I. Executive Summary

The mission of the Department of the Treasury ("Treasury") focuses on promoting economic growth and stability in the United States. Critical to this mission is a sound and competitive financial services industry grounded in robust consumer protection and stable and innovative markets.

Financial institutions play an essential role in the U.S. economy by providing a means for consumers and businesses to save for the future, to protect and hedge against risks, and to access funding for consumption or organize capital for new investment opportunities. A number of different types of financial institutions provide financial services in the United States: commercial banks and other insured depository institutions, insurers, companies engaged in securities and futures transactions, finance companies, and specialized companies established by the government. Together, these institutions and the markets in which they act underpin economic activity through the intermediation of funds between providers and users of capital.

This intermediation function is accomplished in a number of ways. For example, insured depository institutions provide a vehicle to allocate the savings of individuals. Similarly, securities companies facilitate the transfer of capital among all types of investors and investment opportunities. Insurers assist in the financial intermediation process by providing a means for individuals, companies, and other financial institutions to protect assets from various types of losses. Overall, financial institutions serve a vitally important function in the U.S. economy by allowing capital to seek out its most productive uses in an efficient matter. Given the economic significance of the U.S. financial services sector, Treasury considers the structure of its regulation worthy of examination and reexamination.

Treasury began this current study of regulatory structure after convening a conference on capital markets competitiveness in March 2007. Conference participants, including current and former policymakers and industry leaders, noted that while functioning well, the U.S. regulatory structure is not optimal for promoting a competitive financial services sector leading the world and supporting continued economic innovation at home and abroad. Following this conference, Treasury launched a major effort to collect views on how to improve the financial services regulatory structure.

In this report, Treasury presents a series of "short-term" and "intermediate-term" recommendations that could immediately improve and reform the U.S. regulatory structure. The short-term recommendations focus on taking action now to improve regulatory coordination and oversight in the wake of recent events in the credit and mortgage markets. The intermediate recommendations focus on eliminating some of the duplication of the U.S. regulatory system, but more importantly try to modernize the regulatory structure applicable to certain sectors in the financial services industry (banking, insurance, securities, and futures) within the current framework.

Treasury also presents a conceptual model for an "optimal" regulatory framework. This structure, an objectives-based regulatory approach, with a distinct regulator focused on one of three objectives—market stability regulation, safety and soundness regulation associated with government guarantees, and business conduct regulation—can better react to the pace of market developments and encourage innovation and entrepreneurialism within a context of enhanced regulation. This model is intended to begin a discussion about rethinking the current regulatory structure and its goals. It is not intended to be viewed as altering regulatory authorities within the current regulatory framework. Treasury views the presentation of a tangible model for an optimal structure as essential to its mission to promote economic growth and stability and fully recognizes that this is a first step on a long path to reforming financial services regulation.

The current regulatory framework for financial institutions is based on a structure that developed many years ago. The regulatory basis for depository institutions evolved gradually in response to a series of financial crises and other important social, economic, and political events: Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system and specialized insured depository charters (e.g., thrifts and credit unions) during the Great Depression. Changes were made to the regulatory system for insured depository institutions in the intervening years in response to other financial crises (e.g., the thrift crises of the 1980s) or as enhancements (e.g., the Gramm-Leach-Bliley Act of 1999 ("GLB Act")); but, for the most part the underlying structure resembles what existed in the 1930s. Similarly, the bifurcation between securities and futures regulation, was largely established over 70 years ago when the two industries were clearly distinct.

In addition to the federal role for financial institution regulation, the tradition of federalism preserved a role for state authorities in certain markets. This is especially true in the insurance market, which states have regulated with limited federal involvement for over 135 years. However, state authority over depository institutions and securities companies has diminished over the years. In some cases there is a cooperative arrangement between federal and state officials, while in other cases tensions remain as to the level of state authority. In contrast, futures are regulated solely at the federal level.

Historically, the regulatory structure for financial institutions has served the United States well. Financial markets in the United States have developed into world class centers of capital and have led financial innovation. Due to its sheer dominance in the global capital markets, the U.S. financial services industry for decades has been able to manage the inefficiencies in its regulatory structure and still maintain its leadership position. Now, however, maturing foreign financial markets and their ability to provide alternate sources of capital and financial innovation in a more efficient and modern regulatory system are pressuring the U.S. financial services industry and its regulatory structure. The United States can no longer rely on the strength of its historical position to retain its preeminence in the global markets. Treasury believes it must ensure that the U.S. regulatory structure does not inhibit the continued growth and stability of the U.S.

financial services industry and the economy as a whole. Accordingly, Treasury has undertaken an analysis to improve this regulatory structure.

Over the past forty years, a number of Administrations have presented important recommendations for financial services regulatory reforms.[1] Most previous studies have focused almost exclusively on the regulation of depository institutions as opposed to a broader scope of financial institutions. These studies served important functions, helping shape the legislative landscape in the wake of their release. For example, two reports, *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (1984) and *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991), laid the foundation for many of the changes adopted in the GLB Act.

In addition to these prior studies, similar efforts abroad inform this Treasury report. For example, more than a decade ago, the United Kingdom conducted an analysis of its financial services regulatory structure, and as a result made fundamental changes creating a tri-partite system composed of the central bank (i.e., Bank of England), the finance ministry (i.e., H.M. Treasury), and the national financial regulatory agency for all financial services (i.e., Financial Services Authority). Each institution has well-defined, complementary roles, and many have judged this structure as having enhanced the competitiveness of the U.K. economy.

Australia and the Netherlands adopted another regulatory approach, the "Twin Peaks" model, emphasizing regulation by objective: One financial regulatory agency is responsible for prudential regulation of relevant financial institutions, and a separate and distinct regulatory agency is responsible for business conduct and consumer protection issues. These international efforts reinforce the importance of revisiting the U.S. regulatory structure.

