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Law and accounting firms brace for regs after The Street's missteps

Credit mess has put Congress and financial regulators on the prowl

MONEY MATTERS: Rule changes are on the way for banks and financial institutions

THE PROBLEM: A perfect storm of slumping housing prices and shoddy lending practices has resulted in billions in losses for banks and homeowners alike. The fallout has lawmakers pointing their fingers and regulators scratching their heads.

THE RESPONSE: A handful of proposals are being vetted. The Bush administration has proposed sweeping changes that would consolidate regulatory agencies and empower the Federal Reserve. Other proposals would boost oversight and tighten rules and liquidity requirements for banks and investment houses.

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In a year that saw the rug yanked from under a massive house of cards built on loose credit and inflated asset prices, Wall Street — as well as the dozens of law and accounting firms that support the finance industry as a whole — are now intensely focused on a slew of new rules proposed by federal regulators.

In March, Treasury Secretary Henry Paulson Jr. introduced more than 200 pages of short-term recommendations, known as the Federal Blueprint for A Modernized Financial Regulatory Structure, for dealing with the credit and mortgage markets, and intermediate-term proposals for consolidating some of the federal regulatory structure. The proposals, if adopted, could trigger a sea change in the way financial institutions, from major Wall Street investment banks to Main Street lenders, are regulated.

The result will likely be a wave of new rules for financial institutions — and business for local legal and accounting firms.

"Depending on who you talk to, this is the most stressful period since World War II," said Richard Spillenkothen, director of Deloitte & Touche's regulatory and capital markets consulting practice. "I think you are going to see supervisors and regulators of financial institutions enhancing and increasing their focus on enterprise-wide risk-management systems."

One idea is to merge the Securities and Exchange Commission with the Commodity Futures Trading Commission. Currently the two go about their jobs in different ways, and their consolidation could make things different — some say more difficult — for a handful of players in the investment industry.

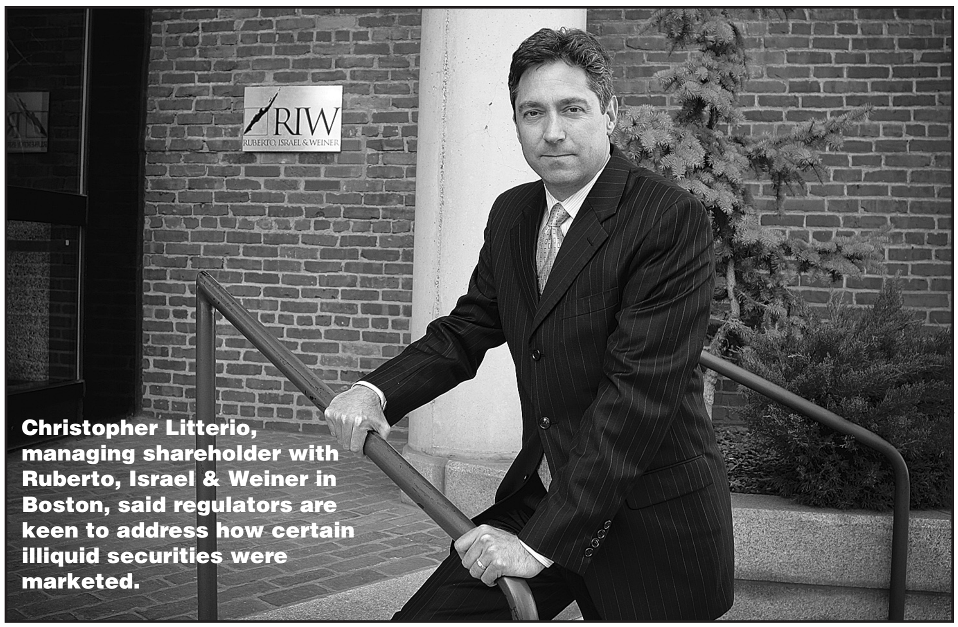
"The SEC has very detailed regulations. The CFTC is a much more principle-based, above-the-fray kind of thing — articulating principles but then leaving it up to firms to figure out how to do it," said Gregory D. Sheehan, a law partner with Ropes & Gray in Boston.

If the CFTC approach prevails, which Sheehan said seems to be Paulson's preference, it could bring a lot more flexibility to advisers of mutual funds. But other proposals are also in the mix, including a plan to give more power to the Federal Reserve.

"I honestly don't think a lot of people know what they could have done to stop this from happening," Sheehan said.

But it may be too early for fi nancial firms to spend much time or money planning for specifi c changes.

"I think there is a long way between his proposal and ultimate regulations. This is just a concept. It is going to be subject to much lobbying, politics and regulatory turf issues," Sheehan continued. "Scrambling at this point would be a waste of time."



Christopher Litterio, managing shareholder with Ruberto, Israel & Weiner in Boston, said regulators are keen to address how certain illiquid securities were marketed.

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Indeed, there's already enough for financial firms to examine in-house.

Some institutions have already taken a closer look at the risks within their businesses. Many have exited the sub-prime lending business; others have stopped acquiring assets through mortgage brokers. Some are cutting back on their investment banking activities.

The key, said Deloitte's Spillenkothen, is to focus on core business strengths and back away from areas that don't maximize returns or are more volatile in terms of yearly earnings.

For lenders, a strong liquidity cushion and better transparency have become priorities. "You've seen a lot of off-balance-sheet activities come back on the balance sheet," he said.

While the Treasury recommendations are the only firm proposals in play right now, additional proposals are expected. For example, Congress has been talking about new laws regarding predatory lending and mortgage foreclosures, Spillenkothen said, and the Federal Reserve wants new regulations defining unfair acts and practices in the credit card industry.

U.S. Rep. Barney Frank, D-Mass., chairman of the House Financial Services Committee, has been among the most outspoken lawmakers on boosting oversight and rules governing the banking and investment sectors.

"I know they are looking closely at the auction-rate securities issue," said Christopher Litterio, managing shareholder with **Ruberto, Israel & Weiner** in Boston. "These securities that were pitched as being very safe and liquid turned out to be not very liquid."

State and local governments, which often used auction-rate securities to park their cash, were among those affected when those markets dried up.

Likewise, those same institutions have been unable to raise new cash for public-works projects and related activities, given similar issues in the municipal-bond market.

"What the state regulators are looking at is what did the brokers say to you to induce you to buy this," Litterio said. If liquidity was touted as a big selling point, there could even be charges of fraud, he said.