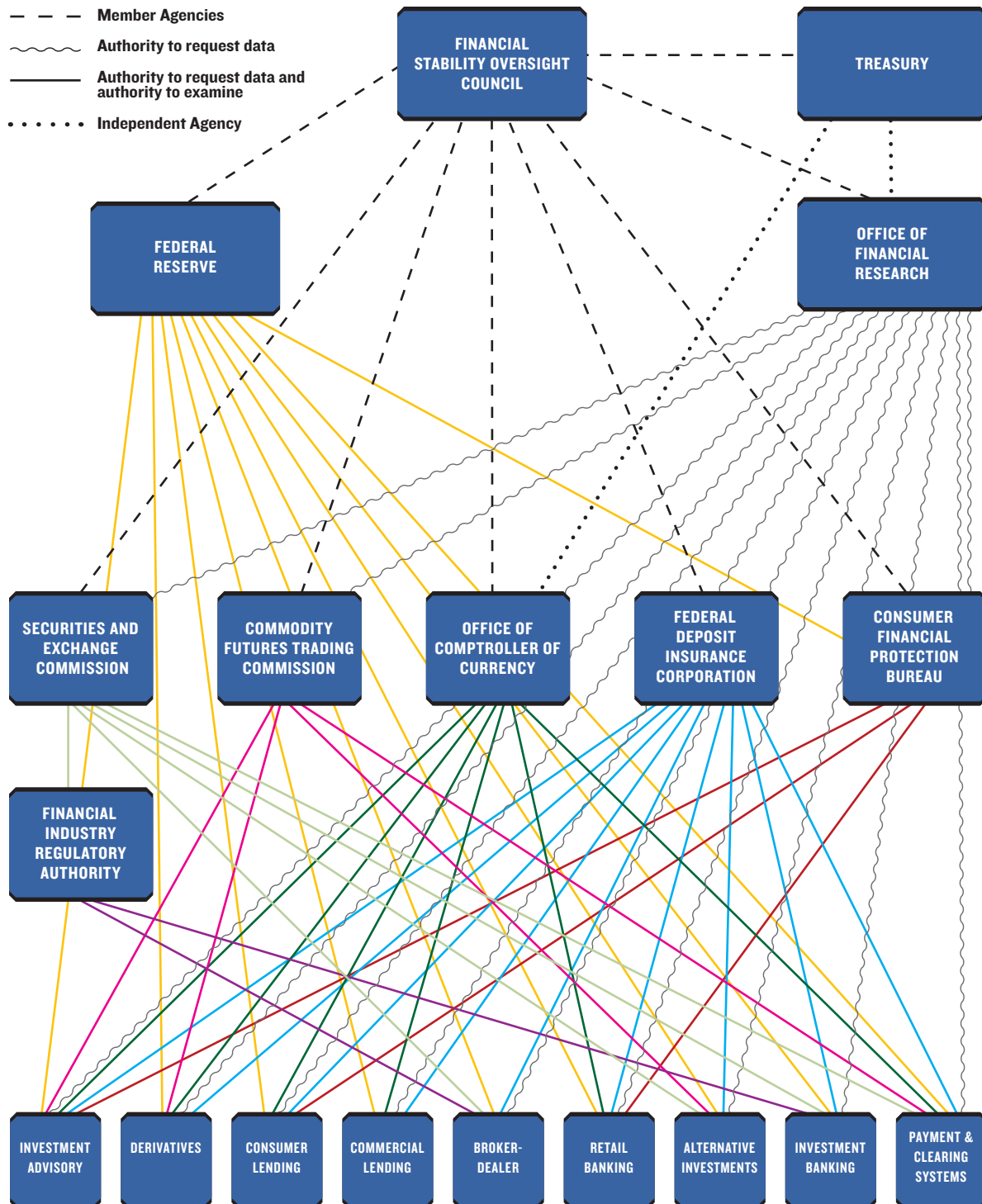
THE DODD-FRANK ACT STRENGTHENED financial regulation but did not reorganize the sprawling regulatory structure.<sup>17</sup> Despite a general consensus that the regulatory framework was flawed, opposition from various interests prevented this important reform from being realized. As former Secretary of the Treasury Geithner recalled recently, “Just about everyone agreed that the current oversight regime was a ridiculously Balkanized mess, but the same tribal warfare that had hobbled the regulatory system would hobble our efforts to rationalize it.”<sup>18</sup> Former Senator Chris Dodd echoed that sentiment in a speech last year, “I would’ve established a single prudential regulator and gotten rid of the rest,” he said. But, he added, “I got about three votes at the time.”<sup>19</sup>

As a consequence, the regulatory structure remains substantially the same as before the financial crisis. A complex web of eight federal regulatory agencies, numerous SROs, and more than 100 state authorities share oversight of the ever-evolving financial system.<sup>20</sup> Many agencies have overlapping jurisdictions, different statutory mandates, and varying levels of funding and independence.<sup>21</sup> Moreover, the framework under which the agencies regulate has become outdated, failing to keep up with market developments, and is replete with regulatory gaps, statutory exemptions, specific grandfathering arrangements, and other loopholes.<sup>22</sup> As former Secretary of the Treasury Paulson has recounted:

Our regulatory system remains a hopelessly outmoded patchwork quilt built for another day and age. It is rife with duplication, gaping holes, and counter-productive competition among regulators. The system hasn’t kept pace with financial innovation and needs to be fixed so that we have the capacity and the authority to respond to constantly evolving global capital markets.<sup>23</sup>

The regulatory system is unworthy of the regulatory agencies that must function within its irrationally configured boundaries and jurisdictions. Each agency has a proud and rich tradition of excellence, with the OCC going back to the Civil War period, the Federal Reserve recently celebrating its centennial, and the FDIC and SEC tracing their roots to the President Franklin D. Roosevelt’s New Deal. But while the agencies’ good faith efforts have historically overcome the limitations of the regulatory framework, financial system evolution in recent years has been so significant that the continuing efforts of the regulatory agencies alone are no longer sufficient to effectively guard against the buildup of systemic risk. A thoughtfully reconfigured regulatory system is, therefore, a necessary step toward effective regulation.

FIGURE I illustrates the fragmentation and complexity of this regulatory structure.



SOURCE: JPMorgan Chase. Via The Dodd Frank Act: Too big not to fail, The Economist. February 18, 2012  
 < <http://www.economist.com/node/21547784> >

A fundamental weakness of the regulatory apparatus is that it allocates responsibility among agencies based in significant part on rigid “functional” business lines, such as banking, insurance, securities, and derivatives.<sup>24</sup> However, the lines of separation between these markets have blurred as large, complex, and globally active firms have emerged to provide most of the broad array of products and services that cross these previously clear lines. In addition, the regulatory system has struggled to keep up with the market for non-bank credit intermediation, or shadow-banking market, which has become a bigger part of the financial system but operates largely outside the sphere of prudential regulation. The current system also has been outpaced by the rapidly evolving, increasingly complex, and sometimes opaque financial products that continue to emerge and transform the system, and that often migrate to less-regulated or unregulated yet critically important parts of the financial system.<sup>25</sup> Finally, assets under management have grown and become concentrated in the largest fund complexes, while the equities markets have become highly fragmented and less transparent.

Specifically, most industry assets are held by a handful of large financial firms, each with as many as 3,000 subsidiaries operating in as many as 40 countries and engaging in businesses and activities ranging from banking, securities and insurance underwriting, and derivatives trading to (in some cases) ownership of coal mines, oil tankers, and power plants.<sup>26</sup> Moreover, cash-rich institutional investors seeking short-term liquid investments have become a major source of short-term funding for securities dealers through the repurchase agreement, or “repo,” market. These dealers continue to finance more than 50 percent of their inventory of securities in this market, creating a significant reliance on short-term, money-like debt that can be susceptible to contagion and fire-sale dynamics during times of stress.<sup>27</sup> Finally, equities markets have become fragmented from a Nasdaq and NYSE duopoly to a far more dispersed market with 18 exchanges and more than 40 alternative trading sites, while trading has become almost exclusively automated and increasingly dominated by high-frequency trading firms in recent years.<sup>28</sup>

Many of the market changes highlighted above placed the regulatory system under significant pressure in the run-up to the financial crisis, exposing its weaknesses. Regulatory gaps in the approximately \$200 trillion OTC derivatives market,<sup>31</sup> the \$75 trillion shadow-banking market,<sup>32</sup> and the \$15 trillion mortgage market<sup>33</sup> allowed significant risks to build in the financial system. In addition, jurisdictional overlaps often led to delays or inaction on critical matters—including with respect to the downgrade of supervisory ratings at cer-

tain financial institutions, the imposition of required remedial measures, and the timely promulgation of interagency guidance and regulations.<sup>34</sup> In describing the views of regulators on various factors that contributed to the financial crisis, the FCIC wrote in its report:

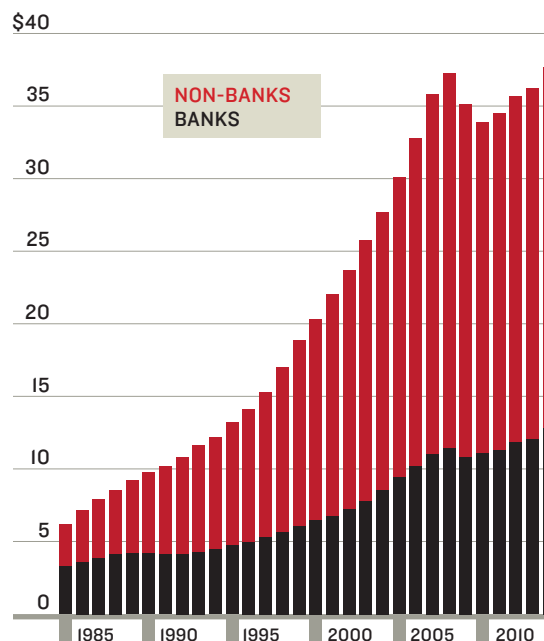
Regulators also blame the complexity of the supervisory system in the United States. The patchwork quilt of regulators created opportunities for banks to shop for the most lenient regulator, and the presence of more than one supervisor at an organization. For example, a large firm like Citigroup could have the Fed supervising the bank holding company, the OCC supervising the national bank subsidiary, the SEC supervising the securities firm, and the OTS supervising the thrift subsidiary—creating the potential for both gaps in coverage and problematic overlap.<sup>35</sup>

Moreover, despite an alphabet soup of regulatory agencies, no one agency had a comprehensive understanding of the risks posed by large financial institutions, with each agency focused only on the areas of the firms it regulated. According to the FCIC:

Both Fed and OCC officials cited the Gramm-Leach-Bliley Act of 1999 as an obstacle that prevented each from obtaining a complete understanding of the risks assumed by large financial firms such as Citigroup. The act made it more difficult—though not impossible—for regulators to look beyond the legal entities under their direct purview into other areas of a large firm. Citigroup, for example, had many regulators across the world; even the securitization businesses were dispersed across subsidiaries with different supervisors—including those from the Fed, OCC, SEC, OTS, and state agencies.<sup>36</sup>

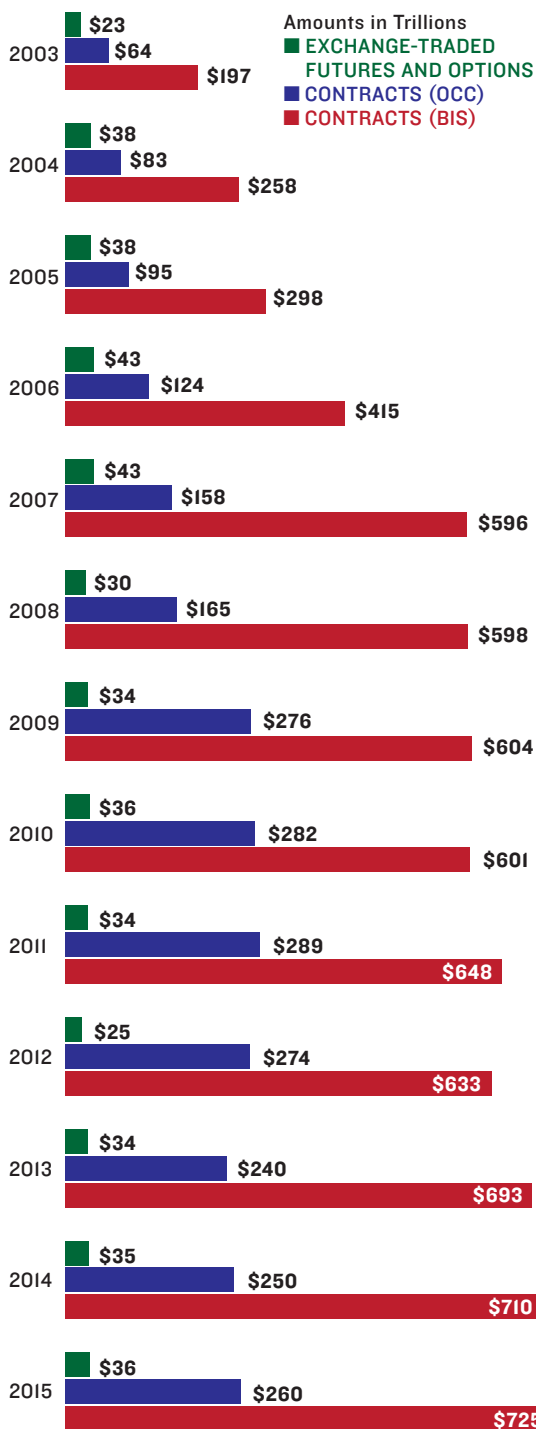
Another particularly egregious example involved the Office of Thrift Supervision (OTS).<sup>37</sup>

