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A New Framework for Financial Regulation

On June 17, the U.S. Treasury Department released its plan to reform the financial sector, entitled "Financial Regulatory Reform: A New Foundation." The far-reaching proposal seeks to shore up our current regulatory structure by addressing the issues that led to our current economic crisis, namely inadequate, fragmented, and inconsistent regulation. Additionally, new tools have been introduced to protect consumers and improve international regulatory standards.

The complex proposal is expected to engender serious debate and significant legislative wrangling over the coming months, and will include all private, public, and regulatory interests in the financial services world. While there is broad understanding that the regulatory scheme currently in place was a major cause of the economic collapse of the past year, the proposal was immediately met with skepticism, and there is expected to be staunch opposition to many of the finer provisions contained in it.

The proposal includes new regulations on financial services firms and the financial markets, regulations protecting customers, as well as provides new tools for the government to use in times of crisis.

Among the new provisions for regulation of financial services firms, the proposal would ensure that any financial firm big enough to pose a risk to the financial system would be heavily regulated by the Federal Reserve, including regular stress tests; gives the Federal Reserve oversight over parent companies and all subsidiaries, including unregulated units and those based overseas; requires hedge funds, private-equity funds and venture-capital funds to register with the SEC, allowing the agency to collect data from the firms (see "Hedge Fund Transparency Act" in this issue of the Monitor); and urges the SEC to give directors of money-market mutual funds the power to suspend redemptions, and take other action to strengthen regulation of money-market mutual funds to prevent runs.

For the financial markets, the administration has proposed bringing the markets for over-the-counter derivatives and asset-backed securities into a regulatory framework, strengthening regulation of derivatives dealers and forcing trades to be executed through public counterparties, such as exchanges. The proposal also calls for strengthened laws designed to protect "unsophisticated parties" from trading derivatives "inappropriately"; more conservative capital requirements and tougher rules on counterparty credit exposure; giving the Federal Reserve more power over the infrastructure that governs these markets, such as payment and settlement systems; and for the SEC to strengthen its regulation of credit-rating firms, including disclosing conflicts of interest, better differentiating between structured and unstructured debt and more clearly stating the risks of financial products.

The proposal also creates the Consumer Financial Protection Agency—which would work with state regulators—with broad authority over consumer-oriented financial products, such as mortgages and credit cards, and gives the agency the power to write regulations and levy fines based on existing statutes. The agency would also be given greater power to regulate unfair, deceptive or abusive practices. The proposal also would give formal recognition to some of the powers used by the government already, such as creating a mechanism that allows the government to take over and unwind large, failing financial institutions, and gives the Treasury the authority to decide how to fix such a failing firm, whether through a conservatorship, receivership or some other method.

While the Members of Congress recognize that regulatory reform is necessary, it may be a long journey for the provisions that the administration is hoping to achieve. That said, NCPERS will continue to monitor the situation on Capitol Hill and when appropriate, represent to legislators the views of this organization and its members.

Hedge Fund Transparency Act

On January 29, 2009, Senators Chuck Grassley (R-IA) and Carl Levin (D-MI) introduced the Hedge Fund Transparency Act of 2009. The bill, S. 334, would clarify current law to remove any doubt that the Securities and Exchange Commission has the authority to require hedge funds to register, so the government knows who they are and what they're doing. It would close the provision previously used by hedge funds to escape the definition of an "investment company" under the Investment Company Act of 1940. The senators said their legislation is needed because of a 2006 decision by the D.C. Circuit Court of Appeals which overturned a regulation imposed by the Securities and Exchange Commission requiring hedge funds to register. The court said the Securities and Exchange Commission was going beyond its statutory authority and effectively ended all mandatory registration of hedge funds with the Securities and Exchange Commission unless and until Congress takes action.

The bill would require funds of a specific size relying on the new exemptions to register and cooperate with the SEC, maintain books and records as required by the SEC, and file annual disclosure statements that include, among other information, the identities of the funds' investors and value of fund assets. The bill also proposes requiring these funds to establish anti-money laundering programs and to report suspicious transactions, in line with requirements for financial institutions.

Notwithstanding its title, the bill would have a significant effect on not only hedge funds but also many private equity buyout funds, venture capital funds, structured finance vehicles, and some real estate funds.

