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INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JULY 17, 2009

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INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS

Friday, July 17, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 11:08 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [member of the committee] presiding.

Members present: Representatives Kanjorski, Waters, Watt, Sherman, Meeks, Clay, Miller, Green, Cleaver, Perlmutter, Foster, Carson, Minnick; Royce, Biggert, Hensarling, Garrett, Neugebauer, McHenry, Posey, Jenkins, Lee, Paulsen, and Lance.

Mr. KANJORSKI. [presiding] This hearing of the Committee on Financial Services will come to order. Without objection, all members' opening statements will be made a part of the record.

Today we will hear from several industries that will soon feel the effects of the regulatory reform this committee will adopt. All affected parties deserve to have a voice in our ongoing deliberations about reform. I hope, however, our witnesses understand that because public faith in our financial system has significantly ebbed, we must enact strong new laws.

Among many of the casualties of the ongoing financial crisis, investors' confidence ranks high. According to a survey by shareowners.org, 58 percent of investors are now "less confident in the fairness of the financial markets than they were 1 year ago." One of the biggest reasons investors cite for their lack of confidence is the failure of regulators.

Earlier this week, I advised Chairman Schapiro of the Securities and Exchange Commission that the Commission must take bold and assertive action as it moves forward to strengthen enforcement. The Commission must also rewrite the rules governing the industry to better protect investors who sorely lack adequate safeguards.

Additionally, Congress must update our securities laws to advance action on regulatory reform for the securities industry. I have already solicited input from the experts at the Commission, and Chairman Schapiro recently transmitted 42 legislative proposals to me. The Commission's Inspector General has also provided input on these matters. Moreover, the Obama Administration's White Paper and accompanying pieces of legislative language complement these suggestions, especially in areas like hedge fund

regulation and establishing a fiduciary duty for broker dealers providing investor advice.

Based upon these many ideas, I am now developing legislation. Ultimately, we need to close loopholes and stop unscrupulous practices. Among other things, we ought to put more cops on the beat by allowing the Commission to pay bounties to whistleblowers whose tips result in catching fraudsters.

Reform of credit rating agencies also has a top spot on our agenda. Overly optimistic ratings, to put it kindly, played a significant role in the global crash. I am therefore working to craft a bill that will bring sanity back to the credit rating process.

As the various ideas for overhauling financial service regulation undergo debate, the industry representatives present today should rest assured that we will dutifully consider your ideas and critiques. However, we can no longer allow the investing public to suffer at the hands of narrow interests. Profit is fine. It is capitalism. But profit seeking alone, without regard to long-term viability of the system, and abated by weak regulatory oversight, has proven disastrous. We must therefore put in place a thoughtful, smart, and efficient regulatory system for the future.

In closing, I welcome the witnesses and look forward to their testimony. The Chair now recognizes Mr. Hensarling for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. For many of us here, we continue to feel like we are in an "Alice in Wonderland" moment, as we look at a piece of legislation that seems to want to give five unelected government bureaucrats the power to essentially ban consumer financial products, decide which mortgages Americans can have, and whether or not they qualify for a credit card.

I had the opportunity yesterday in the House to introduce the guest clergy to offer the prayer. I saw once again over the Speaker's chair were the words, "In God we trust." I fear for many on this committee, they now may want to change the words to, "In government we trust." They have a lot more faith in government than I do.

As I look again at the financial turmoil that we have in our economy, I think about Fannie Mae and Freddie Mac. Government really wasn't to be trusted there with that particular policy.

I think about oligopolies that were in the credit rating agency. Government was not to be trusted there.

I think about AIG and the head of OTS telling us that he had the supervisory capacity, he had the regulatory authority, but he just missed it when it came to AIG's credit default swap exposure.

I am particularly concerned, as I look at this Draconian piece of legislation, how it will impact jobs in an economy that is seeing the highest unemployment rate in a quarter of a century—2.6 million people have lost their jobs since President Obama was sworn in.

I am concerned about a credit contraction that can be caused by this regulator of consumer products. I am concerned about what may happen to derivatives that are used by those who want to finance our small businesses and our jobs to lower their risk. I am wondering what is going to happen to the cost, the greater cost of clearing these. The lack of the ability to customize them is going to cause many financial firms to no longer have the ability to less-

en their risk, leading to less credit and fewer jobs in an economy that is drowning in unemployment.

So Mr. Chairman, we have to take a very, very careful look at this rather radical Draconian piece of legislation before it is passed through this committee. I look forward to hearing from our witnesses, and I yield back the balance of my time.

Mr. KANJORSKI. Thank you, Mr. Hensarling. Now, we will hear from Mr. Sherman for 3 minutes.

Mr. SHERMAN. Thank you. I shared the gentleman from Texas's concern that the Consumer Financial Protection Agency would be a lawmaking body until I received assurances from the chairman, I believe the author, that we were creating a law enforcement body that would issue interpretive and implementing regulations, and would not be a lawmaking body. The chairman has invited me, and I assume all members of this committee, to suggest legislative language that would nail that down, and I don't think it is the purpose of this bill to transfer to an unelected body the decisions, and very tough decisions. I would prefer to punt them, actually. But as long as I am paid to be a Member of Congress, we should be debating them here.

There are three other issues. First, we have to look at how the banks dominate the selection of the members of the regional Boards of Governors of the Federal Reserve, especially as the Fed acquires more power, and particularly because those regional boards then elect members to the Open Markets Committee.

Second, we need to look at a system where the issuer of a debt instrument picks the rating agency. That is like the home team picking the umpire. They gave triple A to Alt-A. They won't do that again soon with dodgy mortgage-backed securities, but we will see other types of dodgy securities out there instead. I will propose legislation, or hopefully an amendment that will allow the SEC to select the credit rating agencies, just as the league selects the umpire, not the home team.

Finally, as to custom over-the-counter derivatives, these have been justified as a way to hedge legitimate risks. But I see perhaps the majority of the transactions are actually just casino bets where someone does not have a risk to hedge. This is of particular concern since Secretary Geithner told this committee and the Agriculture Committee that he reserves the right to perhaps bail out derivatives, their issuers, and their counterparties, even derivatives that are being issued now. So the Federal Government has a real interest in restricting these instruments as long as we have a Secretary of the Treasury who may want to bail them out.

We at least need to see much higher capital requirements for over-the-counter derivatives. We might look toward restricting those derivatives, to only use them where you cannot hedge a legitimate risk in a market-traded derivative. In any case, we should by legislation make it clear that none of these derivatives, over-the-counter or exchange, are going to be subject to any bailouts in the future, and that if you buy an AIG derivative, you have to look only to the balance sheet of AIG.

I yield back.

Mr. KANJORSKI. The gentleman from Texas, Mr. Neugebauer, for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I appreciate the witnesses providing us today with their views on the Administration's financial regulatory restructuring proposal. While we have draft legislation covering a few of these areas now, I hope that we will have an opportunity to get further feedback when we actually have additional legislative language, particularly with regard to over-the-counter derivative proposals. There seems to be an agreement with broad principles of the Administration's proposal on improving transparency and information about the activities in this market. But with complex products in a complex marketplace, the devil will certainly most be in the details.

At the end of the day, we must ensure businesses large and small, hedge risks, particularly risks that are customized to their particular business, and having the ability to do so. We shouldn't take actions that make users of derivatives less competitive, and we shouldn't take actions that put U.S. markets at a disadvantage with our competitors.

As we consider options to correct regulatory failures, we have to acknowledge that the government cannot micromanage our capital markets to prevent future failures or losses. Government regulation can't substitute for due diligence for investors and other market participants. They need to know, in no uncertain terms, the responsibility rests on them and that future government bailouts for poor behavior are not an option.

Basically, what we have seen so far is product regulation, not a new way of doing business in the regulatory structure. And one of the concerns I have is that in product regulation, we are trying to protect investors from themselves. What we do need, though, is a robust look at the way we have been doing business, looking at where the failures were in the system and making sure that we address those, but not radically changing the way that businesses have been able to take precautions to hedge their risks, which in fact protect investors, and also make sure that the marketplace is a more streamlined place to do business in a way that we can make sure that American markets continue to be very competitive.

With that I yield back.

Mr. KANJORSKI. Thank you very much, Mr. Neugebauer. Now we will hear from Ms. Waters for 3 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. As some of our witnesses may already know, I am very concerned with protecting our financial system from similar crises in the future. To accomplish this, we will need stronger and more innovative investor protections. We must also make sure that institutional financial instruments, such as over-the-counter derivatives, never have the chance to halt consumer or small business lending again.

While products such as credit default swaps may have been sold to institutions, many of them were used to insure consumer debt in the form of CDOs. As these CDO structures failed and credit events occurred, these credit default swap contracts came due. A lack of transparency, combined with an overwhelming number of improperly collateralized swap contracts, served to freeze our lending markets and transfer billions of dollars from taxpayers to all kind of Wall Street firms such as Goldman Sachs and banks such as Bank of America.

Some say we should only be concerned about naked credit default swaps, which is swaps where people have no interests insuring anything they actually own. Those who enter into naked CDS contracts are simply trying to profit from some company's bankruptcy, yet as Gillian Tett pointed out in a recent Financial Times column, even nonnaked CDSs have motivated investors to send a company into bankruptcy.

No matter what shape our financial reforms take, rooting for companies, especially American companies, to fail should no longer be allowed. That is why I introduced H.R. 3145, the Credit Default Swap Prohibition Act of 2009. Banning credit default swaps is vital to preserving companies, jobs, and taxpayer funds. Our constituents and their 401(k)s will not be safe until we eliminate this product.

I know that is highly controversial, and I am sure we will hear a lot of disagreement. But I thank you for arranging this hearing, Mr. Chairman, and I yield back the balance of my time.

Mr. KANJORSKI. Thank you very much, Ms. Waters. Now we will hear from Mr. Royce of California for 2 minutes.

Mr. ROYCE. Thank you, Chairman Kanjorski. Much of the blame for the recent economic turmoil has centered on the belief that a lack of regulation was the root cause of the excessive risks and residual effects that followed, whereas there was a great deal of regulation in the banking sector. It was our most regulated sector.

I think that Congressman Richard Baker was the first to really point out at great length the enormous overleveraging that was occurring in Fannie Mae and Freddie Mac, as did the Federal Reserve, and the systemic risk they posed to the system. But I think it is worth noting that while hedge funds and private pools of capital have experienced significant losses, they have not asked for or received any direct government bailouts in an era where the government has become savior of all things failed.

The losses borne by hedge funds and their investors did not pose a threat to our capital markets or the financial system. A major reason why this was the case was because of the general lack of leverage within the hedge fund sector. Thus far it appears counterparty risk management, which places the responsibility for monitoring risk on the private market participants who have the incentives and capacity to monitor the risks taken by hedge funds, has held up well.

Considering so many of our major heavily regulated financial institutions acted recklessly, drove up their leverage ratios to unstable levels, suffered significant losses on failed investments, and then came to the American taxpayers for assistance, the performance of these private pools of capital over that same period is reassuring.

I must also note my concern with adding additional responsibilities to the SEC given their recent handling of the Bernie Madoff incident and what looks like a similar misstep in the handling of Allen Stanford's firm. The few hearings on the Madoff Ponzi scheme revealed an overlawyered, overly bureaucratic SEC.

As former SEC Commissioner Paul Atkins recently noted, if hedge funds and private equity firms are forced to register with the SEC, the burden to the agency's examiners would be enormous. I

think it would be wise to first address the problems within the SEC, and then discuss adding new responsibilities onto the agency.

I would like to thank the panel of witnesses for coming here today, Mr. Chairman. Thank you.

Mr. KANJORSKI. Thank you very much, Mr. Royce. Now we will hear from Mr. Green for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman. And I welcome our colleague Mr. Baker back to the committee. Mr. Chairman, it is very obvious, intuitively obvious to the most casual observer that our regulatory institutions failed. We allowed persons to be qualified for teaser rates, but we did not qualify them for the adjusted rate. We had undisclosed yield spread premiums that allowed persons to be pushed into the subprime market who actually qualified for prime rates. We had universal defaults that were taking place. We had persons who were having to make payments on interest rates such that they were allocated to lower rates when they could have been allocated to higher rates.

Some changes have taken place. But these changes have been reactionary changes; they were not proactive changes. Reactive legislation is fine, but proactive legislation is better. I think we must take advantage of the opportunity to make some serious changes that will look out for the consumer in the future. The consumer must be protected. Safety and soundness must be protected. These things are not mutually exclusive.

I yield back.

Mr. KANJORSKI. Thank you, Mr. Green. And we will now hear from the gentleman from North Carolina, Mr. McHenry, for 2 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you all for being here today. This is by far one of the most wide-ranging panels that we have had representing the financial markets, and I am glad you are here.

My concern is for my constituents and average Americans to have options for investments, have options for the type of savings accounts they have, the type of investment vehicles they have. And my additional concern is about the credit rating agencies.

But beyond that, when you look at CFPA and the idea of creating another bureaucracy by which you have to jump through hoops, will that limit options for my constituents to have products that they can invest in? Will it basically make vanilla bean products, will it limit innovation in the marketplace? Will it hamstring our capacity and my constituents' capacity to get the lending that they need to grow this economy?

The fact is that in this severe downturn, capital is hard to come by for average Americans. Will this proposal further restrict capital? And what are your firms and the people that you represent doing in anticipation of this massive regulatory reregulation, overregulation? So what are they doing right now? Are your firms holding more capital in anticipation of regulatory changes? Are we further limiting options because Congress is talking about completely changing financial regulations?

That is a concern that I have, and I would hope that the panel would touch on that today as well. Thank you, Mr. Chairman.

Mr. KANJORSKI. Thank you very much, Mr. McHenry. We will now have our panel, the only panel for today. And each witness will be recognized for 5 minutes to present their testimony. Their written testimony will be made a part of the record.

First, we have our friend and former colleague, the gentleman from Louisiana, the Honorable Richard Baker, President of the Managed Funds Association. Mr. Baker?

STATEMENT OF THE HONORABLE RICHARD BAKER, PRESIDENT, MANAGED FUNDS ASSOCIATION

Mr. BAKER. Thank you, Mr. Chairman, Mr. Hensarling, and members of the committee. I am pleased to be back in this very familiar room and enjoy the opportunity and appreciate your courtesy in asking me to participate.

I am Richard Baker, President and CEO of the Managed Funds Association (MFA), which represents the majority of the world's largest hedge funds and are the primary advocate for sound business practices for professionals in hedge funds, funds of funds, and managed futures. Our funds provide liquidity and price discovery to markets, capital for companies to grow, and risk management services to investors such as our Nation's pension funds. Our work enables them to meet their commitments to their retirees.

With an estimated $1.5 trillion under management, the industry is significantly smaller than the $9.4 trillion mutual fund industry or the $13.8 trillion banking industry. I make note of this fact for the reason to assess the appropriate level of risk that our sector could present to broader market function.

Further, many hedge funds use little or no leverage, as has been stated earlier this morning, which additionally limits their contribution to market risk. In a recent study, 26.9 percent do not deploy leverage at all. And a recent analysis by the Financial Services Authority found that industry-wide, over a 5-year period, fund leverage averaged between two and three to one. This is certainly not the generally accepted view of leverage in our industry.

The industry's modest size, coupled with the relatively low leverage, give reasons for those to view that we are not and have not been contributors to the current dislocation in the market and, unfortunately, that has led to the broad deployment of taxpayer dollars.

Notwithstanding these facts, our funds have a shared interest with other market participants in restoration of investor confidence and in establishing a more stable and transparent marketplace. These important objectives we believe can be attained with careful analysis and construction of a smart regulatory structure. This will require appropriate and sensible regulation. It is aided by the adoption of industry-sound practices, which we have promoted at the MFA, and it will require investors to engage in their own due diligence. There is no substitute for asking the right questions before you write the check.

Our members recognize that mandatory SEC registration for those advisers who are not currently registered for all private pools of capital is a key regulatory reform. Registration under the Investment Advisers Act, we believe, is the smartest approach. Currently, over half of our members are registered in this manner with the

SEC. The Advisers Act is a comprehensive framework, and among many other elements, requires disclosure to the SEC regarding the advisers' business, detailed disclosure to clients, policies and procedures to prevent insider training, maintenance of books and records, periodic inspection, and examination by the SEC.

We do believe it is important to establish an exemption from registration, however, for the smallest investment advisers that have de minimis amount of assets under management. This exemption should be narrowly drawn to ensure that an inappropriate loophole from registration is not created.

Also the provision should coordinate, not duplicate, we hope, regulation at the State level. Good regulation is also efficient regulation. In that regard, we do have some concerns with the Administration's proposed legislation that would impose duplicative registration requirements on a number of our commodity trading advisers, most of whom who are already regulated by the CFTC. We hope, Mr. Chairman, that we would be able to work with the committee to remedy this particular concern.

With regard to a subject of some recent interest, credit default swaps, we have worked with regulators to reduce risk and improve market efficiency. We support efforts to increase standardization and central clearing or exchange trading of OTC derivatives. However, it is essential to maintain the ability of market participants to enter into customized OTC contracts. All market participants should post appropriate collateral for OTC transactions. And that collateral should importantly be segregated, meaning that it is protected. And there should be reporting to the regulator as deemed appropriate.

The subject of systemic risk is also of current concern as well. There should be a systemic risk regulator with oversight of the key elements of the entire financial system, but it should only be enabled with confidential reporting by our firms to that regulator. A clear mandate for the regulator should be established to protect the integrity of the financial system, not individual market participants. The regulator should have clear authority to act as required by his evaluation of the circumstance and in a decisive manner.

We believe these views are consistent with the Administration's stated goals. I appreciate this courtesy to present these views, and look forward to working with the committee toward effective resolution.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Baker can be found on page 30 of the appendix.]

Mr. KANJORSKI. Thank you very much. And now, we will have our next witness. We have Mr. William J. Brodsky, chairman and chief executive officer of the Chicago Board Options Exchange. Mr. Brodsky.

STATEMENT OF WILLIAM J. BRODSKY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OPTIONS EXCHANGE

Mr. BRODSKY. Thank you, Chairman Kanjorski, and Mr. Hensarling. I am honored to be here on behalf of the Chicago Board Options Exchange. I also want to just mention that I have had the distinct honor in my career to have served as a senior executive of

the American Stock Exchange. I was for 11 years the CEO of the Chicago Mercantile Exchange, a futures exchange, and now for 12 years as chairman of the Chicago Board Options Exchange.

The CBOE actually operates several exchanges. We have a stock exchange, we have a futures exchange, and our main business, of course, is a securities options exchange. And we also own an interest in One Chicago, which is a single stock futures exchange.

Just a minute on the growth of the options business. The options industry in 2008 traded 3.5 billion contracts, which was a 25 percent increase from the prior year. And our 5-year compound growth has been 25 percent. That is spread among seven vibrant and highly competitive exchanges. A lot of that growth is due to the risk management tools that we provide for all investors who can hedge their individual stocks, their ETFs, and their mutual funds.

I applaud the Administration's proposal on financial regulatory reform, but I don't think that the Congress should squander the opportunity offered by this period we have just experienced to design and mandate regulatory reforms that are long overdue. The status quo should not be an option. At the outset, I would like to commend the Administration for drafting a proposal that seeks that reform, and I will comment on certain aspects of it.

We are also gratified that the proposal addresses not only the underregulation of OTC derivatives, but also the existing regulations, including the CFTC–SEC jurisdictional divide, which we believe is dramatically antiquated. While this jurisdictional matter may be a mere technical issue to some, given the many serious issues that face this committee, this bifurcated system has had persistent negative consequences that we ignore at our peril.

The proposal clearly describes that the regulation of securities and futures under different structures, with separate agencies and separate congressional committees, causes legal uncertainty, delay, and impedes innovation and competition, and imposes unnecessary costs on our regulated financial markets. But it is important to note that in the midst of the financial tsunami that we have endured, when precious little worked, regulated exchanges delivered as promised. There were no failures. There were no closures. And there were no taxpayer rescues. Despite the most extreme market conditions, exchanges continued to provide transparent, liquid, and orderly markets, and protections against counterparty risk through centralized clearing without interruption, and continued to fulfill those essential functions of capital formation and risk management.

Yet the effectiveness of many exchanges is severely compromised by the yoke of the regulatory structure that is outdated. The nature of our legacy system of regulation has had the perverse effect of facilitating regulatory arbitrage and the problems it fosters by inhibiting the inherent strengths of regulated exchanges. I would like to give you two examples.

One, in the area of new products, there have been persistent problems and conflicts between the SEC and the CFTC in determining whether a product is a future or whether it is a security. It has caused interminable delays. The most vivid example is the CBOE proposal to trade options on gold ETFs. ETFs, as you know, are a very valuable investor tool. We proposed to trade this, and

it took the SEC and CFTC 3½ years to come to a resolution on that issue. In another case Eurex, which is Europe's largest derivative exchange, proposed to trade a credit default instrument on an exchange with counterparty clearing, and they proposed to do that in a matter of weeks, and it took our agencies 7 months to agree on how to approve that product.

I note that these product delays are not just an exchange issue, but also represent loss of revenue to the Federal Government. Dual jurisdiction means that futures and comparable securities are not regulated consistently. This leads to disputes between the agencies in areas involving default of market participants.

And the fact that the CFTC doesn't have an insider trading provision potentially enables a wrongdoer to use inside information when others are prohibited from doing so under the SEC. This disparity will take on increased importance as this committee grapples with the jurisdiction of credit-related products.

We heartily endorse the Administration's recommendation as necessary first steps toward a comprehensive regulatory reform. Specifically, we support the reform proposal's recommendation that there be created a Federal Regulatory Oversight Council, chaired by the Treasury, to resolve disputes between the two agencies. Currently, there is no dispute mechanism, and we believe that Treasury is well suited to chair that group.

In addition, we strongly recommend that exchanges, as self-regulatory organizations, have the ability to bring issues directly before the new Council. We support the Administration's recommendation for harmonization of the statutes that exist between the two agencies, and we urge Congress to adopt that proposal.

However, while harmonization may represent an improvement, we believe it is only a step toward ending the ultimate issue of bifurcated jurisdiction. Even with optimal harmonization, the existence of two separate agencies with different philosophies will continue to foster conflicting interpretations and enforcement of similar laws and perpetuate regulatory uncertainty and delay. While the reform proposal outlines interim steps that can dampen some of the ill effects of divided jurisdiction, consolidation of the SEC and the CFTC is the only truly comprehensive solution. Any rational, unbiased assessment of the bifurcated regulatory system would lead to this conclusion.

On other issues, I would just summarize by saying that we agree with the reform proposal's recommendation that there should be a single authority, the Federal Reserve Board, to supervise all firms that pose a systemic risk.

Second, we agree with the proposal that greater regulatory oversight is needed of OTC derivatives. At a minimum, we believe that jurisdiction over all OTC derivatives involving securities, including corporate events, should be with the SEC. I might point out that I gave testimony in 1997 saying that the absence of regulation on OTC derivatives would be a very dangerous thing. And I said that it had seeds of great danger. Unfortunately, that was 1997, and there was an exemption granted which we opposed. That was part of my testimony.

We recognize that there are competitive disadvantages inherent in the way the SEC approves rule filings, and we support the re-

port's recommendation that the SEC should overhaul its process of reviewing proposed rule changes by allowing more SRO rule filings to become effective upon filing.

Finally, in conclusion, the CBOE believes that Congress should promptly adopt the harmonization of SEC and CFTC rules and regulations and the establishment of the Federal Regulatory Oversight Council as well as the proposal's call for the streamlining of SRO rule processes at the SEC.

Taking these steps will at least help our markets remain competitive in the global marketplace until we are able to complete a more comprehensive reform. No other major country with well-developed derivative markets uses a system of having two different government agencies regulating equivalent financial products. The U.S. markets require a 21st Century system of market regulation to operate in today's global marketplace.

On behalf of CBOE, I personally thank you for the opportunity to appear before the committee, and we would certainly welcome an opportunity to work with you in the coming months.

[The prepared statement of Mr. Brodsky can be found on page 54 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Brodsky. Next, we will hear from Mr. Randy Snook, executive vice president, Securities Industry Financial Markets Association.

STATEMENT OF RANDOLPH C. SNOOK, EXECUTIVE VICE PRESIDENT, SECURITIES INDUSTRY FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. SNOOK. Thank you, Mr. Chairman, and members of the committee. We appreciate the opportunity to testify at this important hearing. We appreciate your continued leadership on regulatory reform. SIFMA supports efforts to make the regulatory reform changes necessary to restore confidence in the financial markets and meet the challenges of the 21st Century marketplace and to protect consumers and investors. The financial system is critical to the Nation's competitiveness, and reform must provide a durable platform for steady economic growth, employment, and investment.

I would like to now highlight elements from our written testimony. Systemic risk has been at the heart of the financial crisis. We have testified before as to the need for a financial markets stability regulator as a first step in addressing the challenges facing financial regulatory reform. Generally, we support Treasury's recommendations for a single accountable systemic risk regulator, balanced with the newly created Financial Services Oversight Council, as it would improve upon the current system. We think this construct should effectively assess threats to financial stability and ensure appropriate action is taken promptly. A Federal resolution authority for certain systemically important financial institutions should be established.

Being systemically important in our judgment does not mean too-big-to-fail, but does require an orderly resolution plan should it be needed. The FDIC has broad powers to act as conservator or receiver of a failed or severely troubled bank, but does not have the experience with the operations of other types of systemically important financial institutions. We welcome Treasury's proposal to es-

tablish this authority for other institutions, and urge that it draw upon the experience of regulators familiar with the entity being resolved.

We support proposals for increased regulation, reporting, and transparency in the derivatives markets. Clearing is a useful tool in the comprehensive risk management framework, and we support clearing of standardized OTC derivative transactions by financial firms whenever possible, but strongly believe there is a role for the continued use of customized contracts, which are employed by thousands of manufacturing and other companies across America every day to manage various kinds of risks. We believe that the transparency needed can readily be achieved without mandating exchange trading of OTC derivative products.

SIFMA supports Treasury's proposal to harmonize the regulation of securities and futures. The key concern in this area is that the law should expressly delegate the regulation of financial products such as broad market indices, currencies, and interest rate swaps to the SEC, and nonfinancial products such as commodities to the CFTC.

We agree that targeted reforms are needed in order to restore confidence and functionality to the securitization market, one of the keys to a better functioning market broadly, and the industry is working aggressively to make improvements in this area.

We support efforts to find appropriate ways to have skin in the game, for securitization market participants to have skin in the game. One mechanism that can promote this goal is the required retention of a meaningful economic interest in securitized exposures, helping to align the incentives of originators and transaction sponsors with those of investors.

SIFMA supports strengthening consumer protection regulation, including the creation of national standards governing consumer credit products and lending practices. There are concerns that creating a new agency for these purposes might result in mixed messages and conflicting directives, and therefore may fail to deliver the hoped-for benefits that underlie the suggestion of a new agency. More critical is the balancing of functions of any new consumer protection entity with other regulators. The CFPA as proposed could inadvertently encroach on the jurisdiction of the SEC and the CFTC. And we understand it was not intended to supersede the broad investor protection mandate of these two agencies, but suggest the clarity of a full exclusion for investment products and services regulated by the SEC and CFTC.

SIFMA has long advocated the modernization and harmonization of disparate regulatory regimes for brokers, dealers, investment advisers, and other financial intermediaries. Individual investors deserve, and SIFMA supports, the Administration's recent proposal to create a new Federal fiduciary standard of care that supersedes and improves upon existing fiduciary standards, which have been unevenly developed and applied over the years, and which are susceptible to multiple and differing definitions and interpretations under existing Federal and State law. The new Federal standards should function as a standard that is uniformly applied to both advisers and broker-dealers when they provide personalized investment advice to individual investors. When broker-dealers and ad-

visers engage in identical service, they should be held to the same standard of care.

Finally, the global nature of financial markets calls for a global approach to regulatory reform. Unless common regulatory standards are applied and enforced across global markets, opportunities for regulatory arbitrage will arise. And so importantly, close cooperation among policymakers on an international basis is essential if we are to effectively address the challenges facing the financial system.

We thank you for your time and look forward to your questions.

[The prepared statement of Mr. Snook can be found on page 90 of the appendix.]

Mr. KANJORSKI. Thank you very much. Now, we will hear from Mr. Paul Schott Stevens, president of the Investment Company Institute. Mr. Stevens.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Chairman Kanjorski, Congressman Royce, and members of the committee. I am very pleased to appear today to discuss the Obama Administration's proposal for financial regulatory reform. And I must say we commend this committee for all the very hard work and attention it is devoting to these important and complex issues.

As you know, mutual funds and other registered investment companies are a major factor in our financial markets. For example, our members hold roughly one-quarter of all the outstanding stock of U.S. public companies, and funds have not been immune from the effects of the financial crisis. But the regulatory structure that governs funds has proven to be remarkably resilient.

As a result of New Deal reforms that grew out of the Nation's last major financial crisis, mutual fund investors enjoy significant protections under the Investment Company Act of 1940 and the other securities laws. These include daily pricing of fund shares with mark-to-market valuations, separate custody of fund assets, very tight restrictions on leverage, prohibitions on affiliated transactions and other forms of self-dealing, the most extensive disclosure requirements faced by any financial product, and strong independent governance. The SEC has administered this regulatory regime effectively, and funds have embraced it and have prospered under it.

Indeed, recent experience suggests that policymakers should consider extending some of these same disciplines, which arrived in our industry in 1940, to other marketplace participants.

We are pleased that the Administration's reform proposals reaffirm the SEC's comprehensive authority not just with respect to registered investment companies and their advisers, but also over capital markets, brokers, and other regulated entities. The SEC can and should do even more to protect investors and maintain the integrity of our capital markets. But for this it needs new powers and additional resources.

We agree with the Administration that the SEC should have new regulatory authority over hedge fund advisers, along with expanded authority over credit rating agencies. And we welcome

plans to give the SEC new powers to increase transparency and reduce counterparty risk in certain over-the-counter derivatives.

We have long supported additional resources for the SEC. It is just as important, however, that the SEC bolster its internal management and deepen the abilities of its staff. We commend SEC Chairman Mary Schapiro for the steps she is taking in this regard.

Lastly, I would like to address one of the central questions of reform, how to regulate systemic risk. ICI was an early proponent of the idea that a statutory council of senior Federal regulators would be best equipped to look across our financial system to anticipate and address emerging threats to its stability. Thus, we are pleased that the Administration recommends creation of a Financial Services Oversight Council.

We are concerned, however, that the Administration proposes that this council would have only an advisory or consultative role. The lion's share of systemic risk authority would be invested in the Federal Reserve. In our view, that strikes the wrong balance. Addressing risks to the financial system at large requires diverse inputs and perspectives. We would urge Congress instead to create a strong systemic risk council, one with teeth. The council should coordinate the government's response to identified risks, and its power to direct the functional regulators to implement corrective measures should be clear. The council also should be supported by an independent, highly experienced staff.

Now, some have said that convening a committee is not the best way to put out a roaring fire. But a broad-based council is the best body for designing a strong fire code. And isn't that the real goal here, to prevent the fire before it consumes our financial system?

This council approach offers several advantages. As I mentioned, the model would enlist expertise across the spectrum of financial services. It would be well suited to balancing the competing interests that will often arise. It would also likely make the functional regulators more attentive to emerging risks or gaps because they would be engaged as full partners. And the council could be up and running quickly, while it might take years for any existing agency to assemble the requisite skills to oversee all areas of our financial system.

Mr. Chairman, thank you again for the opportunity to testify. We look forward to continuing to work with the committee as it develops legislation on these and other issues.

[The prepared statement of Mr. Stevens can be found on page 121 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Stevens. Next, we will hear from Mr. Douglas Lowenstein, president, Private Equity Council. Mr. Lowenstein.

STATEMENT OF DOUGLAS LOWENSTEIN, PRESIDENT/CEO, PRIVATE EQUITY COUNCIL

Mr. LOWENSTEIN. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to be here this morning and to present our views on the financial regulatory reform issues.

The Private Equity Council is a trade association representing 12 of the largest private equity firms in the world. I think members of this committee are well aware of the positive role private equity

has played in helping hundreds of American companies grow, create jobs, innovate, and compete in global markets. In the process, over the last 20 years, private equity firms have been among the best, if not the best performing asset class for public and private pension funds, foundations, and university endowments, distributing $1.2 trillion in profits to our investors.

In these remarks, I want to make four general points. First, it is important for Congress to enact a new reform regime. Obviously, action which elevates speed over quality is undesirable. But the sooner businesses understand how they will be regulated, the quicker they will be able to organize themselves to carry out their roles in reviving strong capital markets. Private equity firms today have $470 billion in committed capital to invest, and we are looking forward to the opportunity to do that.

Second, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: first, the impact a firm's failure would have on the financial system and the economy; second, the firm's combination of size, leverage, including off balance sheet exposures, and the degree of its reliance on short-term funding; and third, the firm's criticality as a source of credit for households, businesses, and State and local governments, and as a source of liquidity for the financial system. Private equity contains none of these systemic risk factors.

Specifically, PE firms have limited or no leverage at the fund level, and thus are not subjected to unsustainable debt or credit or margin calls. PE firms don't rely on short-term funding. Rather, PE investors are patient, and commit their capital for 10 to 12 years or more, with no redemption rights. Private equity does not invest in short-term tradeable securities like derivatives and credit default swaps, and private equity firms are not deeply interconnected with other financial market participants through derivative positions, counterparty exposures, or prime brokerage relationships.

And finally, private equity investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt.

Third, we support creation of an overall systemic risk regulator who has the ability to obtain information, is capable of acting decisively in a crisis, and possesses the appropriate powers needed to carry out its mission. As to exactly how you carry that out, we are frankly agnostic on that subject.

And fourth, regarding private equity and regulation specifically, we generally support the Administration's proposal for private equity firms, venture capital firms, hedge funds, and other private pools of capital to register as investment advisers with the SEC. And we support similar legislation introduced by Representatives Capuano and Castle.

To be clear, registration will result in new regulatory oversight for private equity firms. There are considerable administrative and financial burdens associated with being a registered investment adviser. And in fact, these could be especially problematic for smaller firms. So it is important to set the reporting threshold at a level which covers only those firms of sufficient scale to be of potential concern. But despite the potential burdens, we do support strong registration requirements for all private pools of capital because it

is clear that such registration can help restore confidence in the financial markets. And in the long run, private equity will benefit when confidence in the system is high.

While supporting registration, we believe Congress should direct regulators to be precise in how new regulatory requirements are calibrated so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk it may pose. It is vital that any information provided to the SEC be subjected to strong confidentiality protections so as not to expose highly sensitive information beyond that required to carry out the systemic risk oversight function.

We stand ready to work with you, Mr. Chairman, and members of the committee as these issues are resolved through the legislative process. Thanks again.

[The prepared statement of Mr. Lowenstein can be found on page 76 of the appendix.]

Mr. KANJORSKI. Thank you again, Mr. Lowenstein. And our next witness will be Ms. Diahann Lassus, president of Lassus Wherley, on behalf of the Financial Planning Coalition.

STATEMENT OF DIAHANN W. LASSUS, PRESIDENT, LASSUS WHERLEY & ASSOCIATES, ON BEHALF OF THE FINANCIAL PLANNING COALITION

Ms. LASSUS. Thank you, Mr. Chairman, and members of the committee. Thank you for the opportunity to speak on this critically important topic.

My name is Diahann Lassus, and I come before you today as a representative of the Financial Planning Coalition, a group of three leading financial planning organizations dedicated to improving consumer access to competent, ethical, and professional financial planning advice. I also serve as chairman of the board of the National Association of Personal Financial Advisers, the leading professional association dedicated to the advancement of fee-only financial planning. Most significantly, however, I am the co-founder and president of Lassus Wherley & Associates, a woman-owned wealth management firm focused on helping families secure their financial future every day.

Consumer protection and the need for accountability and transparency are not abstract concepts or academic debates. They are the reality my clients and I face every day. Every time I meet with new clients, I hear stories about their experience with other financial planners. These clients often explain that they trusted and followed the planner's advice because the planner said he was putting the client's best interests first. Based on the recommended products, it is abundantly clear that the planner was looking to profit from commissions, and may not have even considered the client's best interests. Sadly, though, these stories are not unusual.

Since the Great Depression, financial services regulation has developed essentially along dual tracks: laws governing the sale of financial products; and laws governing investment advice. When the delivery of financial services involves a combination of product sales and financial advice, the dual regulatory structure has led to consumer confusion, conflicts of interest, and gaps in oversight.

No single law governs the delivery of financial planning advice to the public. There is a patchwork regulatory scheme where financial planners currently maintain as many as three different licenses—insurance, brokerage, and investment adviser—with different standards of care and accountability to consumers. This has led to consumer confusion, misrepresentation, and fraud, all things that the Administration seeks to correct in their reform package.

We were very happy to see the President propose that broker-dealers who provide investment advice be held to the same fiduciary standard as investment advisers. We are pleased that this committee is considering that proposal, and hope it results in an unambiguous fiduciary duty for all financial professionals who provide investment advice, and does not undermine the fiduciary duty that already exists under the Investment Advisers Act of 1940.

We are working with a group of organizations that represent diverse interests and constituencies to support this concept. We all share the view that the highest legal standard, the fiduciary duty, should apply to all who give financial advice to consumers.

Taking a step beyond extending the fiduciary duty, and in an effort to close the regulatory gap I mentioned, the Financial Planning Coalition supports the creation of a professional oversight board for financial planners and advisers, much like professional or medical legal boards, that would establish baseline competency standards for financial planners and require adherence to a stringent fiduciary standard of care. We seek to apply a principles-based regulation to individuals providing comprehensive financial planning services or holding themselves out as financial planners, not to the firms that employ them. This leaves intact other regulatory coverage for institutions, and operates consistently with existing Federal regulation for broker-dealers and investment advisers, as well as State regulation of insurance producers, accountants, and lawyers.

As a small business owner, I am very sensitive to charges of increased administrative and cost burdens, especially in this economy. However, the ability of Americans to identify and place their trust in competent, ethical, and professional financial planners outweighs these burdens.

We fully support the Administration's five key principles for strengthening consumer protection: transparency; simplicity; fairness; accountability; and access. And we are pleased to see the chairman carry these principles forward as he works to fill the regulatory gaps to protect consumers.

Thank you.

[The prepared statement of Ms. Lassus can be found on page 72 of the appendix.]

Mr. KANJORSKI. Thank you very much. And now, finally, we will have Mr. Rob Nichols, president and chief operating officer of the Financial Services Forum.

STATEMENT OF ROBERT S. NICHOLS, PRESIDENT AND CHIEF OPERATING OFFICER, THE FINANCIAL SERVICES FORUM

Mr. NICHOLS. Chairman Kanjorski, members of the committee, I would like to thank you as well as Chairman Frank and Ranking Member Bachus for the opportunity to participate in today's hear-

ing and to share the Financial Services Forum's views on the Administration's proposal to reform and modernize our Nation's framework of financial supervision.

