

PART ONE

**Financial Services Industry:
Its Markets, Regulations,
and Governance**

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Fundamentals of the Financial Markets and Institutions

INTRODUCTION

More than half of all households (over 115 million) in the United States are now investing in the securities markets through private investments in company shares, mutual funds, and pension funds. Furthermore, due to the recent financial crisis, bank failures, the risks regarding Social Security, and the high-profile failure of some large pension funds, Americans are being forced to take responsibility for their financial future and retirement funds. The sustainability and financial health of public companies in general and financial services firms in particular is vital to keeping investor confidence high, and this sustainability requires public trust in the reliability of financial reports. Reliability of public financial information contributes to the efficiency, liquidity, and soundness of financial markets that may drive economic development and prosperity for the nation. This introductory chapter discusses the importance of our financial markets to the nation's economic prosperity, the promotion of the free enterprise system, the vital role of financial services firms in our society, and the importance of financial information as the lifeblood of financial markets.

FINANCIAL MARKETS

The efficiency, liquidity, and safety of the financial markets, both debt and capital markets, have been threatened by the recent financial crisis and resulting global economic meltdown. These threats have significantly increased the uncertainty and volatility in

the markets, which adversely affected investor confidence worldwide. These crises prevent investors from receiving meaningful financial information to make savvy investment decisions. U.S. capital markets traditionally have been regarded as the deepest, safest, and most liquid in the world. For many decades, they have employed stringent regulatory measures to protect investors, which has also raised the profile and status of listed companies. However, the recent global financial crisis and the competitiveness of capital markets abroad have provided global companies with a variety of choices of where to list, possibly subject to less vigorous regulatory measures. As these markets abroad become better regulated, more liquid, and deeper, they enable companies worldwide to raise their capital needs under different jurisdictions. Investors now have a wide range of options to invest globally to secure their desired return on investment.

To a significant extent, the global competitiveness of U.S. capital markets depends on the reliability of financial information in assisting investors to make sound investment decisions, cost-effective regulations that protect investors, and efficiency in attracting global investors and companies. The U.S. free enterprise system has transformed from a system in which public companies, including banks and other financial institutions, traditionally were owned and controlled by small groups of investors to a system in which businesses are owned by global investors. The United States has achieved this widespread participation by adopting sound regulations and by maintaining high-quality disclosure standards and enforcement procedures that protect the interests of global investors.¹

Recent financial regulatory reforms—both the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)—are intended to protect investors and consumers.²

FINANCIAL INFORMATION AND CAPITAL MARKETS

Reliability, transparency, and quality of financial information are the lifeblood of the capital markets. The efficiency of the markets depends on the reliability of that information which enables the markets to act as signaling mechanisms for proper capital allocation. Investor confidence in “the same level playing field” of all market participants has encouraged investors to own stock, and billions of shares trade hands to provide capital to businesses. Society, particularly the investing community, relies on the quality of corporate financial reports in making investment decisions. William McDonough, the former chairman of the Public Company Accounting Oversight Board (PCAOB), stated, “Confidence in the accuracy of accounting statements is the bedrock of investors being willing to invest, in lenders to lend, and for employees knowing that their firm’s obligations to them can be trusted.”³ As investor confidence in financial information drives the willingness to invest, America’s economic future is tied to how successfully companies respond to this call for greater transparency and reliability in financial information as well as cost efficiency and effectiveness of regulatory reforms of financial services firms.

A greater number of people are now investing through retirement funds or are actively managing their portfolios and therefore are affected by financial information

disseminated to the market. Reliable and transparent financial information contributes to the efficient functioning of the capital markets and the economy. In recent years, investment banks and major brokerage firms have grown rapidly and generated record revenue. Recently five major financial institutions have failed: Goldman Sachs Group, Bear Stearns Co., Morgan Stanley, Lehman Brothers Holdings, and Merrill Lynch & Co. The subsequent government bailout of some of these firms raises serious concerns about the value-adding activities of financial services firms, their ethics and governance, as well as the professional accountability of their board of directors, senior management, internal and external auditors, and other corporate governance participants. The lack of public trust and investor confidence in corporate America, Wall Street, and its financial dealings and reports has continued to adversely affect the vibrancy of the capital market. Bailed-out banks and their continuous excessive executive compensation schemes have left us with a legacy of mistrust. Policy makers and regulators have been challenged to establish and enforce more effective and efficient regulatory reforms; business leaders have been challenged to change their culture, behavior, and attitudes to restore confidence and trust in Wall Street.

FINANCIAL CRISIS AND FINANCIAL REGULATORY REFORMS

A historical perspective of the financial crisis in the United States indicates that real estate markets started to collapse in the second half of 2007, and investors began shorting real estate markets. Where shorting or short selling is defined as; borrowing an asset from a third party and selling it with a promise to buy back at a future point in time at a predetermined price. Collateralized debt obligations (CDOs) and mortgage-backed securities were written down, and financial panic continued into 2008, which caused major financial institutions to go bankrupt. The persistence of the financial panic in 2009 and lack of public trust and investor confidence in the financial system have caused the disappearance or reorganization of once-prominent Wall Street firms, some of which have changed their corporate structures and become bank holding companies. The U.S. financial crisis eventually affected global financial markets. Financial institutions worldwide have lost more than \$1.5 trillion on mortgage-related losses. The failed financial institutions Bear Stearns, Lehman Brothers, AIG, and Merrill Lynch played important roles in the recent financial crisis by engaging in risky mortgage lending practices, credit derivatives, hedge funds, and corporate loans. The Federal Reserve responded by reducing interest rates and flooding the market with money, and the Treasury Department asked for a \$700 billion package dubbed the Troubled Asset Relief Program (TARP) to buy toxic mortgages and other assets. The U.S. government responses to mitigate the financial panic were the TARP stimulus packages, temporary increases in deposit insurance coverage of \$250,000 per person by the Federal Deposit Insurance Corporation (FDIC), and the Dodd-Frank Act of 2010.

Recent financial reforms (Dodd-Frank), and corporate governance reforms, including SOX, convergence in regulatory reforms (from the Group of 20 [G-20]) worldwide, and TARP have shifted the power balance among shareholders, directors, and management of all entities, particularly banks. Shareholders including the U.S.

government have been more proactive in monitoring and scrutinizing corporations. Directors are held more accountable in fulfilling their fiduciary duties by overseeing management's strategic plans, decisions, risk assessment, and performance. Management is expected to achieve sustainable shareholder value creation and enhancement and to enhance the reliability of financial reports through executive certifications of internal controls and financial statements. Some provisions of SOX that were not previously practiced by public companies and that are intended to benefit all companies include:⁴

- Creating the PCAOB to oversee audits of public companies and to improve the ineffective self-regulatory environment of the auditing profession.
- Improving corporate governance through more independent and vigilant boards of directors and responsible executives.
- Enhancing the quality, reliability, transparency, and timeliness of financial disclosures through executive certifications of both financial statements and internal controls.
- Prohibiting nine types of nonaudit services considered to adversely affect auditor independence and objectivity.
- Regulating the conduct of auditors, legal counsel, and analysts and their potential conflicts of interest.
- Increasing civil and criminal penalties for violations of security laws.