Currently, virtually all hedge funds, private equity funds, venture capital funds, and structured finance vehicles rely upon exceptions under Section 3(c)(1) (for funds with fewer than 100 beneficial owners) or Section 3(c)(7) (for funds made up solely of "qualified purchasers") of the Investment Company Act. By replacing the current Sections 3(c)(1) and 3(c)(7) with identical text but in Sections 6(a)(6) and 6(a)(7), the HFTA would turn these exceptions from the definition of "investment company" into exemptions from certain requirements of the Investment Company Act. Although funds relying on these exemptions would continue to avoid many of the burdensome requirements placed on registered investment companies (*i.e.*, mutual funds), this change would explicitly clarify that the SEC has legislative authority to oversee and supervise these private funds. It not clear from the text of the HFTA whether all references to a "registered investment company" in the Investment Company Act will include funds relying on these new exemptions.

The HFTA would add a new Section to the Investment Company Act, requiring funds with assets or assets under management of $50 million or more that wish to rely on the new exemptions to comply with four new conditions. These funds would be required to:

- Register with the SEC.
- File an annual information form with the SEC.
- Maintain books and records as required by the SEC.
- Cooperate with any request for information or examination by the SEC.

The information form would be filed electronically at a time and in a manner as required by the SEC, but no less frequently than once every 12 months. It would be made available by the SEC to the public at no cost in an electronic, searchable format and would include such information as Names and current addresses of natural persons that are beneficial owners in the fund, companies with an ownership interest in the fund, the primary accountants and primary brokers used by the fund, and

information on any affiliation that the fund has with another financial institution.

The HFTA also imposes new anti-money laundering obligations on funds relying on the new exemptions in Sections 6(a)(6) and 6(a)(7). Each fund would be required to establish an anti-money laundering compliance program and to report suspicious transactions, in line with existing requirements for financial institutions.

The bill was referred to the Senate Banking, Housing and Urban Development Committee, and NCPERS will continue to monitor the legislation and report on developments as they occur.

Healthcare Reform Debate Begins

Legislators on Capitol Hill are busy putting together blueprints for comprehensive reform of America's health care system, and Democratic leaders have suggested that they would like to send President Obama a bill by October. Though some members of Congress have introduced bills that would reform parts of the health care system, those bills likely will serve as markers, to be incorporated in a single massive bill that is expected to be introduced this summer.

Despite the desire by Democrats to craft and pass the legislation quickly, many Republicans are alarmed by the speed with which the legislation is being crafted, and legislators on both sides of the aisle have expressed concern with the price tag for reform, which the Congressional Budget Office has estimated to be as high as $1.6 trillion over the next ten years. In fact, the two most prominent issues facing legislators are how to pay for reform without creating a greater deficit and whether the reformed health care and insurance system would be hybrid private sector system with a government option—citizens could continue to purchase private health insurance or they could opt into a government run insurance plan— or whether a single-payer system (i.e., government insurance system) would be instituted. The single-payer issue has created a real rift among Democrats, with many believing that it is the best way to ensure that all Americans are covered, while others believe that the private insurance system should remain an option for those who would prefer to purchase in the private sector.

That said, legislators continue to move forward with their efforts. The Senate Health, Education, Labor and Pensions Committee recently began its review of amendments with new calls for action from the panel's acting chairman, Sen. Christopher J. Dodd (D-CT), while Sens. Max Baucus (D-MT) and Chuck Grassley (R-IA), Chairman and Ranking Member of the Senate Finance Committee, are still working on creating a blueprint for reform. In the House of Representatives, bills are being worked on in the Ways & Means Committee, chaired by Rep. Charles Rangel (D-NY), the Committee on Education and Labor, chaired by George Miller (D-CA), and Rep. Henry Waxman's Energy and Commerce Committee.

As a result of the recent action, NCPERS reconstituted its Health Care Task Force in late June to determine how the organization would proceed during the debate. The members of the Task Force determined that there were a number of other organizations, such as Health Care for Americans Now and the National Coalition on Health Care, that were working toward the broader principles of full inclusion, minimum coverages, equitable access to health care, and affordability, among others, that NCPERS believes are important to reform. Therefore the Task Force turned its eye toward issues related to retiree health care. To that end it was decided that NCPERS will focus on issues related to pre-Medicare retirees, taxation of employer-based retiree benefits, taxation of VEBAs and ensuring that any tax regimes developed to cover the costs of health care will be equitably applied. Members of the Task Force and NCPERS staff continue to work on more fully developing the specifics related to those issue areas.