The Need for Review

Market conditions today provide a pertinent backdrop for this report's release, reinforcing the direct relationship between strong consumer protection and market stability on the one hand and capital markets competitiveness on the other and highlighting the need for examining the U.S. regulatory structure.

Prompting this Treasury report is the recognition that the capital markets and the financial services industry have evolved significantly over the past decade. These developments, while providing benefits to both domestic and global economic growth, have also exposed the financial markets to new challenges.

Globalization of the capital markets is a significant development. Foreign economies are maturing into market-based economies, contributing to global economic growth and stability and providing a deep and liquid source of capital outside the United States. Unlike the United States, these markets often benefit from recently created or newly

[1] See Appendix B for background on prior Executive Branch studies.

developing regulatory structures, more adaptive to the complexity and increasing pace of innovation. At the same time, the increasing interconnectedness of the global capital markets poses new challenges: an event in one jurisdiction may ripple through to other jurisdictions.

In addition, improvements in information technology and information flows have led to innovative, risk-diversifying, and often sophisticated financial products and trading strategies. However, the complexity intrinsic to some of these innovations may inhibit investors and other market participants from properly evaluating their risks. For instance, securitization allows the holders of the assets being securitized better risk management opportunities and a new source of capital funding; investors can purchase products with reduced transactions costs and at targeted risk levels. Yet, market participants may not fully understand the risks these products pose.

The growing institutionalization of the capital markets has provided markets with liquidity, pricing efficiency, and risk dispersion and encouraged product innovation and complexity. At the same time, these institutions can employ significant degrees of leverage and more correlated trading strategies with the potential for broad market disruptions. Finally, the convergence of financial services providers and financial products has increased over the past decade. Financial intermediaries and trading platforms are converging. Financial products may have insurance, banking, securities, and futures components.

These developments are pressuring the U.S. regulatory structure, exposing regulatory gaps as well as redundancies, and compelling market participants to do business in other jurisdictions with more efficient regulation. The U.S. regulatory structure reflects a system, much of it created over seventy years ago, grappling to keep pace with market evolutions and, facing increasing difficulties, at times, in preventing and anticipating financial crises.

Largely incompatible with these market developments is the current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures. A functional approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. In addition, the inability of any regulator to take coordinated action throughout the financial system makes it more difficult to address problems related to financial market stability.

Second, in the face of increasing convergence of financial services providers and their products, jurisdictional disputes arise between and among the functional regulators, often hindering the introduction of new products, slowing innovation, and compelling migration of financial services and products to more adaptive foreign markets. Examples of recent inter-agency disputes include: the prolonged process surrounding the

development of U.S. Basel II capital rules, the characterization of a financial product as a security or a futures contract, and the scope of banks' insurance sales.

Finally, a functional system also results in duplication of certain common activities across regulators. While some degree of specialization might be important for the regulation of financial institutions, many aspects of financial regulation and consumer protection regulation have common themes. For example, although key measures of financial health have different terminology in banking and insurance—capital and surplus respectively—they both serve a similar function of ensuring the financial strength and ability of financial institutions to meet their obligations. Similarly, while there are specific differences across institutions, the goal of most consumer protection regulation is to ensure consumers receive adequate information regarding the terms of financial transactions and industry complies with appropriate sales practices.

Recommendations

Treasury has developed each and every recommendation in this report in the spirit of promoting market stability and consumer protection. Following is a brief summary of these recommendations.

Short-Term Recommendations

This section describes recommendations designed to be implemented immediately in the wake of recent events in the credit and mortgage markets to strengthen and enhance market stability and business conduct regulation. Treasury views these recommendations as a useful transition to the intermediate-term recommendations and the proposed optimal regulatory structure model. However, each recommendation stands on its own merits.

President's Working Group on Financial Markets

In the aftermath of the 1987 stock market decline an Executive Order established the President's Working Group on Financial Markets ("PWG"). The PWG includes the heads of Treasury, the Federal Reserve, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") and is chaired by the Secretary of Treasury. The PWG was instructed to report on the major issues raised by that stock market decline and on other recommendations that should be implemented to enhance market integrity and maintain investor confidence. Since its creation in 1988, the PWG has remained an effective and useful inter-agency coordinator for financial market regulation and policy issues.

Treasury recommends the modernization of the current PWG Executive Order in four different respects to enhance the PWG's effectiveness as a coordinator of financial regulatory policy.

First, the PWG should continue to serve as an ongoing inter-agency body to promote coordination and communication for financial policy. But the PWG's focus should be broadened to include the entire financial sector, rather than solely financial markets.

Second, the PWG should facilitate better inter-agency coordination and communication in four distinct areas: mitigating systemic risk to the financial system, enhancing financial market integrity, promoting consumer and investor protection, and supporting capital markets efficiency and competitiveness.

Third, the PWG's membership should be expanded to include the heads of the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of Thrift Supervision ("OTS"). Similarly, the PWG should have the ability to engage in consultation efforts, as might be appropriate, with other domestic or international regulatory and supervisory bodies.

Finally, it should be made clear that the PWG should have the ability to issue reports or other documents to the President and others, as appropriate, through its role as the coordinator for financial regulatory policy.

Mortgage Origination

The high levels of delinquencies, defaults, and foreclosures among subprime borrowers in 2007 and 2008 have highlighted gaps in the U.S. oversight system for mortgage origination. In recent years mortgage brokers and lenders with no federal supervision originated a substantial portion of all mortgages and over 50 percent of subprime mortgages in the United States. These mortgage originators are subject to uneven degrees of state level oversight (and in some cases limited or no oversight).