**FIGURE 2** compares credit market assets held by banks and nonbanks over time (in trillions of dollars).



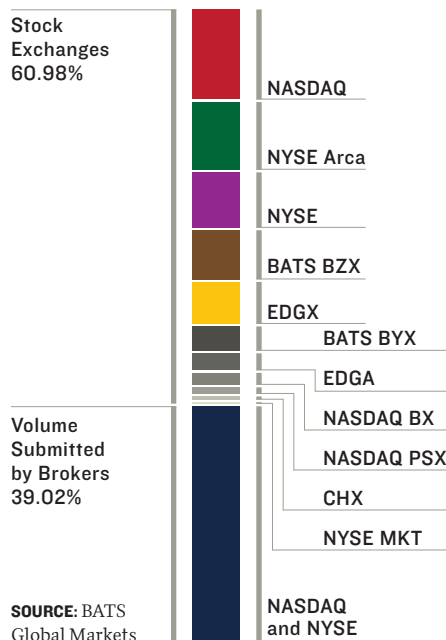
**SOURCE:** Board of Governors of the Federal Reserve System (2015), Statistical Release Z.1, “Financial Accounts of the United States” (1985 to 1994, 1995 to 2004, and 2005 to 2014).  
<http://www.federalreserve.gov/releases/z1/current/data.htm>

**FIGURE 3** illustrates the growth of OTC derivatives contracts in the US and globally.

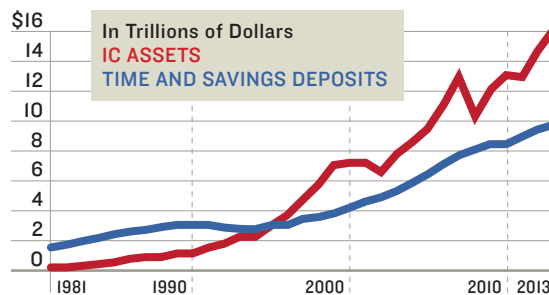


**SOURCE:** CFTC President's Budget and Performance Plan, CFTC, Fiscal year 2015, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2015.pdf>

**FIGURE 4** illustrates US equity market share by trading venues in January 2014.<sup>29</sup> Securities exchanges provide a public market for buyers and sellers of securities to match their orders. As recently as a decade ago, two exchanges, the Nasdaq and the New York Stock Exchange, dominated US equities trading. Today, trading is much more dispersed, as illustrated below.



**FIGURE 5** illustrates a comparison of investment company assets to time and savings deposits.<sup>30</sup> Over the past three decades, the value of investment company assets has grown from a small fraction of the total value of US bank deposits to become significantly larger.



**SOURCE:** FY 2015 Congressional Budget Justification, U.S. Securities and Exchange Commission, <http://www.sec.gov/about/reports/secfy15congbudgjust.pdf>

Although ostensibly AIG's consolidated home country regulator, the OTS kept its focus primarily on AIG's small thrift, AIG Federal Savings Bank, and failed to recognize or address the risks emanating from AIG's derivatives business outside the thrift.<sup>38</sup> Finally, enhanced opportunities for regulatory arbitrage, particularly in the regulation and supervision of large thrift holding companies and the now-extinct large, stand-alone investment banks, allowed risks in the financial system to multiply.<sup>39</sup>

As noted in the Department of the Treasury's 2009 report *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation*:

While this crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system. Gaps and weaknesses in the supervision and regulation of financial firms presented challenges to our government's ability to monitor, prevent, or address risks as they built up in the system. No regulator saw its job as protecting the economy and financial system as a whole. Existing approaches to bank holding company regulation focused on protecting the subsidiary bank, not on comprehensive regulation of the whole firm. Investment banks were permitted to opt for a different regime under a different regulator, and in doing so, escaped adequate constraints on leverage. Other firms, such as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not "banks" under relevant law.<sup>40</sup>

In his 2014 memoir *Stress Test*, Secretary Geithner elaborated further on the regulatory system:

Our current oversight regime, with its competing fiefdoms and overlapping jurisdictions and perverse incentives encouraging firms to shop around for friendly regulators, was an archaic mess. Vast swaths of the financial system had no one in charge. Others were swarming with regulators engaged in tribal warfare. I often compared the situations to the wild frontiers of the Afghanistan-Pakistan border region or the Balkans a century ago. We needed a simpler structure that would make sure the more conservative rules we envisioned were applied more evenly and more broadly across the financial system, with clearer accountability for monitoring risk within every major firm and especially across the entire system.<sup>41</sup>



Many of the weaknesses highlighted by the financial crisis remain substantially undressed. Indeed, the regulatory system remains highly fragmented, with: (1) parent holding companies of banks and thrifts regulated separately from their functional subsidiaries; (2) depository institutions regulated by a combination of at least three separate federal and various state regulators; and (3) the intertwined securities and commodities markets regulated by at least two regulatory agencies and various SROs.<sup>42</sup> Moreover, while the FSOC and OFR are important regulatory innovations, significant questions have arisen about their independence and effectiveness.<sup>43</sup>

### **A. The Independence and Effectiveness of the FSOC and OFR**

The Dodd-Frank act sought to address some of the weaknesses highlighted by the financial crisis by establishing the FSOC and the OFR. Chaired by the secretary of the Treasury and composed of, among others, the heads of each of the eight federal regulatory agencies, the FSOC has the mandate to identify and address emerging threats to financial stability.<sup>44</sup> The FSOC's primary tool is its ability to enlarge the regulatory perimeter by designating nonbank financial firms SIFIs. Once designated, the firms become subject to enhanced regulatory requirements and oversight by the Federal Reserve.<sup>45</sup>

While the FSOC represents an important step in the right direction, because it is grafted on top of an already confusing and disjointed regulatory system, it suffers from many of the same problems as the framework upon which it sits. Reflecting the underlying regulatory structure, the FSOC has too many member agencies to fulfill its mission effectively and is too divided to provide a comprehensive, forward-looking view and to take decisive and timely action.

In particular: (1) the FSOC member agencies have their own organic interests and statutory mandates, and some of the agencies have historically had difficulty agreeing on important matters; (2) the FSOC has limited ability to resolve jurisdictional disputes among its member agencies;<sup>46</sup> (3) the FSOC may recommend but cannot *require* new or heightened standards or safeguards for certain activities and practices that, in the judgment of a majority of its members, may pose a threat to financial stability; and (4) the FSOC has very limited authority to promulgate or require rules even when the primary functional regulator responsible for the rules has failed to finalize them as required by law.<sup>47</sup>

Illustrative of some of these weaknesses is the lengthy history associated with the money market rule finalized last year. As Donald Kohn, former vice chairman of the Federal Reserve,



said in an April 2014 speech:

FSOC had reached the conclusion that the reforms of money market funds in 2010 were not sufficient to address the systemic risk of these funds that became very evident in the wake of the failure of Lehman Brothers, and recommended further action to better assure financial stability. The fact that FSOC had to make a recommendation on a comply or explain basis—that discussions in the [FSOC] were not enough to trigger a response at the SEC to correct perceived systemic risks—is indicative of difficulties. And the recommendation itself was resisted by current and former SEC commissioners on the grounds that the recommendation impinged on SEC independence, that only the SEC had the procedures and expertise to judge what was best for securities markets, and that the chair of the SEC on the FSOC could not and should not undermine the SEC’s regular procedures involving all commissioners.<sup>48</sup>

While acknowledging that “every jurisdiction faces challenges patrolling the regulatory perimeter,” Kohn said, “I wonder whether the fragmented US system, with each agency protecting its prerogatives and listening to its regulated industry, won’t have more problems spotting and making recommendations for change than other regulatory structures.”<sup>49</sup>

In its August 2013 report on certain aspects of the US regulatory system, the Financial Stability Board (FSB), an international group of regulators, made a similar observation:

Given its broad and diverse membership, the FSOC’s decisions and actions reflect the views of a wide range of agencies with different mandates and interests. This might affect in some cases the FSOC’s ability to take decisions in an effective and prompt manner, as the desire to reach a reasonable consensus among a large group of authorities might come at the expense of delivering clear and timely messages.<sup>50</sup>

Moreover, the FSOC is chaired by the secretary of the Treasury. This creates an appearance that the FSOC may lack the necessary independence and insulation from outside influence to make the often difficult and politically contested decisions required of a systemically focused body.<sup>51</sup>

Realigning the decision-making structure of the FSOC would substantially reduce the appearance that the FSOC may lack necessary independence.

Concerns also have been raised that FSOC’s research arm, the Department of the Treasury’s OFR, may lack the level of independence, authority, and stature necessary to be effective

in its mission to assist the FSOC. The director of the OFR reports to the undersecretary of domestic finance, a senior official at Treasury.<sup>52</sup> This reporting structure has raised concerns about the OFR's possible lack of independence and authority to conduct and provide timely and objective analysis of issues of systemic stability.

Moreover, recent criticisms of the OFR in connection with its September 2014 study on asset managers have raised serious questions about the OFR's stature, role, and authority in the regulatory hierarchy and the level of influence it might have on important, yet politically contested, systemic stability matters.<sup>53</sup> The FSOC had requested the OFR to study and report on the asset management industry, which resulted in friction between the SEC and the OFR. As *The Wall Street Journal* reported:

Shortly after the Treasury released the report, the SEC published it on the agency's website and sought public comment – giving industry groups and others a forum to criticize the document. Treasury officials were taken aback by the move, according to several people familiar with the matter. It is unusual for the SEC to seek comment on a report it hasn't produced and that doesn't include agency policy recommendations. SEC officials acknowledge the situation is unique – an outside regulatory body has never previously commissioned a study on an industry overseen by the agency. SEC officials say they sought comment to collect industry reaction in a central location.<sup>54</sup>

The OFR's mission is particularly important given the significance of the less understood nonbank sector to the financial system. For the OFR to be effective, its important work should be robust, independent, uninhibitedly objective, and timely; and the OFR should have some measure of insulation from interagency jurisdictional concerns. An appropriately empowered OFR could play the very important role of serving as a check on the agencies involved in financial stability, raising important questions, challenging conventional wisdom, and spurring action when necessary.

## **B. The Regulatory Structure Remains Disjointed and Antiquated**

Aside from the FSOC and OFR, the underlying regulatory structure itself continues to display many of the same weaknesses exposed by the financial crisis, and that could again threaten the financial system and the health of the economy. The antiquated framework creates opportunities for regulatory capture, fuels jurisdictional conflict among regulators, promotes competition in laxity, causes communication and coordination problems between and among

agencies and international regulators, and fosters a lack of accountability.

All these issues manifest themselves in the form of poor supervisory outcomes, including: (1) possibly inconsistent exam reports, communication and coordination problems among regulators, duplication of effort, and mixed messages to regulated institutions; (2) increased difficulties in identifying and preventing the buildup of excessive risk at financial institutions, particularly where regulators have disagreed over supervisory ratings downgrades and the terms of a contemplated enforcement action; and (3) a diffusion of the available talent, training, expertise, and resources in the regulatory system.

