ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS—PART II

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S. HRG. 111–144

ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS—PART II

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

FURTHER EXAMINING WHAT WENT WRONG IN THE SECURITIES MARKETS, HOW WE CAN PREVENT THE PRACTICES THAT LED TO OUR FINANCIAL SYSTEM PROBLEMS, AND HOW TO PROTECT INVESTORS

MARCH 26, 2009

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS—PART II

THURSDAY, MARCH 26, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:36 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will come to order. Let me welcome my colleagues who are here, as well as our witnesses. We have a very busy morning today. We have got a long list of very distinguished witnesses to appear before us this morning on the subject matter of enhancing investor protection and the regulation of securities markets. This is the ninth—is it the ninth or tenth?—on the general matter of the modernization of Federal regulations and the second very specific hearing on the securities industry itself.

There is an awful lot of ground to cover here. We have three panels this morning, the first, of course, involving Mary Schapiro, the Chairman of the Securities and Exchange Commission, and Fred Joseph, who is the President of North American Securities Administrators Association.

A second panel of witnesses who have been before this Committee on numerous occasions, of course, the previous Chairs—I see Mr. Breeden is here already this morning, and Arthur Levitt and others, along with Paul Atkins, who will be testifying about their experience, background, how this all emerged, and their thoughts on how we move forward.

And then a third panel of witnesses who will give us some very current experiences they are going through and ideas and thoughts as to how we ought to proceed. So I appreciate their testimony.

What I am going to do is have opening statements by just Senator Shelby and myself, although Senator Warner is here, and as long as no one else shows up, you can make an opening statement, because I worry about if we have everybody show up, we will be here until midnight tonight.

[Laughter.]

Senator SHELBY. Governor Warner—he is used to those opening statements.

Chairman DODD. Yes, I know. Well, he was a good Governor and he is a good Senator. We welcome him to this Committee.

Then I am going to ask my colleagues—we are going to have one round on the first panel. As much as there are many questions, obviously, we have for both of you, but if we end up with too many rounds, we will never get to the second and third panels, and colleagues have busy schedules as well, as do our witnesses. So we will cut it off after one round.

Then we will go to the second panel, which I will leave a little more open, given the backgrounds of our witnesses, and the third panel.

With that, let me share some opening comments and then turn to Senator Shelby, and then we will go right to our witnesses this morning.

Today, the Committee meets, as I said, for our second hearing to examine the securities market regulation, the ninth hearing on this general matter of modernization of Federal regulations. This hearing is to discuss how investors and our entire financial system are protected, or lack of protection, in the future from the kind of activities that led to the current crisis. This hearing is one of a series, as I mentioned, of nine we have already convened to modernize the overall regulatory framework and to rebuild our financial system. And I saw this morning the headlines of our local newspaper here, the direction that the Secretary of the Treasury is heading. I welcome that. This is all within about 60 days of this administration coming to office. We will not have all the time this morning to go over that. This Committee will be meeting at the request of the Treasury tomorrow with Democrats and Republicans to listen to some of these thoughts. It is not a formal hearing. We will have one of those. But given the time constraints and the fact that the administration is heading overseas to the meeting coming up with the G-20, we thought it would be worthwhile to have at least a briefing as to where this thing is heading. So we welcome that and are excited over the fact that they are going to be proposing some thoughts in this area as well.

We are also very excited to have two witnesses who are not only former Chairmen of the SEC but also, I might add, residents of my own State as well, having Arthur Levitt and Richard Breeden with us.

From the outset, I have argued that our financial system is not really in need of reform but modernization, that truly protecting consumers and investors in the decades to come will require a vast overhaul of our financial architecture that recognizes the extraordinary transformation that has occurred over the last quarter of a century, and it is extraordinary. And nowhere has that transformation been clearer than in the area of securities, which have come to dominate our financial system, now representing 80 percent—80 percent—of all financial assets in the United States.

With pension funds, the proliferation of 401(k)s and the like, today half of all households in the United States are invested in some way in the securities markets. As Federal Reserve Governor Dan Tarullo said at our last hearing on this subject matter, "The source of systemic risk in our financial system has, to some consid-

erable extent, migrated from traditional banking activities to markets over the last 20 or 25 years."

In essence, as the assets of our financial system have shifted from banking deposits to securities, so too have the dangers posed to our economy as a whole. We need regulators with the expertise, tools, and resources to regulate this new type of financial system.

At our last hearing on this subject, this Committee heard about the need to watch for trends that could threaten the safety of our financial system. Our witnesses had different views on what regulatory body should perform that function. Some felt it should be given to a special commission made up of the heads of existing agencies. Others have argued for a new agency or to give that authority to an existing regulator.

As I have said, given the regulatory failures we saw in the lead-up to this crisis, I have concerns, and I think many of my colleagues have also expressed, about this authority residing exclusively within one body. And I re-express those views this morning.

For instance, we have seen problems with the regulated bank holding companies where they have not been well regulated at the holding company level. And while there are many aspects to our financial system, systemic risk itself has many parts as well. One is the regulation of practices and products which pose systemic risk, from subprime mortgages to credit default swaps, and that is why I remain intrigued by the idea of a council approach to address this aspect of systemic risk. And I know our previous witnesses Paul Stevens with the Investment Company Institute and Damon Silvers with the AFL–CIO have both recommended this type of concept.

Of course, systemic risk is only one issue which we are examining. At our last hearing on this subject matter, we heard how we could increase transparency by addressing the risks posed by derivatives. We heard ways to improve the performance of credit rating agencies, who failed the American people terribly, by requiring them to verify the information they used to make those ratings. And, more recently, Secretary of Treasury Geithner has proposed the creation of a resolution mechanism for systemically important nonbank financial institutions, and I will be very interested in hearing from you, Chairman Schapiro, on that subject matter, what your thoughts are and the role the SEC should play.

In providing this authority to the FDIC, I am pleased that they have recognized the need to ensure that powerful new tools do not all reside, again, with any single agency.

These are all ideas that deserve careful examination, which we will engage in here at this Committee. Today's diverse panel, including representatives from hedge funds, credit rating agencies, retail investors, industry self-regulatory organizations, paints a very vivid picture of the numerous issues facing the securities markets at this moment.

The goals of modernization are clear, in my view: consistent regulation across our financial architecture with strong cops on the beat in every neighborhood; checks and balances to ensure our regulators and the institutions that oversee them are held accountable; and transparency so that consumers and investors are never in the dark about the risks they will be taking on.