However, the weaknesses in mortgage origination are not entirely at the state level. Federally insured depository institutions and their affiliates originated, purchased, or distributed some problematic subprime loans. There has also been some debate as to whether the OTS, the Federal Reserve, the Federal Trade Commission ("FTC"), state regulators, or some combination of all four oversees the affiliates of federally insured depository institutions.

To address gaps in mortgage origination oversight, Treasury's recommendation has three components.

First, a new federal commission, the Mortgage Origination Commission ("MOC"), should be created. The President should appoint a Director for the MOC for a four to six-year term. The Director would chair a six-person board comprised of the principals (or their designees) of the Federal Reserve, the OCC, the OTS, the FDIC, the National Credit Union Administration, and the Conference of State Bank Supervisors. Federal legislation should set forth (or provide authority to the MOC to develop) uniform minimum licensing qualification standards for state mortgage market participants. These should include personal conduct and disciplinary history, minimum educational requirements,

testing criteria and procedures, and appropriate license revocation standards. The MOC would also evaluate, rate, and report on the adequacy of each state's system for licensing and regulation of participants in the mortgage origination process. These evaluations would grade the overall adequacy of a state system by descriptive categories indicative of a system's strength or weakness. These evaluations could provide further information regarding whether mortgages originated in a state should be viewed cautiously before being securitized. The public nature of these evaluations should provide strong incentives for states to address weaknesses and strengthen their own systems.

Second, the authority to draft regulations for national mortgage lending laws should continue to be the sole responsibility of the Federal Reserve. Given its existing role, experience, and expertise in implementing the Truth in Lending Act ("TILA") provisions affecting mortgage transactions, the Federal Reserve should retain the sole authority to write regulations implementing TILA in this area.

Finally, enforcement authority for federal laws should be clarified and enhanced. For mortgage originators that are affiliates of depository institutions within a federally regulated holding company, mortgage lending compliance and enforcement must be clarified. Any lingering issues concerning the authority of the Federal Reserve (as bank holding company regulator), the OTS (as thrift holding company regulator), or state supervisory agencies in conjunction with the holding company regulator to examine and enforce federal mortgage laws with respect to those affiliates must be addressed. For independent mortgage originators, the sector of the industry responsible for origination of the majority of subprime loans in recent years, it is essential that states have clear authority to enforce federal mortgage laws including the TILA provisions governing mortgage transactions.

Liquidity Provisioning by the Federal Reserve

The disruptions in credit markets in 2007 and 2008 have required the Federal Reserve to address some of the fundamental issues associated with the discount window and the overall provision of liquidity to the financial system. The Federal Reserve has considered alternative ways to provide liquidity to the financial system, including overall liquidity issues associated with non-depository institutions. The Federal Reserve has used its authority for the first time since the 1930s to provide access to the discount window to non-depository institutions.

The Federal Reserve's recent actions reflect the fundamentally different nature of the market stability function in today's financial markets compared to those of the past. The Federal Reserve has balanced the difficult tradeoffs associated with preserving market stability and considering issues associated with expanding the safety net.

Given the increased importance of non-depository institutions to overall market stability, Treasury is recommending the consideration of two issues. First, the current temporary liquidity provisioning process during those rare circumstances when market stability is threatened should be enhanced to ensure that: the process is calibrated and transparent;

appropriate conditions are attached to lending; and information flows to the Federal Reserve through on-site examination or other means as determined by the Federal Reserve are adequate. Key to this information flow is a focus on liquidity and funding issues. Second, the PWG should consider broader regulatory issues associated with providing discount window access to non-depository institutions.

Intermediate-Term Recommendations

This section describes additional recommendations designed to be implemented in the intermediate term to increase the efficiency of financial regulation. Some of these recommendations can be accomplished relatively soon; consensus on others will be difficult to obtain in the near term.

Thrift Charter

In 1933 Congress established the federal savings association charter (often referred to as the federal thrift charter) in response to the Great Depression. The federal thrift charter originally focused on providing a stable source of funding for residential mortgage lending. Over time federal thrift lending authority has expanded beyond residential mortgages. For example, Congress broadened federal thrifts' investment authority in the 1980s and permitted the inclusion of non-mortgage assets to meet the qualified-thrift lender test in 1996.

In addition, the role of federal thrifts as a dominant source of mortgage funding has diminished greatly in recent years. The increased residential mortgage activity of government-sponsored enterprises ("GSEs") and commercial banks, as well as the general development of the mortgage-backed securities market, has driven this shift.

Treasury recommends phasing out and transitioning the federal thrift charter to the national bank charter as the thrift charter is no longer necessary to ensure sufficient residential mortgage loans are made available to U.S. consumers. With the elimination of the federal thrift charter the OTS would be closed and its operations would be assumed by the OCC. This transition should take place over a two-year period.

Federal Supervision of State-Chartered Banks

State-chartered banks with federal deposit insurance are currently subject to both state and federal supervision. If the state-chartered bank is a member of the Federal Reserve System, the Federal Reserve administers federal oversight. Otherwise, the FDIC oversees state-chartered banks.

The direct federal supervision of state-chartered banks should be rationalized. One approach would be to place all such banking examination responsibilities for state-chartered banks with federal deposit insurance with the Federal Reserve.

Another approach would be to place all such bank examination responsibilities for state-chartered banks with federal deposit insurance with the FDIC.

Any such shift of supervisory authority for state-chartered banks with federal deposit insurance from the Federal Reserve to the FDIC or vice versa raises a number of issues regarding the overall structure of the Federal Reserve System. To further consider this issue, Treasury recommends a study, one that examines the evolving role of Federal Reserve Banks, to make a definitive proposal regarding the appropriate federal supervisor of state-chartered banks.