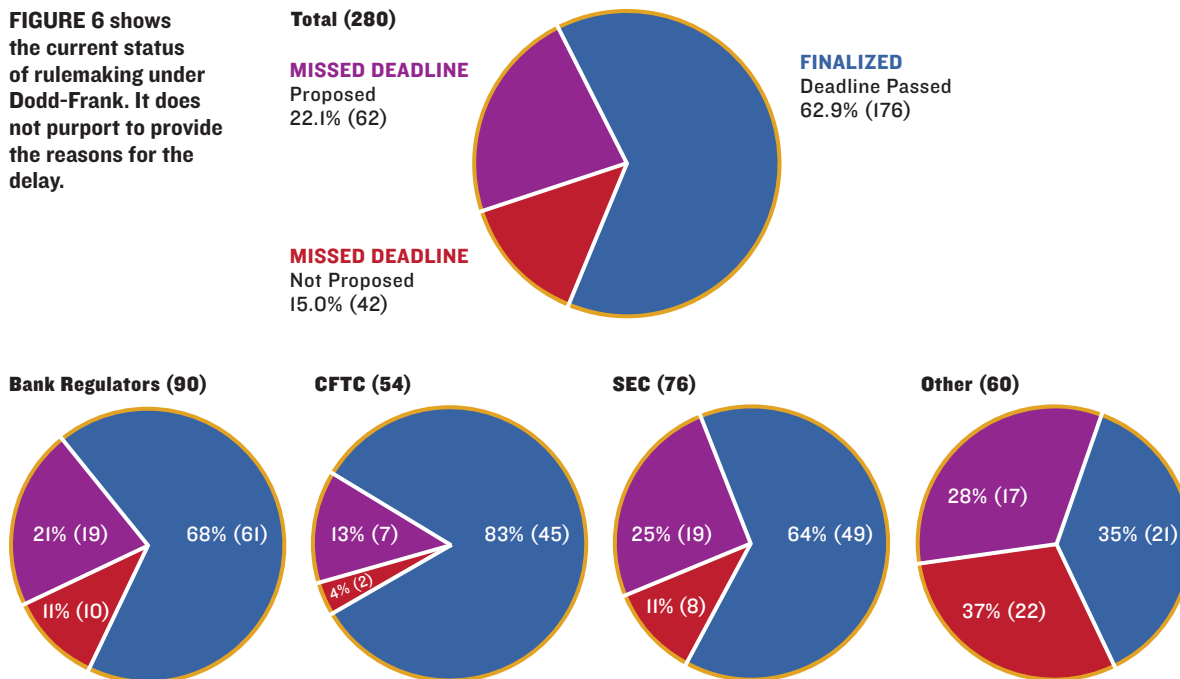
Moreover, the multiagency dynamic, in addition to other factors including the woefully inadequate funding for certain agencies (discussed later in this report), has led to delays or inaction in interagency guidance and rulemakings on important matters. Indeed, many statutorily required rules under Dodd-Frank have suffered from serious setbacks and delays, in some cases *years* beyond the statutory deadlines imposed by Congress. According to one tracking system, nearly 37 percent of the rules required to be implemented under Dodd-Frank continue to miss their statutory deadlines.<sup>55</sup> While joint rulemakings are important to ensure checks and balances and a broad perspective in policy development, in the current regulatory framework, they too often lead to delay and dysfunction.

The joint rulemaking process post-Dodd-Frank has been difficult. Regulators acting in good faith have often remained locked in debate over provisions, with each agency armed with the ability to derail the process or lengthen it significantly. And the rules that have emerged from this process have arguably been unnecessarily complicated and full of exemptions and loopholes. While some of this is attributable to the complexity of the issues the rules are designed to address, much of it is also because different agencies may be exposed to diverse lobbying and other political pressures. As Sheila Bair, the former chairman of the FDIC, noted:

[Rules] are now written as part of a painstaking negotiated process among rival agencies, producing rules that are hundreds of pages long, mind-numbingly complex, and sometimes riddled with special exceptions and exclusions, all too often to accommodate the interests of the individual agencies and the industries they regulate.<sup>56</sup>

The Volcker Rule is a prime example. It required the coordinated efforts of as many as two-dozen staff members of the Federal Reserve, the OCC, the FDIC, the SEC, and the CFTC all armed with their own authority. While the regulators eventually agreed on a final, harmonized rule, the process took three years, and it appeared the agencies might issue separate,

**FIGURE 6** shows the current status of rulemaking under Dodd-Frank. It does not purport to provide the reasons for the delay.



Rulemaking counts are based on estimates and require judgment. Values refer to number of rulemaking requirements.

**SOURCE:** Dodd-Frank Progress Report, Davis Polk, Dec 2014

possibly inconsistent regulations.<sup>57</sup> According to some reports, the extended delay was due to a rift between the SEC and the banking regulators.<sup>58</sup> Notably, the Volcker Rule was not the only rule that suffered delays from this process. Rules related to risk retention and derivatives, among others, have experienced similar delays.

### I. The SEC and the CFTC Under the Disjointed Framework

With respect to the SEC and the CFTC specifically, the disjointed regulatory system has resulted in:

- A less than robust focus on the supervision of very important financial entities that are also participants in the shadow-banking market, including broker-dealers, DCOs, clearing members, FCMs, and MMFs; and
- An unnecessary bifurcation in the regulation of securities and derivatives, which has resulted in interagency friction, jurisdictional and court battles, market surveillance and oversight challenges, asymmetrical regulatory treatment of like instruments, and confusion with international partners.<sup>59</sup>

These problems have been compounded by:

- Politically polarized boards composed of commissioners increasingly at odds with one another; and
- A lack of adequate funding, even while the agencies' responsibilities post-crisis have increased exponentially, making both agencies more susceptible to outside political influence.

As he introduced legislation in 2012 to merge the SEC and the CFTC, then-House Financial Services Committee Chairman Barney Frank argued that “the existence of a separate SEC and CFTC is the single largest structural defect in our regulatory system.”<sup>60</sup>

At a fundamental level, the SEC and the CFTC face tension between their core mission of investor protection and market integrity on the one hand and their supervision of entities such as broker-dealers and DCOs on the other. Supervision appears to be an area where the agencies have lacked experience, expertise, and sufficient resources. In some cases, there is an overreliance on SROs, such as the National Futures Association (NFA), which serve as frontline supervisors. In areas where there are no SROs, such as for investment advisers and investment companies, the SEC has struggled to conduct regular examinations of entities it is charged with overseeing.<sup>61</sup>

Indeed, the SEC examines annually only 9 percent of the 11,000 investment advisers and 11 percent of the 10,000 investment companies it is charged with supervising.<sup>62</sup> Together with the Financial Industry Regulatory Authority Inc. (FINRA), the SEC examines less than one-half of the 4,500 broker-dealers under its supervision.<sup>63</sup> With respect to the entities that *are* examined and found to be deficient, the SEC issues a “deficiency letter” detailing the matters that require remedial action<sup>64</sup>; however, the agency is able to perform only a limited number of “corrective action reviews” to verify that the corrective steps promised by the entity have in fact been taken.<sup>65</sup> As former SEC Secretary Jonathan Katz wrote, “[No] matter how talented or effective the SEC staff may be, if investment advisers are subjected to onsite exams once every 10 (or even 30) years, the program will not be credible.”<sup>66</sup>

Moreover, despite the lessons of the financial crisis, the SEC continues to regulate broker-dealers, including large, independent broker-dealers, under simple rules that do not address potential financial vulnerabilities. This is consistent with the SEC's long-standing position that its statutory mandate is investor protection, market integrity, and capital formation, and not prudential supervision or financial stability. SEC Chairwoman Mary Jo White understandably included on a list of “critical initiatives” the need to address this very problem:

“[We] will also increase our oversight of broker-dealers with initiatives that will strengthen and enhance their capital and liquidity, as well as providing more robust protections and safeguards for customer assets.”<sup>67</sup> Given the significant internal and external obstacles that this proposal might face, it remains unclear how soon these reforms will be proposed, how robust they will ultimately be, and how consistent or coordinated with prudential approaches of other authorities they might be.

Like the SEC, the CFTC faces many structural challenges in the area of supervision. For example, the CFTC relies heavily on SROs for many of the entities it is charged with regulating, including swap dealers, FCMs, and clearing members.<sup>68</sup> However, the scope of SRO frontline supervision is broad, and the SROs are arguably ill-equipped to act as frontline supervisors—particularly of large clearing members where the SRO, itself a DCO, may have conflicting incentives.<sup>69</sup>

Moreover, as some have argued, overreliance on SROs has led to circumstances in which no authority clearly has primary responsibility for the oversight of particular entities. In recent years, fraudulent enterprises such as MF Global (now the subject of bankruptcy proceedings) serve as a cautionary tale of the overlapping oversight of the CFTC, the SEC, the NFA, and exchanges. Numerous entities were charged to serve as watchdogs, but no one uncovered the fraudulent activity until too late.<sup>70</sup>

There also are concerns that the CFTC is not equipped to act as a prudential regulator. Currently, it has at least some prudential supervision over DCOs, clearing members, and FCMs. Each of these entities effectively extends credit to clients. While the CFTC has written clear rules for these entities, it simply does not have the staff to provide on-site supervision analogous to the supervision provided by the banking regulators. In particular, as more swaps have moved to clearing as a result of Title VII of the Dodd-Frank act, concerns have arisen regarding the appropriate level of supervision for clearing entities. Critics have noted that with increased reliance on central clearing, adequate oversight of DCOs takes on more importance.

Prudential supervision aside, the bifurcated nature of the regulation of the securities and commodities markets continues to cause confusion and coordination problems among regulators, including with their international counterparts, as well as inefficiencies in the private markets. As a joint report of the SEC and the CFTC noted, “Financial engineers [have] developed products that [have] the attributes of both futures and securities, thus helping to confuse the line between futures and securities regulation.”<sup>71</sup> The Treasury Department’s 2008 Blueprint posits that the “realities of the current marketplace have significantly dimin-

ished, if not entirely eliminated, the original reason for the regulatory bifurcation between the futures and securities markets.”<sup>72</sup> Indeed, “[Product] and market convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient.”<sup>73</sup>

The securities and derivatives markets are highly intertwined, with trading strategies of market participants often encompassing many or even all the types of markets regulated by the SEC and the CFTC.<sup>74</sup> Bifurcation in the regulation of the securities and commodities markets also (1) deprives regulators of a comprehensive understanding of the activities of financial firms; (2) results in asymmetrical regulatory treatment of economically similar instruments in some markets;<sup>75</sup> and (3) reduces the effectiveness of market surveillance activities which leads to regulators’ missing things.

## 2. The SEC and the CFTC Remain Underfunded

The SEC and the CFTC are funded by congressional appropriations. Both agencies have remained underfunded even as their regulatory responsibilities have increased exponentially since the financial crisis.<sup>76</sup> As SEC Chairwoman White explained in a speech in early 2014:

Today the agency also faces an unprecedented rulemaking agenda. Between the Dodd-Frank and JOBS acts, the SEC was given nearly 100 new rulemaking mandates ... These rulemakings, coupled with the implementation and oversight effort that each one brings, have added significantly to our already extensive responsibilities and challenge our limited resources. These mandates also present the risk that they will crowd out or delay other pressing priorities. But we must not let that happen.

All of this is upon us at a time when our funding falls significantly short of the level we need to fulfill our mission to investors, companies, and the markets. As Chair, I owe a duty to Congress, the staff, and to the American people to use the funds we are appropriated prudently and effectively. But it also is incumbent upon me to raise my voice when the SEC is not being provided with sufficient resources.<sup>77</sup>

In 2012, then-CFTC Chairman Gary Gensler testified in support of the CFTC’s 2014 budget submission:

Without sufficient funding for the CFTC, the nation cannot be assured this agency can closely monitor for the protection of customer funds in the futures



and swaps markets. Without sufficient funding, we will not be able to implement more regular and more in-depth examinations of clearinghouses, trading platforms, and major market intermediaries the CFTC oversees. Without sufficient funding, we cannot be sufficiently responsive to the hundreds of incoming questions and requests regarding implementation of reform. Without sufficient funding, we cannot utilize our enforcement arm to its fullest potential to go after bad actors in the markets. And without sufficient funding for the CFTC, the nation cannot be assured that this agency can effectively enforce essential rules that promote transparency and lower risk to the economy.<sup>78</sup>

The lack of funding has contributed to both agencies' suffering criticism for their handling of critical components of their core mission. In addition, the lack of independent funding has made both agencies susceptible to lobbying and political gamesmanship. As former FDIC Chairman Sheila Bair wrote:

Both the SEC and CFTC must rely on the congressional appropriations process for their funding. This means that each year they go hat in hand to the appropriations committees of the House and Senate to seek approval for money to continue to operate. (Both agencies collect registration and other fees as part of their work, but this money is turned over to the Treasury Department and then a portion of it is doled back to them as part of the appropriations process. The SEC in particular collects fees that are far in excess of the budget it is given by Congress.)

Regrettably, industry lobbyists have found that the best way to harass the SEC and CFTC and block efforts at financial reform is through convincing appropriations committees to restrict how these agencies can use their money. For instance, in the House, there have been attempts to prohibit the CFTC from using its funds to implement rules forcing more derivatives onto public trading facilities, and other measures. ...