The time has come for a new era of responsibility in financial services. That begins with the rebuilding of our 21st century financial architecture from the bottom up, with the consumer clearly in our minds in the forefront. It begins with the work of this Committee, and, again, this is now almost the tenth hearing on the subject matter. Senator Shelby and I and our colleagues here are determined to play a constructive and positive role as we help shape this debate in the coming weeks.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

I look forward to hearing from our witnesses today. I am particularly interested in hearing from SEC Chairman Schapiro about the steps that she is taking to address the agency's recent regulatory failures. This includes the disappearance of the investment banks, the SEC's largest regulated entities there; the systemically devastating failures by the credit rating agencies that enjoy the SEC's implicit seal of approval; and the Madoff fraud. I believe that changes in the way the agency is managed and how its resources are used will be of utmost importance in getting the SEC back on the right track.

The insights of former SEC Chairmen and Commissioners, State securities regulators, and self-regulatory organizations will also be useful in determining what changes may be needed. For that reason, I am pleased that we have representatives of each of these groups here today. Only by hearing a wide range of perspectives and by digging deep inside these agencies and failed financial institutions will we be able to fully understand how we got into this crisis, how we can get out of it, and how we can prevent them in the future.

Mr. Chairman, I think we are on the right road here breaking all this down into the various parts, and I commend you for that.

Chairman DODD. Thank you very much.

I only see a couple of our colleagues, and I know that Senator Corker likes to give long opening statements.

[Laughter.]

Chairman DODD. So I am going to presume we are going to pass and get right to our witnesses. All right. Senator Tester, any quick comments?

Senator TESTER. Well, since Senator Corker is here, I want to give a long opening statement.

[Laughter.]

Senator TESTER. I pass.

Chairman DODD. Well, again, Chairman Schapiro and Mr. Joseph, we thank you for coming before the Committee, and let me just say to my colleagues and witnesses—I always say this, but it needs to be said—that any supporting documents and information you think would be helpful in expanding your answers to questions or comments or full opening statements my colleagues would like to make will be included in the record as we go forward. And we will leave the record open for several days because invariably there will be additional questions I think my colleagues would like to

ask, and we will leave that record open and ask you to respond as quickly as possible.

With that, Chairman Schapiro, we welcome you before the Committee again.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you very much, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to testify as we face a critical juncture in the history of our Nation's financial markets. It is a particular pleasure to appear with Fred Joseph, Securities Commissioner from the State of Colorado and the head of NASAA.

I am testifying today on behalf of the Commission as a whole. The Commission agrees that our goal is to improve the financial regulatory system, that we will work constructively to that end, and that we are all fully committed to the mission of the SEC. In light of the recent economic events and their impact on the American people, I believe this Committee's focus on investor protection and securities regulation as part of a reconsideration of the financial regulatory regime is timely and critically important.

I strongly support the view that there is a need for systemwide consideration of risks to the financial system and for the creation of mechanisms to reduce and avert systemic risks. I am equally convinced that regulatory reform must be accomplished without compromising the integrity of our capital markets or the protection of investors. This is the SEC's core mission, and we believe that an independent agency with this singular focus is an essential element of an effective financial regulatory regime.

I believe that three general principles should feature prominently in regulatory reform. The first is that an integrated capital markets regulator that focuses on investor protection is indispensable to restoring investor trust and confidence, which is in turn indispensable to the recovery of our economy; second, that regulator must be independent; and third, a strong and investor-focused capital markets regulator complements the role of a systemic risk regulator, resulting in a more effective oversight regime.

The SEC's regulation of the Nation's capital markets involves an integrated set of functions that promote the efficiency, competition, and fairness of our markets for the benefit of investors; through the regulation of the exchanges, clearing agencies, and transfer agents that provide the infrastructure that makes our markets work at lightning speed, with remarkable efficiency, and at low cost to investors; through the provision of accurate, meaningful, and timely corporate information which allows investors to allocate capital efficiently; through the independence of expert accounting standard setters to ensure that the primary focus in standard setting is investors reading financials, not the companies preparing them; through the rules that ensure that mutual and money market funds which hold over $9 trillion of assets are operated for the benefit of investors and only investors; through the oversight of 5,500 broker-dealers and over 11,000 investment advisers to whom investors turn for guidance when accessing our capital markets; and, fi-

nally, through enforcement, done aggressively and without fear or favor.

Each of the SEC's core functions interacts with the others. As an aggregated set, they provide for strong capital markets oversight. Take any function away, and the investor protection mission suffers. If the functions are disaggregated, capital markets oversight becomes diluted and investors suffer.

As we look to the future of securities regulation, we believe that independence is an essential attribute of a capital market's regulator. Congress created the SEC to be the investor's advocate, and Congress did so precisely so that we can champion those who otherwise would not have a champion and, when necessary, take on the most powerful interests in the country. Regulatory reform must guarantee that independence in the future.

Finally, the SEC, as a strong and independent capital markets regulator, will work cooperatively to support the mission of systemic risk regulation, whether it is accomplished through the designation of a single entity to monitor and control risk or through a college of regulators approach.

When I returned to the SEC as Chairman in January, I appreciated the need to act swiftly to help restore investor confidence in our markets and in the SEC. In less than 2 months, we have instituted important reforms to reinvigorate our enforcement program, better train our examination staff, and improve our handling of tips and complaints. To address short selling, the Commission will consider proposals early next month to reinstate the uptick rule. And on April 15th, the Commission will hold a public roundtable on possible credit rating agency reforms.

This spring, I will ask the Commission to consider proposals to strengthen money market funds through improvements to credit quality, maturity, and liquidity standards; improve investor access to public company proxies; and significantly enhance controls over the safekeeping of investor assets.

But we cannot do everything alone, and this crisis highlights several pressing needs. I expect to ask for the Committee's help with legislation that would require registration of investment advisers who advise hedge funds, and likely of the hedge funds themselves; legislation to break down statutory barriers between broker-dealers and investment advisers, and to fill other gaps in regulatory oversight, including those related to credit default swaps and municipal securities, an area that has far too long needed more robust oversight.

Every day when I go to work, I am committed to putting the SEC on track to serve as a forceful regulator for the benefit of America's investors. Today, the SEC's core mission of capital markets oversight and investor protection is as fundamentally important as it ever was, and I am fully committed to ensuring that the SEC carries out that job in the most effective way it can.

Thank you again for the opportunity to share the SEC's views. We very much look forward to working with the Committee on any financial reform efforts in the months ahead, and I, of course, would be pleased to answer any questions.

Chairman DODD. Thank you very much, Chairman Schapiro.