The Forum, as many of you know, is a nonpartisan financial and economic policy organization comprised of the chief executives of 17 of the largest and most diversified financial institutions doing business in the United States. Our purpose is to promote policies that enhance savings and investment, and that ensure an open, competitive, and sound global financial services marketplace.

Reform and modernization of our Nation's framework of financial supervision is overdue and needed. Our current framework is simply outdated. Our Nation needs a new supervisory framework that is effective, efficient, ensures institutional safety and soundness and systemic stability, promotes the competitive and innovative capacity of the U.S. capital markets and, quite importantly, protects the interests of depositors, investors, consumers, and policyholders.

With this imperative in mind, we applaud the Administration's focus on reform and modernization and the ongoing hard work of this committee. We agree with much of the Administration's diagnosis of the deficiencies of our current framework, and we applaud the conceptual direction and many of the details of the Administration's reform proposal. I will briefly touch on a couple elements of that plan.

Perhaps the most significant deficiency of our current supervisory framework is that it is highly balkanized, with agencies focused on specific industry sectors. This stovepipe structure has led to at least two major problems that created the opportunity for, and some would say exacerbated, the current financial crisis: one, gaps in oversight naturally developed between the silos of sector-specific regulation; and two, no agency is currently charged with assessing risks to the financial system as a whole. No one is looking at the big picture.

A more seamless, consistent, and holistic approach to supervision is necessary to ensure systemic stability and the safety and soundness of all financial entities. We believe the cornerstone of such a modern framework is a systemic risk supervisor. Indeed, one of the reasons this crisis could take place is that while many agencies and regulators were responsible for overseeing individual financial firms and their subsidiaries, no one was responsible for protecting the whole system from the kinds of risks that tied these firms to one another.

As President Obama rightly pointed out when he announced his plan just a few weeks ago, regulators were charged with seeing the trees, but not the forest. This proposal to have a regulator look not only at the safety and soundness of individual institutions, but also for the first time at the stability of the financial system as a whole, is essential. During Q&A, we could visit about who might be best suited to be a systemic risk supervisor and how you could make that entity accountable.

Of the many unfortunate and objectionable aspects of the current financial crisis, and the subsequent policy response, perhaps none is more regrettable and evoking of a more passionate objection than too-big-to-fail. Failure is an all-American concept because the discipline of potential failure is necessary to ensure truly fair and

competitive markets. No institution should be considered too big to fail. A critical aspect of regulatory reform and modernization, therefore, must be to provide the statutory authority and procedural protocol for resolving, in a controlled way that preserves public confidence and systemic integrity, the failure of any financial entity, no matter how large or complex.

So while no institution should be considered too big to fail, there are some that are too big to fail uncontrollably. We think that putting in place safeguards to prevent the failure of large and interconnected financial firms, as well as a set of orderly procedures that will allow us to protect the economy if such a firm in fact does go under water, should go hand in hand.

The Forum's insurance industry members agree that it is essential that there be increased national uniformity in the regulation of insurance. Congressman Kanjorski, you and I have had this discussion. And we are supportive of the creation of an Office of National Insurance within the Treasury Department. ONI will ensure that knowledge and expertise is established at the Federal level, which is critical to ensuring that insurance industry interests are represented in the context of international negotiations and regulatory harmonization efforts.

Again, thank you for the opportunity to appear before you today. I look forward to your questions.

[The prepared statement of Mr. Nichols can be found on page 84 of the appendix.]

Mr. KANJORSKI. Thank you very much.

If I may just comment, I wish we had about 3 hours today just for my own questions. All your testimony has excited me, and I have tried to limit in my mind what we would ask.

I think, Mr. Stevens, you talked about a systemic risk regulator and you raised the question of where that should exist, that it ought to be clear and separate. Have you had an occasion to examine Mr. Donaldson's suggestions in his most recent report?

Mr. STEVENS. I have read the news reports about them, Mr. Chairman.

Mr. KANJORSKI. Well, I do not have a full understanding, nor have I had the opportunity to read the report fully, but, from what I gather, it is the closest thing to setting up a philosopher king elevated expert panel, a supreme court of economics, if you will. And it is rather interesting from the standpoint that I myself have extreme doubts about imbuing the Federal Reserve with additional responsibilities and powers, particularly some of them which appear to be inherently in conflict if we make them the systemic risk regulator also. I do not know how they carry out all the monetary policy decisions that may be contrary to what may be good for the entire economy.

On that regard, though, most recently—I do not even know if I should refer to this—but we have a troubling financial institution right now on the brink of either going into bankruptcy or being rescued, and I had a rather national retailer call me on the phone yesterday in regard to part of the operations of that organization. I think you understand the organization I am talking about. I prefer not to mention it, if we can, although most people are informed.

Part of it is they are a factoring operation, which affects 3,000 suppliers and manufacturers.

The question that disturbs me is that I do not know whether or not we are recognizing the systemic risk. We are tending to think systemic risk has to be the size of the individual institution within their industry or within their field, but it does not necessarily have to be that. It could be interconnection. It could be providing vital services.

This retailer said, look, these are 3,000 suppliers, and they are all factored by this organization. If they cannot continue that, they close down; and I cannot get goods to sell in the store, so that when we get the consumers' demand increase, there is nothing for him to buy.

And it seems to me a pretty logical argument that comes close to systemic risk. I guess that is what we are faced with. Do you have any thoughts on that?

Mr. STEVENS. Well, with respect to what I understood to be the proposal by former Chairman Donaldson and former Chairman Levitt, it is to create a whole new agency that would be the systemic risk regulator, to put it on top of the entire framework that we have currently. I think that harbors, frankly, Mr. Chairman, even more troublesome concerns than vesting that authority in some existing player.

I think the point that you make in addition is one that certainly we have given a lot of attention to, what is a systemic risk and what is a firm that should in the Administration's proposal be a Tier 1 financial holding company?

The criteria that have been proposed, I think, are very uncertain of application. That could range to a small group of firms or it could range to a very wide group of firms, and I suppose it is in the eye of the beholder. I think if there is authority of that kind created, it would be imperative on the Congress to make sure that the standards are written as clearly as possible.

In extremis, virtually any firm's management will say, "I am systemically significant. You have to bail me out." I think that is just the reality of it. We can't have a system that works that way. You have to maintain, like it or not, some Darwinian element so that strong firms will survive and weaker firms simply go the way of history.

Mr. KANJORSKI. Thank you.

Mr. Brodsky, you have been involved in some discussions and proposals on short sales, and those proposals are outstanding. Could you give us the benefit of your thinking on these proposals?

Mr. BRODSKY. Thank you, Mr. Chairman.

The SEC is in the throes of analyzing responses that are in the thousands of comments to a proposal they put out on whether the short sale rule should be brought back in terms of up-tick or circuit breakers or other things. I believe that this committee should be reviewing the actions of the SEC in that regard, recognizing that the markets of 2009 are very different than they were 5 years, 10 years, or 20 years ago, and that we want to make sure that we don't hurt the markets in trying to deal with something that maybe already has been dealt with.

The SEC has done a very good job in the last 18 months or so in dealing with the issue of closing out short stock positions and making sure that all fails-to-deliver have been taken care of.

But we are very concerned that there are people who would like to see a world that doesn't exist anymore because of the success of the national market system and the way stocks are currently traded; and our concern is that if the SEC were to take any action, that the agency should not do anything that hurts the liquidity of the markets. Our most specific concern is there should be a market maker exemption for option market makers who are under very strict SEC requirements.

Having said that, I would refer the committee to the IOSCO principles, which are the international standard of all SECs of the world, and urge the committee to make sure that our SEC does not put this country into a less competitive situation from other countries as the SEC proceeds on their determination of whether they should make any changes in the short sale rule.

I think this is something from an oversight point of view that is very critical. Because our markets, as I said earlier, have provided tremendous liquidity and transparency, I think it is very important that we don't throw out the baby with the bath water.

So I appreciate your question. We are very concerned that we should not put ourselves in an international competitive disadvantageous situation, and the IOSCO principles which were adopted by all SECs of the world would hold us in very good stead if we complied with them.

Mr. KANJORSKI. Thank you very much, Mr. Brodsky.

Now the gentleman from California, Mr. Royce.

Mr. ROYCE. Yes, Mr. Chairman.

I would like to briefly address an issue from yesterday's hearing regarding Sheila Bair's perspective on the Consumer Financial Products Agency. Sheila Bair has been very vocal, as have most of the other banking regulators, in expressing her concern over separating consumer protection from safety and soundness regulation. I am sure, under duress, all will tote the line and endorse. But let's hear her concerns. This is March 19th she raised this issue before the Senate Banking Committee.

She said, the current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety and soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed by a broader understanding of other risks in financial institutions.

Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness would result in similar problems.

Our experience suggests that the development of policy must be closely coordinated and reflect a broad understanding of institution's management, operations, policies and practices, and the bank supervisory process as a whole. Placing consumer protection policy

setting activities in a separate organization apart from existing expertise and examination of infrastructure could ultimately result in less effective protection for consumers.

I would ask the Chair that Ms. Bair's testimony before the Senate Banking Committee be included into the record.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. ROYCE. Those concerns were the reason that I mentioned Ms. Bair, and I just wanted to correct the record to state her precise views.

I will go now to Mr. Brodsky with a question.

As Congress looks at overhauling the regulatory structure over private pools of capital and the broader financial system, I think it is important that we focus more on effective regulation, as opposed to simply additional regulation.

We witnessed some gross negligence on behalf of the SEC during the Bernie Madoff instance and the hearing featuring Harry Markopoulos, whom we heard from here in this committee. Do you believe the SEC and other financial services regulators are currently equipped to conduct examinations and other necessary regulatory steps?

Mr. BRODSKY. I think this is a question of management at the SEC, and I think that the SEC under its current leadership has the proper focus to organize itself to do that. I mean, there is always going to be a situation where the cop on the beat misses something.

I think the Madoff situation is particularly regrettable, and I think there were things that were missed. But I think the SEC has the proper legislative mandate to do it, and I think they just have to organize themselves in a better way, and I think the current chairman is the person to do that.

Mr. ROYCE. Let me ask you a question here that is on my mind. Because, in the hearing, it became very clear that there was no one at the SEC who understood the Ponzi scheme strategy. There was no one who could undercover that. There was one in the Boston office, but in the over-lawyered SEC, he didn't have a seat at the table.

Under that kind of culture, are you going to have anyone who can understand how an OTC derivatives contract is structured? Are you going to have anybody who understands how a hedge fund engages in quantitative analysis and complex trading strategies? I just wonder about what the SEC has already proven itself incapable of handling, and now we transfer this on top of the SEC.

A story just broke, I think yesterday, about another example of another Bernie Madoff-type swindle that the SEC had missed, where, again, the information allegedly had been turned over to them. They had not even been able to decipher that with the information that was given them. Hence my thoughts on that.

I would also ask if any of the other panelists, maybe Mr. Stevens or Mr. Baker or anybody, would have any thoughts on this front?

Mr. Stevens?

Mr. STEVENS. We have over the recent years, Congressman, emphasized the need for the SEC to focus on internal management issues and the capabilities and organization of its staff. That is, unfortunately, a priority that has not always been something that

chairmen have been able to attend to because their tenures are fairly short. The markets have changed over the years much more than the SEC has.

I think Chairman Shapiro has made it clear that kind of reinvention of our agency is what she is about and that is what is required. I am a lawyer, and I would agree with you. Different skill sets and different mixes and different organizational structures at the SEC would be very desirable. And I look at that not only as an issue of examination and enforcement. I look at it as an issue with respect to the formulation of appropriate regulations as well, where understanding regulated entities and regulated markets more intimately, not as lawyers do but perhaps as economists do, would be very helpful in the mix. I think we are encouraged in that direction.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. KANJORSKI. Ms. Waters from California, for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

I would like to thank all of our presenters here today, but I especially would like to welcome Mr. Baker to his old committee.

You have been talked about a lot since you have been gone, and I know you have just gloated because you feel we didn't take your advice and your direction of FM Watch, and because of what has happened. I am sure you are saying, "I told them so." I would love to talk about that with you some sometime, but I can't do it with you today. But welcome back.

I want to ask you about credit default swaps. I have always appreciated your extreme knowledge of the financial markets, and I think that you could share information that could be very helpful to all of us.

Now, did your members enter into credit default swap contracts with banks and other hedge funds?

Mr. BAKER. There is broad utilization of credit default swaps in the investment world, and our members do engage in utilization of those products.

Ms. WATERS. Did any of these CDS contracts insure consumer debt packaged as collateralized debt obligations, CDOs?

Mr. BAKER. If I may separate the collateralized debt obligations from the credit default swap protection, they really run on two separate tracks. Not to avert your question, but I can answer it this way: Our members engage in broad investment strategies, and almost every financial product that you would have a concern about I am sure that some of our members somewhere are engaging in the deployment of those credit risk strategies.

But I can give you more specific answers at another time. I don't want to take an inordinate amount of your time this morning.

By the way, thank you for your kind words.

Ms. WATERS. You are welcome.

In your absence, I have not always been this kind, but I want you to know that I really do want to meet with you and talk sometime about the GSEs still and the future of the GSEs.

Mr. BAKER. I would be delighted to do that.

Ms. WATERS. Well, let me just further question you a little bit more about these credit default swaps.

You know, I dropped a bill to discontinue them altogether. Of course, I have gotten a lot of pushback and feedback on that. But we do know that credit default swaps brought down AIG. We know that other companies, such as those that Gillian Tett has written about, were forced into bankruptcy over CDS contracts. Is it accurate to say credit default swaps are being misused and that the American taxpayer is paying the price?

Mr. BAKER. I would not characterize it quite that way. I won't attempt to argue your perspective relative to AIG. I will say that there were other circumstances that contributed mightily to their demise.

But if I may, by way of best response, give you an example of concern I would have with regard to the legislation, and then quickly add there are things we can do that would help with your concerns relative to transparency, relative to centralized clearing, exchanges, collateral segregation, enhanced regulatory authorities, I think we can get to the safe point you would wish to go.

But let me give the quickest, shortest example of the concern I have that I think you will find as a legitimate validating reason.

If there is a pension who has a variety of investments, and let's just call one portfolio a technology-heavy, long-only type of investment strategy. But the pension is worried about having to meet its monthly flat obligations to write those pension checks. We all know there has been extreme volatility in the markets. The pension then wants to protect against that volatility in that technology portfolio. They turn around to a bank and say, we would like to buy credit index protection from you. No need to get into the definition, but it is a way to hedge against the volatility in that broad price swing of those technology stocks, enabling them for a small cost to make those monthly payments to retirees. Not only is that a credit default swap product, it could be defined—and I worry about this—as a naked credit default swap, and here is why:

The pension might have 20 technology stocks in that portfolio. When you buy the credit index protection, it might have 100 companies in it, and you would have no underlying relationship, no bond, no debt, nothing with those 80 firms. And technically, if Congress would move ahead in this regard, you might preclude the pension from getting access to the credit index protection.

It even gets worse. Because the bank then, because of regulator pressure, wanting to lower its risk profile, will turn that credit index exposure over to a hedge fund. The hedge fund will buy it and then perhaps need to go long on technology stocks because it just shorted the credit index.

Amazing as it may sound, people will go buy IBM stock and then turn around and at the same time go short Apple. Now, it is not because they believe Apple is going to go south tomorrow and they are actually doing predatory shorting. They are doing it because they might be wrong on the long side on IBM, but since they have strong belief in the technology sector, they cover both ways. Hence, the definition of hedge fund.

We can provide a lot more technical analysis to your staff. The SEC's Office of Risk Analysis has some really good work on the contributing causes to AIG's demise, and I think it would be very

helpful in the appropriate context to have that made available to you.

Ms. WATERS. You see what I meant about Mr. Baker? He just gave us a lesson in credit default swaps and indexes that we probably have not even discussed before. I thank you very much.

Let me just complete my remarks by saying I am interested in trying to find out who benefits from bankruptcy with these credit default swaps.

Mr. BAKER. Let me echo, I think disclosure is at the heart of many of the problems you have concerns about, and very legitimate concerns, and I believe we can find ways to offer assistance on this matter that would be very constructive.

Ms. WATERS. Thank you very much. I yield back.

Mr. KANJORSKI. I just want to advise the committee that we have 15 votes—18 votes, I am sorry. We are trying to determine—think about it, if you will, while we have Mrs. Biggert take her 5 minutes—whether we should return at 2:00 or thereabouts, or else let this panel go. Those are famous words, "let our people go."

Mr. WATT. Mr. Chairman, my vote would be to allow us to propound our questions in writing. I may be a little biased, because you may even get to me.

Mr. SHERMAN. Mr. Chairman, I hope we would reconvene the hearing after the votes.

Mr. KANJORSKI. Mrs. Biggert?

Mrs. BIGGERT. If I might ask my questions. Thank you.

Mr. Brodsky, what was the impact of the ban that Mr. Cox put on the short sales?

Mr. BRODSKY. That was a very regrettable situation. In fact, Chairman Cox, in his final farewell remarks, said it was his biggest single mistake.

I think one of the things was that he caught the market by surprise, and it had broad ramifications. And in the studies I have seen, the liquidity in the stocks where he banned short selling actually got worse, not better. I think it is a good lesson for all of us. I think that whatever is done has to be done in a very thoughtful way and not done in an ad hoc, knee-jerk way.

So there are markets, including the convertible bond market, for example, that seized up, which hurt pension funds and other investors, because the people who were doing the hedging and other strategies in convertible bonds couldn't then, as Mr. Baker said, short the stock as a countervailing move.

So I think when you are dealing with market mechanisms, you have to do these things in a very thoughtful way. And admittedly, we were in a very unique environment. But it is instructive that Mr. Cox, in retrospect, said it was his biggest single mistake.

Mrs. BIGGERT. Mr. Baker?

Mr. BAKER. I will just give you one quick example that really impacted our industry.

In the convertible securities world, if an institution wants to borrow money and doesn't want to do it through a conventional bank loan, they could come to a hedge fund, borrow the money and, at time of settlement, instead paying it back in cash, they would actually transfer ownership to stock. The stock would be held separately from the company and separate from the hedge fund, and we

would be worried in the intervening period of exposure that the value of the stock would go down, meaning we wouldn't get repaid.

It had nothing to do with our view that it was a bad deal or a bad company. But we would enter into a short position, hence insure against any downturn in value, so when we get settled we get as much as we could toward the full obligation.

Of that practice, the 12 months preceding the issuance of the order, the convertible securities world was about a $70 billion business. Of that amount, ironically, $42 billion of it was going to banks. So when the short order was issued to protect banks, it seized up the convertible securities world because we couldn't go short, and therefore we did not extend the credit.

Mrs. BIGGERT. Thank you.

I do have one more question for you. We have been talking a lot about what I am calling the Credit Rationing and Pricing Agency, which is the Consumer Protection Agency. Could you give me your opinion on this? Is this really a wise thing to do, to separate the consumer protection from the safety and soundness that the other regulator would be responsible for?

Mr. BAKER. My members have directed me on this particular issue that we had an understanding or maybe a misperception about the applicability of this agency to certain financial sectors, and it is not now clear to me exactly how an SEC-regulated or a CFTC-regulated entity will relate to this new agency, if adopted. We would need to have a lot more clarity before I could fairly respond. But we have some big questions, I would say is a fair characterization.

Mrs. BIGGERT. Thank you. I am going to yield back.

Mr. KANJORSKI. Thank you very much.

Mr. Watt, for 30 seconds, if possible.

Mr. WATT. That is fine.

I just wanted to welcome Mr. Baker and ask Mr. Nichols to let me know what his position—his organization's position on the consumer thing was. You didn't mention that very much. And ask Mr. Brodsky to give me some more explanation about how he can be so out of step with everybody else in this industry about consolidating, unless he addressed it more directly in his written comments.

I will pass to Mr. Sherman.

Mr. SHERMAN. Do all of that in writing.

Mr. Brodsky, I am impressed that you were warning the Agriculture Committee of these dangers clear back in 1997. That is the only time I wish I had been a member of the Ag Committee.

Mr. Nichols, you say no one should be too big to fail, but it is not clear whether you are saying that, through effective regulation, no matter how big they are, they are not too big to fail, or whether you are saying that there should be a limit on the size, of the complexity of an institution and we might have to break somebody up. I need to be convinced that the regulatory system was really good before I was convinced that unlimited size was not a problem.

And I believe my time has expired.

Mr. KANJORSKI. Mr. Green?

Mr. GREEN. Yes, sir. Thank you, Mr. Chairman.

Let me just say this: Too big to fail is really the right size to regulate.

I want to make a comment about a number of things that I mentioned. I can't get to all of them, but I want to say this.

I mentioned the notion that you had teaser rates and you didn't qualify for the adjusted rate. Many of you took mortgage-backed securities into your portfolios—and I wanted to connect all of this—but those mortgage-backed securities were a problem for you because they did not qualify people for those teaser rates, and I am sorry we didn't get to develop that.

Thank you very much, Mr. Chairman.

Mr. KANJORSKI. Thank you very much.

Mr. Foster?

Mr. FOSTER. I think getting to the kind of detailed questions I was hoping to go to on OTC derivatives is not going to happen in 30 seconds, so I will just try to get back to you individually.

Mr. KANJORSKI. The Chair notes that some members may have additional questions for today's witnesses which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to any of today's witnesses and to place their responses in the record.

Without objection, it is so ordered.

The panel is dismissed. We thank you very much. We are going to have to run. You know what it is like, Richard.

This hearing is adjourned.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]

A P P E N D I X

July 17, 2009

MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JULY 17, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals
July 17, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" held on July 17, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on financial regulatory reform, including the important subjects of investor protection, systemic risk and prudential regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate assumptions.

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

To perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other market participants, including retail investors and policy makers, in reestablishing a sound financial system. We support efforts to protect investors, manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not pose a threat to our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not pose systemic risks despite their losses. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated $9.4 trillion in assets under management, or the U.S. banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence in and stabilize our financial markets and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

MFA supports a smart approach to regulation, which includes appropriate, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection and; (ii) better monitor and reduce systemic risk. Smart regulation will likely mean increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundant, overlapping, or inefficient responsibilities, where identified.

The first step in creating a smart regulatory framework is identifying the risks or intended objectives of regulation with the goal of strengthening investor protection and

market integrity and monitoring systemic risk. Identifying the underlying objectives of proposed regulation will help ensure that proposals are considered in the appropriate context relative to addressing the identified risks or achieving the intended objectives. Regulation that addresses the key objectives of efficient capital markets, market integrity and investor protection is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*.[1] As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics.

Regulation is also not a panacea for the structural market breakdowns that currently exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition. Investors' lack of confidence in the financial health of these institutions has been, and continues to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests earlier this year on the 19 largest bank holding companies were designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. While those stress tests appear to have helped develop greater certainty, we believe that it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing

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[1] MFA's *Sound Practices* is available at: http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf

regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

We believe that regulatory reform objectives generally fall into three key categories, discussed in separate sections below. Those categories are: investor protection, market integrity and prudential regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling.

II. HEDGE FUND MANAGER REGISTRATION

In adopting a smart and effective approach to the regulation of unregistered managers of private pools of capital, it is important to recognize that many, if not all, of these regulatory issues will be relevant to all such managers, including firms that manage hedge funds, private equity funds, venture capital funds, commodity pools and real estate funds. The Obama Administration, in its release *Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation* (the "Administration Proposal"),[2] is supportive of this approach, calling for the registration of advisers of hedge funds and other private pools of capital with the SEC. MFA supports the registration of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management.

MFA has publicly supported this comprehensive approach to adviser registration over the past several months, even when the Administration called for a narrower registration requirement only for advisers to the largest and most systemically relevant private pools of capital. We strongly encourage policy makers also to consider the issue of registration in the context of all private pools of capital and the unregistered managers of those pools. Likewise, we strongly encourage regulators to consider regulations that apply to all private investment firms and not just hedge fund managers. This approach will both promote better regulation as well support the many benefits private investment firms provide to the US markets.

MFA and its members recognize that mandatory SEC registration for advisers of private pools of capital is one of the key regulatory reform proposals being considered by policy makers. We believe that the general approach set out in the Administration Proposal of requiring the registration of currently unregistered investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 (the "Advisers Act") is a smart approach in considering this issue. I note that more than half of MFA member firms already are registered with the Securities and Exchange Commission (the "SEC"), as investment advisers. Applying the registration requirement

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[2] Available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

to currently unregistered investment advisers to all private pools of capital, instead of focusing solely on hedge fund managers is also consistent with the objective of a "smart" approach to this type of reform. We believe that removing the current exemption from registration for advisers with fewer than fifteen clients would be an effective way to achieve this result.[3] The form and nature of registration and regulation of investment advisers to private pools of capital should be evaluated in the context of how to best promote investor protection, market integrity and systemic risk monitoring, each of which may be best achieved by different types of regulation.

We believe that the Advisers Act provides a meaningful regulatory regime for registered investment advisers. The responsibilities imposed by Advisers Act registration and regulation are not taken lightly and entail significant disclosure and compliance requirements, including:

- Providing publicly available disclosure to the SEC regarding, among other things, the adviser's business, its clients, its financial industry affiliations, and its control persons;
- Providing detailed disclosure to clients regarding, among other things, investment strategies and products, education and business background for adviser personnel that determine investment advice for clients, and compensation arrangements;
- Maintaining of books and records relevant to the adviser's business;[4]
- Being subject to periodic inspections and examinations by SEC staff;
- Adopting and implementing written compliance policies and procedures and appointing a chief compliance officer who has responsibility for administering those policies and procedures;
- Adopting and implementing a written code of ethics that is designed to prevent insider trading, sets standards of conduct for employees reflecting the adviser's fiduciary obligations to its clients, imposes certain personal trading limitations and personal trading reports for certain key employees of the adviser; and
- Adopting and implementing written proxy voting policies.

In addition to registration and regulation of advisers through the Advisers Act, the hedge fund industry is subject to other, meaningful regulatory oversight. Hedge funds, like other market participants, are subject to existing, extensive trading rules and

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[3] We note that this approach is consistent with the approach taken by H.R. 711 and S. 1276.

[4] Attachment A sets out the extensive list of books and records required to be kept by registered investment advisers.

reporting requirements under the U.S. securities laws and regulations.[5] Increasing investor confidence and promoting market integrity are carried about by the SEC and other regulators through these regulatory requirements.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[6] This raises the question whether the SEC would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We encourage policy makers to consider the issue of resources and regulatory capabilities as they develop proposals for an expanded regulatory mandate.

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator.

In considering the appropriate adviser registration framework, and in light of concerns about resources, capabilities and regulatory structure, we believe that it is important for there to be an exemption from registration for the smallest investment advisers that have a *de minimis* amount of assets under management. This exemption should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration. We are supportive of a comprehensive adviser registration regime, however, we recognize that registration carries with it significant costs that can overwhelm smaller advisers and force them out of business. We believe that the amount of any *de minimis* exemption should appropriately balance the goal of a comprehensive registration framework with the economic realities of small investment advisers. As mentioned above, regulatory resources, capabilities and structure should also be considered as policy makers determine an appropriate *de minimis* threshold.[7] We are not

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5 As discussed in section III below, we are also supportive of providing regulatory authorities, on a confidential basis, with information regarding trading/investment activities to promote better monitoring of systemic risk.

6 Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

7 We believe that Congress should ensure that any approach in this regard is consistent with state regulation of smaller investment advisers and avoids duplication.

proposing a specific *de minimis* amount, however, we encourage policy makers to determine an amount that is not so high as to create a significant loophole that undermines a comprehensive registration regime, and also not so low that the smallest investment advisers are unable to survive because of regulatory costs.

We would like to share with you today some initial thoughts on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider the appropriate regulatory framework. Those principles are:

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our financial system stronger for the benefit of consumers, businesses and investors.

- Regulation should address identified risks or potential risks, and should be appropriately tailored to those risks because without clear goals, there will be no way to measure success.

- Regulation should not impose limitations on the investment strategies of private pools of capital. As such, regulatory rules on capital requirements, use of leverage, and similar types of restrictions on the funds should not be considered as part of a regulatory framework for private pools of capital.

- Regulators should engage in ongoing dialogue with market participants. Any rulemaking should be transparent and provide for public notice and comment by affected market participants, as well as a reasonable period of time to implement any new or modified regulatory requirements. This public-private dialogue can help lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility.

- Reporting requirements should provide regulators with information that allow them to fulfill their oversight responsibilities as well as to prevent, detect and punish fraud and manipulative conduct. Overly broad reporting requirements can limit the effectiveness of a reporting regime as regulators may be unable to effectively review and analyze data, while duplicative reporting requirements can be costly to market participants without providing additional benefit to regulators. It is critical that regulators keep confidential any sensitive, proprietary information that market participants report. Public disclosure of such information can be harmful to members of the public that may act on incomplete data, increase risk to the financial system, and harm the ability of market participants to establish and exit from investment positions in an economically viable manner.[8]

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[8] MFA also believes that regulators should also ensure that they share information with foreign regulators only under circumstances that protect the confidentiality of that information. For example, the SEC has adopted Rule 24c-1 under the Exchange Act (17 CFR §24c-1), which

Regulations should not force market participants publicly to reveal information that would be tantamount to revealing their trade secrets to competitors.

- We believe that the regulatory construct should distinguish, as appropriate, between different types of market participants and different types of investors or customers to whom services or products are marketed. While we recognize that investor protection concerns are not limited to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored approach. One such relevant distinction is that between private sales of hedge funds to sophisticated investors under the SEC's private placement regulatory regime and publicly offered sales to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over 75 years and has generally proven to be a successful framework for financial regulation. We do not believe this distinction should be lost, and we strongly believe that regulation that is appropriate for products sold publicly to retail investors is not necessarily appropriate for products sold privately to only sophisticated investors.
- Regulation regarding market issues that is applicable to a broad range of market participants, such as short selling and insider trading, should be addressed in the broader context of all market participants. Market issues are not specific to the hedge fund industry and, therefore, regulatory reform regarding these issues should be considered in the broader context and not in the context of hedge fund regulation.
- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and recognized as an important complement to prudential regulation. Regulators will tell you that their oversight is no substitute for a financial firm's own strong business practices and investors' robust diligence if we are to promote market integrity and investor protection concerns.

Initial Views on Administration's Proposed "Registration of Advisers to Private Funds" Language

As mentioned above, MFA is supportive of the general approach taken in the Administration Proposal – a comprehensive registration regime under the Advisers Act designed to ensure that there is appropriate regulatory oversight over investment advisers to private pools of capital. We recognize and appreciate the Administration's objective of registering and regulating important market participants that have previously been exempt from registration. It is critical that this objective be done in a way that creates a

allows the SEC in its discretion to share nonpublic information with a foreign financial authority if the authority receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate. MFA believe that US regulators should employ this type of approach when sharing information with foreign regulators.

"smart" regulatory framework, and we believe the removal of the so-called 'private adviser' exemption currently in the Advisers Act achieves that objective with respect to investment adviser registration.

Ensuring that the registration framework is comprehensive is an important component of a "smart" regulatory framework; however, it is equally as important to ensure that any new regulatory framework does not impose unnecessary, duplicative and costly requirements on advisers to private pools of capital. Such action would have adverse consequences for markets and investors while providing little to no benefit with respect to enhancing investor protection and market integrity, promoting greater transparency to either markets or regulators, or monitoring systemic risk. In that regard, we believe that, as drafted, the Administration's proposed legislation would impose overlapping registration requirements for a number of commodity trading advisers that are already registered with, and well regulated by, the Commodity Futures Trading Commission. We are continuing to review the Administration's proposed legislation, and we look forward to working with Congress and policy makers to discuss this issue and other details of the proposed legislation to ensure that ultimately we achieve a comprehensive, "smart" regulatory framework.

III. SYSTEMIC RISK REGULATION

The second area of regulation that I would like to discuss today is systemic risk regulation. Today, I would like to highlight what we believe are the key aspects of systemic risk regulation as well as offer some thoughts on some of the key aspects of the systemic risk framework set out in the Administration Proposal.

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets under management of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework. As policy makers and regulators seek to determine whether any individual hedge fund is of systemic relevance, however, it is important that consideration be given to the relatively small size of hedge funds compared to other financial institutions, the relatively low levels of leverage used by hedge funds, and the narrower focus of hedge funds. As institutional investors, hedge funds do not provide payment and settlement services to the public nor are hedge funds licensed to open bank accounts or brokerage accounts for the public. For these reasons, and others, hedge fund losses have not caused systemic risk during this global crisis.

As stated in my previous testimony, MFA believes that a systemic risk framework should have the following components:

- A central systemic risk regulator with oversight of the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis;
- Confidential reporting to a systemic risk regulator, from those entities that it determines (at any point in time) to be of systemic relevance, providing information that the regulator determines is necessary or advisable to enable it to adequately assess, on both a current and a forward-looking basis, potential risks to the financial system;
- A clear, singular mandate for the systemic risk regulator to protect the financial system, including the ability to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system, though such authority should be implemented in a way that avoids the unfair competitive advantages gained by market participants with a government guarantee and also avoids the moral hazards that can result from a company having a government guarantee; and
- Ensuring that the systemic risk regulator has adequate authority to enable it to be forward-looking to prevent potential systemic risk problems, as well as the authority to address systemic problems once they have arisen; and implements that authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products.

MFA believes that the above approach is generally consistent with the approach taken in the Administration Proposal. In particular, we are supportive of the Proposal's approach of creating a central systemic risk regulator, while creating a mechanism designed to foster greater communication and coordination among financial regulators. We also support risk reporting to the systemic risk regulator, though it is critical that such reporting be done on a confidential basis. We also generally support the Proposal's approach to systemic risk regulation, which calls for stronger regulation of systemically relevant firms, though we encourage policy makers to consider what type of heightened regulation is appropriate for different types of systemically relevant firms. Because there will likely be significant differences in the business models of systemically relevant firms, with different risks associated with those businesses, we believe appropriately tailored regulation of systemically relevant firms, rather than one-size-fits-all regulation of those firms, is the appropriate approach to systemic risk regulation. We look forward to continuing to work with Congress and the Administration in considering the details of a smart framework for systemic risk regulation.

IV. MARKET-WIDE ISSUES

As stated above, issues that are relevant across market participants should be considered in that broader context, rather than in the specific context of hedge funds. One such issue, which has been the focus of a great deal of discussion recently, is short selling, specifically the role of short selling in capital markets. Short selling, as recognized by the SEC "plays an important role in the market for a variety of reasons,

including providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities and, importantly, limiting upward market manipulations."[9] Similarly, the FSA has noted that short selling is, "a legitimate investment technique in normal market conditions," and "can enhance the efficiency of the price formation process by allowing investors with negative information, who do not hold stock, to trade on their information." In addition, short selling can "enhance liquidity by increasing the number of potential sellers," and increase market efficiency.[10] We strongly agree with the SEC and the FSA that short selling, along with derivatives trading, provides capital markets with necessary liquidity and plays an important role in the price discovery process. Markets are more efficient, and securities prices are more accurate, because investors with capital at risk engage in short selling.

Short selling and other techniques, including listed and over-the-counter derivatives trading, are important risk management tools for institutional investors, including MFA members, and essential components of a wide range of *bona fide* cash and derivatives hedging strategies that enable investors to provide liquidity to the financial markets. Additionally, hedged investors primarily use short sales and derivatives to prudentially reduce their long side investment risk, so this activity can enable such investors to invest more on the long side. Thus, when the SEC restricted short sales in late 2008, overall volume and investing declined, not just short sales.

We are supportive of providing proprietary nonpublic information to regulatory authorities on a nonpublic, confidential basis. We are concerned, however, that requirements that investors publicly disclose short position information, or that create the potential for public disclosure, would negatively reduce overall market efficiency by undermining the important role that short selling plays in providing liquidity and price discovery to markets. Public disclosure of short trades/positions can be misleading to the public as implying that an investor has a negative view regarding a particular public company stock when the opposite may be true, such as when the investor is primarily long and is using the short sale or short derivative as a prudential risk reduction hedge.

We believe that concerns which have led some to propose public disclosure of short positions could be substantially mitigated through effective, comprehensive reporting of short sale information by prime brokers and clearing brokers. Regulators could require short sales and short position information to be provided by brokers on an aggregate basis. A regulator could request specific information as to short sales and short positions of individual investors if it suspected or became concerned about manipulation of a particular security. Such reporting also would provide regulators with a more effective means by which to identify manipulative activity.

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9 Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008).

10 Temporary Short Selling Measures, FSA Consultation Paper 09/1 (January 2009), at page 4.

We commend the SEC for their thoughtful, deliberative approach to considering short sale regulation which included holding a roundtable on these issues and publishing notice and seeking comment on the proposals recently put forward. MFA has filed a comment letter in response to the SEC's short selling release.[11]

V. MARKET-BASED INITIATIVES

MFA and its members recognize the importance of a smart regulatory framework designed to protect investors, prevent systemic risk and ensure appropriate oversight by regulators. In addition to regulation, it is important for market participants to promote investor protection and limit systemic risk through high standards of business conduct, as reflected in industry best practices. MFA and its members are actively engaged in efforts to promote and implement those high standards. I would like to discuss two particular initiatives, MFA's *Sound Practices* and MFA's work on initiatives to reduce risks with respect to the credit default swaps market.

MFA's Sound Practices for Hedge Fund Managers

As mentioned earlier, MFA has been at the forefront of developing and promoting industry best practices through the recommendations in its *Sound Practices*. Over the past ten years, MFA and its members have regularly updated and enhanced *Sound Practices* to ensure that the recommendations in that document are at the forefront of best practices for the hedge fund industry. Most recently, MFA and other industry groups have developed global, unified principles of best practice for the hedge fund industry. These unified principles are designed to be applicable to hedge fund managers in all jurisdictions. MFA's *Sound Practices* contains robust recommendations that address, among other things, important investor protection considerations such as robust disclosure from managers as well as risk management, which can help guard against systemic risk concerns. Adoption of these recommendations by hedge fund managers will help managers develop strong business practices. Strong business practices are an important complement to regulation to achieve the goals of investor protection and prevent systemic risk.[12]

Credit Default Swaps

MFA and its members have also actively worked with other market participants and regulators to reduce risks and improve market efficiency and the operational infrastructure in the CDS market and other OTC derivatives markets. MFA and its members have played an important role in improving market practices through collaboration with global regulators (including the SEC, Commodity Futures Trading

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[11] MFA's comment letter is available at: http://www.managedfunds.org/downloads/MFA.Amendments%20to%20Reg%20SHO.6.22.09.pdf

[12] To assist investors in their diligence process, MFA has published a model due diligence questionnaire, which illustrates the types of information commonly requested by investors prior to investing. MFA's model DDQ is available at: http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf

Commission, Federal Reserve Bank of New York, FSA, Bank of England, Federal Financial Supervisory Authority (BaFin), Bank of Japan, European Central Bank, *et al.*), major OTC derivatives dealers, asset managers and other market participants. Specifically, MFA and its members currently engage in a myriad of initiatives, hold educational events and also participate in a number of projects that focus on standardizing transaction documentation and industry practices/conventions related to OTC derivatives trading.