Six provisions of SOX address the quality, reliability, transparency, and timeliness of public companies' financial reports:

1. The board of directors should adopt a more active role in the oversight of financial reports.
2. The audit committee is responsible for overseeing financial reports and related audits.
3. Management (chief executive officer [CEO], chief financial officer [CFO]) must certify the completeness and accuracy of financial reports in conformity with generally accepted accounting principles (GAAP).
4. Pro forma financial information must be presented in a manner that is not misleading and that is reconciled with GAAP items.
5. All material correcting adjustments identified by the independent auditor must be discussed with the audit committee and reflected in any reports that contain financial statements.
6. Management must assess the effectiveness of internal controls, audit of internal control over financial reporting (ICFR), communication of significant deficiencies to the audit committee, and public disclosure of material weaknesses in ICFR.

The first summit of the 20 largest advanced and emerging countries, better known as the G-20, was held in Toronto in June 2010 to ensure international economic cooperation by addressing the global economic crisis, reforming and strengthening global financial systems, and promoting a full return to growth with quality jobs.⁵

The 2010 G-20 agreed to:

1. Reduce budget deficits by cutting the global deficit in half by 2013.
2. Promote growth through global economic stimulus and more government spending.
3. Full return to growth with quality jobs.
4. Reform and strengthen financial systems.
5. Create strong sustainable and balanced global growth.
6. Reduce government debt-to-gross domestic product (GDP) ratios by 2016.

The important provisions of the 2010 G-20 are discussed next.

- The Framework for Strong, Sustainable, and Balanced Growth assesses global policy actions and strengthens policy frameworks.
- Financial service reform establishes a more resilient financial system, improving risk assessment, promoting transparency, and reinforcing international cooperation.
- International financial institutions (IFIs) should develop as a global response to the financial and economic crisis and a platform for global cooperation including \$750 billion by the International Monetary Fund (IMF) and \$235 billion by the multi-lateral development banks (MDBs).
- Fighting Protectionism and Promoting Trade and Investment by refraining from raising barriers or imposing new barriers to investment or trade in goods and services at least until the end of 2013.
- Moving toward convergence in accounting standards by adopting a single set of high-quality globally accepted accounting standards.

The most important declaration of the 2010 G-20 summit is the development of financial sector reform that encourages a systemic risk assessment, supports strong and stable global economic growth, requires prudential oversight, and promotes transparency and reinforces international cooperation. The G-20 financial sector reform consists of four pillars. The first pillar is a strong financial regulatory framework built on the progress of the Basel Committee on Banking Supervision. This regulatory framework would establish a new regime for bank capital and liquidity that will eventually raise levels of resilience for the global banking systems and enable banks to withstand the pressure of the recent financial crisis. This first pillar will come to fruition by the end of 2012 and is intended to strengthen financial market infrastructure by implementing effective measures to improve transparency and regulatory oversight of the over-the-counter (OTC) derivatives, credit rating agencies, and hedge funds.

The second pillar is effective oversight and supervision of global financial institutions. The Financial Stability Board (FSB) in consultation with the International Monetary Fund (IMF) issued its report, in February 2011, entitled “Progress in the Implementation of the G 20 Recommendations for Strengthening Financial Stability” which makes recommendations to finance ministers and central bank governors to strengthen oversight and supervision while providing adequate resources and defining roles and responsibility of supervisors.⁶

The third pillar is the development of a system that systematically restructures and resolves all types of financial institutions in crisis with no burden on taxpayers. This system would consist of policy framework, implication procedures, resolution tools, supervisory provisions, and core financial market infrastructures.

The fourth pillar is robust and transparent international assessment and peer review of global financial institutions. This pillar demonstrates G-20's commitment to the IMF/World Bank Financial Sector Assessment Program to support transparent peer review through the FSB. The review process would address noncooperative jurisdictions based on effective assessment regarding the fight against money laundering, tax havens, and terrorist financing.

The Basel Committee is intended to strengthen global capital and liquidity regulations to promote a more resilient banking sector with proper ability to absorb shocks arising from financial and economic stress and to improve risk management, governance, transparency, and disclosures. The Basel Committee addresses the market failures caused by the recent financial crisis and establishes measures to strengthen bank-level and micro-prudential regulation.

On September 12, 2010, global bank regulators agreed to require banks to significantly increase their amount of top-quality capital in an attempt to prevent further international crisis.⁷ Basel III will require banks to maintain top-quality capital totaling 7 percent of their risk-bearing assets compared to the currently required 2 percent. Effective compliance with Basel III rules would require banks to raise substantial new capital over the next several years as the Tier 1 rule (4.5%) will take effect from January 2015 and the requirement for the capital conservation buffer (up to 10.5%) will be phased in between January 2016 and January 2019. The primary objective of Basel III rules is to strengthen global capital standards to ensure sustainable financial stability and growth for banks worldwide. The rules are intended to encourage banks to engage in appropriate risk business strategies to ensure their financial health and their ability to withstand financial shocks without government bailout supports. The increased capital requirement, however, could reduce the amount of funds available to lend out to customers.

Specifically, Basel III will require banks to: (1) maintain top-quality capital (tier 1 capital, consisting of equity and retained earnings) up to 4.5 percent of their assets; (2) hold a new separate "capital conservation buffer" of common equity worth at least 2.5 percent of their assets; and (3) build a separate "countercyclical buffer" of up to 2.5 percent when their credit markets are booming. The tier 1 rule will take effect from January 2015 and the requirement for the capital conservation buffer will be phased in between January 2016 and January 2019.

Other rules of Basel III include: (1) provisions for reducing risk-taking by banks, (2) requirements for liquid banks' assets, (3) promotion of financial stability, and (4) improvements in risk management, governance, banks' transparency and disclosures,

Eleven important provisions of Basel III are listed next.

1. Basel III rules are more robust than those of Basel II in the sense that they require higher capital standards (more than triple that required by Basel II) to withstand future financial crisis.