Payment and Settlement Systems Oversight

Payment and settlement systems are the mechanisms used to transfer funds and financial instruments between financial institutions and between financial institutions and their customers. Payment and settlement systems play a fundamental and important role in the economy by providing a range of mechanisms through which financial institutions can easily settle transactions. The United States has various payment and settlement systems, including large-value and retail payment and settlement systems, as well as settlement systems for securities and other financial instruments.

In the United States major payment and settlement systems are generally not subject to any uniform, specifically designed, and overarching regulatory system. Moreover, there is no defined category within financial regulation focused on payment and settlement systems. As a result, regulation of major payment and settlement systems is idiosyncratic, reflecting choices made by payment and settlement systems based on options available at some previous time.

To address the issue of payment and settlement system oversight, a federal charter for systemically important payment and settlement systems should be created and should incorporate federal preemption. The Federal Reserve should have primary oversight responsibilities for such payment and settlement systems, should have discretion to designate a payment and settlement system as systemically important, and should have a full range of authority to establish regulatory standards.

Insurance

For over 135 years, states have primarily regulated insurance with little direct federal involvement. While a state-based regulatory system for insurance may have been appropriate over some portion of U.S. history, changes in the insurance marketplace have increasingly put strains on the system.

Much like other financial services, over time the business of providing insurance has moved to a more national focus even within the state-based regulatory structure. The inherent nature of a state-based regulatory system makes the process of developing national products cumbersome and more costly, directly impacting the competitiveness of U.S. insurers.

There are a number of potential inefficiencies associated with the state-based insurance regulatory system. Even with the efforts of the National Association of Insurance Commissioners ("NAIC") to foster greater uniformity through the development of model laws and other coordination efforts, the ultimate authority still rests with individual states. For insurers operating on a national basis, this means not only being subject to licensing requirements and regulatory examinations in all states where the insurer operates, but also operating under different laws in each state.

In addition to a more national focus today, the insurance marketplace operates globally with many significant foreign participants. A state-based regulatory system creates increasing tensions in such a global marketplace, both in the ability of U.S.-based firms to compete abroad and in allowing greater participation of foreign firms in U.S. markets.

To address these issues in the near term, Treasury recommends establishing an optional federal charter ("OFC") for insurers within the current structure. An OFC structure should provide for a system of federal chartering, licensing, regulation, and supervision for insurers, reinsurers, and insurance producers (i.e., agents and brokers). It would also provide that the current state-based regulation of insurance would continue for those not electing to be regulated at the national level. States would not have jurisdiction over those electing to be federally regulated. However, insurers holding an OFC could still be subject to some continued compliance with other state laws, such as state tax laws, compulsory coverage for workers' compensation and individual auto insurance, as well as the requirements to participate in state mandatory residual risk mechanisms and guarantee funds.

An OFC would be issued to specify the lines of insurance that each national insurer would be permitted to sell, solicit, negotiate, and underwrite. For example, an OFC for life insurance could also include annuities, disability income insurance, long-term care insurance, and funding agreements. On the other hand, an OFC for property and casualty insurance could include liability insurance, surety bonds, automobile insurance, homeowners, and other specified lines of business. However, since the nature of the business of life insurers is very different from that of property and casualty insurers, no OFC would authorize an insurer to hold a license as both a life insurer and a property and casualty insurer.

The establishment of an OFC should incorporate a number of fundamental regulatory concepts. For example, the OFC should ensure safety and soundness, enhance competition in national and international markets, increase efficiency in a number of ways, including the elimination of price controls, promote more rapid technological change, encourage product innovation, reduce regulatory costs, and provide consumer protection.

Treasury also recommends the establishment of the Office of National Insurance ("ONI") within Treasury to regulate those engaged in the business of insurance pursuant to an OFC. The Commissioner of National Insurance would head ONI and would have

specified regulatory, supervisory, enforcement, and rehabilitative powers to oversee the organization, incorporation, operation, regulation, and supervision of national insurers and national agencies.

While an OFC offers the best opportunity to develop a modern and comprehensive system of insurance regulation in the short term, Treasury acknowledges that the OFC debate in Congress is difficult and ongoing. At the same time, Treasury believes that some aspects of the insurance segment and its regulatory regime require immediate attention. In particular, Treasury recommends that Congress establish an Office of Insurance Oversight ("OIO") within Treasury. The OIO through its insurance oversight would be able to focus immediately on key areas of federal interest in the insurance sector.

The OIO should be established to accomplish two main purposes. First, the OIO should exercise newly granted statutory authority to address international regulatory issues, such as reinsurance collateral. Therefore, the OIO would become the lead regulatory voice in the promotion of international insurance regulatory policy for the United States (in consultation with the NAIC), and it would be granted the authority to recognize international regulatory bodies for specific insurance purposes. The OIO would also have authority to ensure that the NAIC and state insurance regulators achieved the uniform implementation of the declared U.S. international insurance policy goals. Second, the OIO would serve as an advisor to the Secretary of Treasury on major domestic and international policy issues. Once Congress passes significant insurance regulatory reform, the OIO could be incorporated into the OFC framework.

Futures and Securities

The realities of the current marketplace have significantly diminished, if not entirely eliminated, the original reason for the regulatory bifurcation between the futures and securities markets. These markets were truly distinct in the 1930s at the time of the enactment of the Commodity Exchange Act and the federal securities laws. This bifurcation operated effectively until the 1970s when futures trading soon expanded beyond agricultural commodities to encompass the rise and eventual dominance on non-agricultural commodities.

Product and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. To address this issue, the CFTC and the SEC should be merged to provide unified oversight and regulation of the futures and securities industries.