Mr. Joseph, thank you very much for being with us.

STATEMENT OF FRED J. JOSEPH, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. JOSEPH. Thank you, Mr. Chairman. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am Fred Joseph, Colorado Securities Commissioner and President of the North American Securities Administrators Association—NASAA. I am honored to be here today to discuss legislative and regulatory changes that are most relevant to Main Street Americans who are looking to regulators and lawmakers to help them rebuild and safeguard their financial security.

In November 2008, NASAA released its Core Principles for Regulatory Reform in Financial Services and subsequently issued a pro-investor legislative agenda for the 111th Congress. Today I would like to highlight the recommendations that we feel are most vital to sound regulatory reform and strong investor protection.

NASAA's top legislative priority is to protect investors by preserving State securities regulatory and enforcement authority over those who offer investment advice and sell securities to their residents. Just one look at our enforcement data shows the effectiveness of State securities regulation. Last year in Colorado alone, my office conducted investigations that led to 246 enforcement actions, resulting in $3 million ordered to be returned to investors and 434 years of prison time for fraudsters. And just last month, a Ponzi scheme investigation launched by my office resulted in a prison sentence of 132 years for the main perpetrator.

And yet, over a number of years there have been calls for preemption of State regulation and enforcement. The National Securities Markets Improvement Act of 1996, NSMIA, preempted much of the States' regulatory authority for securities traded in national markets. Although it left State antifraud enforcement largely intact, it limited the States' ability to address fraud in its earliest stages before massive losses have been inflicted on investors.

An example of this is in the area of private offerings under Rule 506 of Regulation D. These offerings enjoy an exemption from registration under Federal securities law, so they receive virtually no regulatory scrutiny. As a result, we have observed a significant rise in the number of offerings made pursuant to Rule 506 that are later discovered to be fraudulent.

Although Congress preserved the States' authority to take enforcement actions for fraud, this power is no substitute for a State's ability to scrutinize the offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors. NASAA believes the time has come for Congress to reinstate State regulatory oversight of all Rule 506 offerings.

Next, the Madoff case illustrates the horrific consequences we face when an investment adviser's illegal activity goes undetected and unchecked for an extended period. NASAA recommends two changes to enhance the States' role in policing investment advisers. First, the SEC should expand the class of IAs that are subject to State registration and oversight. In NSMIA, Congress provided that the States would regulate IAs with up to $25 million in assets under management, while the SEC would regulate the larger IAs. Congress further intended that the SEC would periodically review this allocation of authority and adjust it appropriately. The time is

now for the $25 million "assets under management" test to be increased possibly to $100 million.

Congress should also consider enhancing the States' enforcement authority over large IAs. Currently, a State can only take enforcement action against a federally registered investment adviser if it finds evidence of fraud. This authority should be broadened to encompass any violations under State law, including dishonest and unethical practices. This enhancement will not interfere with the SEC's exclusive authority to register and oversee the activities of large IAs.

NASAA also urges Congress to apply the fiduciary duty to all financial professionals who give investment advice regarding securities—broker-dealers and investment advisers alike. This step will enhance investor protection, eliminate confusion, and even promote regulatory fairness by establishing conduct standards according to the nature of the services provided and not the licensing status of the provider.

The fiduciary duty is the obligation to place a client's interest first, to eliminate any conflicts of interest, and to make full and fair disclosure to clients. We recommend that Congress ratify the highest standard of care. For all financial professionals, the interests of the clients must come first at all times.

Many observers believe that private actions are the principal means of redress for victims of securities fraud, but they also play an indispensable role in deterring fraud and complementing the enforcement efforts of Government regulators and prosecutors. The problem is that Congress and the U.S. Supreme Court have restricted the ability of private plaintiffs to seek redress in court for securities fraud. These restrictions have not only reduced the compensation available to those who have been the victims of securities fraud, but they have also weakened a powerful deterrent against misconduct in our financial markets. Removing excessive restrictions on access to the courts would not only provide just compensation for investors, it would also benefit regulators by restoring a powerful deterrent against fraud and abuse—that is, the threat of civil liability.

In conclusion, State securities regulators believe that enhancing our securities laws and regulations and ensuring they are being vigorously enforced is the key to restoring investor confidence in our markets. NASAA and its members are committed to working with the Committee to ensure that the Nation's financial services regulatory regime undergoes the important changes that are necessary to enhance Main Street investor protection, which State securities regulators have provided for nearly 100 years.

Thank you very much.

Chairman DODD. Thank you very much, Mr. Joseph. We appreciate that very much. We will begin with the first round, and I will ask the clerk to keep an eye on this clock here so we make sure we get to everybody and move along with as many witnesses we have.

Madam Chairman, thank you again for being with us here this morning. Lehman Brothers, Financial Products Division, AIG, among others, I guess, you have heard Secretary Geithner and Fed Chairman Bernanke propose the creation of a resolution mecha-

nism for nonbank entities as a way to move things forward. Obviously, you are talking about an area in which the SEC plays a very critical role. So, one, I would be interested to know whether or not you were consulted on this at all. We have talked about the Treasury Secretary and the Chairman of the Federal Reserve, but given the fact we are talking about entities that would normally fall under the jurisdiction of the SEC or the State regulators, were you at all consulted by the Treasury and the Fed? What role do you think the SEC should play in this resolution mechanism given the oversight and regulator responsibilities? And let me take advantage of the moment as well to ask you, if you would, to comment on the reports of the regulatory changes that Secretary Geithner has mentioned this morning. In fact, I will ask both of you to do that, but let me begin with Chairman Schapiro.

Ms. SCHAPIRO. Thank you, Mr. Chairman. I would say broadly and quite generally there was consultation with respect to the concept of filling the gaps in the existing resolution regime, but really very little conversation about what that would look like and what the legislative proposal ultimately would propose.

We clearly have gaps in our resolution regime for large financial institutions. SIPC obviously handles the unwinding and the liquidation of a broker-dealer. FDIC is empowered to handle the unwinding or the resolution of a bank, but we have bank holding companies and other large financial institutions for which there really is no organized resolution regime. And I do think that that was an issue, clearly an issue with AIG, but also an issue with Lehman Brothers and other institutions.

So I fully support the concept of closing the gap in resolution regimes so that we have a more coherent approach. Whether that ultimately rolls SIPC, over which the SEC has authority, into it or it works to be highly coordinated and cooperative with an entity like SIPC I think is something we should probably discuss as this legislation moves forward.