Some of the more recent market improvements and risk mitigating measures in which MFA and its members have participated include:

- The reduction by 80% of backlogs of outstanding CDS confirmations since 2005;
- The establishment of electronic processes to approve and confirm CDS novations;
- The establishment of a trade information repository to document and record confirmed CDS trades;
- The establishment of an auction hardwiring completed April 8, 2009, to allow for auction-based settlement of CDS;
- More than 40 credit events have been processed globally since October 2008;
- The reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006;
- The first central counterparty ("CCP") for central clearing of CDS trades went live for U.S. index CDS as of March 2009 and, to date, has cleared U.S. $600 billion notional amount of CDS contracts;
- The roll out of a restructuring credit event protocol (also known as the "small bang" protocol) to further standardize CDS contracts for centralized clearing; and
- Major Dealer clearing will expand to European CDS by July 31, 2009.

The success of coordinated, industry initiatives with regulatory involvement is also evidenced by the relative speed in which the CDS market has grown. Although the CDS market emerged approximately ten years ago (which is relatively young as compared with other OTC derivatives and financial products), the majority of contracts have quickly achieved a level of standardization and trading efficiency that has made them amenable to centralized clearing. MFA and its members are generally supportive of clearing of standardized CDS contracts, provided that the CCPs are appropriately structured as discussed below. Recently, MFA and its members have been very involved in industry working groups that have been tasked to analyze ways in which asset managers and other customers of the Major Dealers can access one or more CCPs to centrally clear their standardized CDS contracts.

In a recent letter addressed to global regulators, the major OTC dealers, several asset management firms and industry trade associations (including MFA) proposed a

series of industry-wide best practices (the "Recent Industry Letter") to address key concerns raised by global regulators and legislators (notably the G20, European Commission and the U.S. Department of Treasury) regarding the risk profile and trading infrastructure of CDS and other OTC derivatives.[13] With respect to transparency concerns, the Recent Industry Letter provides that all market participants are strongly encouraged to report all CDS trades (both standardized and non-standardized CDS trades) by August 14, 2009 and other OTC derivatives trades based on an aggressive timeline. The purpose of this best practice, as reported in the Recent Industry Letter, is to assist global supervisors with oversight and surveillance activities related to the OTC derivatives market.

CONCLUSION

Hedge funds, as sophisticated institutional investors, have important market functions, in that they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. MFA and its members acknowledge that smart regulation helps to ensure stable and orderly markets, which are necessary for hedge funds to conduct their businesses. We also acknowledge that active, constructive dialogue between policy makers and market participants is an important part of the process to develop smart regulation. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Committee. I would be happy to answer any questions that you may have.

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[13] *See* Operations Management Group, Letter to William Dudley, President of the Federal Reserve Bank of New York, June 2, 2009, under the heading "Reporting of Trades in Central Repositories." A copy of the Recent Industry Letter is available at: http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html

ATTACHMENT A

§ 275.204-2 Books and records to be maintained by investment advisers.[1]

(a) Every investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3) shall make and keep true, accurate and current the following books and records relating to its investment advisory business;

(1) A journal or journals, including cash receipts and disbursements, records, and any other records of original entry forming the basis of entries in any ledger.

(2) General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts.

(3) A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

(4) All check books, bank statements, cancelled checks and cash reconciliations of the investment adviser.

(5) All bills or statements (or copies thereof), paid or unpaid, relating to the business of the investment adviser as such.

(6) All trial balances, financial statements, and internal audit working papers relating to the business of such investment adviser.

(7) Originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security:

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1 Available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6143582bf9cd6fce86a19b85a5c4fc21&rgn=div8&view=text&node=17:3.0.1.1.23.0.147.20&idno=17

Provided, however, (*a*) That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (*b*) that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof.

(8) A list or other record of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client.

(9) All powers of attorney and other evidences of the granting of any discretionary authority by any client to the investment adviser, or copies thereof.

(10) All written agreements (or copies thereof) entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such.

(11) A copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser), and if such notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication recommends the purchase or sale of a specific security and does not state the reasons for such recommendation, a memorandum of the investment adviser indicating the reasons therefor.

(12)

(i) A copy of the investment adviser's code of ethics adopted and implemented pursuant to §275.204A–1 that is in effect, or at any time within the past five years was in effect;

(ii) A record of any violation of the code of ethics, and of any action taken as a result of the violation; and

(iii) A record of all written acknowledgments as required by §275.204A–1(a)(5) for each person who is currently, or within the past five years was, a supervised person of the investment adviser.

(13)

(i) A record of each report made by an access person as required by §275.204A–1(b), including any information provided under paragraph (b)(3)(iii) of that section in lieu of such reports;

(ii) A record of the names of persons who are currently, or within the past five years were, access persons of the investment adviser; and

(iii) A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons under §275.204A–1(c), for at least five years after the end of the fiscal year in which the approval is granted.

(14) A copy of each written statement and each amendment or revision thereof, given or sent to any client or prospective client of such investment adviser in accordance with the provisions of Rule 204–3 under the Act, and a record of the dates that each written statement, and each amendment or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

(15) All written acknowledgments of receipt obtained from clients pursuant to §275.206(4)–3(a)(2)(iii)(B) and copies of the disclosure documents delivered to clients by solicitors pursuant to §275.206(4)–3.

(16) All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); *provided, however,* that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of d accounts shall be deemed to satisfy the requirements of this paragraph.

(17)

(i) A copy of the investment adviser's policies and procedures formulated pursuant to §275.206(4)–7(a) of this chapter that are in effect, or at any time within the past five years were in effect, and

(ii) Any records documenting the investment adviser's annual review of those policies and procedures conducted pursuant to §275.206(4)–7(b) of this chapter.

(b) If an investment adviser subject to paragraph (a) of this section has custody or possession of securities or funds of any client, the records required to be made and kept under paragraph (a) of this section shall include:

(1) A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts.

(2) A separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

(3) Copies of confirmations of all transactions effected by or for the account of any such client.

(4) A record for each security in which any such client has a position, which record shall show the name of each such client having any interest in such security, the amount or interest of each such client, and the location of each such security.

(c)

(1) Every investment adviser subject to paragraph (a) of this section who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

(i) Records showing separately for each such client the securities purchased and sold, and the date, amount and price of each such purchase and sale.

(ii) For each security in which any such client has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount or interest of such client.

(2) Every investment adviser subject to paragraph (a) of this section that exercises voting authority with respect to client securities shall, with respect to those clients, make and retain the following:

(i) Copies of all policies and procedures required by §275.206(4)–6.

(ii) A copy of each proxy statement that the investment adviser receives regarding client securities. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a copy of a proxy statement (provided that the adviser has obtained an undertaking from the third party to provide a copy of the proxy statement promptly upon request) or may rely on obtaining a copy of a proxy statement from the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

(iii) A record of each vote cast by the investment adviser on behalf of a client. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a record of the vote cast (provided that the adviser has obtained an undertaking from the third party to provide a copy of the record promptly upon request).

(iv) A copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision.

(v) A copy of each written client request for information on how the adviser voted proxies on behalf of the client, and a copy of any written response by the investment adviser to any (written or oral) client request for information on how the adviser voted proxies on behalf of the requesting client.

(d) Any books or records required by this section may be maintained by the investment adviser in such manner that the identity of any client to whom such investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some similar designation.

(e)

(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1)(i), inclusive, and (c)(2) of this section (except for books and records required to be made under the provisions of paragraphs (a)(11), (a)(12)(i), (a)(12)(iii), (a)(13)(ii), (a)(13)(iii), (a)(16), and (a)(17)(i) of this section), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

(2) Partnership articles and any amendments thereto, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

(3)

(i) Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication.

(ii) *Transition rule.* If you are an investment adviser to a private fund as that term is defined in §275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, paragraph (e)(3)(i) of this section does not require you to maintain or preserve books and records that would otherwise be required to be maintained or preserved under the provisions of paragraph (a)(16) of this section to the extent those books and records pertain to the performance or rate of return of such private fund or other account you advise for any period ended prior to February 10, 2005, provided that you were not registered with the Commission as an investment adviser during such period, and provided further that you continue to preserve any books and records in your possession that pertain to the performance or rate of return of such private fund or other account for such period.

(f) An investment adviser subject to paragraph (a) of this section, before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this section for the remainder of the period specified in this section, and shall notify the Commission in writing, at its principal office, Washington, D.C. 20549, of the exact address where such books and records will be maintained during such period.

(g) *Micrographic and electronic storage permitted.* —

(1) *General.* The records required to be maintained and preserved pursuant to this part may be maintained and preserved for the required time by an investment adviser on:

(i) Micrographic media, including microfilm, microfiche, or any similar medium; or

(ii) Electronic storage media, including any digital storage medium or system that meets the terms of this section.

(2) *General requirements.* The investment adviser must:

(i) Arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;

(ii) Provide promptly any of the following that the Commission (by its examiners or other representatives) may request:

(A) A legible, true, and complete copy of the record in the medium and format in which it is stored;

(B) A legible, true, and complete printout of the record; and

(C) Means to access, view, and print the records; and

(iii) Separately store, for the time required for preservation of the original record, a duplicate copy of the record on any medium allowed by this section.

(3) *Special requirements for electronic storage media.* In the case of records on electronic storage media, the investment adviser must establish and maintain procedures:

(i) To maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction;

(ii) To limit access to the records to properly authorized personnel and the Commission (including its examiners and other representatives); and

(iii) To reasonably ensure that any reproduction of a non-electronic original record on electronic storage media is complete, true, and legible when retrieved.

(h)

(1) Any book or other record made, kept, maintained and preserved in compliance with §§240.17a–3 and 240.17a–4 of this chapter under the Securities Exchange Act of 1934, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept maintained and preserved in compliance with this section.

(2) A record made and kept pursuant to any provision of paragraph (a) of this section, which contains all the information required under any other provision of paragraph (a) of this section, need not be maintained in duplicate in order to meet the requirements of the other provision of paragraph (a) of this section.

(i) As used in this section the term "discretionary power" shall not include discretion as to the price at which or the time when a transaction is or is to be

effected, if, before the order is given by the investment adviser, the client has directed or approved the purchase or sale of a definite amount of the particular security.

(j)

(1) Except as provided in paragraph (j)(3) of this section, each non-resident investment adviser registered or applying for registration pursuant to section 203 of the Act shall keep, maintain and preserve, at a place within the United States designated in a notice from him as provided in paragraph (j)(2) of this section true, correct, complete and current copies of books and records which he is required to make, keep current, maintain or preserve pursuant to any provisions of any rule or regulation of the Commission adopted under the Act.

(2) Except as provided in paragraph (j)(3) of this section, each nonresident investment adviser subject to this paragraph (j) shall furnish to the Commission a written notice specifying the address of the place within the United States where the copies of the books and records required to be kept and preserved by him pursuant to paragraph (j)(1) of this section are located. Each non-resident investment adviser registered or applying for registration when this paragraph becomes effective shall file such notice within 30 days after such rule becomes effective. Each non-resident investment adviser who files an application for registration after this paragraph becomes effective shall file such notice with such application for registration.

(3) Notwithstanding the provisions of paragraphs (j)(1) and (2) of this section, a non-resident investment adviser need not keep or preserve within the United States copies of the books and records referred to in said paragraphs (j)(1) and (2), if:

(i) Such non-resident investment adviser files with the Commission, at the time or within the period provided by paragraph (j)(2) of this section, a written undertaking, in form acceptable to the Commission and signed by a duly authorized person, to furnish to the Commission, upon demand, at its principal office in Washington, DC, or at any Regional Office of the Commission designated in such demand, true, correct, complete and current copies of any or all of the books and records which he is required to make, keep current, maintain or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in such demand. Such undertaking shall be in substantially the following form:

The undersigned hereby undertakes to furnish at its own expense to the Securities and Exchange Commission at its principal office in Washington, DC or at any

Regional Office of said Commission specified in a demand for copies of books and records made by or on behalf of said Commission, true, correct, complete and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Securities and Exchange Commission under the Investment Advisers Act of 1940. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all of said books and records at a place within the United States in compliance with Rule 204–2(j) under the Investment Advisers Act of 1940. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the Securities and Exchange Commission shall extend to and cover any action to enforce same.

and

(ii) Such non-resident investment adviser furnishes to the Commission, at his own expense 14 days after written demand therefor forwarded to him by registered mail at his last address of record filed with the Commission and signed by the Secretary of the Commission or such person as the Commission may authorize to act in its behalf, true, correct, complete and current copies of any or all books and records which such investment adviser is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the Commission adopted under the Act, or any part of such books and records which may be specified in said written demand. Such copies shall be furnished to the Commission at its principal office in Washington, DC, or at any Regional Office of the Commission which may be specified in said written demand.

(4) For purposes of this rule the term *non-resident investment adviser* shall have the meaning set out in §275.0–2(d)(3) under the Act.

(k) Every investment adviser that registers under section 203 of the Act (15 U.S.C. 80b–3) after July 8, 1997 shall be required to preserve in accordance with this section the books and records the investment adviser had been required to maintain by the State in which the investment adviser had its principal office and place of business prior to registering with the Commission.

(l) *Records of private funds.* If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in §275.203(b)(3)–1), and the adviser or any related person (as defined in Form ADV (17 CFR 279.1)) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Act (15 U.S.C. 80b–4).

TESTIMONY OF WILLIAM J. BRODSKY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CHICAGO BOARD OPTIONS EXCHANGE

CONCERNING THE ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSAL

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

July 17, 2009

Mr. Chairman and members of the Committee, I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange, Inc. ("CBOE"). For the past 35 years, I have served in leadership roles at major U.S. stock, futures and options exchanges, including 11 years as CEO of the Chicago Mercantile Exchange and 12 years in my current role as CBOE Chairman and CEO.

Exchange-traded options have become a major component of the U.S. -- and the world's -- financial markets. In 2008 over 3.6 billion options contracts traded on the seven U.S. options exchanges, an increase of 25% over 2007. This was the fifth consecutive year that volume growth has exceeded 25%. The annual number of contracts traded has tripled over that five-year period, outstripping the growth in both stock and futures trading. This dramatic growth is a reflection of the expanding use of options as a tool for managing the risk of owning stocks, Exchange Traded Funds (ETFs) and mutual funds and also reflects the highly competitive environment in which exchange-traded options are traded.

In addition to my role at CBOE, I am currently serving as chairman of the World Federation of Exchanges (WFE), a 49-year old organization, which is based in Paris and includes over 50 of the world's major regulated stock, futures and options exchanges. WFE promotes the highest standards of market integrity by working on a global basis with policy makers, regulators and government organizations for fair, transparent and efficient markets. The fact that the CEO of a derivatives exchange has been elected Chairman of the WFE illustrates the heightened role that exchange-traded derivatives now play in the global financial system.

Throughout my career at exchanges, I have witnessed and participated in many meaningful improvements in the efficiency, functionality and value of our exchange markets. Following the 1987 stock market crash, U.S. exchanges made significant enhancements to market infrastructure and resiliency, but very little changed in the way of regulatory oversight despite the Brady Report, the seminal presidential study of the crash, which found that our regulatory system was already sorely outmoded when the markets fell precipitously in 1987.[1]

The regulatory system deemed antiquated in 1987 remains in place today, but now labors under the weight of increasingly sophisticated technology and instruments that trade around the world in less than a blink of an eye. The ongoing failure to modernize our regulatory system has resulted in a disjointed,

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[1] See attached *The Wall Street Journal* op-ed of October 19, 2007, "A Real Regulatory Redundancy."

overlapping situation that causes bottlenecks in some markets, unregulated gaps in others, and lacks entirely an overarching regulatory perspective.

While reasonable people may disagree on the best ways to create a 21st century system for market regulation, there is clearly a national consensus that retaining the status quo is not an option. Congress should not squander the opportunity afforded by this broad public consensus to design and mandate regulatory reforms that are long overdue.

I am honored to share our perspective in today's testimony on the Administration's proposal for financial regulatory reform ("Reform Proposal"). At the outset, I would like to commend the Administration for the progress made in drafting a proposal that seeks comprehensive regulatory reform. My testimony will focus primarily on the harm caused by the split jurisdiction between securities and futures in the U.S. and the partial, but incomplete, steps the Reform Proposal takes to address this situation. I will touch on certain other aspects of the Reform Proposal of particular interest to CBOE, as well.

Throughout the financial crisis of the past year, regulated exchanges, not only in the U.S. but also around the world, provided important investor safeguards, such as transparency, price discovery, certainty of execution and protection against counterparty risk through centralized clearing. Despite credit failures, bank and brokerage meltdowns, extreme market volatility, and the imposition of emergency short sale rules, exchanges continued to provide transparent, liquid and orderly marketplaces – without interruption – and continued to fulfill the essential functions of capital formation and risk management. In the midst of a financial tsunami when precious few financial institutions "worked," regulated exchanges promised as delivered: no failures, no closures, no taxpayer rescues.

The reliability of regulated exchanges amidst recent market turmoil belies the fact that the ongoing effectiveness of many of our nation's exchanges is severely compromised by the yoke of a cumbersome regulatory system. Indeed, perhaps no area of regulation has longer been in need of a structural fix than that of the bifurcated system of regulating exchange-traded financial products in the U.S. To the extent that we ignore this reality, we place at peril the ongoing ability of the U.S. to operate and compete effectively in an increasingly global and sophisticated marketplace.

We are particularly gratified, therefore, that the Administration's Reform Proposal not only addresses the immediate and urgent issue of under-regulation of OTC derivatives, but also acknowledges the need to address those areas of existing regulation, such as the SEC/CFTC jurisdictional divide, which are dangerously antiquated.

It has become increasingly clear over the past two decades that our system of regulating securities and futures under two distinctly different statutory structures – with separate regulatory agencies and different congressional committees -- causes needless legal uncertainty and delay, impedes innovation and competition, and imposes unnecessary costs on our financial markets.

Since the enactment in 1974 of amendments to the Commodity Exchange Act, which gave the Commodity Futures Trading Commission ("CFTC") jurisdiction over all futures, there have been conflicts between the CFTC and the Securities and Exchange Commission ("SEC") as to their respective jurisdictions, particularly involving financial instruments that have elements of both securities and futures. This is a result of divided jurisdiction in which the SEC has oversight of "securities," including stocks, bonds, mutual funds and options on these instruments or an index of such instruments, and the CFTC has jurisdiction over "commodities," which is very broadly defined and includes futures on securities indexes or government securities.

The vesting of jurisdiction over futures and commodity options in the CFTC was developed at a time when the futures markets traded contracts almost exclusively on traditional commodities, such as agricultural products and metals, so that a separate agency sprung from the Department of Agriculture was deemed appropriate for this specialized segment of the market. However, the bifurcated system was already outmoded by the 1980s, when the "commodities" markets began trading contracts on a variety of financial instruments, including stock indexes, foreign currencies, and government securities. Attempts to clarify the jurisdictional boundaries of the SEC and CFTC, such as the Shad-Johnson Accord in 1982, merely addressed the then existing issues but in no way resolved the ongoing philosophical differences between the two agencies.

As the Reform Proposal clearly outlines, the differing missions of the SEC and CFTC, as well as the separate statutes under which they operate, mean that futures and comparable securities products are not regulated in a consistent manner. This has led to conflict between the agencies when both are involved in a default or malfeasance by a large market participant, as evidenced by the different approach the two agencies took two years ago with respect to the problems surrounding the failure of Sentinel Management Group, Inc.[2] In

[2] Sentinel was both an investment adviser registered with the SEC and a futures commission merchant registered with the National Futures Association. When questions arose as to the disposition of certain funds held by Sentinel on behalf of various futures commission merchants ("FCMs") and other clients, the SEC and the CFTC took very different positions. While the SEC sought to freeze the proceeds in all Sentinel accounts (which it asserted had been improperly commingled) for the ultimate benefit of injured investors (including, but not limited to, the affected FCMs), the CFTC sought to ensure that

addition, the lack of an insider trading prohibition for CFTC products potentially enables a miscreant to use such instruments to engage in transactions using inside information when otherwise prohibited from doing so using securities. This disparity will take on increasing importance with the growth of credit-related instruments. On an ongoing basis, the bifurcated regulatory system has led to persistent negative consequences for our markets -- it creates regulatory inefficiencies, hampers competitiveness, and impedes innovation. No other major country with well-developed derivatives markets uses a system of two different government agencies regulating equivalent financial products.

New Products

CBOE is known throughout the world as a wellspring of options innovation and has engineered virtually every major options innovation since launching the options industry in 1973. It is not surprising, therefore, that the most vexing aspect of the U.S. regulatory structure to CBOE is that the split jurisdiction and different governing statutes has led to delays in bringing new products to market. Legal uncertainties frequently arise because a novel aspect of a new securities derivative product could cause the CFTC to claim that the product has elements of a futures contract, and a novel aspect of a new futures product could cause the SEC to claim the product is a security. This can result in an interminable delay in bringing a new product to market while the two agencies try to decide who has jurisdiction over the instrument.

Product delays have occurred repeatedly over the past 20 years when CBOE attempted to introduce a novel product. For example, CBOE had two new product proposals -- one involving an option on an exchange traded fund that holds investments involving gold and one involving an option on a credit default product -- both placed on hold for an extremely long period of time (3½ years in the case of Gold ETFs and 7 months for the credit default product) because the two agencies could not agree on jurisdiction. In contrast, Eurex (Europe's largest derivatives exchange) was able to introduce a credit default product in Europe within weeks of announcing its intention to do so, and well before the U.S. exchanges had approval to introduce their credit default products in the U.S. due to the disagreement between the two agencies.

Clearing

Legal uncertainties caused by duplicative regulation also impede the clearing of new products. The Options Clearing Corporation (OCC), the clearing agency

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the FCMs were given access to their (or their customers') funds that had been in a segregated account in order to preserve the integrity of the futures markets and prevent a potentially broader, market-wide collapse.

for the seven U.S. options markets and the world's largest derivatives clearing house, clears exchange-traded derivative products and is registered with both the SEC and the CFTC. OCC clears securities options, which are under the jurisdiction of the SEC, security futures, which are jointly regulated by the SEC and CFTC, and futures, which are under the jurisdiction of the CFTC. OCC is the only U.S. clearing organization with the ability to clear all of these products within a single clearing organization, which provides for greater operational efficiency and, hence, reduces systemic risk in the clearing and settlement process. However, because of its dual registration, the OCC is subject to the jurisdiction of the CFTC, as well as that of the SEC, every time it introduces a new securities option product.

Although the CFTC operates under a self-certification process by which OCC could certify that a particular new product does not fall within the jurisdiction of the CEA, there are cases where there is genuine ambiguity as to where the jurisdictional line lies. In such cases, OCC has felt compelled to ask for prior approval of both agencies in order to avoid the risk of litigation after trading has begun. Split jurisdiction forces OCC to operate under this cumbersome process, thus inhibiting common clearing by a third party guarantor even though the benefits of centralized clearing were dramatically highlighted by the recent crisis. By contrast, futures exchanges and their captive clearing houses have no concomitant need to pre clear their new products with the SEC.

Margins

The problems from divided jurisdiction go beyond our pressing concerns about legal uncertainty for new products. U.S. financial firms are subject to duplicative and disjointed oversight from separate agencies when trading virtually equivalent products. Key investor protection and market soundness provisions, such as margin levels, are handled very differently by the two agencies for similar products. A concrete example of the harm this causes to our markets involves portfolio margining.

In 2007, the availability of portfolio margining was greatly enhanced for securities customers, including those who trade security futures, through expansion of an existing portfolio margin pilot program approved by the SEC. This expanded pilot includes equity options, security futures and individual stocks as instruments eligible for portfolio margining. The pilot enhances U.S. competitiveness by bringing the benefits of risk-based margining employed in the futures markets, and in most non-U.S. securities markets, to U.S. securities customers. The exchange rules adopting this pilot also authorized the inclusion of related futures positions in securities customer portfolio margining accounts.

The ability to margin all related instruments in one account would allow customers to fully realize the risk management potential of these instruments in a way that is operationally and economically efficient. However, legal impediments that prevent putting those futures positions in a securities customer portfolio margining account significantly undercut the ability of customers to fully realize the capital efficiencies of portfolio margining. For over four years, the SEC and CFTC have been unable to agree on how to permit futures to be included in a securities portfolio margin account. Because the two agencies continue to disagree on the most appropriate approach to implementing portfolio margining, the ability of many customers to employ portfolio margining between futures and securities has been stymied. Unless this deadlock is broken, portfolio margining will not reach its full potential in the United States, even though it is used in many jurisdictions abroad.

Financial Regulatory Oversight Council

We support the Reform Proposal's recommendation for the creation of a Financial Regulatory Oversight Council (FSOC), chaired by Treasury, to resolve potential disputes between the two agencies.

The FSOC would replace the President's Working Group on Financial Markets and maintain a permanent staff at Treasury. Among its responsibilities, the FSOC would help facilitate coordination of policy and resolution of disputes among the agencies. Currently, there is no real dispute mechanism in place other than sporadic dialogue between the two agencies. This has led to long delays in the decision-making process, which hinders competitiveness to the detriment of investors and our markets. This is not intended to imply that, when disputes do arise, either agency is not putting forth a good-faith effort to resolve them. Instead, each earnestly believes that it is properly applying its statute when analyzing a particular jurisdictional issue. The impasses that frequently arise may be the natural result of the differing, and sometime conflicting, philosophies of the securities laws and commodities laws. No matter how well intentioned the cause, a neutral arbiter is needed to resolve an impasse.[3]

We believe that the Treasury Department is well versed in the issues typically presented in jurisdictional disputes and is thus ideally suited to resolve them. Prompt resolution of jurisdictional disputes is extremely important to be able to bring new products to market quickly or to facilitate approval of new market mechanisms so that the U.S. capital markets can maintain their global

[3] Last year the SEC and CFTC entered into a Memorandum of Understanding ("MOU") on the review of products that raise jurisdictional issues. We believe that the MOU is not an effective mechanism to resolve jurisdictional disputes where the two agencies have strongly differing views on an issue.

competitiveness. In addition, we strongly recommend that the Exchanges, as self-regulatory organizations (SROs), be authorized to bring issues directly before the Council for resolution.

Harmonization

The Reform Proposal recognizes that split regulation is outmoded and harmful, and for this reason offers constructive steps toward addressing the situation. Specifically, the Reform Proposal recommends that the statutory and regulatory regimes for futures and securities be harmonized.[4] Harmonization may reduce the disparities between regulation of securities and futures, and we commend the Administration for recommending this important initiative and urge Congress to adopt it. While harmonization of the securities and futures statutes would represent a vast improvement, we believe it is only the first step -- albeit a critically necessary one -- toward ending bifurcated jurisdiction.

We have serious concerns about how much harmonization can truly occur between two separate agencies.[5] Even in the most hopeful of outcomes, with optimal harmonization of the securities and futures laws, the existence of two separate agencies, with differing philosophies, will continue to foster conflicting interpretations and enforcement of the same laws, perpetuating disjointed regulation, duplication of efforts, regulatory uncertainty, and delay.

Consolidation

While there are interim steps that can be taken to dampen some of the ill effects of divided jurisdiction, consolidation of the agencies is the only truly comprehensive solution. Any rational, unbiased, assessment of the bifurcated regulatory system would lead to this conclusion. In calling for a merger, we do not want to suggest that the securities system of regulation is preferable to the futures system, or vice versa, or that the SEC should take over the CFTC. Each

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[4] Pursuant to the Reform Proposal, the SEC and the CFTC would retain their current responsibilities and authorities as market regulators, although the Administration proposes to "harmonize the statutory and regulatory frameworks for futures and securities." In that regard, the Reform Proposal notes that "[w]hile differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified," suggesting that there are gaps and inconsistencies in the regulation of derivative instruments by these two regulators that should be rectified.

[5] For example, the securities and futures markets use very different models for clearance and settlement. The securities options markets employ a common clearing structure that facilitates the development of competing exchanges. In contrast, the futures markets use a captive clearinghouse model where a product traded on an exchange must be cleared through an affiliated clearinghouse. It is unlikely that separate securities and futures regulators could reach an agreement to harmonize these two clearing models.

system has its pluses and minuses and CBOE has, and could continue to, operate under either. What we should not continue to tolerate is the inefficient and ineffective dual structure currently in place.

Other Issues

Aside from the jurisdictional issues, we would like to touch upon several other issues discussed in the Reform Proposal. First, we agree with the Reform Proposal's recommendation that a single authority, such as the Federal Reserve Board, should supervise all firms that could pose a risk to financial stability. The events in our financial markets over the past two years underscore the need for a single body to have ultimate oversight over the broad risks in our financial system. In creating such an oversight role, however, we need to be careful not to drain away the existing and important role that the SEC, CFTC, and Treasury play in monitoring for risk issues in their respective areas.

Second, we agree with the Reform Proposal that greater regulatory oversight is needed for OTC derivatives. These products serve many useful functions, but will continue to introduce significant risks into the financial system if left unregulated. The determination of which agency should be responsible for regulation of these products will be a key issue. The split jurisdiction between the SEC and CFTC may introduce an unnecessary complication in creating efficient regulation of these products, once again highlighting the compelling need for a merger of the two agencies. In order to avoid some of the harm of split jurisdiction, the most sensible path, at a minimum, would be to vest jurisdiction over all OTC derivatives involving *securities* (including corporate events) with the SEC.[6]

Third, given the very real competitive disadvantages to securities exchanges caused by unnecessary delays in bringing a new product to market or in making adjustments to trading systems, we applaud the Proposal's recommendation that the SEC should overhaul its process for reviewing proposed rule changes by self-regulatory organizations to allow more SRO rule filings to become effective on filing.

Conclusion

CBOE believes that review of the Reform Proposal provides an opportunity to bring needed changes to the U.S. regulatory landscape in order to promote the competitiveness of U.S. financial markets. Congress should promptly adopt the

[6] Our concerns regarding the need for regulating OTC derivatives date to my testimony in April of 1997. See attached testimony.

harmonization and FSOC recommendations of the Reform Proposal, as well the proposal's call for the SEC to streamline its SRO rule approval process. Taking these steps will at least help our markets remain competitive in the global marketplace until we are able to complete a more comprehensive reform.

CBOE, WFE, and I, personally, stand ready to work with the Committee and its staff as it considers these important issues. Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions you may have.

OPINION

A Real Regulatory Redundancy

By William J. Brodsky

Today marks the 20th anniversary of the 1987 crash, when the U.S. stock market dropped 22% in a single day, capping a week where it lost a third of its value. This event shocked market participants and caused the greatest crisis in confidence in the stock market in 50 years. Multiple studies were done to investigate the causes of the crash and to suggest actions to restore investor confidence in U.S. financial markets.

Today the Dow Jones Industrial Average hovers near 14,000, almost *seven times* the DJIA value at the time of the 1987 crash. Trading volume in stocks, options and financial futures on an average day dwarfs the volume that overwhelmed the markets during the crash. In many ways, the strength of our financial markets is due to improvements implemented to the infrastructure of the securities and derivatives markets as a result of the crash, as well as to the transition to electronic from manual trading.

Although improvements were made to the overall resiliency of our markets in the wake of the 1987 crash, a troubling aspect of our regulatory system persists today and continues to threaten the soundness and competitiveness of our markets: Regulation of equivalent financial instruments continues to be divided between two agencies, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

The SEC regulates "securities," which include stocks, bonds, mutual funds and options on these instruments. The CFTC regulates "commodities," which include futures on financial instruments. As a result, options on stocks and stock indexes come under the SEC's purview and are subject to securities laws, while futures on similar instruments fall within the CFTC's area and are subject to a completely separate regulatory and statutory regime.

This structure was developed in the 1970s when the futures markets traded contracts almost exclusively on traditional commodities such as grains and metals. A separate agency sprung from the Department of Agriculture was deemed appropriate for "this specialized segment of the market."

The bifurcated system was already outmoded when the market crashed in 1987. At that time, the "commodities" futures markets were already trading contracts on a variety of financial instruments, including stock indexes, foreign currency and government securities. The quaint divide between commodities and securities no longer held up. Indeed, the presidential study of the crash, the Brady Report, found that the markets for stocks, options, and futures were actually one market and should come under the overarching purview of a single regulatory agency.

> Why have two agencies to govern equivalent financial products? The result is less innovation.

Fast-forward 20 years, and the problems with divided regulation have intensified. Today's CFTC-regulated "commodities" markets have become primarily markets for futures on financial instruments and options on those futures. Yet, the divided regulatory and statutory system remains intact.

This structure hampers the competitiveness of U.S. financial markets, impedes innovation and creates serious public-policy concerns. No other country uses such a structure.

For over 30 years the divided jurisdiction has created needless legal uncertainty as to the status of new financial products. Any novel derivative that hints of a futures contract must be vetted by the SEC and the CFTC as to its legal status. The result often is an interminable delay as the two agencies try to decide which has jurisdiction over the product.

For example, our exchange, the Chicago Board Options Exchange, filed a proposal in June 2005 with the SEC to trade options on exchange-traded funds that invest in gold. The proposal has gone nowhere because the SEC and CFTC are still trying to decide, more than two years later, who should regulate the product. Markets overseas do not have this problem and, as a result, often trade new derivative products long before they are available in the U.S.

The public-policy issues from the system are numerous. U.S. financial firms are subject to duplicative and disjointed oversight from separate agencies when trading virtually equivalent products. Key investor protection and market soundness provisions, such as margin levels, are handled very differently by the two agencies for similar products. Disputes arise on managing market events.

For example, when Sentinel Management Group experienced problems this summer, the SEC and the CFTC clashed in court as to how to dispose of client funds held by Sentinel. The judge in the matter asked, "Why doesn't this agency of government go over and talk to this [other] agency of the government and get your act together, for crying out loud?"

Any rational, unbiased assessment of the bifurcated regulatory system leads to the conclusion that there should be a single agency. Recently Mary Schapiro, who has served both as chairman of the CFTC and as acting chairman of the SEC, called the U.S. oversight regime a "spaghetti bowl" of regulators and questioned the sense of having two separate regulatory agencies.

Combining the SEC and CFTC into a single agency (or even creating a new agency) has been a much-needed fix for the past 20 years. The combination of the two agencies has failed to occur for one reason: congressional turf. The SEC and CFTC are overseen by different committees in Congress, none of which wants to lose jurisdiction in the event of a merger of the agencies.

It is high time to end the congressional roadblock to addressing a problem that impedes the competitiveness of our markets and compromises investor protection. Combining oversight of the two agencies under a single committee in each chamber of Congress, and allowing these committees to address this pressing need, is one way to bypass the roadblock.

In calling for a single agency, I do not seek to favor one agency over the other. I believe the Chicago Board Options Exchange could readily live under the statutory and regulatory oversight of a properly constituted federal agency. What we cannot, and should not, tolerate is being subject to the ongoing duplication, uncertainty, and delay that results from divided jurisdiction under two agencies.

The Treasury Department currently is conducting a study of the competitive issues facing U.S. financial markets and has included this issue as part of its study. I am very encouraged by this, and hope that members of Congress likewise give this issue serious consideration. It should not take another catastrophic market event to spur Washington to do the right thing.

Mr. Brodsky is chairman and CEO of the Chicago Board Options Exchange. He previously served from 1985-1997 as CEO of the Chicago Mercantile Exchange. This article was adapted from his recent testimony before the House Agricultural Committee on Risk Management.

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Testimony
April 16, 1997

House of Representatives
Agriculture
Risk Management and Specialty Crops

Revision of Commodity Market Regulations

Testimony of William J. Brodsky,
Chairman and Chief Executive officer
Chicago Board Options Exchange
Regarding H.R. 467
The Commodity Exchange Act Amendments of 1997
Subcommittee on Risk Management and Specialty Crops
Committee on Agriculture
United States House of Representatives
April 16, 1997

I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange ("CBOE"). I appear today on behalf of CBOE and nine other securities self-regulatory organizations: the American Stock Exchange, the Boston Stock Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, the National Association of Securities Dealers, the New York Stock Exchange, the Pacific Exchange, the Philadelphia Stock Exchange and The Options Clearing Corporation.

We welcome this opportunity to provide our views on H.R. 467. Our essential message is that the Shad-Johnson Accord, codified as Section 2(a)(1)(B) of the Commodity Exchange Act ("CEA" or "Act"), is well-considered legislation. The underpinnings of the Accord are as valid - if not more so - today as when it was originally enacted. We fully agree with SEC Chairman Levitt, who has stated that any amendments that fundamentally affect Shad-Johnson "should be enacted only after the type of consultation and cooperation displayed by the Commission, the CFTC, and their oversight committees in reaching the Accord in 1982."[1] Therefore, we believe that the Commit--tee should add a savings clause in Section 102 of H.R. 467 to make certain that the proposed professional market transactions exemption does not affect Shad-Johnson.

[1] Letter dated February 12, 1997 from Arthur Levitt, Chairman, SEC, to Senator

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Richard Lugar, Chairman, Senate Committee on Agriculture.

Equities are Different
The U.S. equity securities markets are unique among equity markets around the world and are a pillar of strength in our economy. The Chairman of the NYSE: has noted that: [n]o other nation has as large or as diverse a body of shareowners as the United States, with its more than 50 million individual shareholders --n addition to more than 10,000 institutional investors. The breadth of participation in the United States is a unique source of strength for the American market . . . [T]he U.S. individual investor community is immense and . . . it not only spans the nation geographically, but also spans a very broad segment of the economic spectrum.[2]

[2] NYSE Share ownership 1995, Preface by Richard A. Grasso, Chairman and Chief Executive Officer, NYSE 2(1995).

According to a recent survey by The Nasdaq Stock Market, 43% of American adults either own stock in individual companies or mutual funds. [3] Money continues to be invested in equity securities at a brisk rate. This includes money from pension funds, IRA's, 401-K's and similar sources representing much of the accumulated wealth of our nation, and the savings and financial security of our workers. Indeed, the financial well-being of the nation, both short-term and long-term, is more and more dictated by stock market movements. The stock market is a unique American strength, and the stability of this national asset is a paramount concern.

[3] A National Survey Among Stock Investors, Conducted for the Nasdaq Stock Market by Peter D. Hart Research Associates 2(1997).