An oft-cited argument against the merger of the CFTC and the SEC is the potential loss of the CFTC's principles-based regulatory philosophy. Treasury would like to preserve the market benefits achieved in the futures area. Accordingly, Treasury recommends that the SEC undertake a number of specific actions, within its current regulatory structure and under its current authority, to modernize the SEC's regulatory approach to

accomplish a more seamless merger of the agencies. These recommendations would reflect rapidly evolving market dynamics. These steps include the following:

- The SEC should use its exemptive authority to adopt core principles to apply to securities clearing agencies and exchanges. These core principles should be modeled after the core principles adopted for futures exchanges and clearing organizations under the Commodity Futures Modernization Act ("CFMA"). By imbuing the SEC with a regulatory regime more conducive to the modern marketplace, a merger between the agencies will proceed more smoothly.

- The SEC should issue a rule to update and streamline the self-regulatory organization ("SRO") rulemaking process to recognize the market and product innovations of the past two decades. The SEC should consider streamlining and expediting the SRO rule approval process, including a firm time limit for the SEC to publish SRO rule filings and more clearly defining and expanding the type of rules deemed effective upon filing, including trading rules and administrative rules. The SEC should also consider streamlining the approval for any securities products common to the marketplace as the agency did in a 1998 rulemaking vis-à-vis certain derivatives securities products. An updated, streamlined, and expedited approval process will allow U.S. securities firms to remain competitive with the over-the-counter markets and international institutions and increase product innovation and investor choice.

- The SEC should undertake a general exemptive rulemaking under the Investment Company Act of 1940 ("Investment Company Act"), consistent with investor protection, to permit the trading of those products already actively trading in the U.S. or foreign jurisdictions. Treasury also recommends that the SEC propose to Congress legislation that would expand the Investment Company Act by permitting registration of a new "global" investment company.

These steps should help modernize the SEC's regulation prior to the merger of the CFTC and the SEC. Legislation merging the CFTC and the SEC should not only call for a structural merger, but also a process to merge regulatory philosophies and to harmonize securities and futures regulations and statutes. The merger plan should also address certain key aspects:

- Concurrent with the merger, the new agency should adopt overarching regulatory principles focusing on investor protection, market integrity, and overall financial system risk reduction. This will help meld the regulatory philosophies of the agencies. Legislation calling for a merger should task the PWG with drafting these principles.

- Consistent with structure of the CFMA, all clearing agency and market SROs should be permitted by statute to self-certify all rulemakings (except those involving corporate listing and market conduct standards), which then become effective upon filing. The SEC would retain its right to abrogate the rulemakings at any time. By

limiting self-certified SRO rule changes to non-retail investor related rules, investor protection will be preserved.

- Several differences between futures regulation and federal securities regulation would need to be harmonized. These include rules involving margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, the SRO rulemaking approval process, and the agency's funding mechanism. Due to the complexities and nuances of the differences in futures and securities regulation, legislation should establish a joint CFTC-SEC staff task force with equal agency representation with the mandate to harmonize these differences. In addition, the task force should be charged with recommending the structure of the merged agency, including its offices and divisions.

Finally, there has also been a continued convergence of the services provided by broker-dealers and investment advisers within the securities industry. These entities operate under a statutory regime reflecting the brokerage and investment advisory industries as they existed decades ago. Accordingly, Treasury recommends statutory changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors. In that vein, the establishment of a self-regulatory framework for the investment advisory industry would enhance investor protection and be more cost-effective than direct SEC regulation. Thus, to effectuate this statutory harmonization, Treasury recommends that investment advisers be subject to a self-regulatory regime similar to that of broker-dealers.

Long-Term Optimal Regulatory Structure

While there are many possible options to reform and strengthen the regulation of financial institutions in the United States, Treasury considered four broad conceptual options in this review. First, the United States could maintain the current approach of the GLB Act that is broadly based on functional regulation divided by historical industry segments of banking, insurance, securities, and futures. Second, the United States could move to a more functional-based system regulating the activities of financial services firms as opposed to industry segments. Third, the United States could move to a single regulator for all financial services as adopted in the United Kingdom. Finally, the United States could move to an objectives-based regulatory approach focusing on the goals of regulation as adopted in Australia and the Netherlands.

After evaluating these options, Treasury believes that an objectives-based regulatory approach would represent the optimal regulatory structure for the future. An objectives-based approach is designed to focus on the goals of regulation in terms of addressing particular market failures. Such an evaluation leads to a regulatory structure focusing on three key goals:

- Market stability regulation to address overall conditions of financial market stability that could impact the real economy;

- Prudential financial regulation to address issues of limited market discipline caused by government guarantees; and

- Business conduct regulation (linked to consumer protection regulation) to address standards for business practices.

More closely linking the regulatory objectives of market stability regulation, prudential financial regulation, and business conduct regulation to regulatory structure greatly improves regulatory efficiency. In particular, a major advantage of objectives-based regulation is that regulatory responsibilities are consolidated in areas where natural synergies take place, as opposed to the current approach of dividing these responsibilities among individual regulators. For example, a dedicated market stability regulator with the appropriate mandate and authority can focus broadly on issues that can impact market stability across all types of financial institutions. Prudential financial regulation housed within one regulatory body can focus on common elements of risk management across financial institutions. A dedicated business conduct regulator leads to greater consistency in the treatment of products, eliminates disputes among regulatory agencies, and reduces gaps in regulation and supervision.

In comparison to other regulatory structures, an objectives-based approach is better able to adjust to changes in the financial landscape than a structure like the current U.S. system focused on industry segments. An objectives-based approach also allows for a clearer focus on particular goals in comparison to a structure that consolidates all types of regulation in one regulatory body. Finally, clear regulatory dividing lines by objective also have the most potential for establishing the greatest levels of market discipline because financial regulation can be more clearly targeted at the types of institutions for which prudential regulation is most appropriate.