As action heats up on Capitol Hill, NCPERS will continue to lobby on those health care related issues that affect its members.

In the STATES

CALIFORNIA

The California Public Employees' Retirement System recently announced the appointment of Stephen Kessler as deputy executive officer of operations and Kathleen Hamilton as deputy executive officer of benefits. Kessler will oversee CalPERS support and operational functions, advising the Board on policy and administration, including human resources, fiscal planning and budgeting, system strategic management, information technology, and facilities management. Hamilton will provide executive leadership for the Pension Fund's retirement programs which serve 1.6 million active and retired State and local public employees. She will also have executive oversight of CalPERS health care program that pays more than $5 billion annually for health care services on behalf of 1.3 million members and their families. The two assumed their new roles on July 1.

MICHIGAN

State Rep. Tim Bledsoe introduced legislation recently that would require municipal pension plans in Michigan to keep travel records and other documents for five years. Bledsoe said his bill was prompted by Detroit Free Press reports that trustees, staff and attorneys with Detroit's two public pension plans spent $380,000 on travel during the past year. The Free Press also reported that Detroit's pension funds destroy their records after closing the books on the year. State law requires local governments to keep travel records for seven years, but experts disagree whether local pensions are covered. Bledsoe said his bill fixes any gap in the rules.

FLORIDA

Jacksonville Mayor John Peyton is preparing to propose to the city council a budget that will raise property taxes by 14 percent, reduce pension costs and cut city staff and wages, claiming the action is necessary to pull the city out of a financial crisis. The city faces a $180 million budget gap after losing $100 million worth of property tax revenue, $40 million in investment losses and an additional $40 million in increased pension costs. Peyton said he will propose to the City Council July 13 that it cut the city's operating budget by $40 million by reducing its non-public safety operating budget by five percent and eliminating more than 100 positions. He also wants to freeze pay for all city employees and give an unpaid furlough of a week or two to all non-public safety employees. Peyton also want to alter the city's pension plan, which has a $1.2 billion unfunded liability, by reducing the 8.4 percent expected rate of return, and by having participants contribute more and changing the retirement age formula to increase the years-of-service criteria.

MINNESOTA

An audit of the Minnesota State Retirement System computer systems has found potential security flaws. The system manages retirement, health care and deferred compensation plans for more than 250,000 current and former public employees and their beneficiaries. However, despite the weaknesses it outlined, the audit report did not say that any security breaches had occurred because of the problems. The audit faulted the retirement system for lacking a comprehensive security management program, inadequate firewall and wireless security, unrestricted access to sensitive parts of the network, inadequate monitoring of security problems, failing to encrypt sensitive data, inadequate management of computer system changes and tardy security updates for software.

OHIO

In June, Governor Ted Strickland proposed reducing the percentage of employee salaries that the state contributes for worker pensions from 14 percent to 8 percent for two years. Employees contribute 10 percent of their wages into the system. Strickland's plan would use $256 million that otherwise would go to the pension fund to help address a $3.2 billion shortfall in the 2010-11 budget, with the intention of repaying

the money over the next decade. According to Julie Graham-Price, a spokeswoman for OPERS, “The result not only hurts current retirees; it threatens the security of retirees for years to come.“ The system, which represents state workers and other public employees, has nearly 770,000 active members, and approximately 166,500 retirees.

TEXAS

In June, Governor Rick Perry vetoed a bill that would have given retirees more say on the board of the Teacher Retirement System of Texas. That additional retiree slot would have resulted in the loss of a financial professional on the nine-member board. According to Perry, that would have been “an inappropriate adjustment in these uncertain economic times.” The final bill was a watered-down version of a previous measure—which would have stripped Perry of much of his authority to appoint members of the nine-member board that—easily cleared the House.

MAINE

Senate President Elizabeth Mitchell introduced emergency legislation in the waning hours of the legislative session to ensure that some 35,000 retired state, city and county workers were protected from a decrease in their retirement benefits resulting from the ailing economy. The bill changed language in the law that requires that state retirement benefits go up or down based on the Consumer Price Index. A drop in the index would mean a reduction in benefits for retired teachers, state workers and others covered by the Maine Public Employees Retirement System. Mitchell said the new language would make retirement system benefits consistent with Social Security, which goes up with the Consumer Price Index but stays at the same level if the index falls. The bill was passed and Governor John Baldacci signed it on June 17.

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