2. The effective implementation of Basel III is undermined by several potential pitfalls during the eight-transition period.
3. The new capital conservation buffer (2.5 percent) will not be effective until January 2019.
4. The total capital requirement of 7 percent is expected to become a norm or standard floor for banks in order to avoid curbs on their payouts such as dividends, bonuses, or share buybacks.
5. Basel III rules along with global liquidity standards that will become effective January 2015 will make banks build up reserves of cashlike assets and more capital than Basel II rules.
6. Financial institutions may reconsider financial market trading in light of the new tougher capital requirements.
7. Big financial institutions may build up more capital than Basel III rules to mitigate the negative effects of the perception of “too big to fail” (TBTF).
8. Regulators may require excess countercyclical buffer.
9. Banks may attempt to adopt Basel III capital requirements prior to the dates specified in Basel rules to demonstrate their commitment to a sound banking system and proper risk assessment. Investors will perceive early adoption of Basel III rules as positive steps toward a more sustainable, liquid, and sound banking sector.
10. It is also expected that large banks will adopt Basel III rules earlier than the required timetable because they have more resources and incentives to do so to rule out the perception of TBTF.
11. A relatively long transition period may put banks that delay adoption at a competitive advantage over early adopters.

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which is called the most sweeping financial reform since the Great Depression. Dodd-Frank is named after Senate Banking Committee chairman Christopher Dodd (D-CT) and House Financial Services Committee chairman Barney Frank (D-MA). Its provisions pertain to banks, hedge funds, credit rating agencies, and the derivatives market. Dodd-Frank authorizes the establishment of an oversight council to monitor systemic risk of financial institutions and the creation of a consumer protection bureau within the Federal Reserve. Dodd-Frank requires the development of over 240 new rules by the Securities and Exchange Commission (SEC), the Government Accountability Office (GAO), and the Federal Reserve to implement its provisions over a five-year period.

Many provisions of Dodd-Frank are considered to be positive and useful in protecting consumers and investors, including the establishment of a consumer protection bureau and a systemic risk regulator and provisions requiring derivatives to be put on clearinghouses/exchanges. The new Consumer Financial Products Commission will make rules for most retail products offered by banks, such as certificates of deposit and consumer loans. Dodd-Frank requires managers of hedge funds (but not the funds themselves) with more than \$150 million in assets to register with the SEC.

Some provisions are subject to study and further regulatory actions by regulators, including the so-called Volcker rule. Dodd-Frank fails to address the misconception of

TBTF financial institutions, the main cause of the financial crisis, inefficiencies in Fannie Mae, Freddie Mac, and the housing agencies and the excessive use of market-based short-term funding by financial services firms.

Provisions of the Dodd-Frank Act of 2010 are summarized next.

1. Broadening the supervisory and oversight role of the Federal Reserve to include all entities that own an insured depository institution and other large and nonbank financial services firms that could threaten the nation's financial system.
2. Establishing a new Financial Services Oversight Council to identify and address existing and emerging systemic risks threatening the health of financial services firms.
3. Developing new processes to liquidate failed financial services firms.
4. Establishing an independent Consumer Financial Protection Bureau to oversee consumer and investor financial regulations and their enforcement.
5. Creating rules to regulate OTC derivatives.
6. Coordinating and harmonizing the supervision, setting, and regulatory authorities of the SEC and the Commodities Futures Trading Commission.
7. Mandating registration of advisors of private funds and disclosures of certain information of those funds.
8. Empowering shareholders with a say on pay of nonbonding votes by shareholders approving executive compensation.
9. Increasing accountability and transparency for credit rating agencies.
10. Creating a Federal Insurance Office within the Treasury Department.
11. Restricting and limiting some activities of financial firms, including limiting bank proprietary investing and trading in hedge funds and private equity funds as well as limiting bank swaps activities.
12. Providing cooperation and consistency with international financial and banking standards.
13. Making permanent the exemption from its Section 404(b) requirement for non-accelerated filers (those with less than \$75 million in market capitalization).
14. Requiring auditors of all broker-dealers to register with the PCAOB and giving the PCAOB rulemaking power to require a program of inspection for those auditors.
15. Empowering the Financial Stability Oversight Council to monitor domestic and international financial regulatory proposals and developments in order to strengthen the integrity, efficiency, competitiveness, and stability of the U.S. financial markets.
16. Making it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940 by lowering the legal standard from "knowing" to "knowing or reckless."
17. Directing the SEC to issue rules requiring companies to disclose in the proxy statement why they have separated, or combined, the positions of chairman and CEO.

The effective implementation provision of Dodd-Frank requires more than 60 studies to be conducted and more than 200 rules and regulations to be established within the next several years (2010–2015). Dodd-Frank is organized in 16 title provisions of the Act, as shown in Exhibit 1.1.

EXHIBIT 1.1 Summary of Provisions of the Dodd-Frank Act of 2010

Title	Heading	Description
I	Financial Stability	<p>Creating a Financial Stability Oversight Council to identify users and respond to existing and emerging systemic risk of bank holding companies and large nonbank financial companies.</p> <p>The Council is composed of ten voting members chaired by the head of the Treasury Department.</p>
II	Orderly Liquidation Authority	<p>Provides recommendations for receivership that may be made by the secretary of the Treasury or Federal Reserve and Federal Deposit Insurance Corporation (FDIC) or Securities and Exchange Commission (SEC) for the financial companies in default.</p> <p>Secretary will petition U.S. district court for an order to appoint the FDIC as receiver if a failing financial company does not consent to it.</p> <p>The liquidation process requires that: unsecured creditors bear losses; shareholders do not receive payment until all claims are fully paid; management and directors responsible for the failure are removed; any funds the FDIC borrows from Treasury to facilitate a liquidation be repaid through asset sales and risk-based assessments; no taxpayer funds to be used to prevent or pay for a liquidation.</p>
III	Transfer of Powers to the OCC, FDIC, and the Federal Reserve	<p>Abolishes the Office of Thrift Supervision; preserves the thrift charter. Allocates supervisory and rule-making authority for all thrift holding companies and their nondepository institution subsidiaries to the Federal Reserve.</p> <p>All rule-making authorities for thrifts will be transferred to the Office of the Comptroller of the Currency (OCC). The OCC will be redefined as a bureau within the Department of Treasury.</p> <p>Imposes a number of deposit insurance reforms to: redefine the assessment base to reflect assets; requires the reserve ratio to reach 1.35% of estimated insured deposits; permanently increases deposit insurance coverage to \$250,000; fully covers non-interest bearing transaction accounts through 2012.</p>
IV	Regulation of Advisers to Hedge Funds	<p>Eliminates the private advisor exemption and requires the investment advisor to maintain certain records and reports.</p> <p>Provides exemptions from the registration requirements for: advisors solely to venture capital funds; foreign private advisors with fewer than 15 U.S clients and less than \$25 million in assets under management; family offices as defined by SEC.</p> <p>Requires the General Accountability Office (GAO) to study and report on appropriate criteria for determining the financial thresholds.</p>
V	Insurance	<p>Monitors the insurance industry and identifies issues contributing to system risk.</p> <p>Determines if the state insurance measures are preempted by certain international insurance agreements.</p> <p>Requires modernization and improvements of the U.S system of insurance regulation.</p> <p>Submits a report to Congress on the global reinsurance market.</p>