To be sure, this issue is about turf. The House and Senate Appropriations Committees do not want to give up their leverage over the SEC and CFTC. They argue that subjecting the SEC and CFTC to the appropriations process increases each agency's accountability to the public. But the Senate Banking Committee and House Financial Services Committee have plenty of power to conduct oversight of the SEC and CFTC, and those committees have con-



siderably greater expertise on financial matters than do the appropriations committees.<sup>79</sup>

During a speech in 2013, Secretary of the Treasury Jack Lew discussed the lack of funding for certain agencies:

Even with the best rules, illegal behavior or excessive risk-taking will go unchecked unless regulators have the resources to conduct regular examinations, monitor suspect behavior, and go after those who break the law. The point is, this is not an either/or proposition. The best rules will fall short without effective supervision and enforcement. And effective supervision and enforcement are only possible with sufficient resources.<sup>80</sup>

Simply put, both the SEC and the CFTC have suffered immensely from a lack of funding in an environment in which their responsibilities have increased drastically. This lack of funding has led to poor regulatory outcomes in the past, and unless resources at these agencies match their responsibilities, such outcomes will unquestionably continue.

### **C. The Checks and Balances Argument Against Reform**

The defense of the existing regulatory arrangement sometimes rests on the argument that restructuring would eliminate important checks and balances in regulation and supervision and increase the ease and likelihood of regulatory capture and groupthink. In this connection, the need for a range of specialized expertise for separate types of financial service providers is also often advanced. Consequently, it is argued, efforts should be focused not on regulatory reconfiguration but on professional development and enhancing the supervisory experience of agency staff and leaders.

These legitimate concerns cannot be an excuse for maintaining the status quo, however.

The multiagency regulatory framework, with all its ostensible checks and balances, was no match for the type of pervasive groupthink among regulators that contributed so significantly to the financial crisis. In short, the current regulatory framework not only has failed to prevent these problems but also has layered on confusion, inefficiencies, inaction, delay, jurisdictional issues, and lack of coordination.

The right course of action is to reorganize the system, building in more effective and robust safeguards that minimize the infection of capture and groupthink, preclude the excessive concentration of authority in one agency, and eliminate the gaps and inefficiencies that continue to permit risk to grow excessively in the financial system.

We also must recognize that regulatory reorganization is not a panacea. Emphasis must be put on infusing greater supervisory expertise and experience into the ranks of regulatory agencies, creating a more satisfying career path for regulators and improving other attributes of an honored and satisfying profession. Doing so would allow agencies to attract and retain talent and enhance the stature of supervision and regulation as a profession. This goal should be pursued independently of regulatory reorganization, whether or not such reorganization is pursued, or whether it is ultimately successful or unsuccessful.

## RECOMMENDATIONS

RECOMMENDATIONS IN THIS REPORT are categorized under three broad, objectives-based rubrics: (1) oversight and surveillance; (2) supervision and regulation; and (3) market integrity and investor protection. As noted elsewhere in this report, the recommendations assume no change with respect to consumer protection, which would remain an important objective of the regulatory system. Likewise, the insurance and mortgage markets are beyond the scope of this report but remain important areas of concern for public policy. Within the categories listed above, the recommendations also address adequate and independent funding of agencies and ways to enhance the stature and professionalism of the regulatory agencies' workforce.

### Oversight and Surveillance

One of the most fundamental lessons of the recent financial crisis was that despite an alphabet soup of federal regulatory agencies in the financial regulatory system, no one regulatory body had the responsibility to maintain a comprehensive understanding of the risks in the entire financial system. To address this weakness, the Dodd-Frank act established the FSOC to facilitate communication and coordination among agencies and enhance the ability of regulators to identify and address threats to financial stability. Dodd-Frank also established the OFR as an office within the Department of the Treasury to assist the FSOC in better understanding the risks in the financial system through data and clarified the Federal Reserve's role as a systemic risk regulator.

While these measures reflect major strides in the right direction, much more needs to be done to shore up the independence and effectiveness of our system of oversight and surveillance. The recommendations outlined below would help ensure that the system for oversight and surveillance: (1) is independent, comprehensive, adaptive, and effective; (2) contains appropriate checks on the power of various regulatory agencies; (3) reflects a breadth of perspectives; and (4) facilitates appropriate coordination and communication among regulatory authorities.

### The FSOC

The FSOC would **continue (1) its role as a coordinating council and designation authority** of SIFIs and **(2) to be chaired by the secretary of the Treasury**. However:

**RECOMMENDATION 1.1: The secretary of the Treasury would no longer have a vote on the FSOC.**

The Department of the Treasury played a critical role in the recent financial crisis. This was entirely appropriate, because using public funds and interpreting existing law required political support.<sup>81</sup> However, the issue that this recommendation addresses is whether the Treasury Department should be involved in regulation or supervision matters in a continuing way, as it is today, with respect to the FSOC and the OFR.

There are two primary opposing arguments.

First, the secretary of the Treasury wields enormous influence. Serving as chair of the FSOC, the secretary could have a significant adverse influence on regulation and infringe on the independence of regulatory agencies. Moreover, particularly on matters of importance, the secretary of the Treasury, as a representative of the administration, could create the appearance of injecting short-term, politically expedient considerations when long-term, often politically difficult decision-making may be required.

The countervailing argument is that Treasury involvement is critical during a crisis, when there may be a need for the use of public funds. In addition, the secretary could serve as a stabilizing counterweight to industry. Further, Treasury support for necessary legislative action could be vital. Finally, it would be important to have the secretary aware rather than being told a crisis is imminent.

This recommendation balances these two competing perspectives by providing for the secretary to continue to chair the FSOC as overall interagency coordinator for systemic risk issues but without a vote on the SIC. Keeping the secretary in the role of chairman of the FSOC but without participation in the SIC would (1) help mitigate the appearance of Treasury's encroachment on matters of regulatory policy, supervision, or enforcement; (2) keep the Department of the Treasury fully informed in the event of a crisis; (3) help insulate the FSOC designation process from outside or political influence; and (4) leverage the ability of the Treasury to coordinate with and corral agencies, if necessary, in times of crisis.

**RECOMMENDATION 1.2: The FSOC would establish an SIC composed of the chairman of the Federal Reserve, the chairman of the FDIC, the director of the FHFA, the director of the CFPB, the chair of a new SEC-CFTC, the director of the OFR, and a state insurance commissioner designated by the state insurance commissioners.**

The SIC would have the ability to designate SIFIs and, as provided in recommendation

1.3 below, require new or enhanced prudential safeguards on all activities and practices that could pose a threat to systemic stability even if conducted outside the present sphere of prudential supervision (see below).

As noted above, the secretary of the Treasury would not be a member of the SIC, to maintain its independent federal agency composition. The secretary of the Treasury would remain as the chairman of the FSOC, playing an important coordinating role especially in dealing with crisis situations. The chair of the National Credit Union Administration (NCUA) would likewise not become a member of the SIC. The NCUA does not have a financial stability mandate or supervisory or regulatory authority over any financial institution requiring enhanced prudential standards necessary for maintaining financial stability.

Finally, a state insurance commissioner, selected by a committee of state insurance commissioners, would serve on the SIC and replace the independent insurance member of the FSOC. The state insurance regulator would bring invaluable expertise and regulatory insight to the designation process, given the states' primary role in the regulation of the insurance market.

With the elimination of the OCC and the consolidation of the SEC and the CFTC, the FSOC's voting members would be reduced to seven from 10 members. Streamlining the voting structure, while maintaining rigorous procedures to assure fairness and transparency for the decision-making process, would (1) make the FSOC much more efficient than it is today; (2) improve the FSOC's capacity to tackle time-sensitive issues; and (3) strengthen the FSOC's ability to meet its overall mandate of identifying and addressing threats to financial stability.

**RECOMMENDATION 1.3: The SIC would have the ability to require new or enhanced prudential standards and safeguards on all activities and practices that could pose a threat to systemic stability even if conducted outside the present sphere of prudential regulation.**

Under Section 120 of the Dodd Frank act, the FSOC has the ability to recommend new or enhanced safeguards and standards on risky financial system activities or practices to the appropriate primary functional regulator. The primary regulator either may comply with FSOC's recommendation or explain its noncompliance. The history of the MMF reform provides insight into the limitations of this FSOC power.

Under this proposal, the SIC could not just recommend, but require the new standards or safeguards. If an activity or practice were conducted by an entity outside the sphere of prudential regulation, the Federal Reserve would be responsible for promulgating the rules for any new or enhanced standards and safeguards required by the SIC, with implementation

of these rules by the new PSA. The Federal Reserve and the OFR, as part of their surveillance functions, would be authorized to make recommendations to the FSOC on particular activities and practices of concern.

These measures would allow the SIC to enlarge the perimeter of prudential regulation more efficiently and effectively than only firm-by-firm. It also would allow the regulatory structure to ensure a comprehensive focus with the ability to tackle issues emanating from less-regulated parts of the financial system. As the financial system has seen more credit intermediation move away from traditional banks with greater reliance on capital markets and short-term wholesale funding for intermediaries, more robust power to designate activities and practices would be particularly helpful in maintaining financial system stability.

**RECOMMENDATION 1.4: The SIC would be empowered to review the rules and regulations of its member agencies and recommend or require changes to the extent necessary to help maintain financial stability.**

The SIC would have the authority to review regulations promulgated by any financial regulatory agency and recommend changes or, if necessary to address threats to financial stability, require them by a majority vote. The purpose of this recommendation is to establish a check on the power of any one agency involved with financial stability issues and to create a mechanism to force action in the presence of the type of groupthink present in the run-up to the financial crisis. Under this proposal, had the SIC existed in the years preceding the crisis, the SIC could have reviewed the Federal Reserve's rules under the Home Ownership and Equity Protection Act and required the Federal Reserve to write more robust rules to stem the flow of poorly underwritten subprime loans.

### **The OFR**

**RECOMMENDATION 1.5: The OFR would be removed from the Department of the Treasury and become an independent entity, with its director continuing to be appointed by the president and subject to Senate confirmation. The director would be required to (1) testify at least semiannually at congressional oversight hearings and (2) serve as a member of the SIC.**

The OFR would continue to be independently financed and would, as it does now, have the mandate to collect, compile, and standardize data; regularly publish aggregated data and analysis; have a reinforced emphasis on identifying possible emerging threats to financial

stability; and issue reports and recommendations to the FSOC on matters of systemic risk.

Removing the OFR from the Treasury Department, transforming it into an independent agency, and giving its director a vote on the SIC would (1) result in an independent and empowered OFR that is more capable of offering strong, uninhibitedly objective, and timely analysis and recommendations; and (2) allow for an effective and independent check on the regulatory entities involved in systemic-risk regulation, and serve as a powerful safeguard against the groupthink and inaction witnessed in the run-up to the financial crisis.

Given OFR's important mission, particularly in light of the continuing emergence of new financial products and risks, these changes would go a long way to help ensure financial stability.

### **The Federal Reserve**

As the central bank, responsible for monetary policy and acting as lender of last resort, the Federal Reserve would maintain its core function for promoting systemic stability. In particular:

**RECOMMENDATION 1.6: The Federal Reserve would monitor activities, practices, trends, and emerging issues horizontally across firms and the financial system, including financial markets not entirely in the sphere of present prudential regulation. It would focus on such matters as the interdependence of institutions, trends in leverage and risk management, the infrastructure of markets, and the significance of innovations and new institutions.**

The Federal Reserve would utilize available authority to address risks to financial stability. Where it might lack such authority, the Federal Reserve would make recommendations to the SIC for designation of systemically risky activities or practices. If the SIC approves the recommendations, the Federal Reserve would have the responsibility for establishing new or heightened safeguards for such activities or practices.

With the supervisory functions now in the PSA (see below), the Federal Reserve would be able to redouble its efforts on systemic stability, utilizing its resources with a sharper focus on stability matters. Moreover, this proposed structure would tie together the Federal Reserve's monetary policy responsibilities, its systemic stability mandate, and its role in writing or approving regulations.

The Federal Reserve would continue to play a central role in identifying and addressing

risks to systemic stability and stay abreast of all supervisory and regulatory issues by having access to necessary records and supervisory exam reports and materials, while conducting backup examinations as necessary. This approach would allow the Federal Reserve to more successfully achieve its systemic stability mandate.

### **Supervision and Regulation**

One of the hallmarks of the US regulatory system is that multiple agencies are involved in supervision and regulation, each operating independently. This has resulted in gaps, overlaps, and inefficiencies. The measures outlined below would (1) eliminate regulatory gaps, overlaps, and conflicting supervisory policies; (2) allow for more effective prudential supervision and regulation of broker-dealers, swap dealers, FCMs, clearing members, DCOs, and other significant nonbank financial institutions; (3) centralize and better allocate resources; (4) ensure an appropriately represented governance structure and congressional oversight; and (5) reduce opportunities for regulatory arbitrage and competition.