The market break of 1987 made it clear that the equities and equity derivatives markets are, in fact, one interrelated market. Thus, the creation of an unregulated "shadow" market in equity derivatives and equity futures could profoundly affect the underlying cash equity securities markets. Ever since the market break, the SEC, the CFTC, the Treasury Department, and the Federal Reserve and the affected SROs have worked toward improving the self-regulatory system and coordinating regulatory activities. After great thought, and, in some cases, experimentation, a number of new measures -- such as circuit breakers, information sharing arrangements, and other emergency measures to safeguard orderly markets were developed and implemented to protect the equity securities markets from systemic risk. We would be ignoring --he lessons we have learned since 1987 if we permit the creation cf an equity derivatives market outside these market coordination measures. Their effectiveness has been proven, and Congress should not take action that could diminish that effectiveness.

The Desirable Level of Regulation
A central focus of this committee should be whether the deregulation proposed in H.R. 467 would generate unacceptable risk to the nation's equity securities markets. The current securities regulatory scheme is the result of over 60 years of development. It is a regulatory scheme that has achieved a high level of investor confidence, making the U.S. equity markets pre-eminent in the world. We believe

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that to interject new instruments - swaps and futures on individual equities and narrow-based equity securities indices -- that could fall completely outside this regimen, is unjustified, unwise, and poses a serious threat to the integrity of this nation's organized and regulated securities markets. Such a fundamental step should not be taken without a strong economic justification for doing so and sound empirical evidence showing that such a step would not adversely affect the underlying securities markets. Indeed, the SEC, in its testimony regarding S. 257, the Senate companion bill to H.R. 467, voiced its strong opposition to the proposed "professional markets" exemption in that bill. The SEC stated that such provisions: would expose futures markets to additional risk of manipulation, call into question the validity of the exchanges as price discovery mechanisms, and place undo pressure on clearing mechanisms for both professional market and retail market transactions. These provisions also would undermine the SEC's ability to regulate trading and detect fraud in the various securities underlying the futures and options to be traded in the professional markets.

Exemption for Professional Markets
Section 102 of the bill provides for an exemption from "all" provisions of the CEA--including the Shad-Johnson Accord--for transactions that "are or may be subject to th[e] Act" so long as they are between "appropriate persons" as defined in Section 4(c) of the Act. These exempt transactions would be subject only to antifraud and antimanipulation rules promulgated by the CFTC. Further, OTC transactions effected under the exemption cannot be submitted to and clearinghouse or clearing system that has not been approved by the CFTC. The proposed definition of "appropriate persons" is so broad that it has been estimated that 90% of current futures trading volume would be exempt under this provision.

We are strenuously opposed to this provision of H.R. 467 as it relates to equity-related products. While we have been informed that Section 102 is not intended to affect the status quo with regard to products covered by the Shad-Johnson Accord, this intention is not reflected in the language of the section. An attachment to our testimony suggests minor changes to Section 102--the addition of a Shad-Johnson savings clause--that would reconcile the language and intention of the provision. The issues raised by modifying or repealing the Accord, as is done in Section 102 of the bill are profound and difficult. In our view, if Congress believes that reconsideration of the Shad-Johnson Accord is necessary, it should instruct the CFTC and SEC, in --consultation with the Department of the Treasury and the Federal Reserve Board, to revisit the Shad-Johnson Accord and report any recommendations for amendments to the Accord to Congress. Any such recommendations should then be fully considered by all relevant committees of jurisdiction. Such a deliberate, careful process is preferable to affecting the Accord in the context of a general exemptive provision.

On-Exchange Transactions
Unless modified as we have suggested, Section 102 of H.R. 467 would permit exchange trading of futures on individual stocks and equity indices by "appropriate" persons virtually free of any regulation. These transactions are now prohibited by Section 2(a)(1)(B) of the CEA. We are unalterably opposed to any exemption from Shad-Johnson for new or existing products and urge you not to permit equity-based derivative products to trade on a professional exchange market. The policy concerns

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--hat led Congress to prohibit futures on individual stocks and narrow-based indices and to impose special requirements on futures on broad-based indices pursuant to the Shad-Johnson Accord in 1982 have not changed, and apply with equal force to new and existing equity-based derivative products. In our view, exemption from Shad-Johnson would entail grave risk to the underlying securities markets without providing appreciable benefits to investors.

Permitting futures on individual securities, narrow-based indices or broad-based indices to trade on a professional market could undermine securities laws to the detriment of market integrity and investor confidence. Shad-Johnson represents a careful balancing of the securities and futures regulatory structures. Yet, even in fully-regulated markets, differences between the futures and securities regulatory regimes are significant. These differences make it essential for the SEC to play a role in any decision to permit trading in these types of securities-related products, to assure coordinated regulation of all securities and related products. [4]

[4] We do not contend that the securities regulatory scheme is inherently better than the futures regulatory scheme. However, these regulatory schemes developed differently in order to address the different public policy issues posed by securities and futures.

For example, a significant number of retail investors participate in the securities markets while this is not the case in the futures markets. Our concerns are magnified by the current proposal to offer these products without any federal government oversight other than the antifraud and antimanipulation rules promulgated by the CFTC. While we are all self-regulatory organizations and believe deeply in the value of self-regulation, we do not believe that self-regulation alone is sufficient to protect our nation's securities markets. Self-regulators cannot, for example, command coordination, information sharing or appropriate action from non- members.

The professional markets exemption would permit the futures exchanges to unilaterally opt out of whatever aspects of the CEA they felt were burdensome or inconvenient. These could include intermarket circuit breakers, margin requirements, front-running rules, recordkeeping requirements and audit trail requirements. While we believe that customers would ultimately reject a market without these protections, great damage could be done to the underlying securities markets in the interim. We do not believe that the nation's securities markets should be subject to such experimentation. The nation's wealth and financial security is inexorably linked to the securities market and it would be reckless to permit unprotected experimentation in this market. H.R. 467 also creates ambiguity with respect to the requirement of Shad-Johnson that all futures on securities be traded only on a contract market that has been designated after specified findings are made by the SEC. The changes contemplated by section 103 could be interpreted as permitting a designated contract market to trade in its exempt professional market any futures contract that had been previously approved for its regulated market. Such a result would obviously be inconsistent with the intent of section 104 of the bill, which makes it clear that the expedited designation procedures are not to apply to futures contracts covered by Shad-Johnson. Further, permitting

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currently designated stock index futures to trade on a professional market would render meaningless the efforts of Congress, the SEC, CFTC, international regulators and market participants themselves to enhance intermarket coordination since the market break of 1987.

We urge the Committee to except both new and existing Shad-Johnson products from the exemption for professional markets.

OTC Transactions
The broad exemption contained in Section 102 significantly expands the exemptions for swaps and hybrid instruments promulgated by the CFTC in 1993. First, the CFTC's Part 35 exemption for swaps has been transformed into an exemption for any "agreement, contract, or transaction" if the only parties are "appropriate persons," without regard to whether they are part of a class of fungible, standardized instruments or to the creditworthiness of the parties or to whether the transaction is effected through a multilateral execution facility. Providing an open-ended regulatory exemption from the CEA for all equity-based OTC transactions puts the current regulatory system at high risk. This broad exemption has within it the seeds of great danger. Limiting the Section 102 exemption to the same instruments and the same conditions as the CFTC's Part 35 exemption would address this concern. This leads to a second, and more important concern: any product that qualifies for the Section 102 exemption would be exempt from the Shad-Johnson Accord. Those favoring such an exemption believe that this would enhance legal certainty for equity swaps and equity-based hybrids, which they could then market on a wide-scale basis. In contrast, we believe that this would likely lead to the proliferation of these products outside an appropriate regulatory scheme, thereby creating an unacceptable risk for the securities markets.

We currently know little about the breadth and scope of the equity swap market. Unlike the interest rate and currency swap markets, the equity swap market is not well developed. However, anecdotal evidence indicates that the domestic market for equity swaps is minuscule. We are not aware of any research on the potential effect of large-scale development of this market on the underlying equity securities. Therefore, there is no basis to conclude that there can be an unbridled expansion of this unregulated market without having a deleterious effect on the underlying securities market.

The reason we have little information on equity derivatives is because the market is unregulated, and the entities engaged in this business have never provided reliable or comprehensive information as to its nature and extent. Firms that belong to the Derivatives Policy Group submit some information to the SEC. [5] The SEC also can inspect firms registered with it to review data if it has cause to believe that swaps may have been involved in or contributed to a questionable movement in the securities market. This system of voluntary filings and limited accessibility is hardly comparable to the extensive intermarket surveillance agreements and early warning systems currently in place at the SEC and CFTC for exchange traded instruments. As a general matter, after-the-fact intervention is no substitute for a regulatory structure that is intended to be anticipatory, and thereby avoid creating problems in the first place.

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[5] The members of the Derivatives Policy Group are: Credit Suisse First Boston; Goldman Sachs; Lehman Brothers; Merrill Lynch; Morgan Stanley; and Salomon Brothers.

We also are concerned that the proposed blanket exemption ignores the proven strong relationship between trading in equity-based derivatives and the related cash markets. The exemption could have a significant adverse effect on the cash markets. We know that there is, at best, incomplete information on the extent or nature of trading in the unregulated equity based derivative markets. We also know that this is a market in which regulators have no legal ability to: require trading reports; impose "circuit breakers," position limits, trading halts or margin requirements, if they should prove necessary; obtain the information required to monitor the markets; prevent evasion of the prohibitions and requirements of the securities laws; or mandate fair competition among participants. Thus, this is a market that could present great potential dangers for the nation's regulated securities markets. To preclude regulators from having the means to step in, if necessary, to address systemic risk is neither wise nor necessary.

We are also concerned that the antifraud rule contemplated by Section 102 may prove toothless for OTC transactions. This is because any antifraud rule promulgated by the CFTC could extend no further than --he antifraud provisions of the CEA itself. Section 4b(a) has been read by some as applying only in the context of fraud committed in the context of a broker-customer relationship. Under this interpretation, principal to principal transactions, such as equity swaps, may be outside the reach of the CEA's basic antifraud provision and any antifraud rule premised on Section 4b.

If the Committee decides that it is appropriate to clarify the legal status of equity swaps and equity hybrids under the Commodity Exchange Act, we recommend that you exclude only those particular products from the CEA, This is the approach advocated by the SEC in its Written Statement Regarding S. 257 before the Senate Committee on Agriculture, dated March 14, 1997. Such an exclusion would make clear that such products are not subject to the exclusive jurisdiction of the CFTC. Sections 103 and 104 provide simplified procedures for contract market designation. These Sections preserve the requirements and procedures of the Shad-Johnson Accord that are applicable to equity-based futures products. These requirements and procedures recognize the legitimate interest of the SEC in these products. While we support the portion of Sections 103 and 104 that maintains the viability of Section 2(a)(1)(B) of the CEA, we have no position on the general issue of whether the current contract designation procedures of the CEA should be amended.

In closing, the Shad-Johnson Accord was a carefully crafted compromise drafted by the SEC and the CFTC. If Congress feels that reconsideration of the Shad-Johnson Accord is necessary, it should instruct the CFTC and the SEC, in consultation with the Department of the Treasury and the Federal Reserve Board, to revisit the Shad-Johnson Accord and report any recommendations for changes to the Accord to Congress. We believe that this approach would help to ensure that the many profound issues raised by equity-based derivatives would be carefully considered prior to any change in the Accord. We strongly urge the Committee to add a Savings clause to Section 102 to make clear that the bill does not affect the Shad-Johnson Accord.

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Thank you for giving us the opportunity to express our views. We look forward to working with the Committee as it progresses in its consideration of H.R 467.

WILLIAM J. BRODSKY

Chairman and Chief Executive Officer

Chicago Board Options Exchange

1997 WL 188975 (F.D.C.H.)

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CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

STATEMENT OF

THE FINANCIAL PLANNING COALITION

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ON

THE OBAMA ADMINISTRATION'S REGULATORY REFORM PROPOSALS

July 17, 2009

Statement Made by
Diahann W. Lassus, CFP®, CPA/PFS
President, Lassus Wherley & Associates
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Mr. Chairman, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to speak on the critically important topic of consumer protection in the Obama Administration's financial regulatory reform proposals. My name is Diahann Lassus and I come before you today as a representative of the Financial Planning Coalition, a group of three leading financial planning organizations dedicated to improving consumer access to competent and ethical professional financial planning advice.[1] I also currently serve as Chairman of the board for the National Association of Personal Financial Advisors, the leading professional association dedicated to the advancement of fee-only financial planning.

Most significantly however, I am the co-founder and President of Lassus Wherley & Associates, a women-owned wealth management firm focused on helping families secure their financial future every day. I come before you as someone who deals on the ground with the issues of consumer protection—and confusion—on a daily basis.

At heart, I am a practitioner. Consumer protection and the need for accountability and transparency are not abstract concepts or academic debates—they are the reality my clients and I face every day. Every time I meet with new clients I hear stories about their experience with other "Financial Planners." Many of them give even me nightmares. These clients often explain that they trusted and followed the planner's advice because the planner said she was putting the client's best interests first. Based on the recommended investments, it is abundantly clear that the planner was looking to profit from commissions and may not have even considered the client's best interests. It is rarely appropriate to transfer funds from an IRA to an annuity with high annual fees and surrender charges, but I see it done often because of the high commissions annuities pay. Other clients are persuaded to invest in complex derivative products without fully understanding the investment, relying solely on the advice of the planner.

Sadly though, these stories are not unusual. Since the Great Depression, financial services regulation has developed essentially along dual tracks: laws governing the sale of financial products and laws governing investment advice. When the delivery of financial services involves a combination of product sales and financial advice however, the dual regulatory structure has led to consumer confusion, conflicts of interest, and gaps in oversight.

One of the most prominent gaps is the delivery of broad-based financial advice to the public. Financial planning as a discipline evolved in the 1960s to provide comprehensive advice across the wide array of areas affecting families including: selecting and managing investments; income taxes; saving for college, home ownership, and a comfortable retirement; obtaining appropriate insurance coverage; and estate planning.

Unfortunately, these areas are covered by a diverse set of existing regulations. As a result, no single law governs the delivery of financial planning advice to the public. The byproduct of this is a patchwork regulatory scheme where financial planners currently maintain as many as three different licenses—insurance, brokerage, and investment adviser—with different standards of care and accountability to consumers.

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[1] The Financial Planning Coalition is comprised of Certified Financial Planner Board of Standards (CFP Board), the Financial Planning Association® (FPA®), and the National Association of Personal Financial Advisors (NAPFA).

There is no easy way for consumers to differentiate among the many people offering advice. Industry research shows that nearly 300,000 financial agents refer to themselves as a financial advisor, using titles such as money manager, investment planner, financial planner, and wealth manager. Many are only qualified to sell certain products or to give advice in just one area of the financial services sector, and the ethical and legal standards to which they are held vary widely.[2] This has led to consumer confusion, misrepresentation, and fraud—all things that the Administration seeks to correct in their financial reform package. That is one reason we were very happy to see the President propose that broker-dealers who provide investment advice be held to the same fiduciary standard as investment advisers. We are pleased that this Committee is considering that proposal and hope it results in an unambiguous fiduciary duty for all financial professionals who provide investment advice and does not undermine the fiduciary duty that already exists under the Investment Advisers Act of 1940.

The Financial Planning Coalition believes consumers deserve the tools and support necessary to make sound financial decisions on their path to the American dream. They should be able to clearly identify competent and ethical financial planners to help them make that dream a reality.

Our goal is to have all financial intermediaries who offer broad-based financial advice subjected to the high standards of a fiduciary. We are working with a group of organizations that represent diverse interests and constituencies to support this concept. We all share the view that the highest legal standard—the fiduciary duty—should apply to all who give financial advice to clients, as we laid out in our July 14 letter to Chairman Frank and Ranking Member Bachus.

Taking a step beyond extending the fiduciary duty, and in an effort to close the regulatory gap I mentioned, the Financial Planning Coalition supports the creation of a professional oversight board for financial planners and advisors—much like professional medical or legal boards—that would establish baseline competency standards for financial planners and require adherence to a stringent fiduciary standard of care.

The professional oversight board would be responsible for:

1. Establishing baseline competency standards;
2. Developing a code of professional conduct;
3. Requiring a fiduciary standard of care; and
4. Investigating and conducting disciplinary hearings.

We seek to apply a principles-based regulation to *individuals* providing comprehensive financial planning services or holding themselves out as financial planners, not to the firms that employ them. This leaves intact other regulatory coverage for institutions and operates consistently with existing federal regulation for broker-dealers and investment advisers, as well as state regulation of insurance producers, accountants, and lawyers.

As a financial services professional I strongly believe that increased transparency and rigorous standards are good for both consumer and industry alike. Consumers instinctively believe that the title "financial planner" holds value. According to a survey conducted by the Partnership for

[2] CERULLI ASSOCIATES, CERULLI QUANTITATIVE UPDATE: ADVISOR METRICS (2008) (on file with author).

Retirement Education and Planning, advisors who self identified as "planning experts" reported clients with double the total assets of those focused on product sales, as well as three times the total assets under management and a 40% higher annual revenue structure.[3] Delivering on a consumer's expectations is always a sound practice.

As a small business owner without the financial protections and organizational assistance of a large financial institution behind me, I am also very sensitive to charges of increased burdens, be they direct costs, administrative time, or regulatory compliance—especially in this economy. However, the ability of Americans to identify and place their trust in competent, ethical, and professional financial planners, which will help rebuild public confidence in our markets, outweighs these burdens. Comprehensive regulation of financial planning advice, through functional oversight, baseline competency standards, and meaningful enforcement mechanisms, will fill a crucial regulatory gap, decrease confusion, and protect consumers.

The Administration has clearly established a goal to protect consumers and investors from financial abuse. The Administration's proposals display a strong belief that consumer protection is sufficiently important as a principle to deserve its own "seat at the table." We fully support the Administration's five key principles for strengthening consumer protection—transparency, simplicity, fairness, accountability, and access—and we are pleased to see the Chairman carry these principles forward as he works to fill the regulatory gaps to protect consumers.

[3] Stuart Kahan, *Holistic Financial Planning is Quite Lucrative*, WEBCPA, May 1, 2009, http://www.webcpa.com/news/-30943-1.html.

Testimony of Douglas Lowenstein

President/CEO, Private Equity Council

House Financial Services Committee

July 17, 2009

Introduction

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to present the Private Equity Council's views on creating a forward looking approach to regulating the financial services sector in the aftermath of the system-wide financial crisis that has shaken so many investors, consumers, and institutions.

The Private Equity Council is a two-year-old trade association representing 12 of the largest private equity firms operating in the United States[1]. Our mission is to educate public policy makers on the positive role private equity investments have played in both strengthening hundreds of companies of all sizes and from all sectors of the economy, and in generating above average returns for scores of public and private pension funds and other investors that have allocated a portion of their portfolios to private equity funds. While PEC members are among the most visible and well known in private equity, each with more than $10 billion in assets under management, the Committee should bear in mind that there are more than 2,000 PE firms doing business in the U.S. The overwhelming majority of these are local firms doing small transactions that rarely attract much attention and yet help power local, state, and the national economies.

The Business of Private Equity

Before directly addressing the policy issues before the Committee, it is useful to describe briefly the private equity industry, how it works, and how it fits contextually into the financial marketplace.

A private equity firm, regardless of its size, creates funds in which it invests its own capital, along with larger amounts of capital raised from from third-party investors. In these partnerships, the private equity firm acts as the general partner, or GP, and the third-party investors are the limited partners, or LPs. In fact, highly sophisticated investors such as large public and private pension funds, endowments and foundations account for 70 percent of the funds invested with the top 100 PE firms since 2005. The 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund,

[1] Apax Partners; Apollo Global Management LLC; Bain Capital Partners; the Blackstone Group; the Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake Partners, and TPG Capital

and the Florida State Board of Administration) have invested nearly $140 billion in private equity.

The PE firm (or GP) uses the partnership's capital, along with funds borrowed from banks and other lenders, to buy or invest in companies that it believes could be significantly more successful with the right infusion of capital, talent and strategy. Historically, PE-owned funds carry virtually no debt at the fund level. Private equity firms do use debt to acquire portfolio companies, but this debt is maintained at the portfolio company level. The typical capital structure of the companies acquired by a private equity fund is approximately 60% debt and 40% equity (though this proportion can vary based on the cost of credit, the economic outlook, and the nature of the business).

A key to the success of private equity investments is the requirement that both the PE firm (the owners/shareholders) and the senior managers invest their own money into the sponsored business. By definition, when you have your skin in the game, when your equity is at risk, you are highly incented to make decisions that will grow the value of your investment. Failure to do so means you lose your own money -- not just the investment of a faceless shareholder. In short, the PE model ensures that the interests of the shareholders (GPs and LPs) and the interests of management are fully aligned. In contrast to publicly-owned companies, PE owned companies can operate without the pressures imposed by public equity markets' focus on quarterly earnings and short-term gains. As a result, they make management decisions focused entirely on what is required to improve long-term performance and value.

In seeking companies to purchase or invest in, PE firms have focused on a number of broad categories, including: struggling and underperforming businesses such as Toys 'R Us or J Crew; unwanted divisions of large conglomerates, such as Dunkin Donuts or Burger King; promising or strong companies in need of venture or growth capital, such as NASDAQ or the online video service Hulu; and family businesses where the founders are seeking to transition beyond family ownership.

Regardless of the type of firm acquired, the objective is the same: increase the value of the business during the time that it is owned by a private equity fund. PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders. Importantly, the PE firms do not share in any profits unless and until they have paid an 8-10% per annum return to their investors.

PE and Jobs

Private equity funds have a proven track record of creating jobs. The World Economic Forum reported that before they were acquired, private equity-owned companies on average were losing jobs at existing facilities faster than their competitors. But by the fourth year of private equity ownership, employment levels at those companies had increased to above the industry

average. It also reported that in the first two years of private equity ownership, private equity portfolio companies increased the rate of job growth at new U.S. facilities to six percent above the industry average.[2]

Ernst & Young (E&Y) reported that at eight out of ten private equity portfolio companies, employment is sustained or increased over time.[3] And economists Dr. Robert Shapiro and Dr. Nam Pham found that large companies acquired by major U.S. private equity firms increased domestic employment by 13 percent between 2002 and 2005, a period when employment at all large U.S. businesses grew by only three percent. Manufacturing companies owned by private equity investors grew employment by 1.4 percent during the same four-year period, while employment in the overall manufacturing sector declined by 7.7 percent. [4]

PE and Performance and Value

According to E&Y, the value of U.S. businesses owned by private equity grew 83% during the years they were owned by PE firms, three times faster than their equivalents in the public sector.[5] E&Y also found that more than half of the earnings growth (before taxes, interest and capital expense) at PE-owned portfolio companies came from business expansion, not cost-cutting or new acquisitions.[6] And Shapiro and Pham reported that 85% of PE firms studied increased capital expenditures in the three years after the PE investment.[7]

PE Returns to Investors

Improving the performance of portfolio companies has enabled private equity firms to deliver above average returns for the pension funds and other limited partners that invest in their funds. Between 1980 and 2005, top-quartile PE firms delivered average annualized net returns of 39 percent[8], significantly beating the S&P 500 and other indices. The overwhelming majority of these returns – 80% typically – is returned to investors in the form of profit. That 80% translates into real dollars -- $1.2 trillion to be exact -- the total profits distributed to pension funds and other investors worldwide from their PE investments between the early 1980s and

[2] The Global Economic Impact of Private Equity Report 2008, "Private Equity and Employment," World Economic Forum, January 2008

[3] Ernst & Young, "How Do Private Equity Investors Create Value? A Study of 2006 Exits in the U.S. and Western Europe," 2007

[4] Shapiro, Robert and Pham, Nam, "American Jobs and the Impact of Private Equity Transactions," Private Equity Council, January 2008

[5] Ernst & Young, 2007

[6] Ernst & Young, Beyond the Credit Crunch: How Do Private Equity Investors Create Value? A Global Study of 2007 Exits - 2008

[7] Shapiro, Robert and Pham, Nam

[8] PEC analysis of data from Venture Economics and Bloomberg

2008.[9] This massive infusion to public and private pensions serving teachers, firefighters, policemen and other retired public employees strengthens the solvency of the pension system.

On a mark-to-market basis, PE investors have seen the current value of their investments decline due to the financial crisis. But since PE firms hold investments for the long term, the current valuation snapshot is of marginal utility in assessing the eventual returns likely to flow to investors. Many investments now marked down as a result of the recession are likely to recover and be profitable for LPs, though perhaps not as profitable as was the case in more robust economic cycles.

Despite lower valuations in the current environment, private equity performance through the third quarter of 2008 still surpassed the performance of public equity markets. One year performance for private equity in the period ending September 30, 2008 was -8.2 percent, compared to -21.4 percent for the NASDAQ and -22 percent for the Standard and Poor's 500 index.[10] Importantly, as noted, these results do not reflect "returns" as these investments are still owned and as the economy improves and their value recovers, many will be sold at a profit.

The investment report of an actual LP is illustrative. In its just released Comprehensive Annual Financial Report, the Pennsylvania State Employees' Retirement System reported that in 2008 its PE investments declined 6.8% while its investment in domestic, global and international equities fell from 37.5% to 52.4%. Over the last 3 years, total returns from PE have been 17% compared to -10.5% for U.S. stocks and -11.0 for non-U.S. stocks.

PE Today

Like other financial institutions, the private equity sector has been adversely impacted by the recession and credit crisis. Restricted credit markets have effectively shut down the market for financing new acquisitions, and many portfolio companies are under stress as they manage through this recession. In this regard, the challenges private equity faces are similar to those that virtually every public and private business in the U.S. is addressing. The good news, if there is any, is that over the last decade top private equity firms have made a major commitment to adding very sophisticated management resources to their portfolio companies, thus allowing them to provide hands-on guidance both from an operational and capital structure perspective, especially in such perilous economic times. The combination of operational expertise and favorable financing terms should enable most portfolio companies in viable sectors of the economy to ride out the economic downturn without violating debt covenants that could force them into default.

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[9] Preqin 2008 Global Private Equity Review

[10] Thomson Reuters Private Equity Performance Index (PEPI)

To be sure, some portfolio companies will not survive this deep recession, just as is the case with dozens of public companies with household names like GM and AIG. Nonetheless, bankruptcies associated with PE investments made in the 2005-7 period will create hardships on workers, communities, and investors, not to mention the PE firms that will lose tens or hundreds of millions of their own equity.[11] But the critical point for the members of this Committee is that the failures of individual PE-owned companies, while hardly trivial, do not give rise to the kind of systemic risk relevant to policy makers seeking to prevent global financial shocks.

Despite the challenges facing the industry, private equity is poised to play a constructive role in the economic recovery. Today, private equity firms have more than $450 billion in committed capital to invest. But that capital is mostly sidelined due to the credit crisis and the recession. This industry is poised to be part of the solution, whether it is helping to recapitalize the banking system or investing in companies that desperately need growth capital and management expertise. We will continue to support traditional U.S. industries like steel and manufacturing, while also providing capital for new companies that are developing green technologies and energy efficient products.

PE and Systemic Risk

As Congress evaluates issues relating to systemic risk, we think it is important that policymakers distinguish among different types of private capital. Private equity is just one form of private capital. Other private investment vehicles include hedge funds, real estate partnerships, and venture capital funds, among others. All these pools of capital have features in common. But there are also important distinctions between them. Accordingly, we believe Congress should focus on regulating activities, not what businesses call themselves.

In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. Private equity contains none of these systemic risk factors and thus should pose little concern for policymakers seeking to develop a new regime to guard against catastrophic, cascading financial shocks.

[11] That said, according to a World Economic Forum study of PE investing over 20 years, private equity-owned companies defaulted on debt obligations at a rate substantially lower than all U.S. companies that issued bonds – and much lower than companies that issued high-yield debt.

Specifically:

- PE firms have limited or no leverage at the fund level (as distinct from leverage maintained at the portfolio company level for a particular acquisition). Thus, PE funds are not subject to unsustainable debt or creditor margin calls.
- Leverage in private equity acquisitions can range from none, in an all-equity acquisition, to 3:1 or 4:1 when credit is more easily obtained. In comparison, Lehman Brothers was levered at 32:1 when it failed. Further, Lehman's leverage was maintained at the parent company level, thus exposing the entire firm to collateral calls.
- PE funds do not rely on short-term funding. Rather, private equity investors are patient and commit their capital for 10-12 years (or more) with no redemption rights. Therefore, investors cannot withdraw their money on short notice, triggering "asset fire sales" to find cash to make the repayments.
- PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships.
- Private equity investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt. In a sense, private equity investments are firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.
- Private equity funds invest in long-term illiquid assets that are typically operating companies. Private equity does not invest in short-term traceable securities, like derivatives, swaps or equities.
- Private equity investments are diversified across multiple industries and there is no over-exposure to any single sector.
- PE firms are not a source of credit to households, businesses, or governments, nor do they act as a primary source of liquidity for the financial system.
- PE companies' borrowing is still a small portion of the overall credit market, well under five percent of all U.S. credit market obligations outstanding. The total value of all private equity holdings is equivalent to just 2.6 percent to 4.3 percent of corporate stocks and 3.1 percent to 5.3 percent of GDP.

<u>In short, when applying the Administration's systemic risk factors to private equity, it is hard to see how any particular private equity fund could be considered a systemic risk.</u>

Financial Services Reform Issues

The goals of financial regulatory reform should be to restore confidence in financial markets generally and the credit markets in particular, and to protect our financial system from the kind of meltdown that has devastated the global economy. We believe the Obama Administration's plan can accomplish these objectives. Although we do not have a direct stake in many specifics of the plan, we do feel very strongly that Congress should take deliberative action to provide clarity to market participants

More specifically, we support creation of an overall systemic risk regulator capable of acting decisively in a crisis, empowered to implement needed policies, and possessing sufficient international credibility to instill confidence in global markets. If the systemic risk regulator finds that an activity, an institution, or a class of institutions is systemically significant it should be empowered to examine and require reports, and promulgate rules on capital adequacy, operational controls, information and audit systems, and credit risk or other significant risk exposure. Further, the systemic regulator should be granted enforcement authority powers to take actions deemed necessary to protect the financial system.

Regarding private equity specifically, as I said PE does not have the potential to create the kind of systemic shocks that contributed to the financial crisis. Therefore we do not believe this form of investment poses significant concerns in the context of the financial regulation debate. As the Committee knows, on Wednesday the Administration proposed legislation that would require private equity firms to register as investment advisers with the Securities and Exchange Commission. Representatives Capuano and Castle have introduced H.R 711, the Hedge Fund Adviser Registration Act, which has a similar goal. We generally support the registration requirements contemplated by the Administration and H.R 711.

Registration will result in new regulatory oversight for many private equity firms. There are considerable administrative and financial burdens associated with record keeping and audits as registered investment advisors. These could be especially problematic for smaller firms. Given the fact that PE firms are not a cause of systemic risk, these additional regulatory requirements are arguably unnecessary. Nonetheless, we support registration because it will help restore confidence in the regulatory system and the financial markets. In the long run the benefits from more trust in the system will outweigh any burdens imposed by registration.

While supporting the concept of registration and data collection from market participants including PE firms, we do believe Congress should direct regulators to be precise in how new regulatory requirements are calibrated so the burdens are tailored to the nature and size of the individual firm and the actual nature and degree of systemic risk it may pose. In this regard, we were pleased that the Administration's White Paper explicitly acknowledges that some of the requirements created by the SEC "may vary across the different types of private pools."

Further, it is absolutely vital that any information provided to the SEC pursuant to a new registration requirement be subject to strong confidentiality protections so as not to expose

highly sensitive business and financial information beyond that required to carry out the systemic risk oversight function. We stand ready to work with this Committee on these issues.

Conclusion

Mr. Chairman, according to research by Dr. Robert Shapiro, private investments typically rise during recessions and continue to rise during the initial years of recovery. Further, Shapiro reports that total private equity investments grow much faster during the initial year of recovery than overall business investment and there is some evidence suggesting that private equity-held firms create jobs during the initial stages of recoveries while employment across the economy continues to contract.[12]

Today, private equity firms have more than $450 billion in committed capital to invest. This industry is poised to be part of the solution. That is our business, it's what we've done in the past, and it is what we will do in the future.

As Dr. Shapiro wrote, "In good and bad times, the core business of private equity funds is to identify firms with long-term potential for higher productivity, sales and profits; secure the capital to purchase these firms; and inject additional capital, improve their strategies and reorganize their operations, to achieve higher returns. Public policy should support these activities, especially during the current crisis, and refrain from imposing additional burdens that could hamper these activities or redirect them to other economies."[13] We believe the Administration's financial reform plan strikes a good balance between regulating PE while still allowing it to play its historically valuable role in making American companies stronger and more competitive.

Thank you.

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[12] Shapiro, Robert, The Role of the Private Equity Sector Promoting Economic Recovery, Private Equity Council, March 2009

[13] Ibid.

Statement of Robert S. Nichols
President and COO
The Financial Services Forum

before the
Committee on Financial Services
U.S. House of Representatives

July 17, 2009

Introduction

Chairman Frank, Ranking Member Bachus, thank you for the opportunity to participate in today's hearing and to share the Financial Services Forum's views regarding the Administration's proposal to reform and modernize our nation's framework of financial supervision.

As you may know, the Forum is a nonpartisan financial and economic policy organization comprised of the chief executives of 17 of the largest and most diversified financial institutions with business operations in the United States. The purpose of the Forum is to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace.

Reform and modernization of our nation's framework of financial supervision is overdue and needed. As you know, our current framework is an outdated and ineffective Depression-era patchwork of regulatory fiefdoms with overlapping jurisdictions, varying statutory responsibilities and powers and, too often, inconsistent supervisory postures, priorities, and methodologies. For years, these circumstances have led to duplication, confusion, regulatory arbitrage, structural imbalances, inefficiency, and waste. Worse, the balkanized nature of the current framework undermines regulators' ability to ensure institutional and systemic safety and soundness – helping to create the opportunity for, and exacerbating, the current financial crisis.

To reclaim its position of financial and economic leadership, the United States needs a 21st century supervisory framework that is effective and efficient, ensures institutional safety and soundness and systemic stability, promotes the competitive and innovative capacity of the U.S. capital markets, and protects the interests of depositors, investors, and policyholders. With this imperative in mind, the Financial Services Forum applauds the Administration's focus on reform and modernization, and the ongoing work of this Committee.

The Administration's Reform Plan

The Forum agrees with the Administration's diagnosis of the deficiencies of our current framework, and applauds the conceptual direction and many of the details of the Administration's reform proposal. Let me briefly address the major elements of the plan:

Systemic Risk Supervisor

Perhaps the most significant deficiency of our current supervisory framework is that it is highly balkanized, with agencies focused on specific industry sectors – commercial banking, securities firms, and insurance companies. This stove-piped structure has led to at least two major problems that created the opportunity for, and exacerbated, the current financial crisis: 1) gaps in oversight naturally develop between the silos of sector-specific regulation; and, 2) no agency is currently charged with assessing risks to the financial system as a whole – the big picture.

A more seamless, consistent, and holistic approach to supervision is necessary to ensure systemic stability and the safety and soundness of all financial entities. The cornerstone of such a modern framework is a systemic risk supervisor.

"Systemic risk" refers to any threat to the stable and efficient functioning of the financial system. It is important to emphasize that such threats can stem from many sources:

- deterioration of a large, interconnected entity;
- problems effecting a collection of smaller institutions;
- rapidly increasing exposures to a particular asset class, like real estate;
- unexpected volatility in key markets;
- pervasive deficiencies in risk management methodologies; or,
- difficulties in the financial system's clearing and settlement infrastructure.

A systemic supervisor should perform three essential tasks: First, looking out over the entire financial system, the supervisor would continuously monitor, assess, and, if necessary, take steps to address any risk that might threaten the stability of the system. In his comments announcing the reform plan a few weeks ago, President Obama aptly described this role of the systemic supervisor as focusing on the "forest," complementing the functional regulators' focus on the "trees."

Importantly, all three aspects of this role – monitoring, assessing, and addressing systemic risk – would require continuous interaction and cooperation with the functional regulators. Indeed, to avoid unnecessary supervisory duplication and confusion, and to avail itself of their sector-specific expertise, the Forum is of the view that the systemic supervisor – in supervising financial firms whose combination of size, leverage, and interconnectedness could pose a threat to the financial system – should rely on the functional regulators for day-to-day regulatory responsibility, examination reports, and other relevant regulator information regarding such firms, except under extreme emergency circumstances. As part of that continuous interaction, the systemic supervisor would perform a second critical task – helping to coordinate the functional regulators, close regulatory gaps, and promote more unified, consistent, and coherent supervision.

Third, the systemic supervisor would lead crisis-fighting efforts. Given the fast-moving and intensely psychological nature of modern financial crises, restoring public confidence and financial stability requires that the systemic supervisor have the capacity and authority to act swiftly and decisively. For this reason, the systemic supervisor cannot be comprised of a council of regulatory authorities, as some have suggested. A single entity is required – with the authority, resources, and tools to effectively combat financial instability.

We do believe that a Risk Council of functional regulators does have an important role to play in a modern supervisory framework, as a complement to the systemic supervisor. I'll have more to say about the Council in a few moments.

The Federal Reserve as Systemic Risk Supervisor

It is the Forum's firm view that the Federal Reserve might be best suited to serve the role of systemic supervisor. Indeed, Congress created the Fed in 1913 in response to another financial crisis, the Panic of 1907. As the monetary authority and lender-of-last-resort, the Fed has unique tools and powers that enable it to reach into financial markets and alter fundamental conditions. And by way of its enormous balance sheet, the Fed can also, if necessary, become the buyer-of-last-resort for various classes of short-term debt instruments critical to the continued operation of businesses, such as commercial paper and asset-backed securities. It is for these important reasons that the Federal Reserve is the agency to which all financial institutions and market participants look in times of crisis. No other agency has the necessary tools. The Federal Reserve is the fire department, with the trucks and hoses needed to put out fast-moving blazes that can threaten major aspects of, or even the entire, financial system.

Moreover, by way of its role as the monetary authority – altering the supply of money by way of open market operations – the Fed has nearly 100 years of institutional experience in the capital markets. No other agency has capital markets experience.

The Fed also brings tremendous institutional experience to bear as the systemic supervisor. It has supervised bank holding companies since 1956. Since the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), the Fed has served as the "umbrella supervisor" of financial conglomerates that include banking, securities, and insurance entities. Moreover, in recent months a number of major non-bank financial institutions – Goldman Sachs, Morgan Stanley, American Express, and even GMAC – have become bank holding companies and submitted to consolidated oversight by the Federal Reserve.

Streamlining of Federal Supervision of Financial Entities

The Forum also supports the Administration's proposal to streamline Federal banking regulation. There are presently four Federal banking agencies – the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve. Meanwhile, there is only one Federal regulator of broker/dealers – the Securities and Exchange Commission (SEC) – and, of course, no Federal regulator of insurance.

