



SECURITIES INDUSTRY

# ALERT

## FRR WOULD DECREASE RELIANCE ON CRAS AND INCREASE SYSTEMIC SAFEGUARDS

On June 17, 2009, the U.S. Department of the Treasury issued a report titled "*Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation*" (FRR Report) in conjunction with a speech by President Obama that outlined new proposals and recommendations to avoid a repeat of the current financial crisis. In particular, the President's speech and the FRR Report addressed the financial market's reliance on credit rating agencies (CRAs). Essentially, the FRR Report would reduce reliance upon the CRAs with a revised incentive structure for market participants. There will also be increased regulation covering systemically important payment, clearing and settlement systems.

The FRR Report specifically recommends increased regulation of CRAs, proposing that the SEC continue its efforts to strengthen regulation of CRAs and implement policies to force disclosure of conflicts. The FRR Report also recommends that CRAs publicly disclose, in a comprehensive manner, precisely the nature of what their risk ratings are designed to assess. Further, the proposals would require CRAs to publicly differentiate the credit ratings they assign to structured credit products from those assigned to unstructured debt. Ultimately, the FRR Report calls upon regulators to reduce wherever possible their use of credit ratings in regulations and supervisory practices.

The FRR Report also recommends that financial firms create appropriate incentives for participants to best serve the interests of their clients. Specifically, it proposes that the compensation of brokers, originators, sponsors, underwriters and others involved in the securitization process should be linked to long-term performance of an asset. The FRR Report recommends that federal banking agencies promulgate

regulations requiring loan originators or sponsors to retain 5 percent of the credit risk of securitized instruments, and the originators or sponsors will then be prohibited from directly or indirectly hedging or transferring the risk. However, the federal banking agencies would still have the authority to specify the permissible forms and duration of the risks under these proposals.

Additionally, the FRR Report expressed concern that weaknesses in settlement arrangements may have led or contributed to the current crises, adding to our financial problems. The FRR Report recommended that the Federal Reserve Board (FRB) be provided with the authority to oversee systemically important payment, clearing and settlement systems (covered systems). If these recommendations are adopted, the FRB would have the power to provide various covered systems with access to FRB accounts and financial services. The FRR Report also proposed legislation providing the FRB with authority to define the characteristics of a covered system. Each system would then be subject to regular, consistent and rigorous on-site safety and soundness examinations by the FRB. In the event that a covered system would be subject to comprehensive federal regulation under the CFTC or SEC, the FRR Report recommended that either federal agency remain the primary regulatory authority. The FRB would retain emergency authority to take enforcement action if it disagrees with agency's conclusions.

Clearly, discontinuing the use of CRAs will create changes in our financial system, and the potential enhanced regulation of covered systems will cause additional regulatory burdens. Fox Rothschild LLP attorneys will continue to monitor the situation and report when necessary.

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