Chairman DODD. Let me just say on that point, before we move to the second question, whether they have consulted with you or not, I would hope that you would demand to be consulted on this. This is something where clearly this is—you are going to have a resolution of these entities here, given the role of the SEC in the regulation of them and the oversight of them. And I am very much supportive of the idea of having a resolution mechanism. I do not want to suggest I am not. But it seems to me you have got to be involved in this.

Ms. SCHAPIRO. There is actually no question but that we have to be involved in this. The SEC has an enormously important role to play here as the expert. But, again, as I said in my opening statement, as the advocate for the investor whose funds are in potentially multiple components of a large financial firm, and most particularly, of course, the broker-dealer, and our concern will always be the protection of investors' assets in the broker-dealers.

So I am not known for being shy. I have no intention of being shy.

Chairman DODD. Kick down the door, if you have to.

Ms. SCHAPIRO. I will kick down the door.

Chairman DODD. Mr. Joseph—let me have you respond to this quickly, and then I want to get back to this—and do not take a long time on the second part of that question, but I would be interested in your general reaction to what you have heard this morning from Treasury and others on the modernization.

Ms. SCHAPIRO. With respect to a systemic risk regulator?

Chairman DODD. Yes.

Ms. SCHAPIRO. Again, the devil is in the details on this one for sure, and my concern is that in the creation of a systemic risk regulator we do not create a monolithic entity that supplants the important functions that are served by multiple other agencies and most especially, in my view, the Securities and Exchange Commission and our role as a regulator of the capital markets with a focus, again, solely on investors and investor protection.

So while I support the concept of either a systemic regulator or a college of regulators—which I think is a concept you have talked about; I know there is at least one bill proposed that would create that sort of a mechanism, and I think it is well worth exploring because I think multiple regulators bring a lot to the table and multiple perspectives.

Nonetheless, whichever way we end up going, I think there is value to a view across the markets of large or rapidly increasing exposures that can threaten the health of the financial system. I think there is an important focus on evaluation of risk management procedures within large firms. I think there are certain prudential standards that ought to be established for very important systemic institutions. And I think a risk regulator can help the appropriate resolution authority in their functions.

But I think what is really important is that while we try to create a mechanism like this, that we do not try to supplant the very important functions that are engaged in by agencies like the SEC in the regulation of markets, clearance and settlement systems, brokerage firms, mutual funds where Americans entrust their savings and so forth.

Chairman DODD. Let me just say, my time is up here, and, again, I think Senator Shelby and I are both very determined to work very closely together on this, so I would not want any of my statements to be taken as a final conclusion on this. But as we talk about a systemic risk regulator and a prudential regulator, my own view is we put that together. I get somewhat uneasy about consolidation of a lot of this. It looks great on a sheet of paper in terms of doing the efficiencies of it. But I for one feel very strongly, at least at this point, that the SEC and the function of the SEC ought not to be so incorporated in something that it ends up diminishing the role of the Securities and Exchange Commission in investor confidence, investor confidence, investor confidence.

Ms. SCHAPIRO. I completely agree with you. My fear is that a systemic risk regulator and systemic risk concerns will always trump investor protection. And given the structure of our markets and the broad participation of the public in our markets, that would be a terrible result.

Chairman DODD. We are interested in your thoughts and views on this as well, but I would not want the moment to pass without expressing my reservations about moving a lot of boxes around and

consolidating things and assuming you are getting something better because you have got fewer boxes.

Ms. SCHAPIRO. Thank you.

Chairman DODD. In fact, the goal is that consumer, that investor, that shareholder, that user of the system, what is in their interest? You begin there.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Picking up on the area that Senator Dodd was in, Chairman Schapiro, the SEC's Consolidated Supervised Entity Program, I believe was not a success. What role, if any, should the SEC—you are the Chairwoman of the SEC—play in prudential supervision?

Ms. SCHAPIRO. I think it is——

Senator SHELBY. Can you bring the microphone up closer, please?

Ms. SCHAPIRO. Sure. I am sorry. Is that better?

Senator SHELBY. Yes.

Ms. SCHAPIRO. I think the SEC's Consolidated Supervised Entity Program was not a success. I think that is a fair evaluation. It has been replaced now because we obviously still have very important oversight of brokerage firms that have financial and operational issues that need the close supervision of the SEC, and it has been replaced by an Office of Broker-Dealer Risk Management.

Nonetheless, our focus on the broker-dealer is very important and it is well ingrained in the SEC. But you can't effectively oversee the broker-dealer and its operations if you don't also have the ability to understand what is going on in a holding company or an affiliate, including overseas affiliates, whose activities can very, very directly impact the broker-dealer and the safekeeping of customer assets at that broker-dealer.

So my view is that we have responsibility for brokerage firms, but we also have to have what we call a touch at the holding company level and at the affiliate level to understand risk management, exposures, leverage, and other issues that have implications for the broker-dealer's health.

Senator SHELBY. You have announced plans to consider reinstating the uptick rule, or a variation of the rule, at an open meeting next month. A lot of economic analysis was done before the rule was eliminated in 2007. How are you incorporating economic analysis into the decision about whether, and if so, how to reinstate an uptick rule?

Ms. SCHAPIRO. Senator, you are absolutely right. We are going to consider at an April 8 Commission meeting proposing to reinstate the uptick rule, or a bid test, or a circuit breaker, or some combination of those as a mechanism for controlling short selling to some extent. We are obviously acutely aware of the tremendous interest in this issue on both sides. Economic analysis did play a very important role in the elimination of the uptick test and we would expect that our economists at the SEC are looking at data now in the context of the changes in the markets to understand what the impact of an uptick rule might be, and I would expect that we will make data available, to the extent we can, to independent economists to do some analysis, as well.

We will also hold in conjunction with the open meeting where we will consider the uptick test a public roundtable where we will so-

licit views more broadly about not just the uptick test, but other potential Governors on short selling.

Senator SHELBY. The SEC's examination function used to be integrated into each of the rulemaking divisions. Over 10 years ago, it was split off into a separate office. Some people have argued that this structure creates a dangerous wall between those who write the rules and those who monitor how firms are implementing them. Are you at the SEC reviewing this structure and how it continues to make sense, especially in light of the Madoff-Stanford financial and market timing scandals?

Ms. SCHAPIRO. Yes, Senator, we are. I have only been on board about 2 months, not quite 2 months, and——

Senator SHELBY. I know that.