In the optimal structure three distinct regulators would focus exclusively on financial institutions: a market stability regulator, a prudential financial regulator, and a business conduct regulator. The optimal structure also describes the roles of two other key authorities, the federal insurance guarantor and the corporate finance regulator.

The optimal structure also sets forth a structure rationalizing the chartering of financial institutions. The optimal structure would establish a federal insured depository institution ("FIDI") charter for all depository institutions with federal deposit insurance; a federal insurance institution ("FII") charter for insurers offering retail products where some type of government guarantee is present; and a federal financial services provider ("FFSP") charter for all other types of financial services providers. The market stability regulator would have various authorities over all three types of federally chartered institutions. A new prudential regulator, the Prudential Financial Regulatory Agency ("PFRA"), would be responsible for the financial regulation of FIDIs and FIIs. A new business conduct regulator, the Conduct of Business Regulatory Agency ("CBRA"), would be responsible for business conduct regulation, including consumer protection issues, across all types of firms, including the three types of federally chartered institutions. More detail regarding the responsibilities of these regulators follows.

Market Stability Regulator – The Federal Reserve

The market stability regulator should be responsible for overall issues of financial market stability. The Federal Reserve should assume this role in the optimal framework given its traditional central bank role of promoting overall macroeconomic stability. As is the case today, important elements of the Federal Reserve's market stability role would be conducted through the implementation of monetary policy and the provision of liquidity to the financial system. In addition, the Federal Reserve should be provided with a different, yet critically important regulatory role and broad powers focusing on the overall financial system and the three types of federally chartered institutions (i.e., FIIs, FIDIs, or FFSPs). Finally, the Federal Reserve should oversee the payment and settlement system.

In terms of its recast regulatory role focusing on systemic risk, the Federal Reserve should have the responsibility and authority to gather appropriate information, disclose information, collaborate with the other regulators on rule writing, and take corrective actions when necessary in the interest of overall financial market stability. This new role would replace its traditional role as a supervisor of certain banks and all bank holding companies.

Treasury recognizes the need for enhanced regulatory authority to deal with systemic risk. The Federal Reserve's responsibilities would be broad, important, and difficult to undertake. In a dynamic market economy it is impossible to fully eliminate instability through regulation. At a fundamental level, the root causes of market instability are difficult to predict, and past history may be a poor predictor of future episodes of instability. However, the Federal Reserve's enhanced regulatory authority along with clear regulatory responsibilities would complement and attempt to focus market discipline to limit systemic risk.[2]

A number of key long-term issues should be considered in establishing this new framework. First, in order to perform this critical role, the Federal Reserve must have detailed information about the business operations of PFRA- and CBRA-regulated financial institutions and their respective holding companies. Such information will be important in evaluating issues that can have an impact on overall financial market stability.

The other regulators should be required to share all financial reports and examination reports with the Federal Reserve as requested. Working jointly with PFRA, the Federal

[2] Treasury notes that the PWG, the Federal Reserve Bank of New York, and the OCC have previously stated that market discipline is the most effective tool to limit systemic risk. See Agreement among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (Feb. 2007). See also PWG, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 24-25, 30 (Apr. 1999); PWG, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 34-35 (Nov. 1999).

Reserve should also have the ability to develop additional information-reporting requirements on issues important to overall market stability.

The Federal Reserve should also have the authority to develop information-reporting requirements for FFSPs and for holding companies with federally chartered financial institution affiliates. In terms of holding company reporting requirements, such reporting should include a requirement to consolidate financial institutions onto the balance sheet of the overall holding company and at the segmented level of combined federally chartered financial institutions. Such information-reporting requirements could also include detailed reports on overall risk management practices.

As an additional information-gathering tool, the Federal Reserve should also have the authority to participate in PFRA and CBRA examinations of federally chartered entities, and to initiate such examinations targeted on practices important to market stability. Targeted examinations of a PFRA- or CBRA-supervised entity should occur only if the information the Federal Reserve needs is not available from PFRA or CBRA and should be coordinated with PFRA and CBRA.

Based on the information-gathering tools described above, the Federal Reserve should publish broad aggregates or peer group information about financial exposures that are important to overall market stability. Disseminating such information to the public could highlight areas of risk exposure that market participants should be monitoring. The Federal Reserve should also be able to mandate additional public disclosures for federally chartered financial institutions that are publicly traded or for a publicly traded company controlling such an institution.

Second, the type of information described above will be vitally important in performing the market stability role and in better harnessing market forces. However, the Federal Reserve should also have authority to provide input into the development of regulatory policy and to undertake corrective actions related to enhancing market stability. With respect to regulatory policy, PFRA and CBRA should be required to consult with the Federal Reserve prior to adopting or modifying regulations affecting market stability, including capital requirements for PFRA-regulated institutions and chartering requirements for CBRA-regulated institutions, and supervisory guidance regarding areas important to market stability (e.g., liquidity risk management, contingency funding plans, and counterparty risk management).

With regard to corrective actions, if after analyzing the information described above the Federal Reserve determines that certain risk exposures pose an overall risk to the financial system or the broader economy, the Federal Reserve should have authority to require corrective actions to address current risks or to constrain future risk-taking. For example, the Federal Reserve could use this corrective action authority to require financial institutions to limit or more carefully monitor risk exposures to certain asset classes or to certain types of counterparties or address liquidity and funding issues.

The Federal Reserve's authority to require corrective actions should be limited to instances where overall financial market stability was threatened. The focus of the market stability regulator's corrective actions should wherever possible be broadly based across particular institutions or across asset classes. Such actions should be coordinated and implemented with the appropriate regulatory agency to the fullest extent possible. But the Federal Reserve would have residual authority to enforce compliance with its requirements under this authority.