(Continued)

EXHIBIT 1.1 (Continued)

Title	Heading	Description
VI	Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions	<p>GAO conducts a study of elimination of exceptions as amended, for thrifts, loan companies and credit banks, etc.</p> <p>Modifies regulations related to transactions with affiliates, charter conversions, and SEC's elective investment bank that holds company framework and also requires the Federal Reserve to examine nondepository institution subsidiaries engaged in activities as banks.</p> <p>Provides rules such as: banking entities to be prohibited from engaging in trading or investing funds; insured depository institution not including an institution that functions solely in a trust or fiduciary capacity.</p> <p>Banking entities must bring their activities and investments into compliance within two years after the rules become effective.</p> <p>Includes activities such as transactions in U.S government obligations or in connection with activities related to market making to meet demand of clients/customers or risk mitigating hedging activities.</p> <p>Transactions will be prohibited if they have conflict of interest between clients or customers; or if they are prone to high-risk assets or trading strategies or even if they pose a threat to the safety of bank.</p>
VII	Wall Street Transparency and Accountability	<p>SEC and Commodity Futures Trading Commission (CFTC) will share authority for regulation of OTC's swaps that actually are required to be submitted for clearing must also be traded on or through exchange or swap execution facility. (The dealers and participants must register with SEC/CFTC.)</p> <p>An exemption is provided for end users who use derivatives to hedge against risks such as fuel prices and interest rates.</p>
VIII	Clearing and Settlement Supervision	<p>Council to design financial market utilities and payment; the Federal Reserve to prescribe uniform risk management standards for the payment and settlement activities.</p> <p>Requires conducting examinations to evaluate compliance with risk management and conduct standards besides the market utilities getting access to Federal Reserve's discount window under few restrictions.</p> <p>Requires that financial institutions not include swap data repositories, security exchanges, and the financial market utility not include the above not a broker, dealer or agent as well.</p>
IX	Investors Protections and Improvements to Regulation of Securities	<p>As per the Investors Protections, SEC is granted authority to promulgate rules to establish fiduciary duty. SEC must study and give suggestions within six months of enactment of care for brokers-dealers or persons associated while advising customers; study enhancing investment advisor examinations, mutual fund advertising, etc.</p> <p>Credit rating agencies to be established within SEC to administer the commission's rules with respect to nationally recognized statistical rating organizations (NRSROs) that in turn will be examined annually by SEC as its employees (of NRSRO) are covered by the whistleblower protections.</p>

(Continued)

EXHIBIT 1.1 (Continued)

		<p>Asset-backed securities would be required to retain economic interest and risk retention requirements for commercial mortgages to be determined by federal banking agencies and the SEC.</p> <p>Executive compensation to be provided as prerequisite for listing shares on an exchange.</p> <p>Create municipal securities; its dealers and advisors are to register with the SEC.</p>
X	Bureau of Consumer Financial Protection	<p>Establish a bureau that comprises of the consumer protection functions (Federal Reserve, OCC, OTC, FDIC and NCUA) to be resident within the Federal Reserve and to be funded by Federal Reserve system.</p> <p>Grants authority to the bureau to regulate any person engaged in offering or providing a consumer financial product or service.</p> <p>Banks and credit unions with total assets of \$10 billion or less would be subject to examination and enforcement of their compliance with federal consumer laws.</p> <p>Exclusions to be provided for some persons including SEC/CFTC regulated entities; real estate brokers; home retailers; accountants, tax preparers; auto dealers.</p> <p>Bureau to take action against covered persons and service providers to stop unfair, deceptive, and abusive acts and practices.</p> <p>Additional offices to be established under the bureau including the Office of Fair Lending, Financial Literacy, Service Member Affairs, and Financial Protection for Older Americans.</p> <p>Interchange fees for electronic debit transactions to be required to be reasonable and proportional.</p>
XI	Federal Reserve System Provisions	<p>Federal Reserve to establish policies and procedures to ensure that a program is used to provide liquidity to the financial system.</p> <p>GAO to audit Federal Reserve loans and other financial assistance and to audit Federal Reserve Bank governance, including consideration of the selection and appointment of directors and conflicts of interest.</p>
XII	Improving Access to Mainstream Financial Institutions	<p>Establish grants to promote initiatives that enable low- and moderate-income individuals access to financial products that meet their needs.</p> <p>Establish multiyear programs to provide low-cost alternatives to small-dollar loans.</p>
XIII	Pay It Back Act	<p>Reduce authorization of the Troubled Asset Relief Program and requiring to proceed from the sale of Fannie Mae, Freddie Mac debt purchased under Treasury's emergency authority.</p>
XIV	Mortgage Reform and Anti-Predatory Lending Act	<p>To create laws/rules requiring mortgage originators to be qualified, registered, and licensed; to set a minimum standard that mortgage originators make a reasonable and good-faith determination while prohibiting steering where no mortgage originator may receive compensation, directly or indirectly based on terms of loans; to limit prepayment penalties.</p>

(Continued)

EXHIBIT 1.1 (Continued)

Title	Heading	Description
		To increase protection for consumers by redefining high-cost mortgages with smaller spreads over the prime offer rate than currently used and by adding requirements regarding escrow accounts and appraisal standards.
XV	Miscellaneous Provisions	Requires the GAO to report to Congress in a year on relative independence, effectiveness, and expertise of appointed inspectors general and designated federal entities.
		Requires the FDIC to evaluate the definitions of core deposits and brokered deposits and their impact on the economy.
XI	Section 1256 Contracts	Adds a new provision to the Internal Revenue Code providing an exception for any securities future contract and any interest rate swap, currency swap, basis swap, interest rate cap, commodity swap, equity swap, or similar agreement.