Merging the OCC and OTS to create the National Bank Supervisor (NBS) is entirely sensible – it is the lowest of the low-hanging fruit when it comes to agency streamlining. Both agencies are bureaus of the Treasury Department and have similar cultures. Moreover, very few, if any, meaningful differences remain between banks and thrifts – both take deposits and make loans. Merging the two agencies would reduce the number of Federal banking agencies by one and would generate significant efficiencies and cost savings, to the benefit of the industry and the American taxpayer.

There is another important opportunity to realize very significant additional streamlining efficiencies and costs savings, one regrettably not contemplated by the Administration's proposal – requiring the FDIC and the Federal Reserve to rely on the NBS and state banking departments for on-site examination reports and other relevant regulatory information.

There is no question that the FDIC needs access to detailed information about the activity and condition of banks in order to effectively perform its role as the administrator of the Deposit Insurance Fund. Similarly, the Federal Reserve requires detailed information about commercial banks to effectively perform its role as the monetary authority and lender-of-last-resort. But there is no reason, in the Forum's view, why the FDIC and Fed should need to conduct duplicative on-site examinations themselves to harvest such information. Both agencies can confidently rely on the examination reports and other relevant regulatory information produced by the NBS and the state banking department – particularly if both agencies participate in the pre-examination planning process, as they commonly do.

We know they can because the Fed has relied on the functional regulators of the subsidiaries of financial holding companies since the passage of GLBA. The Act repealed the "Glass-Steagall" provisions of the Banking Act of 1933, permitting well-managed and well-capitalized financial institutions to become "financial holding companies" (FHCs) and to engage in a diversified range of financially related activities. GLBA also created a new regulatory arrangement for the effective supervision of FHCs – designating the Federal Reserve as their "umbrella" supervisor, with the OCC, the 50 state banking departments, the SEC, and the 50 state insurance authorities serving as the "functional regulators" of the banking, securities, and insurance subsidiaries of the Fed-supervised FHCs.

GLBA specifically prohibits the Fed from conducting on-site examinations of the non-bank subsidiaries of FHCs, except under extreme circumstances. Rather, GLBA stipulates that the Fed must rely "to the fullest extent possible" on examination reports and other relevant information provided by the functional regulators, which is a sensible approach.

Because the on-site examination is perhaps the most onerous and costly aspect of official oversight (for regulated entities as well as the taxpayer), the consolidation of on-site examination power within the NBS – thereby eliminating the duplication of multiple on-site examinations of the same institutions by multiple regulators – would achieve tremendous additional rationalization of the current supervisory framework.

Risk Council of Functional Regulators

Despite the compelling logic for designating the Federal Reserve as the single systemic supervisor, doing so also raises certain legitimate concerns – specifically: 1) concentration of power within the Fed; and, 2) the "single-point-of-failure" dilemma. Concern regarding the Fed's power would be significantly mitigated by the requirement that the Fed rely on the functional regulators for examination reports and other relevant information.

Creation of a "Risk Council" comprised of the functional regulators, as the Administration has proposed, would also significantly mitigate these concerns and help make the Fed a more effective systemic supervisor. The purpose of the Council is to provide input to the Fed regarding emerging risks in any area of the financial system, and how those risks can most effectively be addressed. Designation of the Fed as the systemic supervisor, coupled with creation of a Risk Council, achieves the significant advantages of a single systemic supervisor equipped with the powers and tools the role requires, while also achieving the value of bringing multiple perspectives to the evaluation of systemic risk.

Creation of an Office of National Insurance

The Forum's insurance industry members agree that it is essential that there be increased national uniformity in the regulation of insurance, and are supportive of the creation of an Office of National Insurance (ONI) within the Treasury Department. ONI will ensure that knowledge and expertise is established at the Federal level, which is critical to ensuring that insurance industry interests are represented in the context of international negotiations and regulatory harmonization efforts. The Forum's insurance industry members also agree with the Forum's broader membership that a systemic supervisor should have a role in the supervision of systemically relevant financial companies, and that the systemic supervisor, except under extreme emergency circumstances, should rely on functional regulators for day-to-day regulatory responsibility.

Resolution Authority for Non-Bank Conglomerates

Of the many unfortunate and objectionable aspects of the current financial crisis and the subsequent policy response, perhaps none is more regrettable and evoking of more passionate objections than "too-big-to-fail." Failure is an all-American concept because the discipline of potential failure is necessary to ensure truly fair and competitive markets. No institution should be considered too big to fail. A critical aspect of regulatory reform and modernization, therefore, must be to provide the statutory authority and procedural protocol for resolving, in a controlled way that preserves public confidence in systemic integrity, the failure of any financial entity – no matter how large or complex.

The Forum agrees with the Administration that the process stipulated by the Federal Deposit Insurance Act for dealing with failing banks, as well as the framework established for Fannie Mae and Freddie Mac by the Housing and Economic Recovery Act of 2008, provide a reasonable and sensible model for such authority. We also agree that the FDIC is the logical agency to serve as the principal coordinating agency for resolution authority, since it has

acquired significant institutional experience as the resolution authority for banks; for insurance companies, we think the wind-down process should continue to be done at the state level, but in cooperation with the FDIC as the principal coordinating agency.

Consumer Financial Protection Agency

The Forum applauds the emphasis the Administration has placed on enhancing consumer protection. Of the many factors that have made the United States the world's premier capital marketplace for 80 years, our robust regime of consumer and investor protections is among the most important. The United States cannot have a world-class financial marketplace unless consumers and investors have full confidence in the safety and soundness of financial institutions, the integrity of the markets, the quality and suitability of financial products, and the basic fairness of the broader financial system. And there is no question that the essential confidence of investors and consumers has been profoundly damaged by the financial crisis.

Enhancement of consumer protection, therefore, must be part of any meaningful policy response to the current crisis. The Forum looks forward to working with Congress and the Administration to ensure that consumers, depositors, investors, and policyholders enjoy the world's most steadfast and effective protection of their interests.

Other Reform Ideas

Other reform and modernization ideas recommended by the Forum include:

- Because they entail potentially profound and pro-cyclical implications, accounting policies (i.e., FASB) should fall within the purview of the systemic supervisor.

- The systemic supervisor should conduct an ongoing review of the practices of the credit rating agencies to address conflicts of interest and to ensure independence and impartiality.

- The systemic supervisor should – in consultation with the Federal banking agencies, HUD, and FTC – develop national standards for mortgage origination, product features, securitization, and sale to ensure the proper and stable operation at every stage of this critical market and the protection of the rights and interests of mortgage consumers.

- Given the government rescue of Fannie and Freddie, the continuing role of the GSEs in the U.S. housing sector, and the large additional losses still anticipated, the systemic supervisor – in consultation with the FHFA – should study and provide guidance to Congress regarding the longer-term role and activities of the housing-related GSEs.

Again, thank you for the opportunity to appear before the Committee today. I'd be pleased to answer any questions you might have.

TESTIMONY OF
RANDOLPH C. SNOOK
EXECUTIVE VICE PRESIDENT OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS"

JULY 17, 2009

I. Introduction

Chairman Frank, Ranking Member Bachus and members of the Committee:

My name is Randy Snook and I am Executive Vice President of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. I will present SIFMA's views on some of the proposed regulatory reforms set forth in Treasury's June 17, 2009 White Paper, *A New Foundation: Rebuilding Financial Supervision and Regulation*, and certain related legislative proposals.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C. and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

Even before the financial crisis, many people, including members of this panel, recognized that the U.S. regulatory framework for financial regulation was in need of modernization. The financial crisis has made the need for reform more pressing than ever. We should all recognize that there will not be many opportunities to get it done right, that is, in a way that protects consumers and investors, supports constructive innovation, returns our financial sector to a position of strength and ensures our country's competitiveness as a leading financial center, while providing a durable platform for steady economic growth, employment and investment. We must take advantage of this unique opportunity to make the changes that are necessary to meet the challenges of the 21st century marketplace.

In addressing the imperatives of a modern financial system, we must recognize that financial markets are global in nature. Individual U.S. and non-U.S. banks, securities firms, insurance companies, hedge funds and other financial institutions operate in all major markets around the world. Non-U.S. financial institutions operate in our financial markets just as U.S. firms operate off-shore. Investors around the globe invest in multiple markets either directly or through financial intermediaries. As a result, we need a global approach to financial regulatory reform – one that promotes common regulatory standards and minimizes the opportunities for cross-border regulatory arbitrage.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue – in the U.S. and abroad – to restore confidence in the

global financial system. Our members understand that a well-designed and implemented regulatory system fosters robust and stable financial markets.

II. Supervision and Regulation of Financial Firms

Systemic risk has been at the heart of the current financial crisis. SIFMA has devoted considerable time and resources to developing a coherent conceptual framework for dealing with systemic risk, and specifically what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future. We have come to a consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our financial regulatory system. Generally, we support Treasury's recommendations for reforming supervision and regulation of financial firms and would like to detail some of SIFMA's thinking.

1. Creation of a Systemic Risk Regulator and a Financial Services Oversight Council

We believe that Treasury's White Paper proposal for a single, accountable systemic risk regulator, balanced with a newly created Financial Services Oversight Council (the "Council"), would improve upon the current system. At present, no single regulator (or collection of regulators) has the duty, authority or resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. A systemic risk regulator that has access to information about any systemically important financial institution – whether a bank, broker-dealer, insurance company, hedge fund or private equity fund – could have the

necessary perspective to ensure firms are not exploiting the gaps between functional regulators, or posing a risk to the larger system. While a systemic risk regulator will not be able to identify the causes or prevent the occurrence of all financial crises in the future, the combined work of the systemic risk regulator and the Council would provide an overview of the aggregate risk in our financial system.

A. Creation of a Systemic Risk Regulator

We strongly endorse designating a single oversight body as systemic risk regulator. We note that the regulator could be the Federal Reserve, as proposed by the White Paper, or another entity. A single systemic risk regulator, in combination with the Council, would be best positioned to efficiently and effectively assess threats to financial stability and ensure that appropriate action is taken promptly. An alternative approach of designating a panel of regulators, such as the President's Working Group or the Council, as the systemic risk regulator might bring together more collective expertise than a single entity would have, but it would raise issues of coordination and collective accountability. This model could perpetuate continued gaps, duplication, inefficiency and waste compared to a single oversight body. Centralizing the responsibilities for systemic risk regulation in a single entity, combined with the advisory, administrative and monitoring functions of the Council, is the right approach.

We understand that there are a number of tradeoffs involved in designating one entity over another as the systemic risk regulator, and we appreciate the advantages of Treasury's proposal to designate the Federal Reserve

as such. The Federal Reserve already has a window into U.S. and global markets. It has an experienced staff and the ability to expand its resources with revenues from its open market activities. The Federal Reserve also has a long history of independence and credibility with the markets and regulators around the world with which the systemic risk regulator would need to coordinate. It possesses many of the tools that we believe are essential for the systemic risk regulator, such as the ability to act as a lender of last resort and to provide emergency financial assistance. The Federal Reserve also has experience and a credible track record of using these tools responsibly. Finally, expanding the Federal Reserve's powers to include those of a systemic risk regulator could be done relatively quickly.

Given the scope of authority the systemic risk regulator may have, and regardless of which regulator is chosen to perform this function, Congress should consider a robust reporting regime for the systemic risk regulator including, at a minimum, annual reports to Congress. The systemic risk regulator might report on (1) the risks to the U.S. financial system, (2) the regulatory measures being taken or that will be taken to address such risks, (3) the costs and benefits of such measures, (4) any adverse effects from such measures on market discipline and (5) the steps being taken to maximize the benefits of market discipline.

B. Powers of the Systemic Risk Regulator

SIFMA supports the proposal for the systemic risk regulator to have a direct role in the oversight of systemically important financial institutions (referred to as Tier 1 FHCs in the White Paper) and markets, including the power

to promulgate regulations establishing minimum consolidated capital, liquidity and risk management requirements, conduct examinations and take prompt corrective action.

The systemic risk regulator should also be able to override the judgments of functional regulators and impose stricter or different requirements on systemically important groups. If the systemic risk regulator receives enforcement authority, it should be required to coordinate the use of that authority with the relevant federal functional regulators. While we believe that the role of functional regulators should be preserved, we are in favor of designating the systemic risk regulator as the consolidated supervisor of such institutions, much as the Federal Reserve is the umbrella supervisor of bank holding companies now.

We do not believe that the activity restrictions that currently apply to financial holding companies under the Bank Holding Company Act should be extended to Tier 1 FHCs. Rather, we suggest that any limitation on the activities of Tier 1 FHCs, as well as financial holding companies under the Bank Holding Company Act, should be based on the relative riskiness of the activities rather than on whether a particular activity falls on one side or the other of the so-called wall between banking and commerce. Thus, whether a particular activity would be permissible, and the conditions under which it could be conducted, would be based on whether the particular institution had the risk management, internal controls, capital and liquidity necessary to conduct the activity in a safe and sound manner, and not on any classification system based on the wall between banking and commerce.

C. Coordination

In a regulatory system where functional regulation is overlaid by financial stability oversight, it is important to consider how the systemic risk regulator coordinates with functional regulators. As a general principle, we believe that the systemic risk regulator should develop processes for coordinating with the relevant functional regulators to avoid duplicative or conflicting regulation and supervision. The Council would be helpful in this regard through its role of facilitating information sharing and coordination among the principal federal financial regulatory agencies.

International cooperation on systemic risk regulation is also critical, in light of how quickly systemic risk can cross borders and the likelihood of regulatory arbitrage to arise if systemically important financial institutions are subject to stricter prudential regulation, as Treasury has proposed. Congress should therefore consider giving the U.S. systemic risk regulator a mandate to coordinate with its foreign and international counterparts, such as the European Systemic Risk Board, on systemic risk issues.

D. Scope of Authority

We support making all systemically important financial institutions and systems, regardless of their charter, functional regulator or unregulated status, subject to the oversight of the systemic risk regulator. Accordingly, we agree with Treasury's Proposal to give the systemic risk regulator access to information about any financial institution that might be systemically important, including banks, broker-dealers, insurance companies, hedge funds, private equity funds

and others. This regulator should have authority to use the information it gathers to determine which financial institutions actually are "systemically important," meaning institutions that would likely have serious adverse effects on economic conditions or the financial stability of other entities if they were allowed to fail.

We support giving the systemic risk regulator discretionary authority to declare entities to be systemically important or to exempt any financial institutions from coverage or determine that an institution once designated as systemically important should no longer be classified that way. This discretion is necessary to ensure that systemically important institutions do not adopt organizational and operational innovations that would otherwise allow them to escape the risk regulator's consolidated supervision and regulation.

We believe that it would be a mistake for the systemic risk regulator's powers to focus exclusively on those financial firms that are systemically important. There may be sectors of the market where individual entities are not systemically important, but which entities in the aggregate can have a significant impact on systemic risk. The financial guaranty insurance industry is one such example. If the authority of the systemic risk regulator is limited to systemically important financial firms, any efforts to identify and control systemic risk will simply result in shifting the risky activity to other financial institutions or off-shore rather than reducing or controlling it. Congress should therefore consider giving the systemic risk regulator the authority to make uniform rules, where applicable, for any class of similarly situated financial institutions, markets, products or services to the extent necessary to reduce systemic risk and promote

financial stability, or to encourage the relevant functional regulators do so. The systemic risk regulator should also have the mandate to gather information from the functional regulators as well as to share information relative to systemic risk issues.

2. Stricter Prudential Regulation for Systemically Important Institutions

SIFMA appreciates the need to impose certain additional regulatory requirements on systemically important institutions. While we believe that such regulation is important to ensure that institutions are adequately monitoring and managing risk, we are also mindful that stricter regulatory standards will create regulatory arbitrage between systemically important institutions and those institutions not so designated. Activities that are regulated more heavily when conducted by a systemically important institution may tend to migrate to less regulated institutions or flow off-shore. Instead of reducing overall risk in the system, this approach could simply shift risk from one group to another. We therefore urge caution when imposing disparate requirements on financial institutions so as to maintain to the extent possible a level playing field between systemically important and other financial firms.

3. Executive Compensation Standards

A responsible approach to executive compensation is key for restoring trust and confidence in the financial system and promoting growth and stability. SIFMA believes that compensation should be aligned with the best interests of shareholders, the financial system and the economy, and we are committed to

structuring compensation arrangements to enhance long-term shareholder value and prevent undue risk-taking. In early June, SIFMA released Guidelines for Compensation in coordination with other industry groups and compensation and governance professionals.[2] The SIFMA Guidelines are in line with the executive compensation principles discussed in the White Paper. We fully support their integration into the supervisory process. We believe that firms should communicate their compensation philosophy, practices and policies, particularly as they relate to risk-taking and sustainable performance. At the same time, we believe it is necessary to balance this transparency with appropriate confidentiality to maintain competitive differentiation among firms and protect personal privacy. Compensation policies must be consistent with effective risk management and be designed to attract, motivate and retain the necessary talent.

III. Comprehensive Regulation of Financial Markets

SIFMA supports comprehensive, well-crafted regulation of financial markets and believes that we must work to rationalize the regulation of financial markets to eliminate regulatory gaps and inconsistencies. We welcome Treasury's proposals on this subject and would like to take this opportunity to address three areas of reform in particular: OTC derivatives, SEC and CFTC regulation of securities and futures and securitization.

[2] Available at http://www.sifma.org/legislative/savings/pdf/SIFMA-Comp-Guidelines-06-09.pdf.

1. OTC Derivatives

We agree with the broad policy objectives laid out for OTC derivatives regulation in Treasury's White Paper: preventing risk to the financial system, promoting market efficiency and transparency, preventing market manipulation and fraud, and prohibiting inappropriate marketing practices. We also believe that Treasury has correctly identified the principal cause for concern in this area, namely "excessive risk taking" by a small number of market participants. We agree with Treasury that clearing is a useful tool for reducing risk, including in particular interconnectivity risk, and financial firms have taken steps to clear more and more types of OTC derivatives. We support clearing of standardized derivatives transactions by financial firms wherever this is possible without disrupting the thousands of companies across America that use derivatives to manage risk.

These non-financial companies use derivatives to hedge individualized risks arising in their day-to-day business activities, and the types of derivatives that are standardized sufficiently for clearing may not precisely match the risks they are hedging. Unless these companies can continue to enter into non-standardized derivatives, they would remain exposed to a portion of the risk or take on additional risk. In addition, their inability to match derivatives closely to underlying risks could prevent companies from utilizing hedge accounting under FAS 133 and thus add to apparent volatility in their earnings, which could increase their cost of capital. While these companies might provide collateral for their contracts, this collateral may not be in the form required by clearinghouses,

generally cash or cash equivalents, and so requiring these companies to use standardized, cleared derivatives would necessitate allocating working capital away from investment in their businesses to fund margin requirements.

To the extent Congress determines that mandatory clearing of some transactions is necessary, we believe that mandate should be applied to derivatives dealers and other organizations that are systemically important and significant participants in derivatives markets. It is also important to recognize that clearing will not necessarily benefit all of these institutions' standardized OTC derivatives contracts. Although standardization is a necessary attribute of OTC derivatives that can be centrally cleared, it is not sufficient by itself to ensure clearability, and so clearing should not be uniformly mandated for all standardized contracts. A standardized contract also must be traded with sufficient frequency and volume (i.e., liquidity) that the clearinghouse can determine its value on a daily basis in order to calculate the amount of collateral it needs to protect itself against loss in the event of a default. Failure to collect an appropriate amount of collateral with this regularity could cause the clearinghouse itself to pose a risk to the financial system. Moreover, the clearinghouse itself must have the resources, operational competence, experience, risk management infrastructure, and broad-based participation by major market participants needed to clear the contract in a prudent manner. To help ensure a clearinghouse meets these conditions, market participants should have choice among clearinghouses for the clearing of their contracts. These considerations are critical to ensure that clearing improves, rather than undermines, financial stability.

We understand that improving regulatory reporting of derivatives transactions is an essential part of a robust prudential supervisory regime. We believe that the transparency goals of Congress can be readily achieved without mandating exchange trading of derivatives products. Exchanges and over-the-counter markets can compete to provide efficient execution services while still providing trade data to regulators. Timely information about market participants' transactions and open positions should be submitted to a data repository, but we caution against requiring TRACE-like real-time public reporting of trade data, which we believe can reduce market liquidity.

We agree with Treasury's view that derivatives dealers and other firms that have large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation, which includes capital requirements. We note that bank regulators already have procedures for setting capital levels that are adequate and believe these should be relied upon wherever possible. Recent instances of significant problems arising out of the credit default swap business involved firms that were not subject to bank capital requirements. Of course, the capital requirements that apply to derivatives dealers and other firms should be developed in concert with financial regulators in other countries so as to avoid competitive advantage or disadvantage on the basis of capital. We believe those requirements should be consistent with existing bank capital requirements for OTC derivatives. We also believe that bank regulatory requirements for collateral should be relied upon where possible and emulated where they do not currently apply.

One issue that was not addressed in Treasury's White Paper, but that we recommend Congress include in legislation, is ensuring that derivatives regulation is the clear purview of the federal regulators. In the recent past, several states and organizations of collected state officials have considered legislative or regulatory proposals to regulate credit default swaps as insurance. They often cite a lack of federal action as the primary cause for their efforts. We are concerned about these efforts for several reasons. In the first place, credit default swaps are not insurance. Among the characteristics that distinguish them are common provisions calling for credit default swap parties (both the seller and the buyer of protection) to post margin and the fact that a protection buyer generally does not have to incur a loss in order to demand payment from the protection seller. But even more important, state regulation of credit default swaps as insurance would be inconsistent with the comprehensive regulatory scheme being proposed by Treasury for the financial services industry generally and derivatives in particular. The burden imposed on market participants, including oversight by as many as 50 different state regulators, would give them a compelling incentive to move their business off-shore and would impair rather than improve the market. If Congress adopts legislation to create new derivatives regulation, it should consider including a provision that broadly preempts state law.

We also would like to take this opportunity to say that we agree with Secretary Geithner that credit default swaps should not be singled out for special, more restrictive treatment. In particular, we are concerned about proposals to prohibit credit default swaps that are not entered into for the purpose of hedging

(so-called "naked" credit default swaps), including section 355 of H.R. 2454, the American Clean Energy and Security Act of 2009. Such swaps provide liquidity to the credit default swap market and active trading in that market provides economically useful data in the form of prices for credit protection with respect to specific companies. We believe that appropriate regulatory oversight and the enforcement of existing laws against market manipulation is the better approach to preventing adverse consequences from these transactions.

2. Harmonization of SEC and CFTC Regulation of Securities and Futures

SIFMA supports the White Paper's proposal to harmonize the regulation of securities and futures. Under current law, certain economically equivalent financial instruments may be subject to very different regulation by the SEC or the CFTC depending on whether they are determined to be "securities" or "futures." In addition, it may be difficult to determine in advance whether a particular instrument will be subject to SEC or CFTC regulation. This uncertainty can cause excessive delay in the creation of new products and even give rise to costly and wasteful litigation.

If Congress determines that a merger of the SEC and CFTC should not occur at this time, then in keeping with each agency's regulatory functions, Congress should expressly delegate the regulation of financial products, such as broad market indices, currencies and interest rate swaps, to the SEC and non-financial products, such as commodities, to the CFTC. We are supportive of the SEC's adopting some of the exchange oversight principles applied by the CFTC

in its supervision of exchanges. SIFMA also supports granting the SEC express authority to regulate advisers to hedge funds.

3. Securitization Market Reforms

We agree that targeted securitization market reforms are needed, and we are working actively on a number of fronts to strengthen the infrastructure for this critically important market in order to help to restore confidence and functionality to the securitization markets. Among other reforms, we support policymakers' efforts to find appropriate ways to require securitization market participants to have "skin in the game." One mechanism that can promote this goal is required retention of a meaningful economic interest in securitized exposures. Retention of a meaningful economic interest would help to align the incentives of originators and transaction sponsors with those of securitization investors. Retention would strengthen incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and eligibility criteria, which would promote responsible and efficient lending.

Further, we support Treasury's proposal that federal bank regulators should be given the authority to design and apply bank retention requirements in a manner that specifies permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of the retention requirements, whether and to what extent hedging of retained interests is permissible and other important implementation details.

We suggest that there are alternatives to mandated retention of credit risk in securitized assets that should be considered as methods to achieve the policy

goal underlying a retention requirement. Many of the other proposals in the White Paper, such as policies relating to risk management, fraud protection and detection mechanisms, will work to improve the function of the securitization markets. In addition, policies previously considered by this Committee could also help better align the incentives of securitization market participants, including a stronger and broader scope of third-party due diligence and stronger, more standardized and more effective representations and warranties made by an asset originator or seller regarding the underwriting standards and performance of loans sold into securitization vehicles could also help better align the incentives of securitization market participants. We note that the industry has already taken steps towards such improved representations and warranties through the American Securitization Forum's Project RESTART.

IV. Consumer and Investor Protection

The consumer and investor protection proposals in Treasury's White Paper are among the farthest-reaching and most important. I would like to take this opportunity to comment on Treasury's proposals in three areas: the Consumer Financial Protection Agency, the regulation of investment advisers and broker-dealers and pre-dispute arbitration clauses.

1. Consumer Financial Protection Agency

SIFMA supports strengthening consumer protection regulation, including the promulgation and enforcement of national standards governing consumer credit products and lending practices. However, we are concerned that creating a new agency for these purposes might lead to wasteful and duplicative regulation

while failing to deliver the hoped-for benefits due to the separation of consumer protection and prudential regulation. My comments will address specific concerns with certain provisions of the Consumer Financial Protection Agency Act of 2009 (the "Act").[3]

SIFMA believes the Consumer Financial Protection Agency (the "CFPA") could inadvertently encroach on the jurisdiction of the SEC and CFTC. The White Paper states that the CFPA would provide consumer protection in the financial products and services markets, "except for investment products and services already regulated by the SEC or CFTC." Treasury officials have reiterated in various public statements that the CFPA is not intended to supersede the broad investor protection mandate of the two agencies. Nevertheless, as proposed, the CFPA's jurisdiction would be broad and have uncertain boundaries, potentially overlapping with those of the SEC and CFTC. We believe the Act should provide a full exclusion for investment products and services regulated by the SEC or the CFTC. As currently drafted, it excludes only a narrow list of activities of some of the persons regulated by the SEC, such as broker-dealers and investment advisers. Arguably the SEC's authority over transparency and disclosure, including its exclusive ability to mandate issuer disclosure in proxy statements and annual reports, also would be called into question. To avoid overlapping jurisdiction, we urge Congress to exclude from the jurisdiction of the

[3] We are aware that Treasury has proposed one version of the Act and that Chairman Frank has introduced another version of the Act (H.R. 3126). The two versions of the Act are similar with respect to the provisions on which I will comment.

CFPA any securities activity and any person, product or other activity that is regulated by the SEC or the CFTC.

With respect to non-securities-related activities, we are concerned about the potential conflicts and redundancies that may arise if the States have concurrent enforcement authority with the CFPA. This would prevent the development of uniform enforcement policy and create fifty-one independent regulatory regimes. Because no one authoritative body would have a final say on what does or does not constitute a violation of the Act, it would be difficult for regulated firms to structure their businesses to ensure compliance. Nor would regulated firms know with which regulator to settle a potential enforcement action. This uncertainty could raise the cost of doing business and have the unintended consequence of driving up prices for consumers.

We believe any legislation establishing a CFPA should clarify that the agency is subject to the standard Office of Management and Budget process for budget approval. We also suggest that funding the CFPA by fees or assessments, as currently proposed, is inadvisable because such costs would ultimately be paid for by consumers in the form of higher prices – harming the people meant to benefit from the establishment of the CFPA. Rather, we believe that it would be better as a public policy matter for the agency's budget to be funded through the regular appropriations process.

However, if Congress chooses to fund the agency by fees or assessments, we would suggest that the CFPA follow the SEC model and set fees at a level to recover a targeted amount, which could be its appropriation for the first full year.

Thereafter, the CFPA could recover this amount, indexed for inflation, unless Congress raised the targeted amount. This would give predictability to the fee-setting process and avoid imposing a costly burden on regulated firms. We would also suggest that Congress ensure that the CFPA applies its fees or assessments in an equitable manner across regulated persons and products and does not unfairly discriminate among them.

We also observe that separating consumer protection regulation from prudential regulation could have serious negative consequences. Situations could arise in which the CFPA demands changes in business practices that would negatively impact a firm's safety and soundness. Such a situation would pit regulators against one another in a tug-of-war over the regulated firm. Congress should consider addressing coordination between the CFPA and the relevant prudential regulators in any proposed legislation to create a consumer protection agency.

The Committee should also clarify ambiguity that could raise questions as to whether the CFPA has jurisdiction over employer-sponsored retirement plans subject to Employee Retirement Income Security Act ("ERISA") or tax-favored accounts such as Individual Retirement Accounts ("IRAs"). These accounts are already subject to significant regulation through ERISA, the Internal Revenue Code (the "Code") and multiple federal and state government agencies and self-regulatory organizations.

It is not only unnecessary for the CFPA to have regulatory authority over these arrangements, the plan sponsors or service providers, but permitting an

ambiguity to exist regarding another layer of regulation to a system that already is subject to an extremely comprehensive set of regulations is very likely to harm the very people the CFPA is designed to help.

ERISA and the Code require plan fiduciaries and providers to provide participants with information about their plans, including significant disclosure to the participants and beneficiaries on a regular basis. The governing laws also provide participants and beneficiaries with the right to sue for breaches of duty or other failures to provide information or benefits. We believe that resolving this ambiguity is very important so that employers will not be discouraged from offering these plans to their employees and to ensure that services can be provided in the most cost-effective manner.

2. Harmonizing the Regulation of Investment Advisers and Broker-Dealers

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for brokers, dealers, investment advisers and other financial intermediaries.[4] When broker-dealers and investment advisers engage in the identical service of providing personalized investment advice about securities to individual investors, they should be held to the same standard of care. Conversely, when broker-dealers are not providing personalized securities investment advice to individual investors (such as, for example, when broker-dealers simply execute orders for customers, or engage in market-making,

[4] See, e.g., Testimony of T. Timothy Ryan, Jr. before the U.S. Senate Committee on Banking, Housing and Urban Affairs in the March 10, 2009 hearing titled "Enhancing Investor Protection and the Regulation of the Securities Markets," available at http://www.sifma.org/legislative/testimony/pdf/Ryan-03-10-2009.pdf.

underwriting or providing cash sweep services), there is no cause for modifying the existing, extensive regulatory regime that governs broker-dealers. We therefore welcome Treasury's newly proposed legislation, the "Investor Protection Act of 2009," which appears to acknowledge these important distinctions, and which would give the SEC the authority to establish rules for a new, uniform, federal standard.

Individual investors deserve – and SIFMA strongly supports – a new federal fiduciary standard of care that supersedes and improves upon the existing fiduciary standards, which have been unevenly developed and applied over the years, and which are susceptible to multiple and differing definitions and interpretations under existing federal and state law. Whatever label, if any, the SEC applies to this new federal standard, we must ensure that it functions as a unitary and exclusive standard that is uniformly and even-handedly applied – at the federal level – to both investment advisers and broker-dealers when they provide personalized investment advice about securities to individual investors. Congress successfully followed a similar approach when it restructured federal-state securities regulation through the National Securities Markets Improvement Act of 1996.

The hallmark of a new federal standard should be putting investors' interests first. At the very outset of the customer relationship, the duties, obligations and expectations of the customer and the financial service provider must be communicated and documented in plain English. Broker-dealers and investment advisers alike should seek to avoid conflicts of interest. If they

cannot, then they must effectively manage conflicts through clear, unambiguous disclosure and, as appropriate, investor consent.

A new federal standard should also protect investors by respecting and preserving investor choice, which is part of putting clients first. This should include investor choice to select, contract for and receive any of the wide range of products and services offered by their financial services provider, and investor choice to define or modify relationships with their financial services provider based on the investor's preference. In light of the numerous, diverse and investor-beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today's investment advisers, a new federal standard should also recognize and preserve product and service innovation and capital formation. Yet another way to support choice, innovation and service is to provide firms with appropriate relief from the SEC's current prohibitions against principal trading, which in today's liquid and transparent markets no longer make sense and have had the effect of foreclosing opportunities for investors to obtain more favorable pricing on transactions because of the requirement of transaction-by-transaction consent. A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice about securities to individual investors.

We recognize the important role that States play in protecting investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions for fraud to the extent consistent

with the new standard of care. Any new legislation, however, should make clear that subjecting a financial professional to the new federal standard does not create any presumption that the financial professional is providing investment advice or is a fiduciary for purposes of any other federal or state laws. This enables broker-dealers to continue to provide investors choice of investment products, particularly in IRAs.

We also hope that harmonization would involve a reaffirmation that pre-dispute arbitration clauses in advisory and brokerage contracts are valid. In the past, the SEC has prohibited the inclusion of such clauses in advisory contracts on the grounds that they may confuse clients by causing them to believe they have waived their rights under the federal securities laws, which would violate the antifraud provisions of the Investment Advisers Act of 1940.[5] As I will describe in further detail in the next section of my testimony, this opposition to arbitration clauses is at odds with federal policy, judicial precedent and empirical evidence.

3. Pre-Dispute Arbitration Clauses

Treasury has proposed giving the SEC authority to prohibit pre-dispute arbitration clauses in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors. Similarly, the CFPA, as proposed, would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the

[5] McEldowney Financial Services, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.

Congress has maintained a policy in favor of arbitration since the passage of the Federal Arbitration Act. The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency. The U.S. Supreme Court has expressly approved the use of pre-dispute arbitration clauses.

SIFMA supports the idea of conducting further study of securities arbitration and pre-dispute arbitration clauses. In fact, we conducted our own study of the matter in October 2007.[6] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them to pursue claims that they could not afford to litigate or that would be dismissed in court. Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system. In fact, it is our view that prohibiting such clauses would essentially be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical

[6] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, seek "jackpot justice" or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of Treasury's proposal. We urge Congress to consider these factors in its deliberation over Treasury's pre-dispute arbitration clause proposals. We also suggest that further study of this subject might be particularly instructive.

V. Resolution Authority

One of the important gaps exposed during the current financial crisis was the lack of federal resolution authority for certain systemically important financial institutions. The Federal Deposit Insurance Corporation ("FDIC") has broad powers to act as a conservator or receiver of a failed or severely troubled bank. These powers include the ability to control the process, to repudiate burdensome contracts, to transfer certain assets and liabilities to a bridge bank and to enter into loss-sharing and other financial assistance arrangements designed to maximize the value of the failed institution for the benefit of its depositors, other creditors and other stakeholders. These are the powers the FDIC used to resolve WaMu,

IndyMac and other thrifts. The Federal Housing Finance Authority exercised similar powers when it placed Fannie Mae and Freddie Mac into conservatorship.

No similar resolution authority is available to resolve other systemically important financial institutions. Neither the Bankruptcy Code nor state insurance insolvency codes gives the government sufficient control over the resolution of these firms. We therefore welcome Treasury's proposal to create a federal resolution authority for these other systemically important financial institutions. Such resolution authority is an essential tool in the government's financial crisis management toolbox. The White Paper's outline for the resolution authority is a good starting point for discussion. It has many elements that are generally well-designed. For example, we think it is sensible to model the resolution authority on the FDIC's current resolution powers over insured depository institutions, provided the authority is adapted to the very different institutions and context to which it would apply. We also believe it is appropriate for the resolution authority to extend to all systemically important financial institutions other than insured depository institutions, in contrast to Treasury's proposed legislation in March, which contained numerous carve-outs for entities such as broker-dealers and insurance companies.

However, the proposed resolution authority has the potential to change the "rules of the game" on the eve of bankruptcy, which would risk seriously disrupting the reasonable expectations of creditors, counterparties, customers and other stakeholders. The current proposal would allow Treasury, in consultation with the President and certain regulators, to designate a firm as systemically

important and subject to the new resolution authority instead of the Bankrupcty Code on the eve of failure. Sections 11 and 13 of the Federal Deposit Insurance Act, upon which the new resolution authority is to be modeled, contain priorities, preference avoidance powers and other provisions that are fundamentally different from the corresponding provisions of the resolution regimes that would otherwise apply, including the Bankruptcy Code, the Securities Investor Protection Act and state insurance insolvency codes.

Congress should consider several steps to ensure that the new resolution authority does not disrupt the reasonable expectations of creditors and other stakeholders. Most importantly, Congress should harmonize the priorities, preference avoidance powers and other key substantive rights under the proposed resolution authority with their counterparts under the Bankruptcy Code or other laws it would be replacing. Second, Congress should make sure that all creditors within a given class are treated equally. Third, Congress should consider requiring the federal agency in charge of resolution to promulgate rules and regulations that provide *ex ante* legal certainty on all key legal issues. Fourth, Congress should consider requiring the agency to provide as much notice as possible that a particular firm would be treated as systemically important and subject to the resolution authority, rather than leaving that determination until the eve of failure. Fifth, the proposed authority should provide for better judicial review of the resolution process, particularly the claims process. Sixth, Congress should impose a duty on the resolving agency to maximize the value of the failed institution's assets for the benefit of creditors and other stakeholders. There may

also be other steps that can be taken to ensure the reasonable expectations of the stakeholders.

The choice of which agency will resolve failing firms is a vital element of any resolution authority. Treasury has proposed that the FDIC play this role, unless the largest subsidiary of the failing firm is a broker-dealer or securities firm, in which case the SEC would do so. Whichever agency is selected, we believe it is essential that it be one with adequate experience with the sort of large, complex, cross-border financial groups to which the new authority would apply.

One aspect that Treasury's proposal does not treat but that is very significant to many market participants is the status that qualified financial contracts ("QFCs") would have under the resolution authority. The White Paper does not mention any provisions guaranteeing counterparties the right to terminate or close-out QFCs, although there are such provisions in the Bankruptcy Code, the resolution provisions that apply to banks and GSEs, and Treasury's March bill. Congress should make sure that the proposed authority contains such provisions.

Finally, it is worth noting what is at stake in the debate over the resolution authority. A poorly designed or unwisely administered resolution authority could increase the likelihood and frequency of seize-ups in the credit markets and otherwise undermine investor, creditor and public confidence during a financial crisis. It could also make credit less available and more expensive during normal times. It is therefore imperative to take the time necessary, and consult a

sufficient array of experts, to create a robust and well-functioning federal resolution authority.