Ms. SCHAPIRO. ——and reviewing the structure of the agency broadly is high on my list of things to get done. It is really critically important that we have an examination staff that has the tools and the skill sets to do a more effective job, the most effective job possible, but that is also linked back to the policymaking parts of the organization so that they can inform policymaking and they can also inform the Commission about areas where we may need to take further action. So I am looking very broadly at the structure of the entire agency and, of course, OC is a component of that.

Senator SHELBY. You have also noted that the SEC may ask Congress for a statutory mandate that hedge fund advisors register. Would your request also extend to venture capital and private equity advisors, and how would the influx of new advisors affect the frequency with which advisors get inspected?

Ms. SCHAPIRO. Well, it is a terrific question because right now, we have something on the nature of 400 examiners to cover 11,300 advisors and more than 8,000 mutual funds. So without additional resources, we could not make, even given the authority to regulate hedge funds, we couldn't make that a reality in a very effective way.

Senator SHELBY. How much money are you going to need there? I know this is an Appropriations Committee question, but I am also on that committee.

Ms. SCHAPIRO. We are working on that analysis right now and will be happy to provide it to the Committee as soon as possible.

Senator SHELBY. OK.

Ms. SCHAPIRO. Also, it is important, though, that in addition to resources, we need to have the skill sets that are appropriate in order to do an effective job with hedge fund regulation.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. Thank you for holding the hearing, and thank you to the witnesses for being here today.

My first question deals with executive compensation. It has become clear that something is out of whack with executive compensation. I think we all believe that people should be rewarded for good performance. That is not the problem. But what we have seen in many instances, that has enraged Americans, is a "heads, I win, tails, you lose" system, in which executives are rewarded for flash-in-the-pan short-term gains, or even worse, rewarded richly when

the company does poorly and the shareholders have been hammered. I think that is what most confounds people—bad performance, higher salary.

Corporate boards are supposed to keep an eye on compensation. They are supposed to keep it aligned with shareholder interests. Lately, they seem to have more interest in keeping the CEOs and top management happy than in carrying out their fiduciary responsibilities, so I think we have to address that. We have learned a lot about this in the last while.

Last year, when he was a Senator, President Obama sponsored an advisory say on pay proposal. I think we have to look at this. I am for it. But for say on pay to have teeth, it seems pretty clear it requires shareholders to have a stronger voice in regard to corporate management. This obviously means shareholders need to have a real voice in the election of directors. Right now, given the fact it is so hard to get access to the proxy materials for nonmanagement shareholders, this isn't true, so I was encouraged to hear in your testimony you don't believe the SEC has gone far enough in this area.

First, how are you proceeding to correct this, and do you agree with me that, in conjunction, real proxy access along with say on pay would have some real impact on compensation practices and on enhanced board responsibility more generally?

Ms. SCHAPIRO. Senator, I agree with everything you have said——

Senator SCHUMER. Oh, well maybe we should stop right now.

[Laughter.]

Ms. SCHAPIRO. I could stop right there in the interest of time.

Let me say quickly, I think there has been a lot of effort to link pay to performance, but there has been a nonsuccessful effort to link pay to risk taking and that is a responsibility for boards, to understand the appetite for risk within the organization and to control it, and one way to control it is through linkage to compensation practices for senior management.

We will move ahead this spring to propose greater access to the proxy for shareholders as a mechanism both to empower shareholders, who are, in fact, the owners of the corporation, but also as a mechanism to help provide greater discipline with respect to compensation and risk taking.

Senator SCHUMER. Thank you, and I look forward to working with you on this area. I think we need to move forward.

Second is enforcement funds. We know—everyone knows about the Madoff case, but it is emblematic of a broader trend of fraud that I believe is going to be uncovered in the aftermath of this financial crisis. Back in the S&L crisis, I helped push a law that would get special prosecutors, FBI agents, and bank examiners to go after that fraud. Mr. Breeden is shaking his head because we worked together on that. And we need to do that again, particularly now. If you saw yesterday's newspaper, the administration, correctly, doesn't want to reduce antiterrorism efforts in the Justice Department, but that squeezes new needs, such as financial investigators.

In conjunction with my colleagues on this Committee, we are trying to increase the SEC enforcement budget. I proposed legislation

to do that with Senator Shelby, which we are going to try to do in the Appropriations Committee. Can you give us a sense of what improvements you could make with a stronger enforcement budget?

Ms. SCHAPIRO. I would be happy to, and we——

Senator SCHUMER. Or an increased budget in general, too.

Ms. SCHAPIRO. We would be grateful recipients of an increased budget and particularly an increased enforcement budget. We have a new Enforcement Director beginning on Monday. He spent 11 years as a prosecutor and head of the Securities and Commodities Fraud Task Force in the Southern District of New York. He is coming in with a renewed commitment to the SEC's focus on bringing the most important cases, the most meaningful cases, in the quickest time possible in order to protect investors more effectively.

We are also looking at technology improvements to support our enforcement and examination staff. The SEC's technology is light years behind Wall Street, and frankly, light years behind everybody else.

Senator SCHUMER. OK.

Ms. SCHAPIRO. We have enhanced our training programs. We have a number of people who are now taking the Certified Fraud Examiner Program, as well as enhancing dramatically our internal training programs. And we are actively seeking new skill sets, including in financial analysis, forensic accounting, trading, and other areas, so that we are better able to keep up with what is going on and what the fraudsters are up to.

Senator SCHUMER. Thank you. So I see you need the money.

Could I ask one more, Mr. Chairman? Quickly, just on derivatives clearing. For a while, I have been advocating that derivatives ought to be traded whenever they can be—some are very complicated and there is no market—in either a clearinghouse, or for me, preferably, an exchange. I know that this morning, Secretary Geithner is going to mention that in his testimony, at least as I understand it, on the House side.

What steps is the SEC encouraging to take to encourage the use of central counterparties? Do you have the authority to require clearing of certain types of derivatives now? If you don't, is it the kind of authority that you want, and if not, what other kinds of authority do you need?

Ms. SCHAPIRO. I believe that——

Senator SCHUMER. Do you agree with the general thrust?

Ms. SCHAPIRO. Yes. CDS should be centrally cleared. We do not have the authority right now to require that. We have facilitated the approval of three central counterparties for CDS clearing that we have done jointly with the Fed and with the Commodities Futures Trading Commission and we would strongly recommend that Congress require central clearing of CDS. I am not a big believer in voluntary regulation and I think that this is an area where we need authority.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Did I hear you say in response to Senator Schumer on the way on pay that you are inclined to be supportive of that in terms of shareholder——

Ms. SCHAPIRO. I do support say on pay, the advisory vote by shareholders of pay, yes.