**RECOMMENDATION 2: Establish a new PSA as an independent agency encompassing: (1) the prudential supervisory functions currently performed by the Federal Reserve, the OCC, and the FDIC with respect to bank and thrift holding companies, federally and state-chartered depository institutions, branches of foreign banking organizations, financial market utilities, and SIFIs; and (2) the prudential supervisory functions of the SEC and the CFTC with respect to broker-dealers, swap dealers, DCOs, clearing members, FCMs, and MMFs.**

The PSA would: (1) be chaired by the vice chairman for supervision of the Federal Reserve who would be required to testify at least semiannually at congressional oversight hearings; (2) include the chairman of the FDIC, the chair of a newly combined SEC-CFTC (see below), and two presidentially appointed independent members with staggered seven-year terms on its governing board; (3) have a special division for the supervision of true community banks to help ensure appropriately tailored regulatory treatment of these institutions; and (4) be funded through industry assessments or the Federal Reserve System while ensuring a system of robust congressional oversight.

The Federal Reserve would have no supervisory authority but would have an enhanced role in rulemaking for entities, activities, and practices subject to PSA supervision or as authorized by the SIC. This rulemaking authority would include establishing enhanced prudential



standards, including setting capital, liquidity, and margin requirements. The PSA would be authorized to propose any such regulations or guidelines to the Federal Reserve for approval.

The Federal Reserve would have access to all supervisory exam reports and data from the PSA and the OFR and have backup examination authority, particularly with respect to any institution seeking Federal Reserve financial support. In furtherance of this purpose, the Federal Reserve would maintain a team of highly qualified examiners.

The FDIC would no longer serve as the primary federal regulator of the portion of state-chartered banks it currently supervises. It would, however, retain its deposit insurance function, as well as its authority for receivership and resolution with respect to all insured banks and significant financial institutions. The FDIC also would have its own team of examiners and retain its backup examination authority, as needed, to discharge its statutory responsibilities with respect to the depositories it insures and the resolution of potentially failing significant financial institutions. To enhance interagency coordination, an independent member of the PSA would serve on the board of the FDIC, replacing the comptroller of the currency. Finally, the OCC would be eliminated.

Consolidating the supervisory functions of the banking agencies, as well as certain such functions of the SEC and the CFTC, would bring greater efficiency into the supervisory process, enhance supervision of certain capital markets participants, and eliminate current coordination challenges. Moreover, it would limit regulatory competition and jurisdictional conflicts among agencies and lead to quicker and more effective action and better supervisory outcomes. A separation between supervision and regulation would allow the PSA to focus sharply on supervisory matters, permitting it to deploy its resources more effectively and efficiently and to maintain an additional check on any agency concentrating too much authority.

With the Federal Reserve vice chairman for supervision as the chairman of the PSA, there would be a beneficial nexus between supervision, regulation, stability, and monetary policy—a nexus that is important to maintain, given that monetary policy and the maintenance of financial system stability are inextricably linked. The chairman of the FDIC, the chair of the SEC-CFTC, and two independent members on the PSA board would enhance coordination and exchange of information among regulatory agencies while ensuring a broad perspective and independence for PSA decision-making. A special division for true community banks would ensure that the supervision is tailored to the risk profile and business models of these entities.

These measures would serve as a guard against groupthink, while ensuring smarter regu-

lation. A broad diversity of regulated entities supervised by the same regulatory agency would help reduce the possibility of regulatory capture by any one industry. Finally, consolidation of supervisory functions in the PSA would centralize talent and result in greater efficiencies in training examiners to, for example, deal with complex products and technologies. There would be fewer agencies trying to hire and retain quality examiners, less diffusion of available talent and resources across the many regulatory agencies, and enhanced opportunity to retain the best staff by, among other things, creating attractive career paths and paying competitive salaries. This also would help limit opportunities for revolving-door regulatory capture.

### **Investor Protection and Capital Market Conduct**

The measures outlined below would (1) assure effective and efficient direction of the key responsibilities of investor protection and capital market conduct; (2) eliminate the unnecessary and inadvisable bifurcation in the regulation of the securities and commodities markets; (3) reduce interagency friction; (4) enhance market surveillance; and (5) ensure independent and adequate funding.

### **RECOMMENDATION 3: The SEC and the CFTC would be merged to create a new, independent investor protection and capital market conduct regulator (SEC-CFTC).**

The combined agency would be governed by a board of five members with relevant experience; they would be appointed by the president and confirmed by the Senate, without regard to political party affiliation, to staggered seven-year terms. The new agency would combine the current rulemaking authority of the SEC and the CFTC with respect to matters of investor protection, the structure of securities and derivatives markets, and the integrity of those markets. (The PSA would be responsible for supervising broker-dealers, swap dealers, DCOs, FCMs, and MMFs with respect to their safety and soundness.) The new agency would be funded through fees and assessments, not including fines and penalties, with full reporting to Congress, but it would not require congressional appropriations.

A desirable arrangement would be for the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services to have oversight over the combined agency, with concurrent oversight by the Senate and House Agriculture committees. The chairman of the combined agency would serve on the board of the PSA and as a member of the FSOC, providing a voice for the agency on prudential supervision of financial institutions while focusing the agency on its core missions.

Merging the SEC and the CFTC to create a new investor protection and capital market-conduct agency would (1) eliminate the unnecessary and artificial bifurcation of the securities and derivatives markets; (2) permit the regulators to better understand financial firms' activities and practices by enabling improved market oversight and surveillance of linked markets; (3) reduce the regulatory burden on regulated entities; and (4) eliminate the asymmetrical regulatory treatment of like products, activities, practices, and financial instruments.

In addition, longer terms of the commissioners that extend beyond the election cycle and the elimination of the party-affiliation requirement would help reduce the polarization in the SEC and the CFTC and would increase independence in decision-making. Moreover, independent funding would allow the agencies to be funded appropriately and enable them to accomplish their core missions more effectively, efficiently, and independently. Furthermore, joint oversight by the Senate Agriculture and Banking committees and the House Financial Services and Agriculture committees would help ensure appropriate and robust congressional oversight. Finally, a combined agency would allow the US to speak with one voice in international regulatory forums.

## APPENDIX A

### Background of the Current Regulatory Framework

THE FINANCIAL REGULATORY STRUCTURE is highly fragmented and disjointed. It follows no specific approach to regulation, instead combining several different approaches. Specifically, it is an amalgam of (1) the institutional approach, under which financial institutions are regulated based on their legal status, such as state bank, national bank, bank or thrift holding company, broker-dealer, or insurer; (2) the functional approach, under which responsibility is allocated among regulatory agencies based on rigid functional lines of business, such as insurance, banking, securities, or commodities; and (3) the objectives-based approach, under which regulatory responsibility is assigned based on certain objectives, such as financial stability, safety and soundness supervision, or consumer protection.

Specifically, eight federal regulatory agencies, together with numerous SROs and state authorities, oversee the financial system. The federal regulatory agencies include the Federal Reserve, the OCC, the FDIC, the NCUA, the SEC, the CFTC, the FHFA, and the CFPB. The OCC is the oldest federal agency, established in 1863, during the Civil War. It is followed by the Federal Reserve, which was established in 1913 as a result of the panic of 1907. The FDIC and SEC were established in 1934, in the aftermath of the Great Depression; the CFTC was established in 1974, following instability in the commodities markets. The regulators worked hard to make the crisis-driven financial regulatory structure work, and they were successful for a while. But the financial markets changed rapidly and became too complicated in the years before the recent financial crisis.

Congress established the FHFA in 2008 after eliminating its predecessor agency, the Office of Federal Housing Enterprise Oversight, as a consequence of egregious regulatory failures in the run-up to the financial crisis. The Dodd-Frank act continued the crisis-built development of the regulatory system by eliminating the ineffectual OTS for egregious failures related to large thrift institutions, while simultaneously establishing the FSOC, the OFR, the CFPB, and the Federal Insurance Office (FIO).

### Banking Regulation

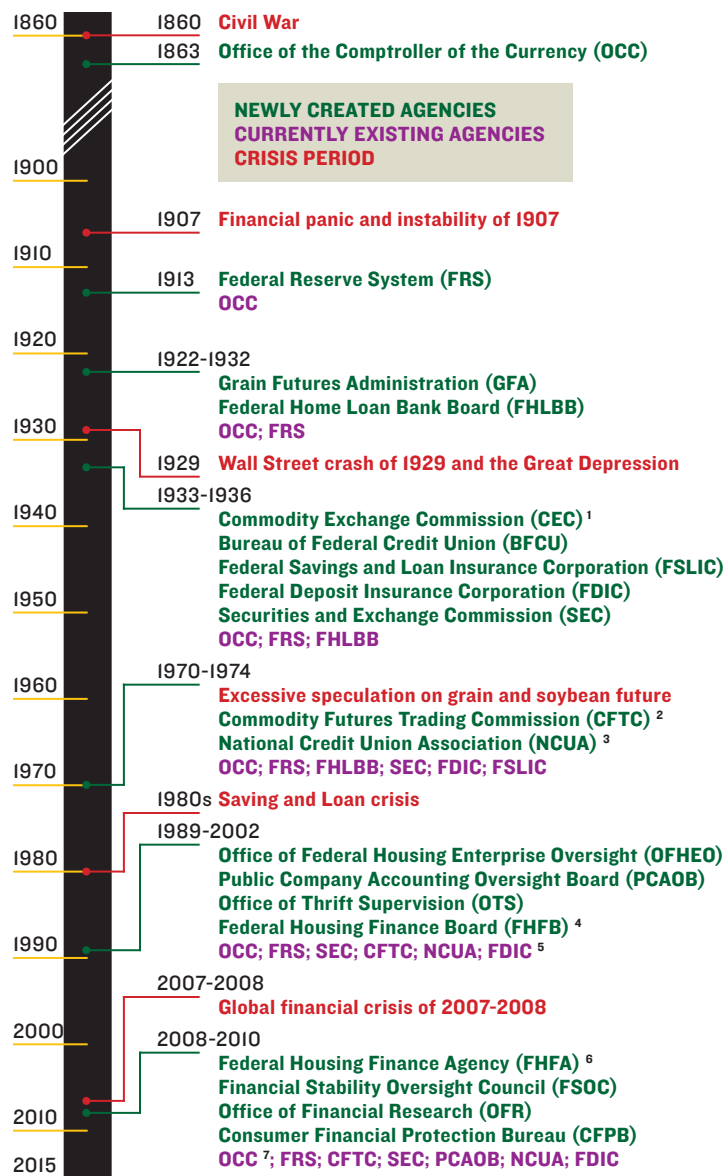
The framework for regulating depositories is highly complex and depends on a system of charters. Federally chartered depository institutions are regulated by the OCC. State-chartered depository institutions are regulated by a combination of the relevant state banking authority

**FIGURE 7: Timeline for Formation of U.S. Federal Financial Regulatory Structure**

The U.S. financial regulatory structure developed over the course of 150 years as Congress added agencies and eliminated others, primarily in an ad hoc response to financial crises and developments.

**FOOTNOTES:** 1. CEC established from the GFA. 2. CFTC established from the CEC. 3. NCUA established from the BCFU. 4. FHFB replaced FHLBB. 5. FDIC absorbed FSLIC. 6. FHFA established from the OFHEO and the FHFBB. 7. OCC absorbed the OTS.

**SOURCE:** Financial regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, January 2009. GAO-09-216. U.S. Government Accountability Office.



and either the Federal Reserve (if the depository is a member of the Federal Reserve System) or the FDIC (if it is not a member). In addition, branches and agencies of foreign banking organizations, if state-licensed, are regulated by a combination of the appropriate state banking authority and the Federal Reserve or, if federally licensed, by the OCC.

Parent holding companies of depositories, whether bank holding companies (BHCs) or savings and loan holding companies (SLHCs), are regulated by the Federal Reserve, while their functional subsidiaries are regulated by the relevant functional regulators—for example, the

SEC for a broker-dealer subsidiary. Notably, the Gramm-Leach-Bliley Act (GLBA) codified “functional” regulation under which the Federal Reserve, as the regulator of a bank holding company, must rely to the “fullest extent possible” on the functional regulators of the various subsidiaries of the holding company. Since the passage of the GLBA, holding company structures have grown increasingly large, complex, and diversified, and product lines have become blurred. Those developments have created significant challenges for the Federal Reserve and other regulators in fully comprehending the risks posed by financial conglomerates.<sup>82</sup>

### **Investor Protection and Capital Market Conduct**

Securities and derivatives regulation is spread over two agencies—the SEC and the CFTC—and numerous SROs, including the NFA and the FINRA. The SEC’s overall mission includes protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.<sup>83</sup> The CFTC’s overall mission is to foster open, transparent, competitive, and financially sound markets; to avoid systemic risk; and to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products subject to the Commodity Exchange Act.<sup>84</sup>

Under Dodd-Frank, the SEC and the CFTC were given extensive authority over the regulation of security-based swaps and swaps, respectively.<sup>85</sup> The two agencies are responsible for developing comprehensive regulations to protect the public from fraud and manipulation, safeguard financial integrity of markets, and promote improved risk management.<sup>86</sup> Although the SEC and the CFTC are primarily focused on investor protection and market integrity issues, they have some prudential regulation responsibilities for certain types of entities, including broker-dealers, FCMs, DCOs, and clearing members.<sup>87</sup> Before the financial crisis, the SEC, through a voluntary program, also supervised the holding companies and affiliates of the now-extinct large, stand-alone investment banks.<sup>88</sup>

### **Consumer Protection**

Before the passage of Dodd-Frank, consumer protection functions were scattered across many agencies that also were charged with safety and soundness supervision. Critics claimed that the agencies would always prioritize their supervisory responsibilities over protecting consumers. Dodd-Frank established the CFPB as an independent bureau within the Federal Reserve and provided it with rulemaking, enforcement, supervisory, and other powers over many consumer financial products and services, as well as many of the entities that sell

them.<sup>89</sup> The CFPB absorbed most of the consumer financial protection functions that were previously housed in the Federal Reserve, the OCC, the OTS, the FDIC, the NCUA, the Federal Trade Commission, and the Department of Housing and Urban Development.