VI. International Coordination and Cooperation

As I noted in my introductory remarks, the global nature of financial markets calls for a global approach to financial regulatory reform. Unless common regulatory standards are applied and enforced across global markets, opportunities for regulatory arbitrage will arise. We must also consider the impact that our financial regulatory reform may have on other markets, as well as the possibility that any particular reform could, unless coupled with a coordinated global approach, give rise to disparate regulatory treatment as among U.S. and foreign markets, or create incentives to move U.S. jobs and businesses off-shore. Conversely, we need to carefully monitor the impact of major non-U.S. regulators or regions on U.S. domestic markets and financial institutions. Regulatory divergence can have a variety of ill effects, including raising costs to investors, unnecessarily complicating compliance, hindering global regulatory cooperation and coordination and, at worst, provoking retaliatory measures and counter-measures, causing a drag on global economic recovery.

Close cooperation among policymakers on an international basis, therefore, will be essential if we are to effectively addressing systemic risk and other challenges affecting the financial system. Accordingly, we strongly support the expanded membership and role of the Financial Stability Board, and the increased cooperation and coordination among regulators in major markets in the U.S., Europe, Asia and elsewhere around the world. We are also observing with

interest the Financial Stability Board's Standing Committee for Supervisory and Regulatory Cooperation, chaired by Adair Turner of the U.K.'s Financial Services Authority, whose mandate is to address coordination issues that arise among supervisors and regulators and to raise any need for subsequent policy development. There are several other international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including the G-20, the Basel Committee on Banking Supervision, IOSCO and the Joint Forum. Congress should continue to support and encourage the efforts of these groups.

VII. Conclusion

Recent challenges have highlighted the necessity of a fundamental review of our regulatory system. SIFMA strongly supports these efforts and commits to being a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers regulatory reform to minimize systemic risk, strengthen and streamline the prudential regulation of financial firms, protect consumers and investors and create a new resolution authority for large, interconnected firms. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.

TESTIMONY OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

ON

"INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS"

JULY 17, 2009

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I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $10.6 trillion and serve over 93 million shareholders. ICI is pleased to offer its perspectives on the Obama Administration's financial regulatory reform proposals.

This hearing takes place at a time when the United States and a host of other nations are still experiencing the effects of the most significant financial crisis in generations. In this country, the crisis has revealed significant weaknesses in our current system for oversight of financial institutions. At the same time, it has offered an important opportunity for robust dialogue about the way forward. And it provides policymakers with the public mandate needed to take bold steps to strengthen and modernize regulatory oversight of the financial services industry. We strongly commend the Obama Administration and the Congress for the attention they are devoting to examining the causes of the financial crisis and considering how the regulatory system can best be improved.

The outcome of these reform efforts will have a direct and lasting impact on the future of our financial system. The decisions you make will affect, among others, many millions of American investors who choose mutual funds, exchange-traded funds, and other registered investment companies (collectively, "funds") as vehicles to help them meet their long-term financial goals. Your actions also will affect funds themselves, which are among the largest investors in U.S. companies, holding about one quarter of those companies' outstanding stock. Funds also hold approximately 45 percent of U.S. commercial paper, an important source of short-term funding for corporate America, and about one third of tax-exempt debt issued by U.S.

municipalities. It is thus imperative to funds, as both issuers of securities to investors and purchasers of securities in the market, that our financial regulatory system works well to protect investors *and* to foster competitive and efficient capital markets.

Like other stakeholders, we have been thinking for much of the last year about how to revamp our current system so that our nation emerges from this crisis with stronger, well-regulated financial institutions operating within a fair, efficient, and transparent marketplace. In March, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of investment companies.[1] Since that time, we have continued to develop and refine our own reform recommendations and to study proposals advanced by others.

In particular, we welcome the Administration's recent white paper outlining a wide-ranging framework for financial services regulatory reform.[2] The changes envisioned by the Administration's white paper are more significant and far-reaching than any since the New Deal. They deserve serious consideration and analysis by this Committee, other members of Congress, and all stakeholders in this debate. ICI has been reviewing these proposals carefully, and this testimony will highlight areas of agreement and disagreement with several of the Administration's recommendations.

Section II below addresses the Administration's proposal to create an additional independent federal agency, the Consumer Financial Protection Agency (CFPA), with broad

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[1] *See* Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf ("ICI white paper").

[2] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ("Administration white paper").

jurisdiction to protect consumers of certain financial products and services and to regulate the providers of such products and services. Section III addresses selected aspects of the Administration's proposed legislative language in its "Investor Protection Act of 2009," which would expand the Securities and Exchange Commission's authority and amend several of the statutes under its purview. Section IV highlights ICI's recommendations of ways to enhance the SEC's ability to protect investors and maintain the integrity of our nation's capital markets. Section V provides ICI's perspective on the appropriate role, composition, and scope of authority of a Systemic Risk Regulator. Finally, Section VI discusses selected other areas for reform, including the SEC's recently proposed recommendations for strengthening money market fund regulation, and ICI's suggestions for addressing certain regulatory gaps that have the potential to affect the capital markets and market participants.

II. PROPOSED CONSUMER FINANCIAL PROTECTION AGENCY

A. Genesis of the CFPA Concept

In evaluating the Administration's proposal for a new agency, it is helpful to reflect on the initial impetus for proposing such a body—the need to address deficiencies in consumer protection relating to credit products. More specifically, the proposal is rooted in a recommendation from a Congressional oversight panel chaired by Professor Elizabeth Warren. Earlier this year, the panel issued a special report on regulatory reform, in which it offered a series of recommendations for "improving oversight, protecting consumers, and ensuring stability."[3] In a section entitled "Create a New System for Federal and State Regulation of Mortgages and Other Consumer Credit Products," the report makes the case that "ineffective regulation of mortgages and other consumer credit products has produced unfair, and often

[3] *See* Congressional Oversight Panel, *Special Report on Regulatory Reform* (Jan. 2009) ("Warren panel report"), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

abusive, treatment of consumers, which destabilizes both families and the financial institutions that trade in those products."[4] As examples, the report cites the rise of subprime mortgages with "exotic and often predatory new features," consumers' inability to understand legally required disclosure documents, and the impossibility of making meaningful comparisons among different mortgage products.

Against this backdrop of abusive practices, the report recommends the creation of a single federal agency with "the responsibility and accountability for drafting, implementing and overseeing effective consumer credit protection rules."[5] The report offers two options for structuring the new regulator—either as an independent agency, or within the Federal Reserve Board. The report indicates that "[p]lacing the new regulator within the [Federal Reserve] Board would keep safety and soundness and consumer protection responsibilities together, on the ground that each responsibility, if properly implemented, could complement and reinforce the other."[6] The suggestion to vest this responsibility within the Federal Reserve underscores that the CFPA proposal was inspired by the need to supplement banking regulators' ability to adequately protect consumers.

B. The Administration's CFPA Proposal

The Administration has set forth a broader vision of the CFPA. In both its white paper and its draft statutory language, the Administration envisions an agency that would "protect consumers of credit, savings, payment and other consumer financial products and services, and

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[4] *Id.* at 30.

5 *Id.* at 34. In recent testimony before this Committee, Professor Warren reaffirmed the original concept behind the CFPA: "[W]e are here today because of a problem that can be explained in five blunt words: the credit market is broken . . . I'm happy to be here today to talk about how I think we can help fix the broken credit market. And I can sum it up in four words: the Consumer Financial Protection Agency." Written Testimony of Elizabeth Warren, Professor of Law, Harvard Law School, before the House Financial Services Committee, Hearing on "Regulatory Restructuring: Enhancing Consumer Financial Products Regulation" (June 24, 2009).

[6] Warren panel report, *supra* note 3, at 35.

to regulate all providers of such products and services." But in discussing the specifics of why this new agency is needed, the Administration, like the Warren panel report, focuses above all on financial products offered to consumers by banks and their non-bank competitors such as mortgage companies. In its white paper, for example, the Administration highlights the fragmentation of consumer protection among the four federal banking agencies, the fact that the expertise and culture of the banking agencies is oriented to institutions and markets as opposed to consumers, and the limited tools and resources available to the Federal Trade Commission—which has a consumer protection mission—to supervise nonbank institutions. Recent testimony about the CFPA by a key Treasury Department official likewise focuses on current shortcomings with regard to the regulation and oversight of consumer products offered by banks, thrifts, credit unions, and their non-bank competitors:

> Instead of leadership and accountability, there is a fragmented system of regulation designed for failure. Bank and non-bank financial service providers often compete vigorously in the same consumer markets but are subject to two different and uncoordinated federal regimes—one based on examinations and supervision, the other based on after-the-fact investigations and enforcement actions. . . . Fragmentation of the supervision of banks and thrifts only makes the problem worse: a banking institution can choose the least restrictive among several different supervisory agencies. Despite best intentions, "regulatory arbitrage" inevitably weakens protections for consumers and feeds bad practices.[7]

The testimony then offers several examples by way of illustration: mortgages, credit cards, payday loans, auto loans, car title loans, and overdraft policies.[8]

The Administration has clearly crafted its proposal with the intention of keeping investor-oriented regulation—including in particular regulation of the fund industry—*outside* the

[7] Testimony of Michael Barr, Assistant Secretary for Financial Institutions, Department of the Treasury, before the House Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, Hearing on "The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC" (July 8, 2009), available at http://www.treas.gov/press/releases/tg199.htm.

[8] *Id.*

jurisdiction of the new agency. The Administration's white paper expressly states that the CFPA would *not* have authority with respect to "investment products and services already regulated by the SEC and [the Commodity Futures Trading Commission]," and its draft legislation contains explicit exclusions for any fund, investment adviser, or broker-dealer required to be registered with the SEC. Moreover, the Administration is separately recommending a series of reforms to "improve the SEC's ability to protect investors, focusing on principles of transparency, fairness, and accountability." These recommendations include initiatives that are intended to provide greater protection for individual (retail) investors.

C. Why Funds and Their Service Providers Are Appropriately Regulated by the SEC

As the Administration has correctly recognized, the CFPA should not have jurisdiction over funds and their investment advisers, because they are already appropriately regulated by the SEC. The same should be true for other service providers to funds that are also under the SEC's jurisdiction.[9]

Funds—as both issuers of securities and as significant investors in the capital markets—are subject to a comprehensive regulatory framework that has worked extremely well for almost 70 years. This framework, which was created by Congress in the wake of our nation's last great financial crisis, includes the four major federal securities laws: the Securities Act of 1933; the Securities Exchange Act of 1934; the Investment Advisers Act of 1940; and the Investment Company Act of 1940. These four statutes, and the extensive SEC rulemaking that flows from them, govern how funds are structured, their day-to-day operations, the types and frequency of disclosures that funds must make to investors, purchases and sales of securities for fund

[9] Subsection D below recommends that Congress include an explicit exclusion for any SEC-regulated entity acting in its regulated capacity.

portfolios, sales of fund shares to investors, permitted and prohibited activities by fund service providers, and so on. Even more important than the breadth of this regulatory framework is its common focus—on protecting investors and maintaining the integrity of our nation's capital markets.

While not immune from problems, this robust and developed system of regulation has proven to be extraordinarily successful in safeguarding investor interests while also allowing for the growth of a competitive and innovative fund industry. As a prime example, funds are subject to more extensive disclosure and transparency requirements than any other financial product. The SEC, with the strong support of investor advocates and the fund industry, has devoted substantial time and resources to making mutual fund disclosure easily accessible, understandable and useful to investors.[10] Hallmarks of this disclosure include clear, standardized disclosure of fund fees and expenses in a table at the front of a fund's prospectus and risk disclosure written in plain English. The availability of clear disclosure helps to ensure that fund shareholders understand their investments and can make educated choices.

This regulatory framework has proven remarkably resilient through difficult market conditions and has shielded fund investors from many of the problems associated with other financial products and services. The greater discipline that has worked so well in core areas of fund regulation—such as daily mark-to-market valuation, tight leveraging restrictions, clear and prominent risk disclosure, independent custody, independent director oversight, and affiliated

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[10] *See, e.g., Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies,* SEC Release No. IC-28584 (Jan. 13, 2009), 74 Fed. Reg. 4546 (Jan. 26, 2009), available at http://www.sec.gov/rules/final/2009/33-8998.pdf (adoption of rule changes requiring funds to include a new "summary section" at the beginning of each prospectus and permitting funds to use a "summary prospectus" to provide key fund information to investors, while making additional information available online or in paper upon request).

transaction prohibitions—may well provide a model for the oversight of other participants in the financial markets.

This regulatory framework, moreover, extends far beyond funds themselves. A fund typically has no employees; its operations are carried out by service providers such as the fund's investment adviser, principal underwriter, and transfer agent. These entities, and the functions that they perform for funds, are also regulated by the SEC, as are the broker-dealer firms that sell fund shares. Large volumes of fund share transactions are cleared and settled through the National Securities Clearing Corporation (NSCC), also regulated by the SEC. And two types of funds—exchange-traded funds and closed-end funds—trade on securities exchanges that operate in accordance with, and impose on listed companies including funds, rules that are subject to SEC approval. The SEC thus has comprehensive regulatory authority under the federal securities laws over funds, their service providers, and various other market participants (such as clearing agencies) whose services are integral to fund operations.

The unique characteristics of funds' structure and operations would make it very difficult as a practical matter to separate fund regulation from all other aspects of their oversight performed by the SEC. A separate regulatory regime for funds under the CFPA could well mean that funds—and their boards, advisers, and distributors—would find themselves subject to conflicting regulatory philosophies and potential regulatory overlap. Either of these results would be burdensome and inefficient. Ironically, such a system could also lead to *gaps* in regulation, because it would be impossible to draw clear lines of authority over funds between the CFPA and the SEC.[11]

[11] SEC Chairman Mary Schapiro has expressed similar sentiments about the idea of a separate consumer protection regulator being given authority over funds and their service providers currently regulated by the SEC. *See* Yin Wilczek, *Schapiro: Discussions Still Ongoing Over SEC Authority in Pending Reform*, BNA Securities Regulation and Law Report, Vol. 41, No. 21, at 960 (May 25, 2009) (stating that the SEC's authority over mutual funds, fund

There are gaps and other weaknesses in the financial regulatory system that must be addressed. But the regulation of funds has not been one of them. In fact, the fundamental investor protection provisions in the Investment Company Act and the other federal securities laws have withstood the test of time. For all of the foregoing reasons, ICI strongly believes that the SEC continues to be the appropriate regulatory standard setter for funds and their service providers.

D. Recommended Clarifications to the Administration's CFPA Proposal

a. Explicit Exclusion for All SEC-Regulated Entities

The Administration's white paper expressly states that the CFPA would *not* have authority with respect to "investment products and services already regulated by the SEC and CFTC." As discussed above, in the fund context, the "investment services" regulated by the SEC include the full range of services integral to fund operations—services provided not only by investment advisers and broker dealers, but also by entities such as transfer agents, custodians, and clearing agencies. The Administration's draft legislation, however, does not sufficiently provide for this intended exclusion. ICI accordingly recommends that the legislation's definition in Section 1022(f)(2)(A) of "person regulated by the SEC" be extended to cover any SEC-regulated entity acting in its regulated capacity. This exclusion not only would better reflect the Administration's original intent, but would avoid the ambiguity that undoubtedly would accompany attempts to parse the federal securities laws in an effort to identify each and every entity and activity that would remain under the SEC's jurisdiction. Failure to draw the lines clearly and properly would result in overlapping—and very possibly conflicting authority—over entities and activities that were overlooked.

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disclosures, and investment management services related to funds "cannot be separated into simple little pieces and moved over to another agency" and that "[t]hose things should remain with the integrated capital markets regulator.").

b. Explicit Exclusions for Tax-Favored Retirement and Education Savings Vehicles

Regulating activities in connection with 401(k) plans, IRAs, 529 plans, and similar tax-favored retirement and educational savings vehicles through a new regulator would be far afield from the Administration's intent to address deficiencies in consumer protection for credit and related products offered by banks, thrifts, credit unions and their non-bank competitors. We are pleased that there is nothing in the public statements of the Administration to suggest that the Administration contemplates extending the jurisdiction of the new regulator to tax-favored savings vehicles and their service providers. Congress should explicitly exclude these entities in any eventual legislation.

Vesting jurisdiction in the CFPA over retirement and education savings vehicles would be ill-advised and disruptive of long-standing and effective regulatory regimes. Congress has already provided for the regulation of retirement and eligible deferred compensation plans and arrangements under the tax laws in sections 401(a), 401(k), 403(a), 403(b), 457(b), 408, and 408A of the Internal Revenue Code ("Code") and in the Employee Retirement Income Security Act ("ERISA"), and has provided for the regulation of educational savings arrangements under section 529 of the Code.

The regulatory framework under the Code, which has existed and been strengthened over a period of more than 60 years (and was extensively expanded in ERISA 35 years ago), imposes strict conditions on obtaining tax-favored treatment, and severe tax consequences for the failure to meet these requirements. These requirements are substantive and oriented to investor protection. The Code also sets out prohibited transaction and disclosure rules, and imposes significant penalties in the form of excise taxes for violations of those requirements.

ERISA, which was enacted in 1974, sets forth reporting requirements (*e.g.*, Form 5500 annual report) and disclosure requirements (*e.g.*, summary plan description, periodic benefit statements, existing and proposed requirements on investment product disclosure) designed to assure that the operations of retirement plans are transparent and that participants have clear and user-friendly information with which to understand and make decisions about their plans. ERISA also contains detailed rules governing the operation of employee benefit plans that apply to those who act on behalf of the plan (plan fiduciaries) and to custodians, trustees, and other service providers. Assets of an ERISA-covered plan must be held in trust for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of the plan. In addition, plan fiduciaries must meet strict fiduciary duties in the exercise of their responsibilities, including duties of care and loyalty, and must assure that plan service arrangements are reasonable and provide for no more than reasonable compensation. Moreover, ERISA provides for a series of publicly and privately enforced civil remedies (as well as certain criminal penalties) for violations of ERISA rules.

In administering the applicable laws, the Department of Labor, the Treasury Department and the IRS focus on assuring that these arrangements operate *solely* in the interest of the participants and beneficiaries. The Treasury Department and the IRS also are charged with assuring that the tax benefits of the arrangements are not abused, a mission fully compatible with protecting participants and beneficiaries.

With respect to 529 plans, in addition to the rigorous standards imposed on these plans under the Code, rules of the Municipal Securities Rulemaking Board, which must be approved by the SEC, ensure that investors are provided with comprehensive and current information

concerning the products and that sellers of these products abide by standards of conduct designed to protect investors.

Creating any measure of parallel jurisdiction in the CFPA over these matters would serve no consumer protection purpose but would create a burdensome and inefficient structure that could subject plans and their service providers to conflicting regulatory philosophies and potential regulatory overlap. For example, although the exclusion for SEC-regulated entities would prevent the CFPA from asserting jurisdiction over funds, the agency might assert jurisdiction over certain aspects of the use of investment products, including mutual funds, in 401(k) plans and IRAs. Because almost half of the assets held in 401(k) plans and IRAs today are invested in mutual funds, the potential regulatory tug of war between the retirement regulators (the Treasury Department, the IRS, and the Department of Labor), the SEC, and CFPA predictably would produce significant confusion and potential conflicts.

c. CFPA Jurisdiction Generally

As the foregoing discussion illustrates, it will be important for Congress—if it establishes the CFPA—to delineate as clearly as possible its lines of jurisdiction, and to provide strong oversight of the new agency in order to prevent any jurisdictional "creep." Our financial markets are dynamic, and new products and services will continue to be introduced. As a result, the lines now drawn for the CFPA could, absent very careful consideration, become less clear over time.

By way of analogy, when the CFTC was established in the mid-1970s, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. As new, innovative financial instruments were developed, the lines between securities and futures often

became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection between CFTC and SEC jurisdiction. In fact, a separate component of the Administration's reform plan is devoted to addressing these very problems.

III. NECESSARY REFINEMENTS AND IMPROVEMENTS TO THE INVESTOR PROTECTION ACT OF 2009

The Administration has also prepared separate draft legislation addressing several issues relating directly to SEC authority and amending several statutes under its purview. The "Investor Protection Act of 2009" contains two provisions that, as currently drafted, present serious concerns to ICI. First, the requirement that *fund* disclosure be delivered at or before the time of sale is highly problematic. ICI has long supported point of sale disclosure, but for *all* retail investment products. Second, the standard of "conduct"—rather than an explicit fiduciary duty—proposed for broker-dealers and investment advisers, may not be sufficient to fully protect the millions of investors who rely on these intermediaries for advice.

A. Broaden the Scope of Point of Sale Disclosure

The Investor Protection Act would fundamentally change the way funds—and only funds—are sold. As previously discussed, funds and their investors have weathered the financial crisis better than many other market participants. We are deeply troubled, therefore, that the Investor Protection Act would apply only to funds in authorizing the SEC to designate the documents or information that must precede a sale to a purchaser of securities. We have long supported the concept of enhanced disclosure to investors at the time they are making investment decisions, but limiting this point of sale disclosure requirement to funds provides incomplete investor protection and may in practice disserve investors. Such rules could create strong

incentives for brokers and other intermediaries to recommend other investment products not subject to the same regulatory burdens, such as variable annuity contracts, collective investment trusts and separate accounts, even when those products do not offer the same level of regulatory protection and other benefits for investors.

Regulators and consumer advocates alike have expressed concerns about this likely result. Former NASD Chairman Robert Glauber, for example, has stressed the need to consider this consequence, explaining that "[a]n investor should be sold a security because it's right for him or her, not because it's easier to sell than something else."[12] Similarly, Barbara Roper of the Consumer Federation of America stated that by considering certain fee disclosures as "a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing."[13]

We therefore strongly believe that any point of sale disclosure obligation should be product-neutral. The policy goals underlying point of sale disclosure—assuring that investors understand their investment and the compensation arrangements of those recommending the investment—are no less valid for other types of investments. If investors would benefit from receiving certain information earlier in the sales process, providing that information should be required for all retail investment products, not just funds.[14]

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[12] Remarks by Robert Glauber, Chairman, NASD, at the Investment Company Institute's 2006 General Membership Meeting (May 18, 2006), available at http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/p016642.

[13] Remarks by Barbara Roper, Director of Investor Protection, Consumer Federation of America, at the Securities and Exchange Commission 12b-1 Roundtable, Unofficial Transcript, p. 196, available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf.

[14] ICI did not support an earlier SEC point of sale proposal because other financial products would not be subject to the same requirements and also because it was inconsistent with the manner in which brokers sell mutual fund shares. *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Mr. Jonathan Katz, Secretary, U.S. Securities and Exchange Commission, dated Apr. 4, 2005.

Crafting rules for all retail investment products would be a substantial undertaking, but that challenge should not permit regulators to shrink from making the difficult decisions necessary to bring these protections to investors in all retail investment products. For example, the appropriate substance of the disclosure, which we believe must include information about intermediary compensation and potential conflicts of interest, must be determined. The SEC's recently adopted summary prospectus proposal—which the Administration's white paper points to as a possible point of sale document—was not designed to provide this information. Rather, the summary prospectus contains important information about a *fund*, which may be sold through a variety of intermediary channels with a range of attendant costs. The challenges of developing a workable and useful point of sale document are evidenced by the fact that the SEC's previous point of sale initiative, which did not extend to all retail investment products, has been underway for more than five years.[15]

We would further emphasize that any point of sale disclosure requirement must be designed to minimize disruptions to the sales process. Investment sales typically occur by telephone or over the Internet, rather than through face-to-face meetings, so the physical transfer of a document is not realistic. Any point of sale disclosure requirement should provide investors with timely and convenient access to the required information without impeding investors' ability to conduct transactions and without imposing inappropriate costs and burdens on intermediaries. For all of these reasons, we strongly oppose a point of sale disclosure regime that focuses solely on funds.

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[15] *See* Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, SEC Release Nos. 33-8358; 34-49148; IC-26341 (Jan. 29, 2004) [69 Fed. Reg. 6438 (Feb. 10, 2004)]; Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds Reopening of Comment Period and Supplemental Request for Comment, SEC Release Nos. 33-8544; 34-51274; IC-26778 (Feb. 28, 2005) [70 Fed. Reg. 10521 (March 4, 2005)].

B. Standard of Care for Investment Advice

Over the last decade, brokers have significantly shifted their business model to include providing investment advice and charging fees based on assets under management, rather than commissions for each transaction. This model previously had been used solely by investment advisers. With the change in brokers' business practices, many investors have become confused about the type of entity providing advice, and the disparate level of protection they may receive depending on the "hat" the intermediary wears. Many, including ICI, have called for clarity for investors seeking investment advice—if broker-dealers and investment advisers are providing virtually identical services to retail investors, the rules and principles governing those activities should be identical as well.

Defining the boundaries of "harmonization" will not be an easy task, but some general principles should guide the debate. First, there must be recognition that brokers have changed their business practices to become more like advisers—who have generally been successfully regulated under the Investment Advisers Act of 1940 for nearly seven decades. "Harmonization" that seeks to make advisers more like brokers has no foundation in investor protection. Second—and following directly from the first principle—the standard that governs the provision of investment advice must be one that explicitly incorporates the fiduciary duty that governs investment advisers' dealings with their clients. Anything less will fall short of the investor protections currently enjoyed by advisory clients. Section 913(b) of the draft legislation attempts to describe a standard that appears to be "in substance" similar to a fiduciary duty. But it fails to state expressly that brokers and advisers alike must act as fiduciaries. In effect, it would dilute the protections currently provided to advisory clients.[16] A statute that purports to

[16] We note that the title of Section 913 does appear to establish a fiduciary duty, but the text of Section 913(b) neglects to use the term. If it is the Administration's intent to impose a fiduciary duty, it should so clearly state.

protect investors must not lower standards and weaken protections they have historically enjoyed.

Chairman Schapiro has endorsed such a fiduciary standard, stating: "I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients."[17] Others have observed that a fiduciary standard "has real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and the client, and it controls all aspects of their relationship. It is not a check-the-box standard that only periodically applies."[18]

IV. ENSURING EFFECTIVE CAPITAL MARKETS REGULATION

Currently, securities and futures—and their respective markets and market participants—are subject to separate regulatory regimes administered by two very different federal regulators. This system reflects historical circumstances but is out of step with the increasing convergence of these two industries. It has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. In its March white paper, ICI recommended the creation of a Capital Markets Regulator as a new independent federal agency that would encompass the combined functions of the SEC and those of the CFTC that are not agriculture-related, with the goal of bringing a consistent policy focus to U.S. capital markets.

In its own white paper, the Administration acknowledges these same shortcomings with the current system but stopped short of recommending a merger of the two agencies, presumably

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[17] Speech by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009).

[18] Speech by Commissioner Luis A. Aguilar, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009).

in recognition of the practical obstacles to such a regulatory consolidation. Instead, the Administration has called upon the SEC and CFTC to recommend changes to existing statutes and regulations aimed at harmonizing the regulation of economically equivalent financial instruments. We understand that the two agencies have begun these discussions, and we look forward to reviewing the agencies' recommendations.

Many of ICI's recommendations on how to fashion an effective Capital Markets Regulator may just as appropriately be applied to the SEC. Most importantly, we recommend that the agency remain sharply focused on investor protection and law enforcement, as distinct from the safety and soundness of regulated entities. The SEC also must remain focused on maintaining the integrity of the capital markets, which will benefit both market participants and investors. Congress should ensure that the agency is given the resources it needs to fulfill its mission.[19] Further, the SEC must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

Paying careful attention to how the SEC is organized and managed will yield large dividends in terms of enhancing the agency's effectiveness. ICI's white paper outlines several recommendations in this regard, including the need for high-level focus on management of the agency. We stress the importance, for example, of the agency's having open and effective lines of internal communication, mechanisms to facilitate internal coordination and information sharing, and a comprehensive process for setting regulatory priorities and assessing progress.

We commend Chairman Shapiro for moving aggressively to strengthen the SEC and restore the agency's reputation for excellence. We were particularly pleased with the Chairman's recent announcement of her intention to retain a chief operating officer to manage

[19] *See* Investment Company Institute, Statement on the U.S. Securities and Exchange Commission's Appropriations for Fiscal Year 2010, submitted to the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate (June 9, 2009).

the SEC's internal operations, a step that is consistent with our white paper recommendations.[20] We likewise are heartened by the Chairman's commitment to hiring more agency staff with significant industry experience, which will help the agency to stay abreast of market and industry developments.[21]

As outlined in ICI's white paper, there are other ways in which the SEC could seek to maximize its effectiveness in performing its responsibilities. Three of our most significant suggestions are briefly mentioned here. First, ICI believes the SEC would benefit from developing close, cooperative interaction with the entities it regulates as a means to identify and resolve problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions, and could be accomplished in a way that would not weaken the agency's strong enforcement program. Second, the SEC should establish a variety of mechanisms to stay abreast of market and industry developments, in addition to hiring staff with considerable industry experience. For example, the agency could establish a multidisciplinary "Capital Markets Advisory Committee" comprised of private-sector representatives from all major sectors of the capital markets. Third, the SEC will be best positioned to accomplish its mission if it conducts economic analysis in various aspects of its work, including rulemaking, examinations, and enforcement. From helping the agency look at

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[20] *See* Statement of Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Before the Subcommittee on Financial Services and General Government, U.S. Senate Committee on Appropriations (June 2, 2009).

[21] *See SEC Announces New Initiative to Identify and Assess Risks in Financial Markets* (April 30, 2009), available at http://www.sec.gov/news/press/2009/2009-98.htm.

broad trends that shed light on how markets or individual firms are operating to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the SEC's capability to conduct economic analysis will be well worth the long-term effort required.

V. SYSTEMIC RISK REGULATION

A. General Observations

The ongoing financial crisis has highlighted the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. Over the past year, various policymakers, financial services industry representatives, and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing these risks. A mechanism that will allow federal regulators to look across the system should equip them to better anticipate and address such risks.

ICI was an early supporter of creating a systemic risk regulator. But we also have long advocated that two important cautions should guide Congress in determining the composition and authority of a systemic risk regulator.[22] First, the legislation establishing a systemic risk regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system that may stifle innovations, impede competition or impose needless inefficiencies. Second, a systemic risk regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance.

Legislation establishing a systemic risk regulator should clearly define the nature of the relationship between this new regulator and the primary regulator(s) for the various financial sectors. It should delineate the extent of the authority granted to the systemic risk regulator, as

[22] *See, e.g.*, ICI white paper, *supra* note 1.

well as identify circumstances under which the systemic risk regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators should act as the first line of defense in detecting potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI was an early proponent of structuring a systemic risk regulator as a statutory council comprised of senior federal regulators. In March, I testified at a Senate Banking Committee hearing focused on investor protection and the regulation of securities markets. My observations about establishing a systemic risk council—and those of another witness on the panel, Damon Silvers of the AFL-CIO—were favorably received by both the Committee Chairman and Ranking Member.[23] Following the hearing, the Committee asked ICI to elaborate, both in writing and by briefing the Committee, about the structure and organization of a systemic risk council, and the positives and negatives of this approach to systemic risk regulation.[24] Since that time, there has been growing support for such an approach, both from federal and state regulators and others.[25]

B. The Administration's Proposed Approach to Systemic Risk Regulation

In view of ICI's support for a council approach to systemic risk, we were pleased to see that the Administration's white paper includes recommendations for a Financial Services Oversight Council. The Council would be charged with monitoring for emerging threats to the

[23] *See, e.g.*, Opening Statement of Chairman Christopher J. Dodd, "Enhancing Investor Protection and the Regulation of Securities Markets, Part II," Senate Committee on Banking, Housing and Urban Affairs (March 26, 2009), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=3412e671-6b45-4b4c-b5ba-2749de825dbe.

[24] ICI's recommendations on how to structure a systemic risk council are set forth in Subsection C below.

[25] *See, e.g.*, Statement of Sheila C. Bair Chairman, Federal Deposit Insurance Corporation, before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Regulating and Resolving Institutions Considered 'Too Big To Fail'" (May 6, 2009) ("Bair Testimony"); Senator Mark R. Warner, "A Risky Choice for a Risk Czar," *Washington Post* (June 28, 2009).

stability of the financial system, and would have authority to gather information from the full range of financial firms to enable such monitoring. As envisioned by the Administration, the Council also would serve to facilitate information sharing and coordination among the principal federal financial regulators, provide a forum for consideration of issues that cut across the jurisdictional lines of these regulators, and identify gaps in regulation.[26] In our white paper, we observe that the stronger links between regulators and the sense of shared purpose that would grow out of these collaborative efforts would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community.

The Administration's proposal would nonetheless vest the lion's share of authority and responsibility for systemic risk regulation with the Federal Reserve, relegating the Council to at most an advisory or consultative role. In particular, the Administration recommends granting broad new authority to the Federal Reserve, including: (1) the ultimate voice in determining which financial firms would potentially pose a threat to financial stability, through its designation of so-called "Tier 1 Financial Holding Companies"[27]; (2) the ability to collect reports from all financial firms meeting minimum size thresholds and, in certain cases, to examine such firms, in order to determine whether a particular firm should be classified as a Tier 1 FHC; (3) consolidated supervisory and regulatory authority over Tier 1 FHCs and their subsidiaries, including the application of stricter and more conservative prudential standards[28]

[26] *See* Administration white paper, *supra* note 2, at 18.

[27] The Administration proposes requiring the Federal Reserve to consider certain specified factors and to get input from the Council; the Federal Reserve, however, would have discretion to consider other factors, and the final decision of whether to designate a particular firm for Tier 1 FHC status would be its alone.

[28] As noted in the Administration's white paper, the Federal Reserve is currently constrained by the Gramm-Leach-Bliley Act from imposing higher prudential requirements or more stringent activity restrictions on subsidiaries of bank holding companies that already have a primary regulator (*e.g.*, broker-dealers and investment advisers subject to SEC regulation).

than those applicable to other financial firms; and (4) the role of performing "rigorous assessments of the potential impact of the activities and risk exposures of [Tier 1 FHCs] on each other, on critical markets, and on the broader financial system."[29] The Administration's white paper acknowledges that "[t]hese proposals would put into effect the biggest changes to the Federal Reserve's authority in decades."[30]

ICI believes that the Administration's approach would strike the wrong balance, by expanding the mandate of the Federal Reserve well beyond its traditional areas of expertise and failing to draw appropriately on the expertise of the other federal functional regulators. The Administration's white paper fails to explain why its proposed identification and regulation of Tier 1 FHC is appropriate in view of concerns over market distortions that could accompany "too big to fail" designations. Further, the standards that would govern determinations of Tier 1 FHC status are highly ambiguous.

The shortcomings that we see with the Administration's plan reinforce ICI's belief that a properly structured statutory council would be an effective mechanism to orchestrate and oversee the federal government's efforts to monitor for potential systemic risks and mitigate the effect of such risks. Below, we set forth our detailed recommendations for the composition, role and scope of authority that should be afforded to such a council.

C. Fashioning an Effective Systemic Risk Council

In concept, a "Systemic Risk Council" would be similar to the National Security Council (NSC), which was established by the National Security Act of 1947. In the aftermath of World War II, Congress recognized the need to assure better coordination and integration of "domestic,

[29] *See* Administration white paper, *supra* note 2, at 24.

[30] *Id.* at 25.

foreign, and military policies relating to the national security" and the ongoing assessment of "policies, objectives, and risks." The 1947 Act established the NSC under the President as a Cabinet-level council with a dedicated staff. In succeeding years, the NSC has proved to be a key mechanism used by Presidents to address the increasingly complex and multi-faceted challenges of national security policy. It was my honor from 1987-1989 to serve as statutory head (*i.e.*, Executive Secretary) of the NSC staff.

As with national security, addressing risks to the financial system at large requires diverse inputs and perspectives. A Systemic Risk Council's membership accordingly should draw upon a broad base of expertise, and should include at a minimum the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and the heads of the federal bank and capital markets regulators (and insurance regulator, if one emerges at the federal level). As with the NSC, flexibility should exist to enlist other regulators into the work of the Council on specific issues as required—including, for example, state regulators and self-regulatory organizations.

By statute, the Council should have a mandate to monitor conditions and developments in the domestic and international financial markets, to assess their implications for the health of the U.S. financial system at large, to identify regulatory actions to be taken to address systemic risks as they emerge, to assess the effectiveness of these actions, and to advise the President and the Congress on emerging risks and necessary legislative or regulatory responses. The Council would be responsible for coordinating and integrating the national response to systemic financial risks, but it would not have a direct operating role (much as the NSC coordinates and integrates military and foreign policy that is implemented by the Defense or State Department and not by the NSC itself). Rather, responsibility for addressing identified risks would lie with the existing

functional regulators, which would act pursuant to their normal statutory authorities but under the Council's direction.

The Secretary of the Treasury, as the senior-most member of the Council, should be designated chairman. An executive director, appointed by the President, should run the day-to-day operations of the council and serve as head of the Council's staff. The Council should meet on a regular basis, with an interagency process coordinated through the Council's staff to support and follow through on its ongoing deliberations.

To accomplish its mission, the Council should have the support of a dedicated, highly-experienced staff. The staff should represent a mix of disciplines (*e.g.*, economics, accounting, finance, law) and should consist of individuals seconded from government departments and agencies (federal and state), as well as recruited from the private sector with a financial services business, professional or academic background. As with the NSC, the staff's focus would be to support the work of the Council as such, and thus the staff would operate independently from the functional regulators.[31] Nonetheless, the background and experience of the staff would help assure the kind of strong working relationships with the functional regulators necessary for the Council's success. Such a staff could be recruited and at work in a relatively short period of time. The focus in recruiting such a staff should be on quality, not quantity, and the Council's staff accordingly need not and should not be large.

Advantages of a Systemic Risk Council:

- The proposed Council would avoid risks inherent in designating an existing agency like the Federal Reserve to serve essentially as an all-purpose systemic risk regulator. In such a role, the Federal Reserve understandably may tend to view risks and risk mitigation

[31] A Council designed in this way would be markedly different from the Administration's Financial Services Oversight Council, which would reside within the Treasury Department.

through its lens as a bank regulator focused on prudential regulation and "safety and soundness" concerns, potentially to the detriment of consumer and investor protection concerns and of non-bank financial institutions. A Systemic Risk Council would bring all competing perspectives to bear and, as a result, would be likely strike the proper balance.

- Systemic risks may arise in different ways and affect different parts of the domestic and global financial system. No existing agency or department has a comprehensive frame of reference or the necessary expertise to assess and respond to any and all such risks. Creating such an all-purpose systemic risk regulator would be a long and complex undertaking, and would involve developing expertise that duplicates that which exists in today's functional regulators. The Council by contrast would enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. It also could be established and begin operation much more quickly.
- A Council would provide a high degree of flexibility in convening those federal and state regulators whose input and participation is necessary to addressing a specific issue, without creating an unwieldy or bureaucratic structure. As is the case with the NSC, the Council should have a core membership of senior federal officials and the ability to expand its participants on an ad hoc basis when a given issue so requires.
- With an independent staff dedicated solely to pursuing the Council's agenda, the Council would be well positioned to test or challenge the policy judgments or priorities of various functional regulators. Moreover, by virtue of their participation on the Council, the various functional regulators would themselves likely be more attentive to emerging risks or regulatory gaps. This would help assure a far more coordinated and integrated

approach. Over time, the Council also could assist in framing a political consensus about addressing significant regulatory gaps and necessary policy responses.