Chairman DODD. Good. Thank you for that.

And let me just say, too, as I turn to Senator Corker, there are some wonderful people who work at your organization and I wouldn't want our comments to talk about needs and resources and so forth to be reflective of how many of us feel about how hard working people are at the SEC. They need the tools, as Senator Schumer points out, the resources and so forth there, but it is not for lack of determination of good people who want to do a good job, and I think that needs to be said. It can't be said often enough.

Ms. SCHAPIRO. I appreciate that very much.

Chairman DODD. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and thank you all for being here and for your testimony.

I just, in looking at my BlackBerry a second, would recite a quote from Secretary Geithner this morning on the other side of the Capitol. We have a moment now where there is broad-based will to change things that people did not want to change in the past.

I am getting a little feeling of nervousness just about the pace at which change is taking place. Typically, when you move in crisis, you end up with not having a cause-neutral solution, OK. I would just say to you, if you are going to be kicking the door down, the kicking is good right now. I mean, you are going to miss an opportunity if that doesn't happen very quickly, and I would just ask your opinion of some of the resolution authority concepts that were laid out in the last 24 hours.

It feels to me like a codification of TARP. The very powers that the Treasury has now under TARP, it seems to me they are codifying under this proposal they have put in place, which allows them to not only take companies down, but to decide to invest in companies. I just wonder if you have any thoughts there and does that concern you in any way.

Ms. SCHAPIRO. It does concern me. I think any time we write blind check legislation, as I sometimes call it, we have to be very conscious of the fact that we could set in motion a complete rewrite of the regulatory regime without perhaps truly intending to do that. So I think it is really critically important the Congress stay deeply involved in this discussion and this debate and set the parameters.

So, for example, the definition of a systemically important institution is absolutely essential, and if it is very, very broadly defined, that resolution regime or the systemic risk regulator could usurp the functions of multiple other regulators, and as you know, my concern is also usurp the importance of investor protection and capital markets regulation in doing so.

So I think it is really an area where Congress needs to stay involved so that we don't end up with such broad legislation that we define the regulatory regime without the input of the broadest number of perspectives and without really careful thought to what the implications are to the other functions that are important in financial regulation.

Senator CORKER. Mr. Chairman, I think we have seen that TARP was set up for an intended purpose and we have moved into indus-

trial policy. The last administration did that. This administration looks like it is going to move more deeply into industrial policy. And it seems to me that what the Secretary has outlined this morning truly gives them the ability to move into any sector of our economy that they choose that they decide might be systemically putting our economy at risk, and I think we should heed Ms. Schapiro's comments here. This is a fearful time. The public is concerned, and lots of time bad things happen legislatively as a result of people being concerned.

Let me ask you this. Do you agree or disagree that hedge funds, derivatives, private equity ought to be regulated?

Ms. SCHAPIRO. I do not disagree. I believe they should be regulated.

Senator CORKER. And to follow up on Mr. Schumer's comment—and obviously, how they are regulated makes a huge difference, would you not agree?

Ms. SCHAPIRO. Absolutely.

Senator CORKER. I mean, we could, in fact, I guess, run all three of those enterprises to other places if we regulate them inappropriately, is that correct?

Ms. SCHAPIRO. That is right, so we need to be sensitive to the fact that a hedge fund is not a mutual fund, and we need to understand the differences in how those investment vehicles work and tailor the regulation appropriately.

Senator CORKER. And we still want private equity to take risk, right?

Ms. SCHAPIRO. Absolutely.

Senator CORKER. I know there is not time right now. I would love to hear your thoughts on how you regulate private equity in such a way as to allow them to continue to take risks, which is what we want them to do, and yet be somewhat under their hood. So maybe you will answer that a little bit later.

I want to ask you one last thing, because time is so short. We have so many panel members. Credit default swaps, I think we all understand some of the problems that have occurred. There have been people that have advocated that credit default swaps are like off-track betting if you don't have any skin in the game. And so I would love to hear your thoughts as to whether credit default swaps should only be used when you have some collateral that you are actually insuring against, or whether you ought to be able just to make bets with no collateral.

Ms. SCHAPIRO. It is a terrific question and it is one where there are very strongly held views on both sides, whether there should be skin in the game in the sense that you have an insurable interest before you engage in a credit default swap. We don't have an agency perspective on that. I think it is actually an issue very much worth exploring as a mechanism to control some of the risk in the system.

I can't tell you I am sophisticated enough to know all of the implications of requiring an insurable interest before engaging in a credit default swap and exactly how you would define that. But I think it is an issue that is worthy of consideration.

Senator CORKER. Well, my time is up, but my sense is that you feel like the Treasury's proposal, as outlined in the last 24 hours, could be very much a power grab, is that correct?

Ms. SCHAPIRO. I certainly wouldn't use those words——

Senator CORKER. But I am using them, and I would love to have a yes or no on that.

Chairman DODD. Nice try, Senator.

[Laughter.]

Ms. SCHAPIRO. I think the devil—I believe the devil is in the details. I believe it is really important we understand what it is exactly that we are proposing to do and what the implications are for the regulatory regime and for investors broadly.

Chairman DODD. Thank you, Senator.

Let me just say, too, to my colleague from Tennessee, whose judgment and counsel I take very seriously, as well, this Committee will be very involved as we listen to the proposal on the resolution mechanism. I said I am generally supportive of the idea of having some sort of a resolution mechanism. What shape that takes and how it is organized and structured is something this Committee will be deeply involved in, and so——

Senator CORKER. I sure hope so. The way things have laid out, Mr. Chairman, I would rather be Treasury Secretary than chairman of the universe, so I hope we will be involved.

Chairman DODD. Well, be careful what you wish for.

Senator Warner.

Senator WARNER. Better than chairman of the universe? That is a high standard.

Well, thank you, Mr. Chairman. I know my time is short, but I would like to echo what my colleague said. In the Chairman's response to the skin in the game question about credit default swaps, I know there are a number of other arguments on the other side. I would like to hear out those arguments because it does seem to me that from at least a broader-based societal standpoint, the outside risk and the downside risk that we as a society, in effect, have taken on by these nonskin in the game offside bets, we are sure seeing the downside of that.

I would like to come at this, maybe look at it from the top and maybe from the bottom in one of the questions, bottom up, and you having served in the role of FINRA. I understand the need for self-regulatory organizations in light of the limited resources you have at the SEC to have the oversight on the number of institutions you have to cover, but we had a previous hearing here a month or so back on the Madoff schedule and it seemed where they were passing responsibility representatives from the SEC and FINRA about where boundaries ended and how far you could go and at what points the operator of an institution could, by simply defining that this was off-limits, could stop investigations.