Technological advances and global competition and regulatory reforms have enabled companies and their investors to “largely meet in the jurisdiction of their choosing . . . [they] have choices about where to invest, where to raise capital and where secondary trading is to occur.”⁸ Thus, companies can choose the regulatory regime they desire to operate under, and investors have a choice of safeguards and protections provided under different regulatory reforms. An effective regulatory reform creates an environment under which companies can operate in achieving their performance targets, being held accountable for their activities, and providing protections for their investors. Regulatory reforms in terms of their effectiveness and context can be classified into three concepts: (1) a race to the bottom; (2) a race to optimality; (3) a race to the top. The race to the bottom concept suggests that global securities regulators, in an effort to attract issuers, deregulate to the points that provide issuers with maximum flexibility for their operations at the expense of not providing adequate protections for investors. The race to the top concept suggests that global securities regulators provide maximum protection for investors through rigid regulations and highly scrutinized enforcements at the expense of putting companies in the global competition at a disadvantage with non-cost-justified regulations. The race to optimality concept is a hybrid of the first two concepts, in which both issuers (companies) and investors prefer a regulatory regime and jurisdiction that provides cost-justified investor protection. In a real-world global competition, a combination of these three concepts may work best, as many provisions of SOX have been globally adopted.

Many provisions of SOX, particularly those pertaining to strengthening auditor independence, assessment of internal control over financial reporting, the creation of an independent board to oversee the accounting profession, and the strengthening of audit committee requirements, have been effectively adopted in other countries. Dodd-Frank is one of the most comprehensive financial regulatory reforms intended to strengthen regulation and oversight of the U.S. financial system in order to reduce the likelihood of future financial crises. Dodd-Frank consists of 16 distinct titles addressing all aspects of

financial institutions from financial stability to mortgage reforms. It requires more than 500 rules to be established, 60 studies to be conducted, and 90 reports to be prepared to ensure proper and effective implementation of its provisions over the next four years. Effective implementation of provisions of Dodd-Frank is expected to have significant impacts not only on financial services firms but also on credit rating agencies, banks and bank holding companies, insurance companies, hedge funds, private equity, broker-dealers, and large asset managers among others.

TYPES AND ROLES OF FINANCIAL MARKETS

A vital financial system and reliable financial information is essential for economic development worldwide. The persistence of differences in global financial systems necessitates a move toward convergence in corporate governance measures and regulatory reforms. Emerging global corporate governance reforms are shaping capital market structure worldwide, their competitiveness and protection measures they provide to their investors in ensuring the desired return on investment (ROI). The financial markets typically are classified into debt and capital markets. In particular, financial markets can be classified into capital, bond, mortgage, equity, derivative, and international financial markets.

Capital Markets

Capital markets are intermediaries facilitating the exchange of securities where business enterprises, including companies and governments, can raise funds and money for long-term investments. Securities are comprised of both debt and equity. Hence, the capital market includes the stock and the bond markets, which are further regulated by the Securities Exchange Commission (SEC). The capital markets are further segregated into two types—primary and secondary markets. A new security—bond/stock—is issued for the first time through the process of underwriting in the primary market. The existing securities are traded to other investors in the secondary market on the organized securities exchanges or OTC.

Bond Markets

Bond markets, also known as debt markets, are a type of financial market where participants purchase and sell debt securities. According to statistical data from the Bank of International Settlements (BIS), the world bond market exceeds the security market almost by 100 percent. The total size of the U.S. bond market is estimated to be \$34.2 trillion. Debt securities have different risk/return characteristics ranging from short-term government bonds to corporate bonds. The types of debt securities and their subsequent weights in a total current debt outstanding amount are illustrated in Exhibit 1.2.

The advantages of the debt market are that debt securities are highly liquid and are not subjected to the same form of credit risk, where principal and coupon rates are received in accordance with the contract. Traditionally when the volatility of the equity market is high, investors turn to safe havens (e.g., bond markets), which pay a “guaranteed” interest rate. Money market funds are considered to be the safest security currently, yielding on average 0.02 percent. The biggest disadvantage of money market

EXHIBIT 1.2 U.S. Bond Market Debt Outstanding

\$6,927.80	U.S. Treasury (marketable securities out of a total debt of \$12 trillion, \$7.5 of which is public)
2,972.4	Agencies of the United States
2,726.8	State and municipal
6,778.4	Corporate
3,430.3	Money market
8,948.7	Mortgage backed
2,533.6	Asset backed
\$34,318.0	Total

Source: Securities Industry and Financial Markets Association, www.sifma.org/.

funds⁹ is their sensitivity to interest rate hikes. If the bonds are bought for the speculative purposes and are not intended to be kept to maturity, then they become subject to the volatility of interest rates. The largest segment in the debt market is the mortgage-backed bond market, which accounts for at least 35 percent of the total debt market. Failure of financial instruments, coupled with loose risk assessment standards for the collateral portfolio of loans, caused one of the worst subprime mortgage crises in history.

Mortgage Markets

The mortgage markets, so-called secondary mortgage markets, offer a diverse number of products. The secondary mortgage market is the market for the sale of securities or bonds collateralized by the value of mortgage loans. The mortgage lender, commercial banks, or specialized firms often group together many loans and sell loan portfolios as securities called collateralized mortgage obligations (CMOs) in an attempt to reduce the risk of the individual loans. The CMOs sometimes are further grouped in other collateralized debt obligations. The most popular mortgage-backed securities are mortgage-backed bonds, mortgage pass-through securities, mortgage pay-through securities, and CMOs.

The mechanism of the mortgage-backed bonds is similar to any other bond; the only difference is the pool of mortgages issued by the specialized lending institutions or banks acts as collateral. Mortgage-backed bonds have a higher yield than other types of bonds and are considered to have lower risk rate. The prepayment risk is the major risk that can affect the profitability of the security instrument. All the income generated by the pool of mortgages (part of interest and principal) is directly distributed to the mortgage pass-through securities investors (excluding the fee that intermediary collects). The mortgage pool can contain either residential property mortgages or commercial property mortgages.

Mortgage pay-through securities are similar to the pass-through securities except pay-through securities act like an amortized fixed-income instruments rather than equity instrument. The amortized payments are made from the cash flow generated by the mortgage pool, and prepayment risk comes into play.

CMOs are a type of pay-through security; the main difference is that CMOs separate the payments of the interest and principal on the pool into different revenue streams and

as a result can offer different rates. CMOs combine features of both mortgage-backed bonds and pass-through securities. Unlike with pass-through securities, with CMOs, the investor assumes the prepayment risk. CMOs are very complex financial instruments that are designed specifically to meet an investor's financial criteria as they do not necessarily synchronize with the original pool payments. The payment schedule can be accelerated or decelerated depending on the investor's choice. Mortgage delinquencies, defaults, and decreased real estate values can make these collateralized debt obligations difficult to evaluate. The recent wave of foreclosures resulted in the highest rate of foreclosures and payment delinquencies in U.S. history. According to the Mortgage Bankers Association, more than 4.6 percent of homeowners were in foreclosure as of May 19, 2010, which a record high for the mortgage market.