After the Dodd-Frank act, the CFPB has primary authority over consumer financial products such as deposit taking, mortgages, credit cards, loan servicing, and debt collection. The CFPB supervises large banks, credit unions, and nonbank financial companies for the purpose of consumer financial protection. However, it does not have similar authority over most activities conducted by insurer or firms regulated by the SEC or CFTC.<sup>90</sup>

### **Insurance**

The insurance sector is regulated and supervised by the states, with little involvement from the federal government. However, the Dodd-Frank act created the FIO within the Department of the Treasury to monitor the insurance sector and represent the US in international issues of insurance regulation.<sup>91</sup> The FIO is not a regulator or supervisor; it is responsible for identifying regulatory issues in the insurance sector that could contribute to systemic crisis.

Each state has its own insurance commission, which in some instances is combined with a banking commission or other state commissions. States regulate insurers at the subsidiary level, though there is an ongoing effort toward group supervision by the states. Some insurance companies are held as part of a BHC or SLHC; in such cases, the Federal Reserve regulates the holding company. An insurer the FSOC has designated a SIFI is also regulated by the Federal Reserve.

### **Systemic Risk Regulation**

Dodd-Frank established the FSOC and the OFR to enhance financial system oversight and surveillance. Chaired by the secretary of the Treasury and made up of the heads of each of the eight regulatory agencies, among others, the FSOC is charged with identifying and addressing risks to financial stability. The FSOC's primary tool is its ability to designate nonbank financial firms as SIFIs, a designation that subjects them to enhanced supervision by the Federal Reserve.

Specifically, the FSOC has a total of 15 members, 10 of whom have the ability to vote on designations. The voting members include the heads of the CFPB, the OCC, the FDIC, the SEC, the CFTC, the Federal Reserve, the FHFA, and the NCUA, as well as an independent insurance expert. The directors of the OFR and the FIO, along with three state representa-



**FIGURE 8: An overarching view of the regulatory system, including the governance and funding structures of each regulatory agency, with their respective jurisdictions.**

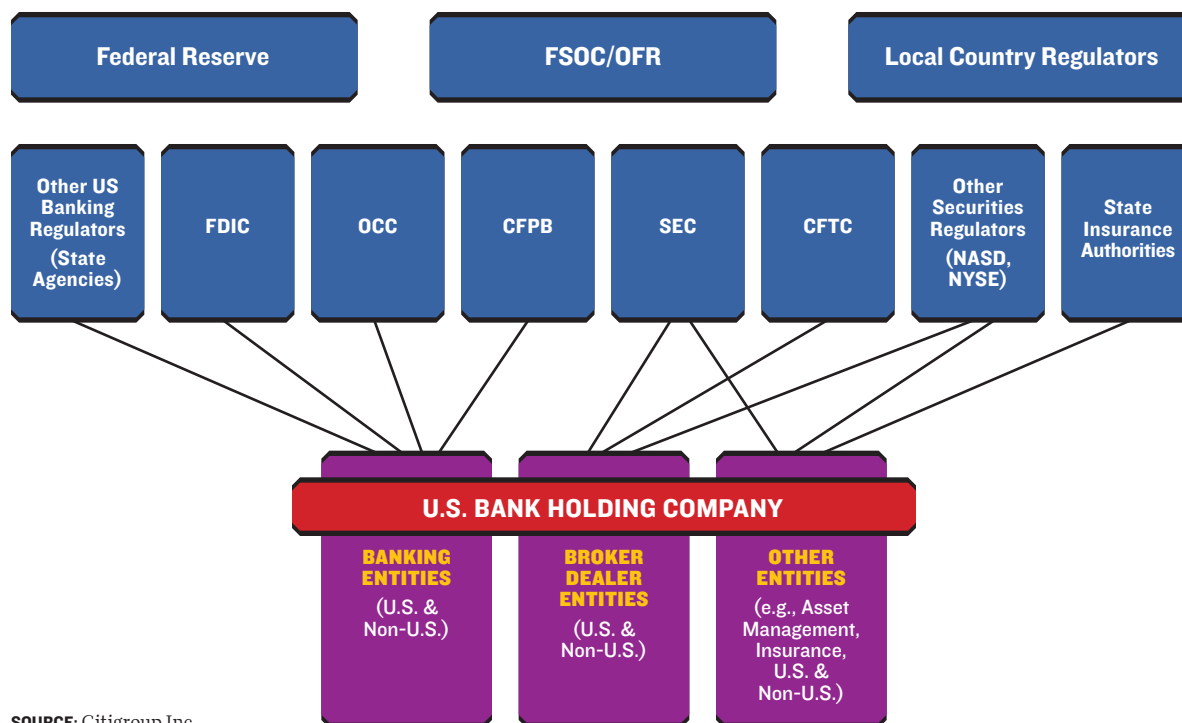
GOVERNMENT AGENCY OR ENTITY	SUPERVISED AND REGULATED ENTITIES	GOVERNANCE	FUNDING
FEDERAL RESERVE SYSTEM	BHCs, SLHCs, state-chartered member banks, state-licensed foreign banking organizations, and systemically important financial institutions, and market utilities	Board of Governors of the Federal Reserve System	Earnings on securities holdings, fees for services provided to depository institutions (check clearing and payment system operations), interest on foreign currencies, and loans to depository institutions
OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)	National banks, federal savings associations, and federally licensed branches and agencies of foreign banking organizations	Singly headed by the comptroller of the currency, who is appointed by the president and approved by the Senate for a five-year term	Direct assessments on the national banks and federal savings associations
FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)	State-chartered banks that are not members of the Federal Reserve System, backup supervisor for the remaining insured banks and thrift institutions, insures deposits in US banks and thrifts, acts as receiver for failing banks, and serves as resolution authority for systemically important financial institutions	Five-member board appointed by the president and confirmed by the Senate, with no more than three from the same political party; the board consists of a chairman, a vice chairman, the FDIC director, the comptroller of the currency, and the director of the CFPB	Risk-based deposit insurance premium
NATIONAL CREDIT UNION ADMINISTRATION (NCUA)	Regulates federally chartered credit unions and insures the deposits of account holders in all federal credit unions and most state-chartered credit unions	Three-member board appointed by the president and confirmed by the Senate for staggered six-year terms, with no more than two board members from the same political party	Mandatory capital contributions from credit unions and an asset-based fee, as well as earnings from assets
SECURITIES AND EXCHANGE COMMISSION (SEC)	Investment advisers, mutual funds, broker-dealers, transfer agents, national securities exchanges, credit rating agencies, Public Company Accounting Oversight Board, Municipal Securities Rulemaking Board, Securities Investor Protection Corporation, Financial Accounting Standards Board, securities-based derivatives, hedge funds, and other private funds; also performs reviews of disclosures of public companies	Five members of the commission are appointed by the president and confirmed by the Senate, and serve staggered five-year terms; one member is designated chairman, and no more than three commissioners can be from the president's political party	Although the SEC's budget is determined by Congress through appropriations, it is paid for by transaction fees on the securities industry
COMMODITY FUTURES TRADING COMMISSION (CFTC)	Derivatives clearing organizations, clearing members, futures commission merchants, designated contract markets, swap execution facilities, swap data repositories, swap dealers, major swap participants, eligible contract participants, commodity pool operators, and commodity trading advisers	Five commissioners are appointed by the president and confirmed by the Senate, and serve staggered five-year terms; the president, with the consent of the Senate, designates one commissioner to serve as chairman; no more than three commissioners can be from the same political party	Direct congressional appropriations of general fund revenues from the Department of the Treasury
FEDERAL HOUSING FINANCE AGENCY (FHFA)	Government-sponsored enterprises (GSEs), including Fannie Mae and Freddie Mac, as well as the Federal Home Loan Banks and the Federal Home Loan Bank System	Single director appointed by the president and confirmed by the Senate for a five-year term	Assessments on the GSEs and the Federal Home Loan Banks
CONSUMER FINANCIAL PROTECTION BUREAU (CFPB)	Examines banks, credit unions, and other financial companies and enforces federal consumer financial laws	Single director appointed by the president and confirmed by the Senate for a five-year term	Funded through the Federal Reserve System; limited by a cap specified by Dodd-Frank that is adjusted annually for inflation
FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC)	Coordinating council and designation authority of SIFIs	Fifteen-member council, with 10 voting members and five nonvoting members; chaired by the secretary of the Treasury	Assessments on bank holding companies with \$50 billion or more in assets and SIFIs
OFFICE OF FINANCIAL RESEARCH (OFR)	No supervisory or regulatory authority	Single director appointed by the president and confirmed by the Senate for a six-year term	Assessments on bank holding companies with \$50 billion or more in assets and SIFIs



tives, make up the FSOC’s five nonvoting members.

The OFR serves the FSOC and its member agencies by improving the quality of financial data and information, as well as conducting research on topics related to systemic risk. The OFR is located in the Department of the Treasury.<sup>92</sup>

**FIGURE 9: A hypothetical large bank holding company and the complexities of regulation under the current regulatory framework.**



**SOURCE:** Citigroup Inc.

## APPENDIX B

### Past Proposals For Reform<sup>93</sup>

THE LAST 100 YEARS OF EFFORT have resulted in more than 25 reform proposals to consolidate the US financial regulatory apparatus. Prominent among them are:

- The Hoover Commission proposal of 1949, which would have consolidated all bank regulation within the Federal Reserve;<sup>94</sup>
- The Hunt Commission proposal of 1971, which would have housed bank regulation in the Federal Reserve, and also would have created an administrator for national banks and an administrator for state-chartered banks;<sup>95</sup>
- A Treasury Department proposal in 1982, which would have created a new bank regulator within the department; and<sup>96</sup>
- A Federal Reserve and Treasury Department proposal in 1994, followed by a US Government Accountability Office (GAO) proposal, both of which would have consolidated the OCC and OTS.<sup>97</sup>

See Background Paper 1 for a comprehensive analysis of all proposals.

As is plainly evident, most of these proposals focused primarily on reconfiguring the regulatory framework for commercial banks. More recently, however, the focus has shifted from regulation of the traditional banking system to regulation of the entire financial system. This shift underscores the emergence of the nonbank financial sector and the acknowledgment that its regulation has been less than robust in recent years.

Two influential reform proposals in recent years are instructive: (1) the 2008 Treasury Department Blueprint for a Modernized Financial Regulatory Structure, developed under the leadership of Secretary Paulson (Blueprint);<sup>98</sup> and (2) the 2009 Treasury Department Financial Regulation Reform—A New Foundation: Rebuilding Financial Supervision and Regulation (2009 Treasury Report), developed under the leadership of Secretary Geithner.<sup>99</sup> Both are worthy of some elaboration here, though they are covered in significant detail in Background Paper 1.

### The 2008 Blueprint for a Modernized Financial Regulatory Structure<sup>100</sup>

The Department of the Treasury began its study of the US financial regulatory structure after convening a conference on capital markets competitiveness in March 2007. Conference participants, including current and former senior policymakers and industry leaders,

noted that while functioning well, the US regulatory structure was not optimal for promoting a competitive financial services sector. Following the conference, Treasury launched an effort to collect views on how to improve the financial services regulatory structure. That effort led to Treasury's 2008 report, which made a series of short-, medium-, and long-term recommendations.

The short-term recommendations focused on immediate action "to improve regulatory coordination and oversight in the wake of recent events in the credit and mortgage markets." The intermediate-term ones focused on "eliminating some of the duplication of the US regulatory system" and trying to "modernize" the regulatory structure. The long-term recommendations presented a conceptual model for an optimal regulatory framework. Treasury cited two broad considerations that prompted the reexamination of the current structure: (1) competition from maturing foreign financial markets and their ability to provide alternate sources of capital and financial innovation in a more efficient and modern regulatory system; and (2) the inability of the US regulatory structure to keep pace with the evolution and globalization of the capital markets and the financial services industry, exposing regulatory gaps and redundancies and preventing effective systemic risk monitoring and coordinated action in matters of financial market stability. The intermediate- and long-term recommendations are the most relevant.