Have you looked through your overview, Chairman Schapiro? Have you looked at, kind of a fresh eye look at all of the SROs and what their role and function should be going forward?

Ms. SCHAPIRO. We have not yet. That is something we will do, because I think it is very important. The SEC is responsible for about 30,000 regulated entities, including about 12,000 public companies. We have a staff of 3,600 people. We have got to have the

ability to leverage third parties in order to do our job, which is not to say in any way that we would ever abdicate our responsibility or delegate our responsibility away. But whether it is accounting firms or SROs, the PCAOB or other entities, we need the ability to utilize them to help us get our jobs done.

I think what the Madoff matter points out to me that I think is something we need to focus on, and I alluded to in my oral testimony and in more detail in the written, is that we do have doubts in the regulatory regime and a particular area of concern, and Fred Joseph raised this, as well, is the different standards of care and the different regulatory regimes that govern investment advisors and broker-dealers when they are providing largely the same service, and investors clearly don't understand that there is either a different standard of care or a different regulatory regime in place.

Those are the kind of gaps that we absolutely need to fill and we need to do so from the perspective of the investor so that they are getting uniform protections and standard of care and regulatory oversight regardless of what the title is of the person who is offering them financial services, and that is an area where I think we need to be very focused.

Senator WARNER. I would love to come back and pursue that later, but I have got two other areas and my time is short.

One is, following up on Senator Schumer's comments, and I was appreciative of your comments that the Chairman brought out, as well, on say on pay. But I do think that at some point, this Committee also needs to take a look at corporate governance. I believe a lot of good things may have come out of Sarbanes-Oxley. One of the challenging things that came out of Sarbanes-Oxley is I think it is even tougher to get good quality board members to serve on public companies. I would actually believe that one of the unintended consequences of Sarbanes-Oxley may be that chairmen of companies end up getting even more captured board members because so few folks, other than maybe their friends, would want to serve on a public board at this point.

I have explored the option of looking at institutional investors, could we create an effective cadre of qualified potential board members so that we really could look at the issue of how we bring some real independence and broader-based oversight on corporate governance, and I just wonder if you had any kind of initial thoughts——

Ms. SCHAPIRO. We would love to work with you on that. We are engaged right now in a pretty complete review of corporate governance issues at the SEC, everything from linking—disclosure concerning pay and its linkage to risk taking, risk disclosure more generally, qualifications of board members, and access to the proxy as a way to try to facilitate more independent boards that are more responsive to shareholders, and my view is we will take all good ideas and put them into the mix and see if we can come up with a system that works better for U.S. shareholders than the one we have——

Senator WARNER. I do think we need something to make sure the board members don't get captured as quickly and often as they do.

One last question. I know my time is up, but this could be perhaps an easier one. I know you are going to deal with the uptick

rule, but I wonder, as well, if you are looking in terms of short selling at some type of real-time disclosure component for short sales so that the market could know on a real-time basis the position of the number of shorts.

Ms. SCHAPIRO. We are, as you point out correctly, talking about the uptick rule at an April 8 Commission meeting. We are looking at a wide range of possibilities and disclosure is certainly one of them with respect to short selling, hard borrow, just the broad panoply of possibilities in this area. The one that is most advanced is the possibility of reinstating the uptick rule at this point.

Senator WARNER. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Just on that last point Senator Warner has raised, as well, I wonder if you will also look at margin requirements. The difference between exposing weakness, which short selling does and has very great value, versus speculation, which has been, I think—you know, people have talked about mark-to-market. The quickest thing you might do about mark-to-market is get this uptick rule in place, in my view, and then look at the margin requirements as Richard Breeden talked about.

Ms. SCHAPIRO. Yes, it is in former Chairman Breeden's testimony.

Chairman DODD. Yes. Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman, and let me just say to the Chairman and Ranking Member, this is another excellent hearing.

If I could, I would like to focus our attention in my limited time on Mr. Madoff and his Ponzi scheme, and I will offer an observation to start out with, and I don't suggest this in a necessarily critical way, but I am very skeptical, and I think there is reason for that skepticism. I hear your need for more people, more money, more staff, the vast regulatory responsibility you have. But I look back on the Madoff case and there is, I think, a fair amount we know today. There is a fair amount we probably don't know because of the ongoing investigation that we will learn as time goes on.

But you have a gentleman out there, for lack of better terminology, I will call him a whistleblower, who I think pretty effectively blew the whistle, and having been in your position as a cabinet member and having regulatory responsibilities also, I read through that information that he provided to you folks and, boy, I would liken it to dropping a grenade in the Secretary's office. I mean, it is explosive. It sets up the possibility that everybody's investment is at risk, if not literally disappearing.

And I put myself in that position and I think about, boy, I would have had the Inspector General, the Department of Justice, I mean, anybody I could have reached out to and grabbed onto to help me deal with that issue, and yet we went along here and now today we learn that maybe a billion dollars will be recovered out of some $65 billion.

Now, I am very mindful of the ongoing investigation. I don't want to interfere with that. I certainly understand that. But what I want to start to understand is what went wrong, because if we don't understand what went wrong, then we can't be very effective in de-

signing a regulatory framework that protects the consumer. What assurance can we have as the Committee that when the next whistleblower shows up, it will be different because of some action we have taken as the U.S. Senate or as the Congress to try to deal with these issues? So help me start to understand that.

Ms. SCHAPIRO. I would be happy to, and let me say very clearly that I don't lay the blame for the SEC's failure to respond appropriately to the Madoff to the whistleblower's information provided to the agency at the feet of a lack of resources. As you rightly point out, a fairly complete set of information was provided over a period of years to the agency and wasn't follows up on appropriately. So in this instance—we do have resource issues. In this instance, I am not sure we can blame resource issues.

The Inspector General, as you correctly point out, is investigating, and that is going to take a number of additional months. My view is I need to run this agency in the meantime and I am not really anxious to wait four or five additional months to find out what went wrong and then start to fix our problems, because as you also point out correctly, we can't fix it if we don't understand how we failed.

My belief is that there are multiple things that contributed to the agency's failure to act and there are a number of things that we can do and have started to do in response. One is that we have a stovepiped approach within the Securities and Exchange Commission, where information is not freely shared across offices and among departments and divisions the way it ought to be and the way that you would hope for in an agency that was really operating efficiently.