The Community Reinvestment Act of 1977¹⁰ encourages commercial banks and savings association to facilitate the lending process for low- to middle- income borrowers. A study conducted by Harvard University Joint Center¹¹ for housing studies suggest that secondary market mortgage investors have little knowledge of the complexity of the mortgage products they are investing in. As a result, the efficiency of the secondary mortgage market is questionable. The study also stated that the existing regulatory framework, which is intended to protect investors, is far from perfect.

Equity Markets

Equity or stock markets are public forums for the trading of public company stock and derivatives at an agreed price determined by demand and supply for these financial instruments. Equity markets comprise securities listed on a stock exchange as well as those only traded privately. Stocks are listed and traded on stock exchanges such as the New York Stock Exchange (NYSE) and Nasdaq in the United States, Euronext (European Union), MICEX (Russia), and Shanghai Stock Exchange (China). According to statistical data from the World Federation of the Exchanges, the total size of the U.S. equity \$14,281trillion.¹² NYSE and Nasdaq are both the first and third largest exchanges in the world. Exhibit 1.3 shows capitalization of the exchanges in 2008 and 2009.

Derivative Markets

Derivatives are financial contracts that are designed to create market price exposure to changes in an underlying commodity, asset, or event. In general, derivatives do not

EXHIBIT 1.3 Change in Capitalization of U.S. Exchanges in 2009

Stock Exchange	Capitalization 2009	Capitalization 2008	Change 2009/ 2008
Nasdaq OMX	3,239,492.4	2,248,976.5	44.0%
New York Stock Exchange Euronext (U.S.)	11,837,793.3	9,208,934.1	28.5%

*Millions of Dollars

Source: Annual statistics. Equity markets, domestic capitalization. World Federation of Exchanges 2009. Available at: www.world-exchanges.org/statistics/annual/2009/equity-markets/domestic-market-capitalization.

involve the exchange or transfer of principal or title and are typically classified into futures, forwards, options and swaps, or some kind of hybrid of those described earlier.¹³ Derivatives can be traded on organized stock exchanges or OTC exchanges. The most famous organized stock exchanges where futures and options are traded are Chicago Mercantile Exchange and NYSE Euronext. The size of the market, according to BIS statistics, was getting close to \$86 trillion at the beginning of 2008. OTC derivative markets are much larger and poorly regulated. OTC derivatives include: commodities forwards, options swaps, equity-linked forwards, options, swaps, foreign exchange forwards, swaps, currency swaps, currency options, interest rate swaps, forward rate agreements and swaps, gold contracts, and many others. The total notional amount of the outstanding positions was around \$615 trillion as of May 11, 2010.¹⁴

The recent financial crisis has underscored the lack of regulations for non-securities based derivatives contracts such as credit default swaps (CDS), which are primarily traded in the OTC markets. Unlike other derivative contracts (insurance, securities, commodities, futures), CDS are not regulated. Thus they are perceived as a form of legalized gambling. Proper regulations require transparent information on OTC transactions to restore investor confidence on speculative derivatives transactions (credit derivatives). Global regulators particularly in the United States and Europe have considered regulating CDS and other OTC derivatives by establishing clearinghouses to serve as a central counterparty for those derivatives.

Prior to 2000, almost all derivatives were traded on regulated central exchanges overseen by the Commodity Futures Trading Commission. After 2002, the derivative markets became unregulated and exempt from all regulations, including state gambling laws. With no regulation scrutiny on derivative trades, the determination of the true value of those exotic instruments became subjective, manipulative, and complex. The Commodities Futures Modernization Act of 2000 was passed by U.S. Congress and allowed the deregulation of financial derivatives. This deregulation enabled insurance giant AIG to engage in CDS. When AIG as a major player in CDS collapsed, other banks, insurance companies, and investment funds suffered tremendous losses. Deregulation of the CDS derivatives promoted speculative activities at the expense of derivative hedging activities, which substantially increased the systemic risks of CDS. Regulation of OTC derivatives has gained considerable attention since the Lehman Brothers collapsed and the AIG debacle. Lack of transparency in OTC markets, the excessive use of CDS, along with improper market discipline and mechanisms and the perceived complexity and speculation encouraged global legislators to issue legislative proposals to regulate OTC derivatives and transfer them from bilateral to multilateral trading.

Derivatives are important tools used by management for mitigating risks. The ever-increasing growth of derivatives suggests that market participants including management find derivatives useful tools for risk management. Credit derivatives can be useful to commercial banks to manage loan portfolio risks, to investment banks to manage risks of underwriting securities, and to asset managers or hedge funds to achieve the desired credit risk portfolio. Nonetheless, credit derivatives can create conflict of interest when a bank performs all three commercial, investment, and insurance activities. Credit derivatives enable banks to take additional risks or transfer risks of loans to another party.

Derivative markets should be better regulated and scrutinized to prevent further financial crises. Inadequate, ineffective, and unenforced regulations, particularly regarding OTC financial derivatives, have enabled and contributed to excessive speculative behavior of the use of credit derivatives.¹⁵

Global Financial Markets

Investor confidence in the global capital markets is the key driver of global economic growth, prosperity, and financial stability. Global capital markets are classified into those with either an inside system or an outside system. In an inside system, in such countries as France, Germany, and Italy, there is a high level of ownership concentration, illiquid capital markets, and liberal regulation of capital markets. Conversely, in an outside system, in such countries as the United Kingdom and the United States, ownership is widely dispersed, capital markets are liquid, markets are active for corporate control, and capital markets are highly regulated. There are more than 50 stock exchanges worldwide that assist companies to conduct their initial public offerings (IPOs). Stock exchanges in India, Italy, and South Korea recently have attracted many domestic IPOs; and many state-owned enterprises in China and France have done their fundraising domestically and have listed their IPOs on their home exchanges. Companies have traditionally listed on their domestic stock exchanges, and only about 10 percent of companies have chosen to list abroad.¹⁶

U.S. capital markets have traditionally been regarded as the deepest, safest, and most liquid in the world. For many decades they have required stringent regulatory measures in protecting investors, measures that also have raised the profile and status of their listed companies.¹⁷ The U.S. financial markets are important sector of the nation's economy.¹⁸

1. The U.S. financial services industry's GDP in 2009 exceeded \$800 billion, accounting for 6 percent of the U.S. GDP.
2. The securities industry accounted for more than \$175 billion, about 17 percent of the total for financial markets.
3. The financial services sector employed about 6 million workers in the United States in 2008, accounting for 6 percent of the total private sector employment.