Third, the Federal Reserve's current lender of last resort function should continue through the discount window. A primary function of the discount window is to serve as a complementary tool of monetary policy by making short-term credit available to insured depository institutions to address liquidity issues. The historic focus of Federal Reserve discount window lending reflects the relative importance of banks as financial intermediaries and a desire to limit the spread of the federal safety net. However, banks' somewhat diminished role and the increased role of other types of financial institutions in overall financial intermediation may have reduced the effectiveness of this traditional tool in achieving market stability.

To address the limited effectiveness of discount window lending over time, a distinction could be made between "normal" discount window lending and "market stability" discount window lending. Access to normal discount window funding for FIDIs—including borrowing under the primary, secondary, and seasonal credit programs—could continue to operate much as it does today. All FIDIs would have access to normal discount window funding, which would continue to serve as a complementary tool of monetary policy by providing a mechanism to smooth out short-term volatility in reserves, and providing some degree of liquidity to FIDIs. Current Federal Reserve discount window policies regarding collateral, above market pricing, and maturity should remain in place. With such policies in place, normal discount window funding would likely be used infrequently.

In addition, the Federal Reserve should have the ability to undertake market stability discount window lending. Such lending would expand the Federal Reserve's lender of last resort function to include non-FIDIs. A sufficiently high threshold for invoking market stability discount window lending (i.e., overall threat to financial system stability) should be established. Market stability discount window lending should be focused wherever possible on broad types of institutions as opposed to individual institutions. In addition, market stability discount window lending would have to be supported by Federal Reserve authority to collect information from and conduct examinations of borrowing firms in order to protect the Federal Reserve (and thereby the taxpayer).

Prudential Financial Regulator

The optimal structure should establish a new prudential financial regulator, PFRA. PFRA should focus on financial institutions with some type of explicit government guarantees associated with their business operations. Most prominent examples of this type of government guarantee in the United States would include federal deposit

insurance and state-established insurance guarantee funds. Although protecting consumers and helping to maintain confidence in the financial system, explicit government guarantees often erode market discipline, creating the potential for moral hazard and a clear need for prudential regulation. Prudential regulation in this context should be applied to individual firms, and it should operate like the current regulation of insured depository institutions, with capital adequacy requirements, investment limits, activity limits, and direct on-site risk management supervision. PFRA would assume the roles of current federal prudential regulators, such as the OCC and the OTS.

A number of key long-term issues should be considered in establishing the new prudential regulatory framework. First, the optimal structure should establish a new FIDI charter. The FIDI charter would consolidate the national bank, federal savings association, and federal credit union charters and should be available to all corporate forms, including stock, mutual, and cooperative ownership structures. A FIDI charter should provide "field" preemption over state laws to reflect the national nature of financial services. In addition, to obtain federal deposit insurance a financial institution would have to obtain a FIDI charter. PFRA's prudential regulation and oversight should accompany the provision of federal deposit insurance. The goal of establishing a FIDI charter is to create a level playing field among all types of depository institutions where competition can take place on an economic basis rather than on the basis of regulatory differences.

Activity limits should be imposed on FIDIs to serve the traditional prudential function of limiting risk to the deposit insurance fund. A starting place could be the activities that are currently permissible for national banks.

PFRA's regulation regarding affiliates should be based primarily at the individual FIDI level. Extending PFRA's direct oversight authority to the holding company should be limited as long as PFRA has an appropriate set of tools to protect a FIDI from affiliate relationships. At a minimum, PFRA should be provided the same set of tools that exists today at the individual bank level to protect a FIDI from potential risks associated with affiliate relationships. In addition, consideration should be given to strengthen further PFRA's authority in terms of limiting transactions with affiliates or requiring financial support from affiliates. PFRA should be able to monitor and examine the holding company and the FIDI's affiliates in order to ensure the effective implementation of these protections. With these added protections in place, from the perspective of protecting a FIDI, activity restrictions on affiliate relationships are much less important.

Holding company regulation was designed to protect the assets of the insured depository institution and to prevent the affiliate structure from threatening the assets of the insured institution. However, some view holding company supervision as way to protect against systemic risk. The optimal structure decouples those two regulatory objectives as the blurring of these objectives is ineffective and confusing. Therefore, PFRA will focus on the original intent of holding company supervision, protecting the assets of the insured depository institution; and a new market stability regulator will focus on broader systemic risk issues.

Second, to address the inefficiencies in the state-based insurance regulatory system, the optimal structure should establish a new FII charter. Similar to the FIDI charter, a FII charter should apply to insurers offering retail products where some type of government guarantee is present. In terms of a government guarantee, in the long run a uniform and consistent federally established guarantee structure, the Federal Insurance Guarantee Fund ("FIGF"), could accompany a system of federal oversight, although the existing state-level guarantee system could remain in place. PFRA would be responsible for the financial regulation of FIIs under the same structure as FIDIs.

Finally, some consideration should focus on including GSEs within the traditional prudential regulatory framework. Given the market misperception that the federal government stands behind the GSEs' obligations, one implication of the optimal structure is that PFRA should not regulate the GSEs. Nonetheless, given that the federal government has charged the GSEs with a specific mission, some type of prudential regulation would be necessary to ensure that they can accomplish that mission. To address these challenging issues, in the near term, a separate regulator should conduct prudential oversight of the GSEs and the market stability regulator should have the same ability to evaluate the GSEs as it has for other federally chartered institutions.