- This model anticipates that functional regulators, as distinct from the Council itself, would be charged with implementing regulations to mitigate systemic risks as they emerge. This operational role is appropriate because the functional regulators have the greatest knowledge of their respective regulated industries. Nonetheless, the Council and its staff would have an important independent role in evaluating the effectiveness of the measures taken by functional regulators to mitigate systemic risk and, where necessary, in prompting further actions.

- The Council as outlined above could have two separate but interrelated mandates—systemic risk and policy coordination/information sharing across the various functional regulators. We believe this model, where all the functional regulators have an equal voice and stake in the success of the Council, would better accomplish this goal than a structure, such as the one the Administration has proposed, with one regulator—the Federal Reserve—having far more influence that the others. Further, the staffing and resources of the Council could be leveraged for both purposes. This would address some of the criticisms and limitations of the existing President's Working Group on Financial Markets.

Potential Criticisms—and How They Can Be Addressed:

- It has been argued that, because of the Federal Reserve's unique crisis-management capability as the central bank and lender of last resort, it is the only logical choice as a systemic risk regulator. To be sure, when we encounter serious financial instability, the Federal Reserve's authorities are indispensible to remedy the problems. But the purpose

of systemic risk regulation should be to identify in advance, and prevent or mitigate, the causes of such instability—a role to which the Council would seem best suited.

- A potential criticism of the council structure is that it may diffuse responsibility and pose difficulties in assuring proper follow-through by the functional regulators. While it is true that each functional regulator would have responsibility for implementing responses to address identified risks, it must be made clear in the legislation creating the Council (and in corresponding amendments to the organic statutes governing the functional regulators) that these responses must reflect the policy direction determined by the Council. Additionally, as suggested by FDIC Chairman Bair, the Council should have the authority to require a functional regulator to act as directed by the Council.[32] In this way, Congress would be assured of creating a Systemic Risk Council with "teeth."
- A related criticism of the council structure may be that it presents the potential for inaction, if its members are unable to reach agreement on a course of action. We believe that this potential could be easily foreclosed by specifying, in the authorizing legislation, a mechanism that requires the elevation of disputes to the President for resolution and/or assures strong Congressional oversight through periodic reporting to Congress of such disputes and their resolution.

VI. SELECTED OTHER AREAS FOR REFORM

A. Regulation of Money Market Funds

Money market funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool

[32] *See* Bair Testimony, *supra* note 25.

for retail and institutional investors, and are an exceptionally important source of short-term financing in the U.S. economy.[33] These funds have been comprehensively regulated by the SEC—not only under the Investment Company Act, but through a specialized and highly proscriptive rule, Rule 2a-7, for 30 years. In March, ICI, working through its Money Market Working Group, issued a comprehensive report outlining a range of measures to strengthen the liquidity and credit quality of money market funds and ensure that money market funds will be better positioned to sustain prolonged and extreme redemption pressures, including mechanisms to ensure that all shareholders are treated fairly if a fund sees its net asset value fall below $1.00.[34]

Consistent with the Working Group's recommendations, the Administration's white paper specifically directed the SEC to move forward with plans to strengthen the money market fund regulatory framework to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs.[35] ICI is pleased that the Administration recognizes that the SEC, as the primary regulator for money market funds, is uniquely qualified to evaluate and implement potential changes to the existing scheme of money market fund regulation. Indeed, last month the SEC proposed amendments to rules that govern money market funds.[36] The proposed amendments, many of which are similar to the Working Group's recommendations, are designed to make money

[33] *See* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Council on Foreign Relations, Washington, D.C.: Financial Reform to Address Systemic Risk (March 10, 2009) (acknowledging the importance of money market funds and the crucial role they play in the commercial paper market, a key source of funding for many businesses).

[34] *See Report of the Money Market Working Group*, Investment Company Institute (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[35] *See* Administration white paper, *supra* note 2, at 38-39.

[36] *See Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009), available on the SEC's website at http://sec.gov/rules/proposed/2009/ic-28807.pdf.

market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share. ICI looks forward to submitting comments on this proposal.

The Administration's white paper also directed the President's Working Group on Financial Markets to prepare a report assessing whether more fundamental changes are necessary to further reduce the money market fund industry's susceptibility to runs, such as eliminating the ability of a money market fund to use a stable net asset value or requiring money market funds to obtain access to reliable emergency liquidity facilities from private sources.[37] The white paper, however, cautioned both the SEC and the President's Working Group to carefully consider ways to mitigate any potential adverse effects of a stronger regulatory framework for money market funds, such as investor flight from money market funds into unregulated or less regulated money market investment vehicles.[38] ICI wholeheartedly agrees with this cautionary language and would be pleased to offer our assistance to the President's Working Group as it reviews these difficult issues.

B. Close Regulatory Gaps

Examination of the recent financial crisis has prompted calls for Congress to close regulatory gaps to ensure appropriate oversight of all market participants and investment products. We recommend that the SEC be given express authority to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the

[37] *See* Administration white paper, *supra* note 2.

[38] *Id.* at 39.

marketplace.[39] ICI supports reforms for these purposes in the areas discussed below, many of which are addressed in the Administration's white paper.

Hedge funds and other unregulated private pools of capital. ICI concurs with the Administration that the SEC should have express regulatory authority to oversee hedge funds (through their advisers) with respect to, at a minimum, their potential impact on the capital markets and other market participants.[40] Requiring hedge fund advisers to register under the Investment Advisers Act of 1940, as the Administration has proposed, would provide the SEC with reliable, current, and meaningful information about the hedge fund industry without adversely impacting the legitimate operations of hedge fund advisers.[41] Many ICI member firm complexes—all of whom are registered with the SEC—currently operate hedge funds and have found that registration is not overly burdensome and does not interfere with their investment activities.

If such a registration requirement is put into place, the SEC may wish to consider the adoption of specific rules under the Advisers Act that are tailored to the specific business practices of, and market risks posed by, hedge funds. Areas of focus for such rulemaking should include, for example, disclosure regarding valuation practices and the calculation of investment performance; both of these areas have been criticized as lacking transparency and presenting the

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[39] Although not necessitating legislative action, another area for reform is the regulation of credit rating agencies. ICI has long supported increased regulatory oversight, disclosure, and transparency requirements for credit rating agencies. We participated at a roundtable held by the SEC on the oversight of credit rating agencies in an effort to further the discussion on ways in which to improve ratings and the ratings process. *See* Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009, available at http://www.sec.gov/comments/4-579/4579-15.pdf.

[40] It is imperative, of course, that the SEC be organized and staffed, and have sufficient resources, to effectively perform this oversight function.

[41] ICI supported the SEC's 2004 adoption of a rule requiring hedge fund advisers to register with the SEC. In June 2006, this rule was struck down by the U.S. Court of Appeals for the D.C. Circuit.

potential for abuse. It also may be appropriate for the SEC to require nonpublic reporting by hedge fund advisers of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants.

To enhance regulatory oversight of the hedge fund industry, some have advocated requiring SEC registration of individual hedge funds.[42] ICI strongly opposes this approach, because it would blur what has been a strict dividing line between registered, highly regulated investment companies and unregistered, lightly regulated hedge funds.

Under current law, hedge funds are effectively outside the purview of the Investment Company Act by reason of Sections 3(c)(1) and 3(c)(7), which require that the hedge fund is not making or proposing to make a public offer of its securities and that those securities be sold only to certain specific groups of investors. These statutory limits on both the offer and the sale of hedge fund securities work together to ensure that hedge funds are made available only to financially sophisticated investors who should not need the comprehensive protections afforded by Investment Company Act regulation and who should be able to bear the risk of loss associated with their investment.

Despite clear statutory language precluding a hedge fund from "making or proposing to make a public offer of its securities," there have been several occasions in the recent past where the hedge fund industry has argued that it should be able to advertise through the public media, provided that sales of shares are made only to financially sophisticated investors. ICI firmly believes that any form of general solicitation or public advertising of unregistered hedge funds would surely cause investors to confuse such funds with registered, highly regulated investment companies. It also would present greater opportunities for perpetrators of securities fraud to identify and target unsophisticated investors. We accordingly recommend that the current "no

[42] *See, e.g.*, S. 344, "The Hedge Fund Transparency Act" (introduced Jan. 29, 2009).

public offering" requirement be reconfirmed in any legislation enacted to regulate hedge funds or their advisers.

No less critical is the need to preserve the current requirement that interests in hedge funds be sold only to financially sophisticated investors. To this end, ICI believes that the SEC should immediately adjust the accredited investor standards in Regulation D under the Securities Act of 1933 (which determine investor eligibility to participate in unregistered securities offerings by hedge funds and other issuers) to correct for the substantial erosion in those standards since their adoption in 1982. This one-time adjustment should be coupled with periodic future adjustments to keep pace with inflation. ICI also continues to support the SEC's 2006 proposal to raise the eligibility threshold for individuals wishing to invest in hedge funds organized under Section 3(c)(1) of the Investment Company Act. Under that proposal, an individual would need to be an "accredited investor" based upon specified net worth or income levels, as is now required, and own at least $2.5 million in investments. This proposed two-step approach is intended to mirror the higher investor eligibility requirements for hedge funds organized under Section 3(c)(7), which Congress added to the Investment Company Act in 1996.

Derivatives. The SEC should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, such as credit default swaps, while not unduly stifling innovation.[43] ICI supports current initiatives toward centralized clearing for certain derivatives, which should help to reduce counterparty risk and bring transparency to trading in the types of derivatives that can be standardized. Not all derivatives are sufficiently standardized to be centrally cleared, however, and institutional

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[43] In its March white paper, ICI recommended a merger of the SEC and the CFTC. In the absence of such a merger, we believe that the SEC is the regulator best suited to provide effective oversight of financial derivatives.

investors will continue to need to conduct over-the-counter transactions in derivatives. For those transactions, we support reasonable reporting requirements, in order to ensure that regulators have enough data on the derivatives market to provide effective oversight and address any market abuses. Finally, we believe that all institutional market participants should be required to periodically disclose their derivatives positions publicly, as funds are currently required to do.

Municipal Securities. The SEC should be granted expanded authority over the municipal securities market, and should use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized, and often stale, and there are numerous disparities from the corporate issuer disclosure regime.

This week, the SEC proposed several measures to improve current municipal securities disclosure. We are encouraged by these efforts but strongly agree with Chairman Schapiro that more will need to be done.[44] The SEC itself has stated on several occasions that it is near to the statutory limits of its present authority to address the disclosure needs of investors in municipal securities. "To provide investors in municipal securities with access to full, accurate, and timely information like that enjoyed by investors in many other U.S. capital markets, the [SEC] requires expanded authority over the municipal securities market."[45]

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[44] *Opening Statement before the Commission Open Meeting*, Mary L. Schapiro, Chairman, Securities and Exchange Commission, July 15, 2009.

[45] *See* U.S. Securities and Exchange Commission, "Disclosure and Accounting Practices in the Municipal Securities Market," White Paper to Congress, July 2007.

VII. CONCLUSION

We appreciate this opportunity to testify before the Committee. Reforming the financial services regulatory regime in the wholesale manner envisioned by the Administration and Congress is a generational undertaking of the utmost import. It is vital that our collective efforts produce a new regulatory regime that protects investors and consumers, but also allows the U.S. financial services industry to thrive and evolve to meet investor and consumer needs for decades to come. We hope that our recommendations strike the proper balance between these important objectives. We look forward to working with this Committee and Congress to achieve these ends.

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 25, 2009

The Honorable Spencer Bachus
Ranking Member
U.S. House of Representatives Committee on Financial Services
B371a Rayburn HOB
Washington, DC 20515

Re: Responses to Questions at a Hearing Regarding, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals", Held Before Financial Services Committee, U.S. House of Representatives, on July 17, 2009.

Dear Representative Bachus:

Managed Funds Association ("MFA")[1] is pleased to submit this letter in response to the written questions that you sent me following the hearing on July 17, 2009, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals". In your questions, you asked MFA to respond to issues relating to certain of the Administration's regulatory reform proposals. For your convenience, we have restated your questions below, followed by MFA's responses.

Over-the-counter derivatives provide thousands of American companies, both large and small, with the tools to manage their business risk, which lowers their cost of doing business. This allows them to pass along valuable savings to American consumers. Why does the Administration's proposal seem to ignore this reality, especially when most of these companies will never be "market makers" like AIG, which the Administration continues to reference when preaching the need to reform the OTC marketplace? One bad actor's behavior should not put an end to the legitimate use of derivatives for thousands of small companies. Under the Administration's plan, would American companies that use derivatives to manage business risk be required to tie up billions in cash, which they may not have, to post as collateral?

For market participants who use them, over-the-counter ("OTC") derivatives serve an important risk management function. In particular, market participants use these products to hedge against market risks and counterparty risks (*i.e.*, default exposure to a trading counterparty). OTC derivatives generally perform this function better than other risk management tools because they are liquid, they have low transaction costs, there is substantial depth to the

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

market, and they are more widely accessible as compared with other financial products, including the corporate bond market.

With respect to the broader economy, the OTC derivatives markets (and specifically, credit default swaps ("CDS")) have increased lending and credit flows, which in turn has: (i) lowered the cost of borrowing for many big and small companies in the United States and around the world; and (ii) provided consumers with greater access to credit to purchase additional goods and services.

The failure of institutions like AIG was a direct result of its poor risk management practices – not OTC derivatives. In particular, AIG's recent CDS difficulties principally resulted from dealers not requiring AIG to post any collateral so long as it had a AAA credit rating. It was highly atypical that a market participant would not be required to post collateral, but this abnormality in effect provided AIG with infinite leverage. As a result, AIG was able to build-up large unrealized and uncollateralized losses, which exposed its dealers and the financial system to the serious risks that eventually occurred.

MFA's members and other non-dealer, non AAA-rated market participants post collateral on all of their OTC derivatives transactions. We believe that posting collateral is an essential component of a good risk management practice in connection with OTC derivatives trading. As such, we support the mandatory posting of collateral in OTC derivatives trading, at least by all financial institutions.

For almost 30 years, we have had a regulatory system that divides financial products into two categories, securities and futures, and regulates them very differently, No other county adheres to these distinctions in how they regulate equivalent products. Instead, other countries have a single regulator for securities and futures. In your view, should there be one U.S. agency that regulates both securities and futures? Which areas should the SEC and CFTC focus on in harmonizing their statutes and regulatory approaches? Does the CFTC have a better approach in handling self-regulatory organization rule filings?

The securities market and futures market serve a different primary purpose — capital formation versus hedging — and the statutory and regulatory frameworks reflect these differences. The historical development of these markets has also played an integral role in shaping each regulatory framework. In light of the different purposes of these two markets, we believe that there should continue to be a separate regulatory framework for each market. Because we believe it is important for securities regulation and futures regulation to remain separate, we also believe that it is appropriate to have two different regulators responsible for implementing and enforcing those regulations.

Although we do not believe that securities and futures regulation should be combined into one regulatory framework, we do believe that greater coordination and communication is necessary between the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"). Further, we support the SEC and CFTC continuing to work to harmonize the two regulatory frameworks to achieve greater consistency, where appropriate. Greater regulatory consistency and uniformity would simplify compliance for market participants, eliminate redundancy and waste, and help avoid regulatory gaps and regulatory arbitrage.

On September 3, 2009, MFA participated in the SEC and CFTC's joint meeting on harmonization of regulation. With respect to investment funds, we recommended that the SEC and CFTC consider harmonizing and/or enhancing coordination and communication in the following areas: registration and oversight, the regulatory framework for private pools, regulation of public commodity pools, investor protection, and oversight of OTC derivatives.

It is important for each of the SEC and the CFTC to have an effective process for handling self-regulatory organization ("SRO") rule filings. These processes should be transparent, provide appropriate opportunity for public comment, and be designed to achieve a timely resolution to any proposed rules. MFA does not have a position, however, as to which agency, if either, has a better process for handling SRO rule filings.

Last week, the Administration released its investor protection legislative proposal. Do you support each component of this proposal? With respect to the prohibition on mandatory arbitration clauses, if investors have been harmed by an investment professional, how would costly and lengthy litigation protect their interests as compared to arbitration which is far more efficient?

We strongly support efforts to enhance investor protection and strengthen the authority of the SEC to enforce the federal securities laws through appropriate rulemaking. We believe that the Administration's proposed legislation contains many beneficial provisions, though we do have some comments on ways to improve certain other the provisions in the proposal.

We support the proposed establishment of an Investor Advisory Committee. We also support ensuring that the SEC has the appropriate authority to seek information from investors and the public; provided that there remains a transparent process of public disclosure for any information gathering, communication with investors or consumer testing the SEC conducts resulting in proposed rulemaking or recommendations that the SEC makes to Congress regarding the need for new legislation.

We further support providing the SEC with authority to collaterally bar persons that violate the securities laws while at a particular firm from associating with other securities firms. We believe the bill could be improved by also amending the Investment Advisers Act of 1940 (the "Advisers Act") to automatically bar a person who has engaged in criminal violations of the federal securities from associating with a registered investment adviser, subject to an appeal to the SEC.

We appreciate the importance of "leveling the playing field" with regard to the duty that investment advisers and broker-dealers owe to retail customers. As investment advisers currently subject to a well established fiduciary duty with respect to client relationships, we applaud that goal. We are concerned, however, that the proposed legislation would create a new standard of conduct for investment advisers, which would create unnecessary confusion for advisers.

We disagree with the provision in the proposed legislation that would permit the SEC to prohibit or limit the use of agreements that require customers or clients of any broker, dealer, municipal securities dealer or investment adviser to arbitrate any future dispute between them. We do not believe such restrictions would be appropriate for hedge fund investors. Hedge fund investors are sophisticated, experienced high net worth individuals and institutions who are capable of deciding whether mandatory arbitration or the right to litigation (which would

generally be more costly than arbitration) is in their best interests. Hedge fund investors also are in a position to negotiate terms with the managers they entrust with making investment decisions and, as such, hedge fund investors can negotiate the terms they need prior to making an investment.

Do you believe that the Consumer Financial Protection Agency's proposed mandate is both broad and vague enough that it could potentially capture securities industry participants and investment products?

It is our understanding that the Administration intended to exclude from its proposed "*Consumer Financial Protection Agency Act of 2009*" (the "CFPA") hedge funds and other entities and activities that are subject to the jurisdiction of the SEC and the CFTC. We believe that the relevant exclusion in the CFPA as drafted does not appear to exclude hedge funds or a number of other entities subject to SEC or CFTC jurisdiction.

On Wednesday, July 15, the Administration released its legislative proposal on private pools of capital. Does this proposal threaten the very comprehensive analysis and due diligence that investors perform prior to selecting a hedge fund manager or private equity firm? Does the SEC have the expertise to oversee all private pools of capital and is the Investment Adviser Act the right statute to govern private pools of capital?

MFA is supportive of the general approach taken in the Administration's proposed legislation – a comprehensive registration regime under the Advisers Act designed to ensure that there is appropriate regulatory oversight over investment advisers to private pools of capital. We recognize and appreciate the Administration's objective of registering and regulating important market participants that have previously been exempt from registration. It is critical that this objective be done in a way that creates a "smart" regulatory framework, and we believe the removal of the so-called 'private adviser' exemption currently in the Advisers Act achieves that objective with respect to investment adviser registration.

Ensuring that the registration framework is comprehensive is an important component of a "smart" regulatory framework; however, it is equally as important to ensure that any new regulatory framework does not impose unnecessary, duplicative and costly requirements on advisers to private pools of capital. Such action would have adverse consequences for markets and investors while providing little to no benefit with respect to enhancing investor protection and market integrity, promoting greater transparency to either markets or regulators, or monitoring systemic risk. In that regard, we believe that, as drafted, the Administration's proposed legislation would impose overlapping registration requirements for a number of commodity trading advisers that are already registered with, and well regulated by, the CFTC.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and

enforcement resources are already seriously constrained.[2] This raises the question whether the SEC would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We encourage policy makers to consider the issue of resources and regulatory capabilities as they develop proposals for an expanded regulatory mandate.

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator.

We do not believe that a registration framework would adversely affect the comprehensive due diligence done by sophisticated investors prior to investing in a hedge fund. Investors today conduct extensive diligence on both registered and unregistered advisers. Sophisticated investors are well aware that government registration and regulation is no substitute for robust due diligence, and these investors conduct their research appropriately. This point was specifically addressed by the President's Working Group's Investors' Committee in its January 15, 2009 report, *Principles and Best Practices for Hedge Fund Investors*. On page 46 of that report, the Investors' Committee specifically notes, "Investors, however, should be cautious in their reliance on registration by a hedge fund manager in any jurisdiction and should not substitute regulator oversight for their own due diligence in any circumstances." We fully agree with this recommendation, and we believe that sophisticated investors will continue to conduct robust due diligence on hedge fund managers, irrespective of the registration requirements for those managers.

MFA would welcome the opportunity to meet with you or members of your staff to respond to any further questions you may have. Feel free to contact me at (202) 367-1140 with any questions or if you would like to arrange such a meeting.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

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2 Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

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August 19, 2009

Ms. Terisa L. Allison
U.S. House of Representatives
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Re: Response to Questions of Ranking Member Congressman Spencer Bachus

Dear Ms. Allison:

Below are my responses to the questions of July 17, 2009, by Ranking Member Spencer Bachus relating to "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals."

Question: For almost 30 years, we have had a regulatory system that divides financial products into two categories, securities and futures, and regulates them very differently. No other country adheres to these distinctions in how they regulate equivalent products. Instead, other countries have a single regulator for securities and futures. In your view, should there be one U.S. agency that regulates both securities and futures? Which areas should the SEC and CFTC focus on in harmonizing their statutes and regulatory approaches? Does the CFTC have a better approach in handling self-regulatory organization rule filings?

Response: As I note in my written testimony, it has become increasingly clear over the past two decades that our system of regulating securities and futures under two distinctly different statutory structures – with separate regulatory agencies and different congressional committees – causes needless legal uncertainty and delay, impedes innovation and competition, and imposes unnecessary costs on our financial markets. I strongly believe that consolidation of the SEC and CFTC is the only comprehensive solution. We should not continue to tolerate the inefficient and ineffective system currently in place. I provide detail in my written testimony on the harms created by split jurisdiction and why a consolidation of the two agencies is urgently needed.

While merger of the two agencies is the best approach, the harmonization of the securities and futures statutory and regulatory structures would be an important first step toward ending bifurcated jurisdiction. I recommend that the SEC and CFTC focus on several areas in harmonizing their regulatory structures. First, the agencies should end the disparate margin treatment of stock index futures and stock index options held outside of a portfolio margin account. Futures exchanges are free to set margins with little or no CFTC involvement. In contrast, options exchanges must get any margin changes approved by the SEC. This has resulted in stock index futures margin being substantially less than the margin for comparable stock index options. Second, the agencies should end their impasse on the expansion of portfolio margining and of cross-margining between securities and futures products. The CFTC has insisted that any stock index futures in a portfolio margin securities account use a

so-called two pot approach where each clearing organization guarantees a member's obligation to the other clearing organization. In contrast, the SEC prefers a one-pot approach where collateral is held in a jointly controlled bank account and daily payments are netted to and from the clearing member. The inability of the two agencies to agree on the structure to employ has stymied any progress on the expansion of portfolio margin for customers. Third, the agencies should harmonize their process for handling broker insolvencies. Fourth, the lack of an insider trading prohibition and strong suitability provisions in the commodities statutes should be addressed.

Aside from these specific areas, the SEC should harmonize its procedures for review of self-regulatory organization ("SRO") rule filings with that of the CFTC. I strongly believe that the CFTC uses a better approach than the SEC in this area. Futures SROs need merely submit to the CFTC a certification of compliance with the futures laws when making a rule change. The CFTC can then decide if it wants to do a full review of the change. In the vast majority of certifications, it chooses not to undertake this review. In contrast, securities SROs must submit every proposed rule change to the SEC for review, with the majority being subject to a lengthy analysis by the agency. The SEC should adopt the certification approach employed by the CFTC.

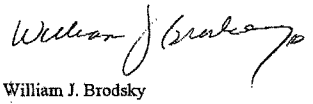
Question: Last week, the Administration released its investor protection legislative proposal. Do you support each component of this proposal? With respect to the prohibition on mandatory arbitration clauses, if investors have been harmed by an investment professional, how would costly and lengthy litigation protect their interests as compared to arbitration which is far more efficient?

Response: I can not comment on every aspect of the investor protection legislation. Many of its provisions do not affect my exchange directly. In general, I support efforts to enhance investor protection as investor confidence is the underpinning of our financial markets. Nevertheless, I am interested in the views of the SEC as to the specific provisions of this legislation.

Question: Do you believe that the Consumer Financial Protection Agency's proposed mandate is both broad and vague enough that it could potentially capture securities industry participants and investment products?

Response: I defer to the SEC as to whether the Consumer Financial Protection Agency's proposed mandate is too broad or vague as to capture securities industry participants and financial products. I would be troubled if the new agency's jurisdiction did overlap with that of the SEC, as duplicative regulation can be inefficient and wasteful.

Sincerely,



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Advancing the Practice of Fee-Only Financial Planning

August 12, 2009

U.S. House of Representatives
Committee on Financial Services
Terrie Allison
2129 Rayburn House Office Building
Washington, DC 20515

Dear Ms. Allison;

Members of the Financial Planning Coalition appreciate the opportunity to testify before the House Committee on Financial Services July 17, 2009. The following are responses to questions posed by Representative Spencer Bachus:

Question: Last week, the Administration released its investor protection legislative proposal. Do you support each component of the proposal? With respect to the prohibition on mandatory arbitration clauses, if investors have been harmed by an investment professional, how would costly and lengthy litigation protect their interests as compared to arbitration which is far more efficient?

Financial Planning Coalition Answer: The Financial Planning Coalition has not evaluated or taken a position on each of the individual components of the Administration's legislative proposal for investor protection. The three independent organizations comprising the Coalition have joined together for the sole purpose of advancing a proposal to create an oversight board that creates baseline competency and ethical standards for financial planning professionals or those who hold themselves out as financial planners. To that end we were pleased to see the Administration propose extending the application of a fiduciary standard to brokers who provide investment advice.

We do share the Congressman's belief that investors who have been harmed by investment professionals have the right to expect a fair and balanced system for redress of the harm caused by others.

Question: Do you believe that the Consumer Financial Protection Agency's proposed mandate is both broad and vague enough that it could potentially capture securities industry participants and investment products?

Financial Planning Coalition Answer: Members of the Financial Planning Coalition are evaluating how the CFPA would impact financial planning services and our proposal. The language defining securities industry participants in their various roles and capacities is a critical piece of any proposed legislation in this arena. The members of the Financial Planning Coalition were keenly aware of the individual buckets of activity when designing our proposal for an oversight board for financial planning professionals and tried to avoid any overlapping regulation. Our proposal directly exempts securities industry participants when they are engaged in the specific and limited activities covered by other state and federal laws, such as the sale of insurance by insurance agents and the sale of securities by brokers.

Once again, as a member of the Financial Planning Coalition, I thank you for the opportunity to testify.

Sincerely,

Diahann W. Lassus, CFP®, CPA/PFA
On Behalf of the Financial Planning Coalition

Ranking Member Spencer Bachus

Financial Services Committee

Answers to Questions for the Record – Douglas Lowenstein, Private Equity Council

"Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"

July 17, 2009

Q: Last week, the Administration released its investor protection legislative proposal. Do you support each component of this proposal? With respect to the prohibition on mandatory arbitration clauses, if investors have been harmed by an investment professional, how would costly and lengthy litigation protect their interests as compared to arbitration which is far more efficient?

A: The proposed legislation seems geared toward transactions in which investment advisers are providing investment advice to retail customers. As described in more detail below, advisers to private equity funds generally do not interact with retail customers.

We note two principal provisions of the Administration's proposed legislation. First, the proposal would amend the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to provide the SEC with rulemaking authority to establish standards of conduct for all brokers, dealers and investment advisers in providing investment advice about securities to retail customers or clients (and such other customers or clients as the SEC may by rule provide), specifically, that any such rules may establish a standard to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice. Second, as your question highlights, the Administration's bill would provide the SEC with rulemaking authority to prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the federal securities laws or the rules of a self-regulatory organization if the SEC finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.

We do not believe that either of these proposed reforms, would be necessary for the protection of investors in private equity funds.

Although there are a number of forms that a private equity fund may take, at its most basic, a private equity fund is a pooled investment vehicle. The members of the Private Equity Council, directly through their affiliates, typically act as an investment adviser to and sponsor of the pooled investment vehicle, and investors subscribe for interests in the pooled investment vehicle. The investment adviser to the private equity fund provides advice to the fund and its manager about investments to be made on behalf of the pooled investment vehicle. It does not provide advice to, or with respect to the investments of, individual investors in the pooled investment vehicle. The investors in the pooled investment vehicle are typically sophisticated institutional and other investors, as opposed to retail clients, with significant bargaining power.

Ranking Member Spencer Bachus
Financial Services Committee
Answers to Questions for the Record Douglas Lowenstein, Private Equity Council
"Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"
July 17, 2009

In general, private equity firms negotiate detailed and comprehensive subscription and fund agreements with their investors, as opposed to using "off-the-shelf" standard form contracts that may be more typical in the retail investor context. Those agreements typically include provisions regarding duties of the investment adviser, the fund manager and investors in the pooled investment vehicle, including conflict provisions and dispute resolution provisions. In some cases, the applicable dispute resolution provisions may require mandatory pre-dispute arbitration.

In general, the fund sponsor and fund investors are partners in the pooled investment vehicle. The subscription process occurs prior to or shortly after commencement of the private equity fund, and typically no additional investors may be admitted to the fund with new capital commitments after the initial subscription period has closed. Investors in the private equity fund receive an interest in the fund, and agree by contract to commit capital to the private equity fund, in specified maximum amounts, typically over a five to six year commitment period. Generally, investors have no right to redeem their interests in the fund and cannot transfer such interests without consent of the sponsor. Capital will be called from investors from time to time during the commitment period as needed to fund expenses or investments of the private equity fund in a manner consistent with the investment strategy or guidelines of the fund. At such time, investors will be apprised of the reason for the capital call and will be required to make capital contributions to the fund. In general, the private equity fund acquires significant stakes in companies that have potential for growth. The sponsor will typically obtain rights to influence management, whether through board representation or otherwise, and will invest time, energy, talent and capital to improve the acquired company's performance and prospects. The private equity fund typically holds the investment on a long-term basis.

Given these characteristics of private equity fund investment, particularly the collective nature of the enterprise and the long-term investment strategy that the private equity fund pursues, and the fact that investors are sophisticated institutional and other investors with bargaining power in establishing the terms of the relevant agreements, we do not believe that rules establishing special duties for advisers to the private equity fund or that would eliminate mandatory pre-dispute arbitration in the private equity fund context are necessary for the protection of private equity investors nor are they applicable and therefore we do not have a position at this time.

Ranking Member Spencer Bachus
Financial Services Committee
Answers to Questions for the Record – Douglas Lowenstein, Private Equity Council
"Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"
July 17, 2009

Q: Do you believe that the Consumer Financial Protection Agency's proposed mandate is both broad and vague enough that it could potentially capture securities industry participants and investment products?

A: As currently drafted, H.R. 3126 applies to anyone "acting as an investment adviser to any person (not subject to regulation by or required to register with the CFTC or the SEC.") We believe this was drafted with the assumption that this bill would pass as part of broader regulatory reform legislation that would require the registration of all private pools of capital with the SEC. Clearly, the intent is to exempt private equity firms (as registered investment advisers with the SEC) from being subject to this new regulatory regime. As described in further detail above, private equity firms do not interact with or market to retail consumers. Investors in private equity funds are highly sophisticated, institutional investors. The Consumer Financial Protection Agency is clearly intended to protect retail investors and we do not believe it would capture private equity funds.

Q: On Wednesday, July 15, the Administration released its legislative proposal on private pools of capital. Does this proposal threaten the very comprehensive analysis and due diligence that investors perform prior to selecting a hedge fund manager or private equity firm? Does the SEC have the expertise to oversee all private pools of capital and is the Investment Adviser Act the right statute to govern private pools of capital?

A: Requiring private equity firms to register as Investment Advisers will enhance transparency and disclosure, however I do not believe that the fact that firms are registered will change the nature or level of analysis private equity investors perform on private equity funds. Investors in private equity funds are highly sophisticated, generally large institutional investors who have a fiduciary duty to the state pension funds and endowments on whose behalf they are investing. Curtailing or reducing the analysis and due diligence would be a breach of that fiduciary duty. Last year's market events were devastating for all investors and even more so for investors who relied solely on credit rating agencies and other rating entities to steer investment decisions for their portfolios without regard for their specific objectives and risk appetite.

The SEC has testified that this new registration requirement will increase the number of registered investment advisers significantly and will require additional resources to handle the new additional responsibilities. The PEC commends the SEC's leadership for identifying areas within the Commission that needed improvement. The SEC has renewed and increased its focus on improving its risk assessment capabilities, hiring new, talented examiners and strengthening internal training all of which will ensure they are well suited to regulate the industry.

Ranking Member Spencer Bachus
Financial Services Committee
Answers to Questions for the Record – Douglas Lowenstein, Private Equity Council
"Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"
July 17, 2009

The PEC believes that the Investment Advisers Act is the appropriate vehicle for private equity firm registration with the SEC. Some have suggested registration under the Investment Company Act which governs the operations of "investment companies" and is a good regime for funds offering securities to retail investors. However that model does not work for private equity firms because private equity investors invest in and manage their companies directly. This creates an alignment of interests among the active investor (the PE firm), the passive investor (the PE firm's limited partners) and the management of the companies. This model cannot be replicated under a regulatory regime designed for retail investors.

Questions for Mr. Paul Schott Stevens, President and CEO, Investment Company Institute

1. For almost 30 years, we have had a regulatory system that divides financial products into two categories, securities and futures, and regulates them very differently. No other country adheres to these distinctions in how they regulate equivalent products. Instead, other countries have a single regulator for securities and futures. In your view, should there be one U.S. agency that regulates both securities and futures? Which areas should the SEC and CFTC focus on in harmonizing their statutes and regulatory approaches? Does the CFTC have a better approach in handling self-regulatory organization rule filings?

ICI strongly believes that a merger or rationalization of the roles of the SEC and the CFTC would be a valuable reform. The current regulatory system reflects historical circumstances that have changed significantly. It has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection and market oversight. In order to address the increasing convergence of securities and futures products, markets, and market participants, a consistent policy focus is needed. With this goal in mind, ICI recommended in its March 3, 2009 white paper, *Financial Services Regulatory Reform: Discussion and Recommendations,*[1] the creation of a new Capital Markets Regulator that would encompass the combined functions of the SEC and those of the CFTC that are not agriculture-related.

As noted in our July 17, 2009 testimony, the Administration has acknowledged the shortcomings of the current system but stopped short of recommending a merger of the two agencies, perhaps in recognition of the practical obstacles to such a regulatory consolidation. Instead, the Administration has called upon the SEC and CFTC to recommend changes to existing statutes and regulations aimed at harmonizing the regulation of economically equivalent financial instruments. We understand that the two agencies have begun these discussions. In addition, the agencies have announced that they will hold joint meetings in early September to seek public input on harmonizing their regulations.

ICI does not have experience with the CFTC's approach to self-regulatory rule filings. We have had occasion to consider, however, possible ways to promote the effective and efficient operation of the self-regulatory organizations (SROs) that form an integral part of the current system of securities markets oversight. We believe there may be several ways to improve SROs' performance and operations, particularly through enhancements to their rules and rulemaking processes, and their governance structure.

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[1] *Financial Services Regulatory Reform: Discussion and Recommendations,* which is available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf.

SRO rules should be crafted both to protect investors and to promote efficiency, competition and capital formation. To achieve these objectives, it is critically important that SROs consider the relative costs and benefits of their rules. We have recommended on several occasions that Congress by law, or the SEC by rule, require that all SROs evaluate the costs and benefits of their rule proposals prior to submission to the SEC and establish a process for reexamining certain existing rules.[2] This process should be designed to determine whether the rules are working as intended, whether there are satisfactory alternatives of a less burdensome nature, and whether changes should be made.

The SRO rulemaking process itself serves important policy goals, including, among other things, assuring that interested persons have an opportunity to provide input regarding SRO actions that could have a significant effect on the market and market participants. ICI has supported amendments that would improve the ability of interested persons to submit comments on SRO actions. In particular, we have recommended extending the length of the comment period for any significant SRO proposal.[3]

Finally, ICI supports efforts to strengthen SRO governance processes.[4] For example, to ensure that the views of investors are adequately represented, we have recommended that SROs be required to have sufficient representation from funds and other institutional investors in their governance structures. In addition, to address concerns that SROs are inherently subject to conflicts of interest, consideration should be given to requiring SRO boards to have an appropriate balance between public members and members with industry expertise.[5]

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[2]*See* Statement of the Investment Company Institute on the Review of the U.S. Financial Markets and Global Markets Competitiveness, Submitted to the Senate Republican Capital Markets Task Force, U.S. Senate (February 25, 2008) and Submission of the Investment Company Institute to the Department of the Treasury, Review of the Regulatory Structure Associated with Financial Institutions (December 7, 2007).

[3]*See* Letters from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 6, 2001, and Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated June 4, 2004.

[4]*See, e.g.,* Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated March 8, 2005.

[5]*See Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?,* Speech by SEC Commissioner Elisse B. Walter Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 5, 2009), available at http://www.sec.gov/news/speech/2009/spch050509ebw.htm.

2. Last week, the Administration released its investor protection legislative proposal. Do you support each component of this proposal? With respect to the prohibition on mandatory arbitration clauses, if investors have been harmed by an investment professional, how would costly and lengthy litigation protect their interests as compared to arbitration which is far more efficient?

As a general matter, ICI fully supports efforts to ensure that the SEC has the regulatory authority it needs to fulfill its mission as "to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation." In the case of our industry, funds have been regulated for nearly 70 years by the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 and other federal securities laws. By almost any measure, this comprehensive regulatory scheme has been very successful in protecting the interests of fund investors while also allowing for the growth and evolution of a vibrant and competitive industry.

With regard to the Administration's proposed Investor Protection Act, ICI has not taken a position on each provision contained in the legislation. We have, however, carefully analyzed two provisions that, as drafted, present serious concerns to ICI. These two provisions—relating to point of sale disclosure and the standard of "conduct" for broker-dealers and investment advisers—are discussed at length in our written testimony and in a more summary fashion below.