However, recent competitiveness of capital markets abroad has provided global companies with a variety of choices of where to list and possibly subject to less vigorous regulatory measures. As these markets abroad become better regulated, more liquid, and deeper, they provide companies worldwide opportunities to raise their capital needs under different jurisdictions. High compliance costs of SOX have prompted companies to think about whether their capital financing should come from U.S. capital markets or from capital markets abroad, which may be less strictness and have looser disclosure requirements. Globalization and technological advances have promoted tight competition among the world's leading capital markets (e.g., NYSE, London Stock Exchange [LSE], Hong Kong, Shanghai, Dubai), and thus regulations governing these markets can have a considerable impact on the balance of capital worldwide.

Stock exchanges in the United Kingdom and the United States are the most liquid in the world. In the United Kingdom, the LSE is primarily for established companies and the Alternative Investment Market (AIM) for smaller companies. In the United States, the NYSE comprises the large-cap company market while Nasdaq is typically the home for high-tech and growing companies. The American Stock Exchange usually lists smaller companies. The other active stock exchanges worldwide are the Tokyo Stock Exchange, NYSE Euronext, and Deutsche Börse. While listing standards in the United States and the United Kingdom are similar in terms of share ownership, market requirements, information disclosures, and board models, there are some differences with respect to shareholders' and directors' roles and responsibilities. Technological advances and globalization including cross-border share ownership necessitate that many global companies observe a variety of corporate governance reforms and guidelines—at least the listing standards of the country in which they are incorporated and the country in which they are listed. These listing standards and corporate governance guidelines are often in conflict, reflecting differences in regulatory, legal, and cultural traditions.

Stock exchanges in both the United States and the United Kingdom have attracted a number of international companies. Foreign companies choose these two main exchanges for raising their capital needs, and investors invest in these companies because of the higher protections provided by these exchanges. Some companies are listed on more than one stock exchange and often face difficult, duplicitous, and confusing listing standards that increase compliance costs. The pervasiveness of global financial scandals has encouraged policy members and regulators to respond by adopting laws and regulations to mitigate problems. The costs and benefits of these laws and regulations are often not assessed in considering their appropriateness on regulatory measures and the international impact of such measures. SOX's impact on foreign registrants is an example of the global reach of regulations and challenges associated with establishing national regulatory reforms. In response to the global reach and extraterritorial effects of national regulations, the Organization for Economic Co-operation and Development (OECD) published the OECD Principles of Corporate Governance in 1999, subsequently revised in 2004, and has already adopted by the International Corporate Governance Network. These principles provide a framework and a platform for all countries in developing their own corporate governance structure. Foreign private issues, while required to comply with listing standards in the United States, are not subject to the listing rules that govern U.K. companies.

U.S. capital markets provide four benefits for global companies' listings:

1. U.S. capital markets are the deepest and most liquid in the world.
2. Cross-listing securities in the United States promotes visibility for foreign listings.
3. Listing on U.S. exchanges subjects companies to increased disclosure requirements, which can lead to more investor confidence and thus lower risk premium.
4. Foreign investors are allowed to benefit from the high level of investor protection experienced by U.S. investors.

LSE is perceived as having less restrictive listing requirements and lower compliance costs. These advantages have resulted in the majority of IPOs being listed on the London AIM in the post-SOX period (870 IPOs listed on the AIM compared with 526 being listed on Nasdaq). Ten factors contributing to the switch include:

1. Higher U.S. underwriting fees than their foreign counterparts.
2. Because foreign exchanges are maturing, they attract and facilitate home IPOs.
3. The decrease of global dependence on the United States to raise capital.
4. The emergence of private equity within the U.S. financial markets.
5. Geographical convenience, as London is closer in proximity to many regional issuing companies.
6. Time zones are a factor, as the U.S. exchanges are in time zones that often conflict with business hours of many international companies.
7. Increased investor confidence in domestic markets resulting from more effective corporate governance reforms in other countries in the post-SOX period.
8. Substantial growth in Islamic financial markets providing many opportunities to foreign exchanges in London and Dubai.
9. Privatization of governmental institutions in countries such as China, India, and their preference for their local market listings.
10. The emergence of government-backed investment entities such as mutual funds and hedge funds outside the United States.¹⁹

FINANCIAL SERVICES FIRMS

Financial services firms include commercial and investment banks and savings institutions, mortgage institutions, investment companies, credit unions, insurance companies, finance companies, real estate investment trusts, and securities brokers and dealers. The more common types of financial are described in this section.

Commercial Banks

Commercial banks normally provide a link between those that have capital and those that need capital. Commercial banks are privately owned financial institutions that accept demand and time deposits, make loans to individuals and organizations, and provide services such as documentary collections, international banking, trade financing cash management and other fiduciary services. The Federal Reserve Banks keeps the statistics about the assets and liabilities of the commercial banks. As of the week ending March 16, 2011, Large domestically chartered commercial banks had \$993.8 billion and small domestically chartered commercial banks had \$442.6 billion in residual assets (assets less liabilities).²⁰ The bank assets include but are not limited to: bank credit, securities in bank credit, treasury and agency securities, commercial and industrial loans, revolving home-equity loans, closed-end residential loans, commercial real estate loans, consumer loans, and credit cards and revolving plans, among others.

Bank liabilities include deposits, large time deposits, borrowing, and trading liabilities, among others.²¹

Investment Banks

Investment banks deal with the financing requirements of corporations, governments, and institutions and are usually organized as corporations or partnerships. Investment banks are financial institutions that assist corporations and governments in raising capital by underwriting and acting as the agent in the issuance of securities. Investment banks also assist companies involved in mergers and acquisitions, derivatives, and other financial instruments. Investment banks as opposed to the commercial banks typically act as short-term principals. However, recently the distinction has become less and less evident. Other countries historically never separated investment banking function from commercial banking function. The leading global investment banks are Goldman Sachs, Citigroup, JPMorgan Chase, Bank of America/Merrill Lynch, CitiGroup, UBS, Credit Suisse, Deutsche Bank, Barclay's Capital, and others. Investment banking fees collected in 2009 amounted to \$59.8 billion, or 13 percent above 2008 fees, but significantly down from 2007 fees of \$86.9 billion.²²

Insurance Companies

The primary purpose of insurance is to manage risks, hedge against uncertainties, and spread unforeseen risks. The two major types of insurance companies are life insurance companies, which provide financial assistance at the time of death, and property and casualty insurance companies, which provide policies to individuals (personal lines including homeowners' and individual automobile policies) and to business enterprises (commercial lines including general liability and workers' compensation). Banks, mutual funds, and health maintenance organizations are aggressively trying to expand into products traditionally sold by insurance companies. The financial crisis had an increasing impact on the insurance industry through the companies' investment portfolios. However, the solvency of the insurance sector as a whole does not seem to be threatened. A majority of companies in the insurance sector have been adversely affected by the financial crisis, which revealed the exposure to credit and market risks in U.S. mortgage and financial guarantee insurance companies and other insurance-dominated financial groups.