**INTERMEDIATE-TERM RECOMMENDATIONS:** These recommendations related to (1) the future of the thrift charter and the OTS; (2) federal supervision of state-chartered banks; (3) a charter for payment and settlement systems; (4) regulation of insurance; and (5) regulation of securities and futures.

Specifically, Treasury recommended a phaseout and transition of the federal thrift charter to the national bank charter. As part of this phaseout, Treasury also recommended the closure of the OTS, with its operations to be assumed by the OCC. The Treasury report said federal supervision of these banks could be transferred to the Federal Reserve or the FDIC. Since many questions were associated with such a transfer, Treasury recommended a study to examine the evolving role of Federal Reserve banks, to make a definitive proposal regarding the appropriate federal supervisor of state-chartered banks. It appears that this study was never conducted.

The report also recommended creating a federal charter for systemically important payment and settlement systems with federal preemption. The Federal Reserve would have

primary oversight responsibilities for such payment and settlement systems, discretion to designate a payment and settlement system as systemically important, and full authority to establish regulatory standards. The report further recommended the creation of an optional federal charter (OFC) for insurers and an Office of National Insurance (ONI) within Treasury to regulate those with an OFC.

The report further recommended that the CFTC and the SEC be merged to provide unified oversight and regulation of the futures and securities industries. The SEC would be required to take specific actions to update its regulatory approach to accomplish a more seamless merger of the agencies.

**LONG-TERM OPTIMAL STRUCTURE:** These recommendations provided a conceptual framework for the optimal regulatory structure.

The report provided that an objectives-based approach would lead to the optimal structure for the future. This regulatory structure would focus on three key goals: (1) market stability regulation to address overall conditions of financial market stability that could impact the real economy; (2) prudential financial regulation to address issues of limited market discipline caused by government guarantees; and (3) business conduct regulation (linked to consumer protection regulation) to address standards for business practices.<sup>101</sup>

The Federal Reserve would serve as the market stability regulator; a new prudential regulator, the Prudential Financial Regulatory Authority (PFRA), would be established to assume the role of the OCC (and the OTS); and a new business conduct regulator, the Conduct of Business Regulatory Agency (CBRA), would be created and would include the combined SEC and CFTC described in the intermediate recommendations. The PFRA and the CBRA would be funded from “equitably distributed fees” imposed on the regulated entities. In addition, the Blueprint recommended the creation of a Federal Insurance Guarantee Corporation (FIGC), which would administer the federal deposit insurance fund and the federal insurance guarantee fund—if such a fund were created—and a corporate finance regulator with some of the functions of the SEC pertaining to public companies.

Although this item was not a direct focus, the report referred to a “coordinating body,” chaired by the secretary of the Treasury, that could resolve jurisdictional disputes between agencies and ensure appropriate coordination. In addition, it mentioned a “market stability council” that also would be chaired by the secretary and that under limited circumstances could veto certain recommended actions by the Federal Reserve on matters of financial stability.

The report further recommended creating three new charters: the federally insured depository institution charter—which would consolidate the national bank charter, the federal savings association charter, and the national credit union charter; a federal insurance institution charter; and a federal financial services provider charter for all other financial institutions.

Finally, the report recommended that a separate regulator conduct prudential oversight of the government sponsored enterprises (GSEs). The Federal Reserve, as the market stability regulator, would have the same ability to evaluate the GSEs as it would for other federally chartered institutions.

As noted above, the report was an influential proposal that unfortunately was released as the financial meltdown began and—as such—did not get the attention it deserved when it was issued. It contains analysis that is valuable in restructuring the regulatory framework.

### **US Treasury Department's Financial Regulation Reform 2009<sup>102</sup>**

In the wake of the 2008 financial crisis, the Treasury Department issued Financial Regulation Reform—A New Foundation: Rebuilding Financial Supervision and Regulation. It recommended changes to address the perceived weaknesses in the regulatory system that contributed to the financial crisis. Congress enacted at least some of its proposed reforms in the Dodd-Frank act. The 2009 report proposed, among other things, consolidating the OTS and the OCC into a new national bank supervisor and creating a consumer financial protection agency and a financial services oversight council.

Specifically, the 2009 report called for establishing a national bank supervisor that would assume the powers of the OTS and the OCC. Like those two agencies, the supervisor would be within the Treasury Department but would operate independently. It would be controlled by a single executive, as were the OCC and the OTS. The 2009 report also recommended eliminating the federal thrift charter and having federal thrifts convert to banks or state thrifts. The Federal Reserve and the FDIC would retain all their powers and supervisory authority, and the NCUA would continue with all its powers intact.

The 2009 report recommended creating a new agency, the Consumer Financial Protection Agency (CFPA) to be an independent regulator that would have the sole authority to issue rules under the consumer financial protection statutes. Thus, it would have acted in some ways like the CBRA proposed in the 2008 Blueprint. On the other hand, the CFPA would not have assumed the regulatory authority of agencies such as the CFTC and the SEC. The latter would have retained their authority to issue rules to protect investors and would have had

that authority expanded.

The 2009 report also recommended creating the Financial Services Oversight Council. It would be composed of “(i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor; (iv) the Director of the Consumer Financial Protection Agency; (v) the Chairman of the SEC; (vi) the Chairman of the CFTC; (vii) the Chairman of the FDIC; and (viii) the Director of the Federal Housing Finance Agency (FHFA).” The FSOC would serve to facilitate coordination among the federal regulators, to identify emerging risks, and to advise the Federal Reserve regarding firms that potentially pose a risk to the stability of the financial system. The report also recommended creating the Financial Consumer Coordinating Council, to be composed of representatives from the federal and state consumer protection agencies.

Dodd-Frank enacted a modified version of the 2009 report’s recommendation to create a National Bank Supervisor. It transferred the OTS’s supervisory functions for thrifts to the OCC and the OTS’s supervisory functions for thrift holding companies to the Federal Reserve. Dodd-Frank also enacted a modified version of the CFPA. It created the CFPB as an independent entity within the Federal Reserve. The CFPB receives its funding from the Federal Reserve, and has authority to issue consumer protection rules on all financial products except insurance.

Finally, the Dodd-Frank act created the FSOC, which now has more members than the Treasury originally proposed. The FSOC is chaired by the secretary of the Treasury and is composed of nine other voting members: the chairman of the Federal Reserve Board, the Comptroller of the Currency, the director of the FDIC, the SEC chairman, the CFTC chairman, the director of the CFPB, the director of the FHFA, the chairman of the NCUA, and an insurance expert appointed by the president. The FSOC also has five nonvoting members: the director of the FIO; the director of the OFR; and three representatives from the state financial regulators, with one of them representing each of the major sectors—banking, securities, and insurance.

The FSOC has all the powers the 2009 report recommended, as well as some additional ones. Dodd-Frank gave the FSOC the power to classify any entity that is not already a financial holding company, a bank holding company, or a thrift holding company—all subject to supervision by the Federal Reserve—as a nonbank financial company to be supervised by the Federal Reserve. For a company to be classified as a nonbank financial company supervised

by the Federal Reserve, two-thirds of the FSOC's voting members must conclude that the company warrants such supervision because its "material financial distress" or "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities could pose a threat to the financial stability of the United States." To help the FSOC make this determination, the Dodd-Frank act lists 10 factors members should consider and says that they may consider "any other risk-related factors" they deem appropriate.

### **Overall Trends in the Reform Proposals**

The reform proposals fit into certain broad categories circumscribed by the era in which they were introduced. For example, in the 50 years between 1913 and 1963, the dominant proposal was to merge bank supervision into the Federal Reserve. For the next 30 years, the dominant proposal was to merge bank supervision into a new banking agency, leaving the Federal Reserve with monetary policy. This was spurred in part by concerns over the Federal Reserve's having too much power.

Proposals made during the next 27 years were much simpler and focused largely on merging the OTS with the OCC. This was primarily because of the savings and loan crisis and the deregulation of savings and loans institutions—a move that had made them very similar to banks—so there was less need for them to have two separate regulators. These proposals frequently called for eliminating the federal thrift charter. From the late 1980s onward, there were periodic calls to merge the SEC and the CFTC. Up until the late 1980s, all consolidation proposals focused on depository institutions and the federal banking regulators.

Arguments supporting reform have tended to recur over the years. They include: (1) eliminating duplication of effort by agencies; (2) eliminating regulatory competition and arbitrage; (3) reducing regulatory costs; (4) creating a level playing field in terms of standardizing regulation; (5) arriving at better and more uniform regulatory standards in terms of both prudential and consumer protection; (6) eliminating regulatory gaps—a large concern of the 2008 Treasury Blueprint; (7) establishing more accountability for agencies; and (8) reducing agency capture.

Arguments by opponents of reform also have tended to be similar over time. They include: (1) the system has worked well enough, and if it is not broken, there is no need to fix it—clearly a position that has lost credibility since the financial crisis; (2) consolidation would work against competition that offered industry different beneficial regulatory strategies and viewpoints; (3) consolidation would undermine the dual banking structure that states maintained

was very important; (4) consolidation would eliminate regulatory competition and lead to overregulation; (5) reform would create a great deal of uncertainty; (6) regulatory agencies themselves opposed reform, sometimes because they did not want to lose power and other times because they did not want additional responsibilities; and (7) concerns in Congress about loss of power and oversight.

Notably, only two agencies have ever been eliminated without new agencies established to replace them—the Federal Savings and Loan Insurance Corporation and the OTS. In both cases, there was overwhelming evidence of egregious regulatory failures. The rest of the changes to the regulatory structure have resulted in an increase in the number of agencies.

The older proposals reflect the fact that the United States has traditionally viewed banking, securities, and insurance as discrete industries that should have dedicated regulators. Only within the past decade have views begun to shift as financial innovations and hybrid products have blurred or eliminated the distinctions between the three and as the growth of financial conglomerates has underscored the need for more effective consolidated supervision. Simply consolidating all banking supervision in a single agency, such as the OCC or the FDIC, will not address the problems caused by financial conglomerates, including AIG or Lehman Brothers, in the 2008 crisis. In the past two decades, financial services have become far more complex and interconnected than they were for most of the 70 years after the Federal Reserve was created. Consolidation proposals that made sense in simpler times might not address the risks posed by hybrid products and financial conglomerates.



## APPENDIX C

### The Foreign Experience<sup>103</sup>

WHEN CONSIDERING HOW TO REFORM its regulatory structure, the United States can draw on the experiences of other developed nations. The experiences of six other nations proved helpful in designing the proposals contained in this report. The nations studied were Australia, Canada, France, Germany, Japan, and the United Kingdom. These nations have financial services sectors that are roughly comparable to that of the United States in terms of sophistication and breadth of products and services offered. Furthermore, these nations have had to address the same problems posed by the growth of financial conglomerates, the blurring of the lines between traditional financial services and products, and the increasing interconnectedness of the different sectors within financial services, with each other as well as with the wider economy.

All of these nations have adopted regulatory regimes that are more consolidated than the current US structure. Four—Australia, Canada, France, and the United Kingdom—have, to varying degrees, implemented the twin peaks system, in which regulatory agencies are organized based upon objectives or the regulation of particular risks. The other two, Japan and Germany, employ an integrated approach, in which a single agency manages both safety and soundness and business conduct regulation and supervision for most, if not all, segments of the financial services sector.

Five of the six nations studied, created their existing regulatory structures in response to a series of financial crises over the past two decades. Only Australia adopted its consolidated structure in a period of relative calm and not in the aftermath of a financial crisis.

As a result of these consolidated structures, these six nations do not have the gaps or overlaps that continue to plague the US regulatory structure. They also have either a single agency or a narrowly tailored committee that is responsible for identifying and managing systemic risks. By consolidating systemic risk regulation into a single agency or a small committee, these nations are better prepared than the United States—which must rely primarily on the unwieldy FSOC with its ten voting members and five non-voting members—to respond quickly when new systemic risks emerge.

Two of the four nations with twin peaks structures have operated them for over a decade—Australia and Canada. The twin peaks structures in France and the United Kingdom have been in place for less than four years. As a result, there is insufficient evidence to draw many

useful conclusions about the success or failure of the twin peaks model based on the French and British experiences. Some evidence, however, exists that the twin peaks structures in Australia and Canada helped those nations avoid the bailouts and severity of the problems the US suffered during the 2008 financial crisis.