Business Conduct Regulator

The optimal structure should establish a new business conduct regulator, CBRA. CBRA should monitor business conduct regulation across all types of financial firms, including FIIs, FIDIs, and FFSPs. Business conduct regulation in this context includes key aspects of consumer protection such as disclosures, business practices, and chartering and licensing of certain types of financial firms. One agency responsible for all financial products should bring greater consistency to areas of business conduct regulation where overlapping requirements currently exist. The business conduct regulator's chartering and licensing function should be different than the prudential regulator's financial oversight responsibilities. More specifically, the focus of the business conduct regulator should be on providing appropriate standards for firms to be able to enter the financial services industry and sell their products and services to customers.

A number of key long-term issues should be considered in establishing the new business conduct regulatory framework.

First, as part of CBRA's regulatory function, CBRA would be responsible for the chartering and licensing of a wide range of financial firms. To implement the chartering function, the optimal structure should establish a new FFSP charter for all financial services providers that are not FIDIs or FIIs. The FFSP charter should be flexible enough to incorporate a wide range of financial services providers, such as broker-dealers, hedge funds, private equity funds, venture capital funds, and mutual funds. The establishment of a FFSP charter would result in the creation of appropriate national standards, in terms of financial capacity, expertise, and other requirements, that must be satisfied to enter the business of providing financial services. For example, these standards would resemble

the net capital requirements for broker-dealers for that type of FFSP charter. In addition to meeting appropriate financial requirements to obtain a FFSP charter, these firms would also have to remain in compliance with appropriate standards and provide regular updates on financial conditions to CBRA, the Federal Reserve, and the public as part of their standard public disclosures. CBRA would also oversee and regulate the business conduct of FIDIs and FIIs.

Second, the optimal structure should clearly specify the types of business conduct issues where CBRA would have oversight authority. In terms of FIDIs' banking and lending, CBRA should have oversight responsibilities in three broad categories: disclosure, sales and marketing practices (including laws and regulations addressing unfair and deceptive practices), and anti-discrimination laws. Similar to banking and lending, CBRA should have the authority to regulate FIIs' insurance business conduct issues associated with disclosures, business practices, and discrimination. CBRA's main areas of authority would include disclosure issues related to policy forms, unfair trade practices, and claims handling procedures.

In term of business conduct issues for FFSPs, such as securities and futures firms and their markets, CBRA's focus would include operational ability, professional conduct, testing and training, fraud and manipulation, and duties to customers (e.g., best execution and investor suitability).

Third, CBRA's responsibilities for business conduct regulation in the optimal structure would be very broad. CBRA's responsibilities would take the place of those of the Federal Reserve and other insured depository institution regulators, state insurance regulators, most aspects of the SEC's and the CFTC's responsibilities, and some aspect of the FTC's role.

Given the breadth and scope of CBRA's responsibilities, some aspect of self-regulation should form an important component of implementation. Given its significance and effectiveness in the futures and securities industry, the SRO model should be preserved. That model could be considered for other areas, or the structure could allow for certain modifications, such as maintaining rule writing authority with CRBA, while relying on an SRO model for compliance and enforcement.

Finally, the proper role of state authorities should be established in the optimal structure. CBRA would be responsible for setting national standards for a wide range of business conduct laws across all types of financial services providers. CBRA's national standards would apply to all financial services firms, whether federally or state-chartered. In addition, field preemption would be provided to FIDIs, FIIs, and FFSPs, preempting state business conduct laws directly relating to the provision of financial services.

In the optimal structure, states would still retain clear authority to enact laws and take enforcement actions against state-chartered financial service providers. In considering the future role of the states vis-à-vis federally chartered institutions, the optimal structure seeks to acknowledge the existing national market for financial products, while at the

same time preserving an appropriate role for state authorities to respond to local conditions. Two options should be considered to accomplish that goal. First, state authorities could be given a formalized role in CBRA's rulemaking process as a means of utilizing their extensive local experience. Second, states could also play a role in monitoring compliance and enforcement.

Federal Insurance Guarantee Corporation

The FDIC should be reconstituted as the Federal Insurance Guarantee Corporation ("FIGC") to administer not only deposit insurance, but also the FIGF (if one is created and valid reasons to leave this at the state level exist as discussed in the report). The FIGC should function primarily as an insurer in the optimal structure. Much as the FDIC operates today, the FIGC would have the authority to set risk-based premiums, charge ex-post assessments, act as a receiver for failed FIDIs or FIIs, and maintain some back-up examination authority over those institutions. The FIGC will not possess any additional direct regulatory authority.

Corporate Finance Regulator

The corporate finance regulator should have responsibility for general issues related to corporate oversight in public securities markets. These responsibilities should include the SEC's current responsibilities over corporate disclosures, corporate governance, accounting oversight, and other similar issues. As discussed above, CBRA would assume the SEC's current business conduct regulatory and enforcement authority over financial institutions.

Conclusion

The United States has the strongest and most liquid capital markets in the world. This strength is due in no small part to the U.S. financial services industry regulatory structure, which promotes consumer protection and market stability. However, recent market developments have pressured this regulatory structure, revealing regulatory gaps and redundancies. These regulatory inefficiencies may serve to detract from U.S. capital markets competitiveness.

In order to ensure the United States maintains its preeminence in the global capital markets, Treasury sets forth the aforementioned recommendations to improve the regulatory structure governing financial institutions. Treasury has designed a path to move from the current functional regulatory approach to an objectives-based regulatory regime through a series of specific recommendations. The short-term recommendations focus on immediate reforms responding to the current events in the mortgage and credit markets. The intermediate recommendations focus on modernizing the current regulatory structure within the current functional system.

The short-term and intermediate recommendations will drive the evolution of the U.S. regulatory structure towards the optimal regulatory framework, an objectives-based regime directly linking the regulatory objectives of market stability regulation, prudential financial regulation, and business conduct regulation to the regulatory structure. Such a framework best promotes consumer protection and stable and innovative markets.