Insurance companies have proved to be a stabilizing factor during the financial crisis. These insurance organizations are primarily large investors with a longer horizon of investments compared to the financial institutions such as banks. For this reason, insurance organizations can withstand and sustain short-term shocks. However, the insurance companies that were involved in activities traditionally associated with investment banks, valuation, and rating pressures have been deeply impacted by the recent financial crisis. The subsequent downgrading of business enterprises in the financial guarantee insurance sector led to downward pressures on market valuations of the securities. These activities had already led to imbalance in the market before the credit and financial crisis hit the market.

Some provisions of Dodd-Frank are relevant to insurance companies and their business transactions. The newly established Federal Insurance Office (FIO) will play an important role in overseeing and coordinating insurance activities between the international insurance market and the U.S. insurance market. Dodd-Frank directed the SEC to establish rules and standards for broker-dealers and investment advisors that would have a substantial impact on insurance companies. The FIO will oversee all aspects of the insurance industry, including systemic risk, capital standards, consumer protection, and international coordination of insurance regulation.

Pension Plans and Mutual Funds

A retirement plan is a financial vehicle that pays an individual, at a contractually agreed on time, a payment throughout retirement and is usually in the form of an annuity. Pension plans are a type of retirement plan, where an employer makes contributions toward a pool of funds set aside for an employee's future benefit. The pool of funds is then invested on the employee's behalf, allowing the employee to receive benefits upon retirement. Depending on the arrangements, retirement plans can be set up by government agencies, employers, trade unions, and other institutions and organizations. There are two distinct pension plans under the Employee Retirement Income Security Act of 1974: defined benefit plans and defined contribution plans. A defined benefit plan is designed to give employers an opportunity to contribute toward employee retirement. Employee contributions are voluntary and not required. Significantly, employers can contribute more under defined benefit plans than under any other plan and consequently can claim more as a tax deduction. Also, employees are promised the certain amount upon retirement and are eligible for the early retirement withdrawals. On the downside, defined benefit plans are expensive to manage, and if an overfunded plan is terminated the employer has to pay excise tax. According to the Pension Benefit Guaranty Corporation, there were about 38,000 insured defined benefit plans in 2010 compared to a high of about 114,000 in 1985. The Internal Revenue Service believes that the reason for the decrease in popularity is the complex nature of the plans.²³

Defined contribution plans are gaining popularity. Under these plans, employers contribute a specific amount annually, and those contributions are later invested on the employees' behalf. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans.²⁴ The total U.S. retirement market as of September 30, 2009, was getting close to \$15.5 trillion and accounts for 35 percent of all household financial assets in the country. Mutual fund managers hold around 13 percent of the total retirement market and 51 percent of the total defined contribution plans.

Mutual funds are investment vehicles that are made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments, and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus. Mutual funds are classified as open-end funds by the Investment Company Act of 1940 and the SEC.

Mutual funds also typically are organized in the form of equity funds. Depending on the investment strategy, mutual funds carefully choose the investment tools they are planning to manage within the portfolio, which include: bond funds, money market funds, funds on funds, growth funds, value funds, index funds, and other integrated funds, and often are invested based on the Russell Indexes. Individual or institutional investors can use the indexes to benchmark the mutual fund performance.

Sovereign Wealth Funds

Sovereign wealth funds (SWFs) are pools of money derived from a country's reserves, intended for investment purposes to generate revenue to benefit the country's economy and citizens. The funding for a SWF comes from central bank reserves that accumulate as a result of budget and trade surpluses and even from revenue generated from the exports of natural resources. The types of acceptable investments included in each SWF vary from country to country; countries with liquidity concerns limit investments to only very liquid public debt instruments. About 75 percent of the total global SWF pool comes from Middle East and Asia and 60 percent of the total global SWF pool comes from oil- and gas-related income. Abu Dhabi's Abu Dhabi Investment Authority is the biggest SWF with total holdings of \$627 billion, according to statistics from the Sovereign Wealth Funds Institution.²⁵ The second and third largest SWFs in the world are the Norwegian Government Pension Fund- Global and Saudi Arabia's SAMA Foreign Holdings with \$443 billion and \$432 billion in holdings respectively. SWFs play a more important role in the capital markets as they become active buyers of the U.S. equity. To illustrate, Roland Beck and Michael Fidora estimated that the world's largest SWFs purchased more than \$60 billion of newly issued equity from developed world's banks during the midst of the recent global economic meltdown.²⁶

Despite the openness of U.S. markets, the U.S. government imposes some restriction on SWF investments. For example, foreign investments in such sectors as energy, communication, and transportations are restricted. Investments in other sectors must comply with the strict regulations as well. According to the GAO report, the legal restrictions on foreign investment exist on the state level for businesses like real estate, agricultural land, banks and financial institutions, insurance companies, and so on. The agencies that are responsible for the international investment law enforcement are the Federal Reserve Board, Federal Communications Commission, Nuclear Regulatory Commission, and the Departments of Transportation, Agriculture, and Interior. Examples of the laws that regulate or prohibit foreign investment are the Agricultural Foreign Investment Disclosure Act of 1978, Magnuson-Stevens Fishery Conservation and Management Act, Communications Act of 1934, Atomic Energy Act of 1954, General Mining Law of 1872, and others.²⁷

CONCLUSION

The financial services industry traditionally has been regarded as vital to the nation's economic growth, development, and prosperity. Nonetheless, recent financial difficulties in the industry prompted large government bailouts of TBTF financial institutions and

has resulted in a series of mergers and acquisitions that consolidated the financial service industry further. If these TBTF financial firms assume that the government's reluctance to hold them accountable for their business failures signals aversion to tough regulatory reforms and actions, moral hazards can arise. To minimize this perceived moral hazard, the Dodd-Frank Act of 2010 establishes stricter regulations for the financial service industry to prevent significant adverse impact of large financial firm failures. Any financial regulations that do not address the real causes of the financial crisis and end TBTF will not be sustainable. Dodd-Frank indirectly addresses the TBTF phenomenon by requiring the newly established Financial Stability Oversight Council to identify and more effectively regulate "systemically important" financial institutions, including bank and nonbank financial companies.

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