Of the six nations studied, only the United Kingdom experimented with a single financial regulator before adopting its current modified twin peaks structure. In 2000, the United Kingdom created the UK Financial Services Authority (UK FSA) to regulate and supervise financial services firms. It was responsible for both prudential and market conduct regulation and supervision. Internally, the UK FSA's structure employed an institutional and functional organizational structure with different offices or departments for different financial services sectors (i.e., banks, insurance companies, etc.). The UK's consolidated structure did not handle the financial crisis any better than the fragmented US structure. In 2010, the newly elected UK government effectively deemed the experiment with a single regulator unsuccessful and announced that it was restructuring the way financial services were regulated. It proceeded to adopt a modified twin peaks regulatory structure. Concluding that the UK FSA had failed to adequately fulfill its prudential supervisory functions, the UK government moved those functions back to the Bank of England, with the bank serving as a macro-prudential regulator and the newly formed Prudential Regulatory Authority (PRA), which is a subsidiary of the Bank of England, serving as the micro-prudential regulatory authority.

Japan's regulatory structure is the only one of the six that was formed from a spin-off rather than a consolidation of agencies. Japan removed the responsibilities for financial services supervision and regulation from the Ministry of Finance and created the Financial Services Agency to handle these responsibilities. Japan's experience highlights the potential dangers of allowing a highly political government agency, such as the Ministry of Finance, to have control over the regulation and supervision of financial services.

Of the six nations studied for this report, fewer than half have separated into different entities the responsibilities for developing and issuing financial services regulations from the responsibilities for implementing such regulations and supervising financial firms and markets. Canada, France, Japan, and the United Kingdom do not separate regulation from supervision. To varying degrees, Australia and Germany separate regulation from supervision. At the federal level in Australia, the Australian Treasury has responsibility for developing economic policy, which includes developing and issuing regulations for banks, insurance companies, and securities firms. Through the Council of Financial Regulators, the Australian

Treasury works with the Bank of Australia, the Australian Prudential Regulatory Authority, and the Australian Securities and Investments Commission. At the federal level in Germany, the Ministry of Finance is responsible for developing and issuing the regulations governing banks, insurance companies, and securities firms. The German Ministry of Finance and the German Ministry of Labor share responsibility for regulating pension funds.

Most of the financial regulators in these nations are funded by fees and assessments on the entities that they regulate rather than from appropriations by the national legislatures. At least in some cases, these nations have concluded that funding a financial regulator through appropriations leads to weaker regulation. For example, the 2014 report on the Australian Securities and Investment Commission (ASIC) by the Economics Reference Committee of the Australian Senate raised concerns that the ASIC was a “weak, timid, hesitant regulator, too ready and willing to accept uncritically the assurances of a large institution that there were no grounds for ASIC’s concerns or intervention.” The committee concluded that the ASIC lacked sufficient funds to adequately undertake all of its responsibilities and it recommended that changes be made to allow the ASIC to move to a “user pays” model, under which the ASIC would be funded from the fees assessed on the firms it supervises rather than from government appropriations. These experiences align with the experiences of US regulators in that funding through appropriations usually results in inadequate funding, leads to regulatory capture, and results in weaker regulation and enforcement. As a result, this report recommends that all federal financial regulators be funded from fees and assessments on the entities that they regulate rather than through congressional appropriations.

The differences in the types of legal systems employed by each of the six nations studied might make some difference in terms of how well a consolidated financial regulatory structure would work in the US. France, Germany, and Japan are civil law countries. Canada, Australia, and the UK are common law countries, like the US. As a result, the way that financial regulations and laws are interpreted by the courts in Canada, Australia, and the UK will more closely resemble how US courts would interpret financial regulations and laws.

Moreover, France, Germany, and the UK are members of the European Union. The European Union has created supra-national entities to harmonize the national regulations for banking, insurance, and securities. Across the European Union, the European Central Bank plays a role in harmonizing banking regulations, the European Insurance and Occupational Pensions Authority plays a role in harmonizing insurance regulations, and the European Securities and Markets Authority plays a role in harmonizing securities regulations. As a result,

the national financial services regulators in France, Germany, and the UK must comply with the standards and practices established by the European Union financial services regulators. Thus, they lack the level of independence of action that the regulators in Australia, Canada, and Japan have.

After considering both the similarities and the differences among the six nations studied and the US, the features of the regulatory structures of those six nations, on balance, provide useful guidance for how the US could address, at least some of, the problems with its regulatory structure that contributed to the 2008 financial crisis.

A comprehensive analysis of the regulatory framework of these six jurisdictions is provided in Background Paper 2.

## APPENDIX D

### Abbreviations

**ASIC** - Australian Securities and Investments Commission

**BHC** - Bank holding company

**CBRA** - Conduct of Business Regulatory Agency

**CFPB** - Consumer Financial Protection Bureau

**CFTC** - Commodity Futures Trading Commission

**DCO** - Derivatives clearing organization

**FCIC** - Financial Crisis Inquiry Commission

**FCM** - Futures commission merchant

**FDIC** - Federal Deposit Insurance Corporation

**FHFA** - Federal Housing Finance Agency Inc.

**FINRA** - Financial Industry Regulatory Authority

**FIO** - Federal Insurance Office

**FSB** - Financial Stability Board

**FSOC** - Financial Stability Oversight Council

**GAO** - Government Accountability Office

**GLBA** - Gramm-Leach-Bliley Act

**GSE** - Government-sponsored enterprises

**JOBS Act** - Jumpstart Our Business Startups Act

**MMF** - Money Market fund

**NFA** - National Futures Association

**NCUA** - National Credit Union Administration

**NYSE** - New York Stock Exchange

**OCC** - Office of the Comptroller of the Currency

**OFR** - Office of Financial Research

**OTC derivatives** - Over-the-counter derivatives

**OTS** - Office of Thrift Supervision

**REPO** - Repurchase Agreement

**SEC** - Securities and Exchange Commission

**SIFI** - Systemically important financial institutions

**SLHC** - Savings and loan holding company

**SRO** - Self-regulatory organization

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60. House Committee on Financial Services. Press release, Frank and Capuano introduce legislation to merge the SEC and CFTC, November 29, 2012, <http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=382948>.
61. CBJ 2015, 61.
62. CBJ 2015, 4.
63. CBJ 2015, 30.
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66. Jonathan G. Katz. US Securities and Exchange Commission: A Roadmap for Transformational Reform, 110, Center for Capital Markets Competitiveness, December 2011, 43, [https://www.uschamber.com/sites/default/files/legacy/reports/16967\\_SECReport\\_FullReport\\_final.pdf](https://www.uschamber.com/sites/default/files/legacy/reports/16967_SECReport_FullReport_final.pdf).
67. Mary Jo White. Chairwoman's Address at SEC Speaks 2014, February 21, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.VFvlick8Smo>.
68. CFTC Agency Financial Report: Fiscal Year 2012, Nov. 2012, 23 <http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2012afr.pdf>.
69. Rena S. Miller. The MF Global Bankruptcy, Missing Customer Funds, and Proposals for Reform, US Congressional Research Service, August 1, 2013, 5, <https://www.fas.org/sgp/crs/misc/R42091.pdf>.
70. See e.g. In re Peregrine Fin. Group, Inc., No. 12-27488 (Bankr. N.D. Ill. 2012); In re MF Global Holdings Ltd. et al., No. 11-15059 (Bankr. S.D.N.Y. 2012); In re Sentinel Management Group, Inc., No. 07-14987 (Bankr. N.D. Ill. 2007); In re Refco, LLC, No. 05-60134 (Bankr. S.D.N.Y. 2005).
71. A Joint Report of the SEC and the CFTC on Harmonization of Regulation, October 16, 2009, 16, <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>.

72. The 2008 Treasury Blueprint, 106.

73. Id.

74. Id, 109.

75. Examples range from more esoteric instruments to very common structures. For example, a credit default swap written on a narrow-based index of loans would be a security-based swap subject to SEC jurisdiction, but a total return swap written on the same index would be a swap subject to CFTC jurisdiction. These closely related transactions would be subject to very different regulatory structures. Similarly, exchange-traded funds mimicking the S&P 500 are SEC products while the e-mini, a futures contract based on the S&P 500, is a CFTC product. A similar situation exists with treasury securities and treasury futures or interest rate swaps.

76. Consider the CFTC's budget, the president has requested \$322 million for the CFTC in 2016, but the track record of agency has not been good in terms of receiving the president's requested amount in the final appropriations bill. In its first budget proposal after passage of the Dodd-Frank act in February 2011, the Obama administration estimated that the CFTC would need an annual budget of \$340 million (from \$169 million in 2010) and over 1,100 staff to execute its new, as well as existing, responsibilities. Four years later, the agency has grown to only \$250 million supporting a little over 700 employees. This is true despite the rapid growth in size and complexity of the markets it regulates and oversees. With the passage of the Dodd-Frank act, the CFTC took on responsibility for regulating the OTC swaps markets with a notional value of over \$400 trillion—a market that did not exist in 1980. The estimated notional value of the futures and options markets now stands at \$34 trillion, with the number of actively traded contracts doubling since 2010 and increasing six-fold over the past 10 years. CFTC, testimony of Chairman Timothy G. Massad before the House Appropriations Committee, Subcommittee on Agriculture, Rural Development, Food and Drug Administration and related agencies, February 11, 2015, <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-10>. Also see Office of Management and Budget, Budget of the United States, FY 2012, Budget Appendix, 1197.

77. Mary Jo White. Chairwoman's Address at SEC Speaks 2014, February 21, 2014, [http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.VR3UCPnF\\_EZ](http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.VR3UCPnF_EZ).

78. Gary Gensler. Testimony before the House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and related agencies, CFTC, March 22, 2012, <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-109>.

79. Sheila Bair. *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself*, (New York: Free Press, 2012), 342-343.

80. Jack Lew, "What Good Are Regulations If We Don't Fund The Regulators?" speech at Pew Charitable Trusts, December 05, 2013, <http://www.treasury.gov/press-center/press-releases/Pages/jl2232.aspx>.

81. Henry M. Paulson, Jr., *On the Brink*. (New York: Business Plus, 2013). See also Timothy F. Geithner, *Stress Test* (New York: Crown Publishers, 2014).

82. The 2008 Treasury Blueprint, 35-72. See also GAO-09-216 and *The Financial Crisis Inquiry Report*.

83. CBJ 2015.

84. The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, SEC, accessed April 2, 2015, [https://www.sec.gov/about/whatwedo.shtml#.VR2j3PnF\\_EY](https://www.sec.gov/about/whatwedo.shtml#.VR2j3PnF_EY).

85 (GAO-13-195) Financial Regulatory Reform: Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks, GAO, January 2013, [hereinafter GAO-13-195], <http://www.gao.gov/assets/660/651401.pdf>.

86. Id.

87. Id.

88. The Financial Crisis Inquiry Report.

89. The Dodd-Frank act. Subchapter V—Bureau of Consumer Financial Protection sections 5481–5603.

90. Id.

91. 31 US Code Chapter 3, Subchapter I—Organization, § 313. Federal Insurance Office, <http://www.gpo.gov/fdsys/pkg/USCODE-2011-title31/html/USCODE-2011-title31-subtitleI-chap3-subchapI-sec313.htm>.

92. GAO-13-195.

93. See Background Paper 1 for a more detailed analysis of the past proposals for reform.

94. Commission on Organization of the Executive Branch of the Government, Report vi (1949) [hereinafter Hoover Commission]. The act was named after the senators who sponsored it, Senator Henry Cabot Lodge (R-MA) and Senator Fred H. Brown (D-NH). Senator Lodge would later claim that the implementation of some of the Hoover Commission recommendations resulted in saving the federal government \$3 billion. Eric Pace, “Henry Cabot Lodge, 82, is Dead,” *The New York Times*, February 28, 1985.
95. The Report of the President’s Commission on Financial Structure & Regulation 1, 1971, [hereinafter Hunt Commission Report].
96. Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment: a Study of the Current System of Deposit Insurance Pursuant to Section 712 of the Garn-St. Germain Depository Institution Act of 1982* v, 1983, [hereinafter *Deposit Insurance in a Changing Environment*].
97. Frank N. Newman, “Consolidating the Federal Bank Regulatory Agencies,” 1993 (reprinted in A.L.I.-A.B.A., *Developments in Bank Regulation: Redefining Banking in a Shrinking Industry*, R182 A.L.I.-A.B.A. 495, 554, 1994), [hereinafter *Clinton Plan*] Frank N. Newman, the Under Secretary of the Treasury, presentation of the Clinton Administration’s plan to the Senate Committee on Banking, Housing, and Urban Affairs on November 23, 1993.
98. The 2008 Treasury Blueprint.
99. The 2009 Geithner Treasury Blueprint.
100. The 2008 Treasury Blueprint.
101. Other than the “optimal approach” outlined above, the Blueprint considered three other broad conceptual options for its review: (1) maintaining the current approach of functional-based regulation by industry segment; (2) moving to a *more* functional-based system regulating the activities of financial services firms as opposed to industry segments; and (3) moving to a single regulator model.
102. The 2009 Geithner Treasury Blueprint.
103. See Background Paper 2 for a comprehensive analysis of the regulatory framework of each jurisdiction.

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