Point of Sale Disclosure

As proposed, Section 914 of the Investor Protection Act would authorize the SEC to require disclosure to investors before the sale of shares issued by a registered investment company (fund). As discussed in our written testimony, such a requirement would fundamentally change the way funds—and only funds—are sold. While ICI has long supported point of sale disclosure, we are concerned that a requirement that singles out funds could create strong incentives for brokers and other intermediaries to recommend other investment products not subject to the same regulatory burdens, even when those products do not offer the same level of regulatory protection and other benefits as funds. Moreover, the policy goals underlying point of sale disclosure—providing investors with information to will help them make an informed investment decision—are equally valid for other types of investments. For these reasons, we strongly believe that any point of sale disclosure obligation should be product-neutral. In addition, it is critical that any such requirement be designed to minimize disruptions to the sales process, recognizing that investment sales typically do not occur in face-to-face meetings.

Standard of Care for Investment Advice

Over the last decade, brokers have significantly shifted their business model to include providing investment advice and charging fees based on assets under management, rather than commissions for each transaction. This model previously had been used solely by investment advisers. With the change in brokers' business practices, many investors have become confused about the type of entity providing advice, and the disparate level of protection they may receive depending on the "hat" the intermediary wears. Many, including ICI, have called for clarity for investors seeking investment advice—if broker-

dealers and investment advisers are providing virtually identical services to retail investors, the rules and principles governing those activities should be identical as well.

An Administration fact sheet states that the proposed legislation "would give the SEC authority to require a *fiduciary duty* for any broker, dealer, or investment adviser who gives investment advice about securities, aligning the standards based on activity, instead of based on legal distinctions that are no longer meaningful."[6] ICI strongly concurs with this approach, because anything less would fall short of the investor protections currently enjoyed by advisory clients. Having reviewed the Administration's draft legislative language, we are concerned that the applicable provision (Section 913(b)) merely describes a standard that appears to be "in substance" similar to a fiduciary duty. ICI thus recommends that Congress adopt a more clearly worded provision that states expressly, and leaves no room for doubt, that brokers and advisers alike *must* be held to a fiduciary standard.

3. Certain retirement products such as 401(k) plans, IRAs, and 529 plans are already highly regulated under ERISA, the tax code, by the Department of Labor, and the SEC in some instances. Mr. Stevens, do you believe that the Consumer Financial Protection Agency's mandate is broad enough to regulate retirement products?

The CFPA's mandate should not be so broad as to regulate activities in connection with 401(k) plans, IRAs, 529 plans, and similar tax-favored savings vehicles. Subjecting these vehicles to a new regulator would be far afield from the Administration's intent to address deficiencies in consumer protection for credit and related products offered by banks, thrifts, credit unions and their non-bank competitors. We are pleased there is nothing in the public statements of the Administration to suggest that it contemplates extending the jurisdiction of the new regulator to these savings vehicles and their service providers. Because activities relating to these vehicles might be read as covered under language in Sections 101(7) and 101(18)(N) of the bill, however, Congress should explicitly exclude these entities in any eventual legislation. Regulating retirement and education savings vehicles would subject these entities and their service providers to conflicting regulatory philosophies and potential regulatory overlap, without serving any consumer protection purpose.

Congress has already provided for the regulation of retirement savings vehicles under the tax laws in Sections 401(a),[7] 403(a), 403(b), 457(b), 408, and 408A of the Internal Revenue Code ("Code") and in the Employee Retirement Income Security Act ("ERISA"), and has provided for the regulation of educational savings arrangements under section 529 of the Code. The regulatory framework under the Code imposes strict conditions on obtaining tax-favored treatment, and severe tax consequences for the failure to meet these requirements. These requirements are substantive. In administering the

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[6] *Administration's Regulatory Reform Agenda Moves Forward: Legislation for Strengthening Investor Protection Delivered to Capitol Hill*, available on the Treasury Department's website at http://www.financialstability.gov/docs/regulatoryreform/investor_protection.pdf.

[7] 401(k) plans are qualified under Code section 401(a).

applicable laws, the Department of Labor, the Treasury Department and the IRS focus on assuring that these arrangements operate solely in the interest of the participants and beneficiaries.

ERISA sets forth reporting and disclosure requirements designed to assure that the operations of retirement plans are transparent and that participants have clear information with which to understand and make decisions about their plans. ERISA also contains detailed rules that apply to those who act on behalf of the plan (plan fiduciaries) and to custodians, trustees, and other service providers. Assets of ERISA-covered plans must be held in trust for the exclusive purposes of providing benefits to participants and their beneficiaries and defraying reasonable expenses of plans. Plan fiduciaries must meet strict fiduciary duties in the exercise of their responsibilities, including duties of care and loyalty, and must assure that plan service arrangements are reasonable and provide for no more than reasonable compensation. Moreover, ERISA provides for a series of publicly and privately enforced civil remedies (as well as certain criminal penalties) for violations of ERISA rules.

With respect to 529 plans, in addition to rigorous standards imposed on these plans under the Code, rules of the Municipal Securities Rulemaking Board, which must be approved by the SEC, ensure that investors are provided with comprehensive and current information concerning the products and that sellers of these products abide by standards of conduct designed to protect investors.

4. Do you believe that the Consumer Financial Protection Agency's proposed mandate is both broad and vague enough that it could potentially capture securities industry participants and investment products?

This question highlights an area of considerable concern for ICI. In its white paper, the Administration expressly states that the CFPA would *not* have authority with respect to "investment products and services already regulated by the SEC and CFTC." As explained in our written testimony, "investment services" in the fund context include the full range of services integral to fund operations—services provided not only by investment advisers and broker-dealers, but also by entities such as transfer agents and clearing agencies. The Administration's draft legislation, however, does not sufficiently provide for this intended exclusion. For this reason, ICI recommends that the legislation's definition in Section 1022(f)(2)(A) of "person regulated by the SEC" be extended to cover several other SEC-regulated entities. This exclusion would better reflect the Administration's original intent.

More broadly, it will be important for Congress—if it establishes the CFPA—to delineate as clearly as possible the lines of this agency's jurisdiction, and to provide strong oversight of the CFPA in order to prevent any jurisdictional "creep." Our financial markets are dynamic, and new products and services will continue to be introduced. As a result, the lines now drawn for the CFPA could, absent very careful consideration, become less clear over time.

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

September 25, 2009

The Honorable Al Green
United States House of Representatives
236 Cannon House Office Building
Washington, D.C. 20515-4309

Re: Responses to Questions at a Hearing Regarding, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals", Held Before Financial Services Committee, U.S. House of Representatives, on July 17, 2009.

Dear Representative Green:

Managed Funds Association ("MFA")[1] is pleased to submit this letter in response to the written questions that you sent me following the hearing on July 17, 2009, "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" (the "Hearing"). In your questions, you asked MFA to respond to several issues relating to residential mortgage-backed securities ("RMBS"). For your convenience, we have restated your questions below, followed by MFA's responses.

Congressman Baker, it is my understanding that many of your member companies invest in residential mortgage-backed securities (RMBS) and other similar products.

- ***Is this understanding correct?***

MFA's members engage in a wide variety of investment strategies and invest in a wide variety of investment products across asset classes. MFA does not, however, track the specific investment strategies or investment products of its members. As such, I cannot provide details on the number of MFA members that invest in RMBS or similar products, or the dollar amount of any such investments. While I cannot provide details as to the level of investment by MFA members in RMBS, I can confirm that there are some MFA members that invest in RMBS.

Do you believe it would be accurate to say that consumers receiving the following types of loans would be more likely than others to default on their loans:

- ***Borrowers receiving mortgage loans for which they were qualified for a teaser rate, but not the adjusted rate that followed the teaser rate?***
- ***Borrowers who were victims of yield spread premiums, where they qualified for prime loans, but received higher-priced subprime loans instead?***

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

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- ***Borrowers in Alt-A loans, where the lender does not require many of the documents that are required for a traditional mortgage loan?***

There are a number of reasons why borrowers default on loans, some of which are more easily anticipated than others. In general, I would agree that borrowers who receive loans with the characteristics you listed above would be more likely to default on their loans than borrowers with more traditional loans.

If both of these are correct:

- ***Would it be fair to say that investors in RMBS (other than those who took short positions on the RMBS) would suffer from the defaults on these underlying loans because the RMBS would become more likely to default?***
- ***Did any of your member companies suffer from defaults on RMBS resulting from these sorts of abusive practices?***
- ***Do you believe that additional consumer protections – in the form of restricting and/or banning the yield spread premium, requiring that borrowers be qualified for the adjusted rate on an adjustable rate mortgage, and the like – could provide more stability to the RMBS market and other secondary markets for consumer loans that currently are tainted by lender abuse?***

It is correct to say that long investors in RMBS have suffered, and continue to suffer, losses as a result of defaults on the loans underlying these securities. Factors that tend to increase the risk of default on underlying loans, therefore, do have an adverse effect on long investors in RMBS. As some MFA members do invest long in RMBS, these investors are suffering from defaults.

MFA and its members support efforts that are designed to improve transparency and clarity in the loan process to better ensure that borrowers fully understand the terms of the loans they are entering into and are appropriately qualified for those loans. We further support rigorous enforcement of existing laws and regulations that prohibit manipulative and abusive practices that are detrimental to borrowers and investors in RMBS. We believe that improved enforcement of existing laws and regulations will have a significant effect on curbing abuses in mortgage origination. In addition to better enforcement of existing laws, we believe that it would be beneficial for policy makers and regulators to consider whether to restrict yield spread premiums or require that lenders qualify borrowers based on a fully indexed fully amortizing rate, and not just on a teaser rate.

MFA would welcome the opportunity to meet with you or members of your staff to respond to any further questions you may have. Feel free to contact me at (202) 367-1140 with any questions or if you would like to arrange such a meeting.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

MODERNIZING BANK SUPERVISION AND REGULATION

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. SENATE

March 19, 2009
Room 534, Dirksen Senate Office Building

Chairman Dodd, Ranking Member Shelby and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the need to modernize and reform our financial regulatory system.

The events that have unfolded over the past two years have been extraordinary. A series of economic shocks have produced the most challenging financial crisis since the Great Depression. The widespread economic damage has called into question the fundamental assumptions regarding financial institutions and their supervision that have directed our regulatory efforts for decades. The unprecedented size and complexity of many of today's financial institutions raise serious issues regarding whether they can be properly managed and effectively supervised through existing mechanisms and techniques. In addition, the significant growth of unsupervised financial activities outside the traditional banking system has hampered effective regulation.

Our current system has clearly failed in many instances to manage risk properly and to provide stability. U.S. regulators have broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system, but there are significant gaps, most notably regarding very large insurance companies and private equity funds. However, we must also acknowledge that many of the systemically significant entities that have needed federal assistance were already subject to extensive federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive. Insufficient attention was paid to the adequacy of complex institutions' risk management capabilities.

Too much reliance was placed on mathematical models to drive risk management decisions. Notwithstanding the lessons from Enron, off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements. Perhaps most importantly, failure to ensure that financial products were appropriate and sustainable for consumers has caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Moreover, some parts of the current financial system, for example, over the counter derivatives, are by statute, mostly excluded from federal regulation.

In the face of the current crisis, regulatory gaps argue for some kind of comprehensive regulation or oversight of all systemically important financial firms. But, the failure to utilize existing authorities by regulators casts doubt on whether simply entrusting power in a single systemic risk regulator will sufficiently address the underlying causes of our past supervisory failures. We need to recognize that simply creating a new systemic risk regulator is a not a panacea. The most important challenge is to find ways to impose greater market discipline on systemically important institutions. The solution must involve, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC insured banks. In short, we need an end to too big to fail.

It is time to examine the more fundamental issue of whether there are economic benefits to institutions whose failure can result in systemic issues for the economy. Because of their concentration of economic power and interconnections through the

financial system, the management and supervision of institutions of this size and complexity has proven to be problematic. Taxpayers have a right to question how extensive their exposure should be to such entities.

The problems of supervising large, complex financial institutions are compounded by the absence of procedures and structures to effectively resolve them in an orderly fashion when they end up in severe financial trouble. Unlike the clearly defined and proven statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large complex non-bank financial entities and financial holding companies was not designed to protect the stability of the financial system. This is important because, in the current crisis, bank holding companies and large non-bank entities have come to depend on the banks within the organizations as a source of strength. Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level.

While the depository institution could be resolved under existing authorities, the resolution would cause the holding company to fail and its activities would be unwound through the normal corporate bankruptcy process. Without a system that provides for the orderly resolution of activities outside of the depository institution, the failure of a systemically important holding company or non-bank financial entity will create

additional instability as claims outside the depository institution become completely illiquid under the current system.

In the case of a bank holding company, the FDIC has the authority to take control of only the failing banking subsidiary, protecting the insured depositors. However, many of the essential services in other portions of the holding company are left outside of the FDIC's control, making it difficult to operate the bank and impossible to continue funding the organization's activities that are outside the bank. In such a situation, where the holding company structure includes many bank and non-bank subsidiaries, taking control of just the bank is not a practical solution.

If a bank holding company or non-bank financial holding company is forced into or chooses to enter bankruptcy for any reason, the following is likely to occur. In a Chapter 11 bankruptcy, there is an automatic stay on most creditor claims, with the exception of specified financial contracts (futures and options contracts and certain types of derivatives) that are subject to termination and netting provisions, creating illiquidity for the affected creditors. The consequences of a large financial firm filing for bankruptcy protection are aptly demonstrated by the Lehman Brothers experience. As a result, neither taking control of the banking subsidiary or a bankruptcy filing of the parent organization is currently a viable means of resolving a large, systemically important financial institution, such as a bank holding company. This has forced the government to improvise actions to address individual situations, making it difficult to address systemic problems in a coordinated manner and raising serious issues of fairness.

My testimony will examine some steps that can be taken to reduce systemic vulnerabilities by strengthening supervision and regulation and improving financial market transparency. I will focus on some specific changes that should be undertaken to limit the potential for excessive risk in the system, including identifying systemically important institutions, creating incentives to reduce the size of systemically important firms and ensuring that all portions of the financial system are under some baseline standards to constrain excessive risk taking and protect consumers. I will explain why an independent special failure resolution authority is needed for financial firms that pose systemic risk and describe the essential features of such an authority. I also will suggest improvements to consumer protection that would improve regulators' ability to stem fraud and abusive practices. Next, I will discuss other areas that require legislative changes to reduce systemic risk -- the over-the-counter (OTC) derivatives market and the money market mutual fund industry. And, finally, I will address the need for regulatory reforms related to the originate-to-distribute model, executive compensation in banks, fair-value accounting, credit rating agencies and counter-cyclical capital policies..

Addressing Systemic Risk

Many have suggested that the creation of a systemic risk regulator is necessary to address key flaws in the current supervisory regime. According to the proposals, this new regulator would be tasked with monitoring large or rapidly increasing exposures -- such as to sub-prime mortgages -- across firms and markets, rather than only at the level of individual firms or sectors; and analyzing possible spillovers among financial firms or

between firms and markets, such as the mutual exposures of highly interconnected firms. Additionally, the proposals call for such a regulator to have the authority to obtain information and examine banks and key financial market participants, including non-bank financial institutions that may not be currently subject to regulation. Finally, the systemic risk regulator would be responsible for setting standards for capital, liquidity, and risk management practices for the financial sector.

Changes in our regulatory and supervisory approach are clearly warranted, but Congress should proceed carefully and deliberately in creating a new systemic risk regulator. Many of the economic challenges we are facing continue and new aspects of interconnected problems continue to be revealed. It will require great care to address evolving issues in the midst of the economic storm and to avoid unintended consequences. In addition, changes that build on existing supervisory structures and authorities -- that fill regulatory voids and improve cooperation -- can be implemented more quickly and more effectively.

While I fully support the goal of having an informed, forward looking, proactive and analytically capable regulatory community, looking back, if we are honest in our assessment, it is clear that U.S. regulators already had many broad powers to supervise financial institutions and markets and to limit many of the activities that undermined our financial system. For various reasons, these powers were not used effectively and as a consequence supervision was not sufficiently proactive.

There are many examples of situations in which existing powers could have been used to prevent the financial system imbalances that led to the current financial crisis. For instance, supervisory authorities have had the authority under the Home Ownership and Equity Protection Act to regulate the mortgage industry since 1994. Comprehensive new regulations intended to limit the worst practices in the mortgage industry were not issued until well into the onset of the current crisis. Failure to address lax lending standards among non-bank mortgage companies created market pressure on banks to also relax their standards. Bank regulators were late in addressing this phenomenon.

In other important examples, federal regulatory agencies have had consolidated supervisory authority over institutions that pose a systemic risk to the financial system; yet they did not to exercise their authorities in a manner that would have enabled them to anticipate the risk concentrations in the bank holding companies, investment bank holding companies and thrift holding companies they supervise. Special purpose financial intermediaries -- such as structured investment vehicles (SIVs) -- played an important role in funding and aggregating the credit risks that are at the core of the current crisis. These intermediaries were formed outside the banking organizations so banks could recognize asset sales and take the assets off the balance sheet, or remotely originate assets to keep off the balance sheet and thereby avoid minimum regulatory capital and leverage ratio constraints. Because they were not on the bank's balance sheet and to the extent that they were managed outside of the bank by the parent holding company, SIVs escaped scrutiny from the bank regulatory agencies.

With hindsight, all of the regulatory agencies will focus and find ways to better exercise their regulatory powers. Even though the entities and authorities that have been proposed for a systemic regulator largely existed, the regulatory community did not appreciate the magnitude and scope of the potential risks that were building in the system. Having a systemic risk regulator that would look more broadly at issues on a macro-prudential basis would be of incremental benefit, but the success of any effort at reform will ultimately rely on the willingness of regulators to use their authorities more effectively and aggressively.

The lack of regulatory foresight was not specific to the United States. As a recent report on financial supervision in the European Union noted, financial supervisors frequently did not have, and in some cases did not insist on obtaining -- or received too late -- all of the relevant information on the global magnitude of the excess leveraging that was accumulating in the financial system.[1] Further, they did not fully understand or evaluate the size of the risks, or share their information properly with their counterparts in other countries. The report concluded that insufficient supervisory and regulatory resources combined with an inadequate mix of skills as well as different systems of national supervision made the situation worse. In interpreting this report, it is important to recall that virtually every European central bank is required to assess and report economic and financial system conditions and anticipate emerging financial-sector risks.

[1] European Union, Report of the High-level Group on Financial Supervision in the EU, J. de Larosière, Chairman, Brussels, 25 February 2009.

With these examples in mind, we should recognize that while establishing a systemic risk regulator is important, it is far from clear that it will prevent a future systemic crisis.

Limiting Risk by Limiting Size and Complexity

Before considering the various proposals to create a systemic risk regulator, Congress should examine a more fundamental question of whether there should be limitations on the size and complexity of institutions whose failure would be systemically significant. Over the past two decades, a number of arguments have been advanced about why financial organizations should be allowed to become larger and more complex. These reasons include being able to take advantage of economies of scale and scope, diversifying risk across a broad range of markets and products, and gaining access to global capital markets. It was alleged that the increased size and complexity of these organizations could be effectively managed using new innovations in quantitative risk management techniques. Not only did institutions claim that they could manage these new risks, they also argued that often the combination of diversification and advanced risk management practices would allow them to operate with markedly lower capital buffers than were necessary in smaller, less-sophisticated institutions. Indeed many of these concepts were inherent in the Basel II Advanced Approaches, resulting in reduced capital requirements. In hindsight, it is now clear that the international regulatory community relied too heavily on diversification and risk management when setting minimum regulatory capital requirements for large complex financial institutions.

Notwithstanding expectations and industry projections for gains in financial efficiencies, economies of scale seem to be reached at levels far below the size of today's largest financial institutions. Also, efforts designed to realize economies of scope have not lived up to their promise. In some instances, the complex institutional combinations permitted by the Gramm-Leach-Bliley (GLB) legislation were unwound because they failed to realize anticipated economies of scope. The latest studies of economies produced by increased scale and scope find that most banks could improve their cost efficiency more by concentrating their efforts on reducing operational inefficiencies.

There also are limits to the ability to diversify risk using securitization, structured finance and derivatives. No one disputes that there are benefits to diversification for smaller and less-complex institutions, but as institutions become larger and more complex, the ability to diversify risk is diminished. When a financial system includes a small number of very large complex organizations, the system cannot be well-diversified. As institutions grow in size and importance, they not only take on a risk profile that mirrors the risk of the market and general economic conditions, but they also concentrate risk as they become the only important counterparties to many transactions that facilitate financial intermediation in the economy. The fallacy of the diversification argument becomes apparent in the midst of financial crisis when these large complex financial organizations -- because they are so interconnected -- reveal themselves as a source of risk in the system.

Managing the transition to a safer system

If large complex organizations concentrate risk and do not provide market efficiencies, it may be better to address systemic risk by creating incentives to encourage a financial industry structure that is characterized by smaller and therefore less systemically important financial firms, for instance, by imposing increasing financial obligations that mirror the heightened risk posed by large entities.

Identifying systemically important firms

To be able to implement and target the desired changes, it becomes important to identify characteristics of a systemically important firm. A recent report by the Group of Thirty highlights the difficulties that are associated with a fixed common definition of what comprises a systemically important firm. What constitutes systemic importance is likely to vary across national boundaries and change over time. Generally, it would include any firm that constitutes a significant share of their market or the broader financial system. Ultimately, identification of what is systemic will have to be decided within the structure created for systemic risk regulation, but at a minimum, should rely on triggers based on size and counterparty concentrations.

Increasing financial obligations to reflect increasing risk

To date, many large financial firms have been given access to vast amounts of public funds. Obviously, changes are needed to prevent this situation from reoccurring and to ensure that firms are not rewarded for becoming, in essence, too big to fail. Rather, they should be required to offset the potential costs to society.

In contrast to the capital standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both size and complexity. In addition, they should be subject to higher Prompt Corrective Action (PCA) limits under U.S. laws. Regulators should judge the capital adequacy of these firms, taking into account off-balance-sheet assets and conduits as if these risks were on balance sheet.

Next steps

Currently, not all parts of the financial system are subject to federal regulation. Insurance company regulation is conducted at the state level. There is, therefore, no federal regulatory authority specifically designed to provide comprehensive prudential supervision for large insurance companies. Hedge funds and private equity firms are typically designed to operate outside the regulatory structures that would otherwise constrain their leverage and activities. This is of concern not only for the safety and soundness of these unregulated firms, but for regulated firms as well. Some of banking organizations' riskier strategies, such as the creation of SIVs, may have been driven by a

desire to replicate the financial leverage available to less regulated entities. Some of these firms by virtue of their gross balance sheet size or by their dominance in particular markets can pose systemic risks on their own accord. Many others are major participants in markets and business activities that may contribute to a systemic collapse. This loophole in the regulatory net cannot continue. It is important that all systemically important financial firms, including hedge funds, insurance companies, investment banks, or bank or thrift holding companies, be subject to prudential supervision, including across the board constraints on the use of financial leverage.

New Resolution Procedures

There is clearly a need for a special resolution regime, outside the bankruptcy process, for financial firms that pose a systemic risk, just as there is for commercial banks and thrifts. As noted above, beyond the necessity of capital regulation and prudential supervision, having a mechanism for the orderly resolution of institutions that pose a systemic risk to the financial system is critical. Creating a resolution regime that could apply to any financial institution that becomes a source of systemic risk should be an urgent priority.

The differences in outcomes from the handling of Bear Stearns and Lehman Brothers demonstrate that authorities have no real alternative but to avoid the bankruptcy process. When the public interest is at stake, as in the case of systemically important entities, the resolution process should support an orderly unwinding of the institution in a

way that protects the broader economic and taxpayer interests, not just private financial interests.

In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. In the case of banks, Congress gave the FDIC backup supervisory authority and the power to self-appoint as receiver, recognizing there might be conflicts between a primary regulators' prudential responsibilities and its willingness to recognize when an institution it supervises needs to be closed. Thus, the new resolution authority should be independent of the new systemic risk regulator.

This new authority should also be designed to limit subsidies to private investors (moral hazard). If financial assistance outside of the resolution process is granted to systemically important firms, the process should be open, transparent and subject to a system of checks and balances that are similar to the systemic-risk exception to the least-cost test that applies to insured financial institutions. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process.

Clear guidelines for this process are needed and must be adhered to in order to gain investor confidence and protect public and private interests. First, there should be a clearly defined priority structure for settling claims, depending on the type of firm. Any resolution should be subject to a cost test to minimize any public loss and impose losses

according to the established claims priority. Second, it must allow continuation of any systemically significant operations. The rules that govern the process, and set priorities for the imposition of losses on shareholders and creditors should be clearly articulated and closely adhered to so that the markets can understand the resolution process with predicable outcomes.

The FDIC's authority to act as receiver and to set up a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the government to prevent a disorderly collapse by preserving systemically significant functions. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the bank and its assets, which can reduce losses to the receivership.

The FDIC has the authority to terminate contracts upon an insured depository institution's failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution authority should be granted similar statutory authority in the resolution of financial institutions.

Congress should recognize that creating a new separate authority to administer systemic resolutions may not be economic or efficient. It is unlikely that the separate resolution authority would be used frequently enough to justify maintaining an expert and motivated workforce as there could be decades between systemic events. While many details of a special resolution authority for systemically important financial firms would have to be worked out, a new systemic resolution regime should be funded by fees or assessments charged to systemically important firms. In addition, consistent with the FDIC's powers with regard to insured institutions, the resolution authority should have backup supervisory authority over those firms which it may have to resolve.

Consumer protection

There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems not just for consumers, but for institutions and investors as well.

To protect consumers from potentially harmful financial products, a case has been made for a new independent financial product safety commission. Certainly, more must be done to protect consumers. We could support the establishment of a new entity to establish consistent consumer protection standards for banks and non-banks. However,

we believe that such a body should include the perspective of bank regulators as well as non-bank enforcement officials such as the FTC. However, as Congress considers the options, we recommend that any new plan ensure that consumer protection activities are aligned and integrated with other bank supervisory information, resources, and expertise, and that enforcement of consumer protection rules for banks be left to bank regulators.

The current bank regulation and supervision structure allows the banking agencies to take a comprehensive view of financial institutions from both a consumer protection and safety-and-soundness perspective. Banking agencies' assessments of risks to consumers are closely linked with and informed by a broader understanding of other risks in financial institutions. Conversely, assessments of other risks, including safety and soundness, benefit from knowledge of basic principles, trends, and emerging issues related to consumer protection. Separating consumer protection regulation and supervision into different organizations would reduce information that is necessary for both entities to effectively perform their functions. Separating consumer protection from safety and soundness would result in similar problems.

Our experience suggests that the development of policy must be closely coordinated and reflect a broad understanding of institutions' management, operations, policies, and practices -- and the bank supervisory process as a whole. Placing consumer protection policy-setting activities in a separate organization, apart from existing expertise and examination infrastructure, could ultimately result in less effective protections for consumers.

One of the fundamental principles of the FDIC's mission is to serve as an independent agency focused on maintaining consumer confidence in the banking system. The FDIC plays a unique role as deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed depository institutions. These functions contribute to the overall stability of and consumer confidence in the banking industry. With this mission in mind, if given additional rulemaking authority, the FDIC is prepared to take on an expanded role in providing consumers with stronger protections that address products posing unacceptable risks to consumers and eliminate gaps in oversight.

Under the Federal Trade Commission (FTC) Act, only the Federal Reserve Board (FRB) has authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, and the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they supervise. The FTC has authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan institutions, and federal credit unions. However, the FTC Act does not give the FDIC authority to write rules that apply to the approximately 5,000 entities it supervises -- the bulk of state banks -- nor to the OCC for their 1,700 national banks. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or non-banks, including mortgage lenders and credit card issuers. While the "deceptive" and "unfair" standards are independent of one another, the prohibition against these practices applies to all types

of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections and the termination of the customer relationship.

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC has recommended that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. The FDIC's perspective -- as deposit insurer and as supervisor for the largest number of banks, many of whom are small community banks -- would provide valuable input and expertise to the rulemaking process. The same is true for the OCC, as supervisor of some of the nation's largest banks. As a practical matter, these rulemakings would be done on an interagency basis and would benefit from the input of all interested parties.

In the alternative, if Congress is inclined to establish an independent financial product commission, it should leverage the current regulatory authorities that have the resources, experience, and legislative power to enforce regulations related to institutions under their supervision, so it would not be necessary to create an entirely new enforcement infrastructure. In fact, in creating a financial products safety commission, it would be beneficial to include the FDIC and principals from other financial regulatory agencies on the commission's board. Such a commission should be required to submit

periodic reports to Congress on the effectiveness of the consumer protection activities of the commission and the bank regulators.

Whether or not Congress creates a new commission, it is essential that there be uniform standards for financial products whether they are offered by banks or non-banks. These standards must apply across all jurisdictions and issuers, otherwise gaps create competitive pressures to reduce standards, as we saw with mortgage lending standards. Clear standards also permit consistent enforcement that protects consumers and the broader financial system.

Finally, in the on-going process to improve consumer protections, it is time to examine curtailing federal preemption of state consumer protection laws. Federal preemption of state laws was seen as a way to improve efficiencies for financial firms who argued that it lowered costs for consumers. While that may have been true in the short run, it has now become clear that abrogating sound state laws, particularly regarding consumer protection, created an opportunity for regulatory arbitrage that frankly resulted in a "race-to-the-bottom" mentality. Creating a "floor" for consumer protection, based on either appropriate state or federal law, rather than the current system that establishes a ceiling on protections would significantly improve consumer protection. Perhaps reviewing the existing web of state and federal laws related to consumer protections and choosing the most appropriate for the "floor" could be one of the initial priorities for a financial products safety commission.

Changing the OTC market and protecting of money market mutual funds

Two areas that require legislative changes to reduce systemic risk are the OTC derivatives market and the money market mutual fund industry.

Credit derivatives markets and systemic risk

Beyond issues of size and resolution schemes for systemically important institutions, recent events highlight the need to revisit the regulation and oversight of credit derivative markets. Credit derivatives provide investors with instruments and markets that can be used to create tremendous leverage and risk concentration without any means for monitoring the trail of exposure created by these instruments. An individual firm or a security from a sub-prime, asset-backed or other mortgage-backed pool of loans may have only $50 million in outstanding par value and yet, the over-the-counter markets for credit default swaps (CDS) may create hundreds of millions of dollars in individual CDS contracts that reference that same debt. At the same time, this debt may be referenced in CDS Index contracts that are created by OTC dealers which creates additional exposure. If the referenced firm or security defaults, its bond holders will likely lose some fraction of the $50 million par value, but CDS holders face losses that are many times that amount.

Events have shown that the CDS markets are a source of systemic risk. The market for CDS was originally set up as an inter-bank market to exchange credit risk without selling the underlying loans, but it has since expanded massively to include

hedge funds, insurance companies, municipalities, public pension funds and other financial institutions. The CDS market has expanded to include OTC index products that are so actively traded that they spawned a Chicago Board of Trade futures market contract. CDS markets are an important tool for hedging credit risk, but they also create leverage and can multiply underlying credit risk losses. Because there are relatively few CDS dealers, absent adequate risk management practices and safeguards, CDS markets can also create counterparty risk concentrations that are opaque to regulators and financial institutions.

Our views on the need for regulatory reform of the CDS and related OTC derivatives markets are aligned with the recommendations made in the recent framework proposed by the Group of Thirty. OTC contracts should be encouraged to migrate to trade on a nationally regulated exchange with centralized clearing and settlement systems, similar in character to those of the futures and equity option exchange markets. The regulation of the contracts that remain OTC-traded should be subject to supervision by a national regulator with jurisdiction to promulgate rules and standards regarding sound risk management practices, including those needed to manage counterparty credit risk and collateral requirements, uniform close-out practices, trade confirmation and reporting standards, and other regulatory and public reporting standards that will need to be established to improve market transparency. For example, OTC dealers may be required to report selected trade information in a Trade Reporting and Compliance Engine (TRACE)-style system, which would be made publicly available. OTC dealers and exchanges should also be required to report information on large exposures and risk

concentrations to a regulatory authority. This could be modeled in much the same way as futures exchanges regularly report qualifying exposures to the Commodities Futures Trading Commission. The reporting system would need to provide information on concentrations in both short and long positions.

Money market mutual funds

Money market mutual funds (MMMFs) have been shown to be a source of systemic risk in this crisis. Two similar models of reform have been suggested. One would place MMMFs under systemic risk regulation, which would provide permanent access to the discount window and establish a fee-based insurance fund to prevent losses to investors. The other approach, offered by the Group of 30, would segment the industry into MMMFs that offer bank-like services and assurances in maintaining a stable net asset value (NAV) at par from MMMFs that that have no explicit or implicit assurances that investors can withdraw funds on demand at par. Those that operate like banks would be required to reorganize as special-purpose banks, coming under all bank regulations and depositor-like protections. But, this last approach will only be viable if there are restrictions on the size of at-risk MMMFs so that they do not evolve into too-big-to-fail institutions.

Regulatory issues

Several issues can be addressed through the regulatory process including, the originate-to-distribute business model, executive compensation in banks, fair-value accounting, credit rating agency reform and counter-cyclical capital policies.

The originate-to-distribute business model

One of the most important factors driving this financial crisis has been the decline in value, liquidity and underlying collateral performance of a wide swath of previously highly rated asset backed securities. In 2008, over 221,000 rated tranches of private-label asset-backed securitizations were downgraded. This has resulted in a widespread loss of confidence in agency credit ratings for securitized assets, and bank and investor write-downs on their holdings of these assets.

Many of these previously highly rated securities were never traded in secondary markets, and were subject to little or no public disclosure about the characteristics and ongoing performance of underlying collateral. Financial incentives for short-term revenue recognition appear to have driven the creation of large volumes of highly-rated securitization product, with insufficient attention to due diligence, and insufficient recognition of the risks being transferred to investors. Moreover, some aspects of our regulatory framework may have encouraged banks and other institutional investors in the belief that a highly-rated security is, *per se*, of minimal risk.

Today, in a variety of policy-making groups around the world, there is consideration of ways to correct the incentives that led to the failure of the originate-to-distribute model. One area of focus relates to disclosure. For example, rated securitization tranches could be subject to a requirement for disclosure, in a readily accessible format on the ratings-agency websites, of detailed loan-level characteristics and regular performance reports. Over the long term, liquidity and confidence might be improved if secondary market prices and volumes of asset backed securities were reported on some type of system analogous to the Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine that now captures such data on corporate bonds.

Again over the longer term, a more sustainable originate-to-distribute model might result if originators were required to retain "skin-in-the-game" by holding some form of explicit exposure to the assets sold. This idea has been endorsed by the Group of 30 and is being actively explored by the European Commission. Some in the United States have noted that there are implementation challenges of this idea, such as whether we can or should prevent issuers from hedging their exposure to their retained interests. Acknowledging these issues and correcting the problems in the originate-to distribute-model is very important, and some form of "skin-in-the-game" requirement that goes beyond the past practices of the industry should continue to be explored.

Executive compensation in banks

An important area for reform includes the broad area of correcting or offsetting financial incentives for short-term revenue recognition. There has been much discussion of how to ensure financial firms' compensation systems do not excessively reward a short-term focus at the expense of longer term risks. I would note that in the Federal Deposit Insurance Act, Congress gave the banking agencies the explicit authority to define and regulate safe-and-sound compensation practices for insured banks and thrifts. Such regulation would be a potentially powerful tool but one that should be used judiciously to avoid unintended consequences.

Fair-value accounting

Another broad area where inappropriate financial incentives may need to be addressed is in regard to the recognition of potentially volatile non-cash income or expense items. For example, many problematic exposures may have been driven in part by the ability to recognize mark-to-model gains on OTC derivatives or other illiquid financial instruments. To the extent such incentives drove some institutions to hold concentrations of illiquid and volatile exposures, they should be a concern for the safety-and-soundness of individual institutions. Moreover, such practices can make the system as a whole more subject to boom and bust. Regulators should consider taking steps to limit such practices in the future, perhaps by explicit quantitative limits on the extent

such gains could be included in regulatory capital or by incrementally higher regulatory capital requirements when exposures exceed specified concentration limits.

For the immediate present, we are faced with a situation where an institution confronted with even a single dollar of credit loss on its available-for-sale and held-to-maturity securities, must write down the security to fair value, which includes not only recognizing the credit loss, but also the liquidity discount. We have expressed our support for the idea that FASB should consider allowing institutions facing an other-than-temporary impairment (OTTI) loss to recognize the credit loss in earnings but not the liquidity discount. We are pleased that the Financial Accounting Standards Board this week has issued a proposal that would move in this direction.

Credit rating agency reform

The FDIC generally agrees with the Group of 30 recommendation that regulatory policies with regard to Nationally Recognized Securities Rating Organizations (NRSROs) and the use their ratings should be reformed. Regulated entities should do an independent evaluation of credit risk products in which they are investing. NRSROs should evaluate the risk of potential losses from the full range of potential risk factors, including liquidity and price volatility. Regulators should examine the incentives imbedded in the current business models of NRSROs. For example, an important strand of work within the Basel Committee on Banking Supervision that I have supported for some time relates to the creation of operational standards for the use of ratings-based

capital requirements. We need to be sure that in the future, our capital requirements do not incent banks to rely blindly on favorable agency credit ratings. Preconditions for the use of ratings-based capital requirements should ensure investors and regulators have ready access to the loan level data underlying the securities, and that an appropriate level of due diligence has been performed.

Counter-cyclical capital policies

At present, regulatory capital standards do not explicitly consider the stage of the economic cycle in which financial institutions are operating. As institutions seek to improve returns on equity, there is often an incentive to reduce capital and increase leverage when economic conditions are favorable and earnings are strong. However, when a downturn inevitably occurs and losses arising from credit and market risk exposures increase, these institutions' capital ratios may fall to levels that no longer appropriately support their risk profiles.

Therefore, it is important for regulators to institute counter-cyclical capital policies. For example, financial institutions could be required to limit dividends in profitable times to build capital above regulatory minimums or build some type of regulatory capital buffer to cover estimated through-the-cycle credit losses in excess of those reflected in their loan loss allowances under current accounting standards. Through the Basel Committee on Banking Supervision, we are working to strengthen capital to raise its resilience to future episodes of economic and financial stress. Furthermore, we

strongly encourage the accounting standard-setters to revise the existing accounting model for loan losses to better reflect the economics of lending activity and enable lenders to recognize credit impairment earlier in the credit cycle.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically important to the financial system. The choices facing Congress in this task are complex, made more so by the fact that we are trying to address problems while the whirlwind of economic problems continues to engulf us. While the need for some reforms is obvious, such as a legal framework for resolving systemically important institutions, others are less clear and we would encourage a thoughtful, deliberative approach. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial institutions -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

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