We have very disparate processes for handling the between 700,000 and a million-and-a-half tips and whistleblower complaints that come into the agency on an annual basis and we don't have all the right skill sets. So that information may well have landed with somebody who didn't understand at all what they were looking at, and because the culture isn't normally one of sharing information easily, it didn't get sent necessarily to the right place.

Those are all things that we can do something about. We have engaged the Center for Enterprise Modernization to come in and review all of our processes for handling those 700,000 tips and complaints and helping us build the technology that will allow us to mine those that are most productive. We will come back to this Committee and ask for whistleblower legislation that will allow us to compensate people who bring us fully formed, well documented instances of abuse or fraud that we can then pursue from a law enforcement perspective. We are bringing in new skill sets and people with the ability to look and understand the data that they are looking at.

And finally, it is the job of the leaders of the agency, myself, most especially, to try to break down the walls that exist between departments and divisions so that sharing information and viewing ourselves as engaged in a common enterprise is the way we approach our work, not as divisions competing sometimes with each other.

So we have a lot to do in this area. I am fully committed to fixing every problem that we have as best as I possibly can. I have only

been there 2 months. I think we have gotten a lot of things started, but it is going to take time and effort to refocus the efforts and the energies of the agency on protecting investors from exactly this kind of conduct.

I will say that in the last couple of months, the Ponzi scheme TRO machine has been fired up and you will not see a week go by where we are not bringing Federal court cases against Ponzi scheme operators and trying to stop them at a much, much earlier point in time.

Senator JOHANNS. I appreciate the candor of the answer. I think you acknowledge there were some things here that just simply were missed.

My time is up. Here is what I would ask for—because this is going to unravel over time. The investigation will continue, but at some point it will conclude. My hope is that when there is a full and complete picture and we can have an open and candid discussion about what the investigation showed, et cetera, that we do that. We owe that to the people who have lost so much. And so I hope you will work with the Chairman and the Ranking Member and the Committee Members to help us just nail this thing down in terms of what happened and why it is not going to happen in the future.

Ms. SCHAPIRO. I completely agree that the Congress, as our oversight body, is entitled to understand that, and the American public is entitled as well.

Senator JOHANNS. Great. Thank you.

Chairman DODD. Let me just say in that regard, too, Jack Reed and Senator Bunning are the Chair and Ranking Member of the subcommittee dealing with securities. And today is an abbreviated session with the Chairperson of the SEC, but I commit to my colleagues this will be an ongoing conversation both formally and informally. We will find means by which we can pursue these matters, and certainly as Chairman Schapiro knows, we have made some requests which the SEC—in fact, the Chairwoman indicated to me this morning—will be getting back to us immediately on some requests the Committee has made regarding this matter, and we welcome that very much. It is very much in line with what the Senator has requested this morning.

With that, Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, Ranking Member Shelby. I appreciate the hearing. Thank you both for being here.

This is a question for both Chairwoman Schapiro and Mr. Joseph. I had conversations around the State, as I am sure we all have, with constituents, regulators, and finance professionals in Montana, and there is pretty much unanimous consent that one of the biggest, if not the biggest, threat to our economy right now is a lack of confidence in the marketplace. Families fear their retirement accounts and all their investments are not as safe as they once were. What do you feel in your individual capacities is the most critical step that we can take to restore consumer/customer confidence? You will both get a chance, so go ahead.

Ms. SCHAPIRO. You know, there are so many pieces to restoring investor confidence. From the perspective of the SEC, we really have to show a single-minded commitment to putting investors first

in every single thing we do. That means aggressive enforcement so that investors understand that there is a penalty and a price to pay for abusing investor trust. It means ensuring that the corporate disclosure that investors get so they can make rational decisions about how to allocate their capital, whether to buy a stock or to buy a mutual fund, is absolutely honest and transparent and readily available to them.

It is ensuring that post the reserve fund "breaking the buck" and scaring everybody about the resilience of money market funds, that we understand those issues and that we move quickly to enhance the liquidity and quality of paper that is held in money market funds.

For us, it is really doing what we do every single day, but with the single-minded focus on investors and ensuring that our efforts are urgent and aggressive. And beyond that, I think obviously the economic stabilization programs need to play out. People need to see credit flowing again. They need to have faith that the people that they are dealing with are going to be honest, and enforcement is obviously a huge component of ensuring that.

Senator TESTER. Thank you.

Mr. Joseph.

Mr. JOSEPH. Thank you, Senator. I agree with the Chairman. Her comments are right on. And you are correct, the whole system—the entire financial system—is built on trust and confidence. And at the moment I think that is a little bit shaky. If people do not believe they are on a level playing field, and if that does not happen, obviously they are not going to invest.

I agree that we need to focus on investor protection. I believe we need to be certain that the people who are licensed to sell securities are adequately prepared and qualified to do so. The securities that they are selling, for example, the Reg. D Rule 506 offerings, need more regulatory scrutiny; otherwise, in some cases it is just pure gambling.

Senator Dodd also pointed out that in some cases it is speculation. Senator Dodd, I would say it is speculation at best and gambling at worst in some cases.

Last, we need to enforce, and enforce strongly. And I believe the SEC and the States must continue on in that role, and we take our roles very seriously.

Senator TESTER. Thank you. One quick comment before I get to my next question. Chairwoman Schapiro, I appreciate your consideration of the uptick rule. There is a bill that Senator Isakson, Senator Kaufman, and myself are on to reintroduce it, and I think it could help, reinstituting that rule that was taken away after 8 years. I appreciate you taking that up.

I want to talk just very briefly, because I have only got a minute left, about the power of a monolithic regulatory scheme versus a patchwork scheme that we have now of regulation that, quite frankly—and I think it was your predecessor who said that there was no regulation in some of these financial instruments, and it is one of the reasons we are at this point, at least from my perspective.

There seemed to be a lack of consistency with the patchwork scheme because of gaps that inherently open up. Then on the other

side of the coin—and I do not want to put words in your mouth—you talked about one agency could get too powerful, and I agree with that, too.

So how do we solve the problem? How do we solve the problem of gaps and people saying, well, I really do not have authority to regulate this, it is somebody else's authority, and they are saying the same thing and things fall through the cracks?

Ms. SCHAPIRO. I think it is critically important that we fill the gaps, first and foremost. We will have overlap, and I think that does create some tension among regulators. But as compared to gaps, that is a pretty manageable process, and sometimes the creative tension that evolves between banking and securities regulators actually results in a positive.

But as we identify those areas of the financial system that have not been subject to regulation—hedge funds, credit default swaps, other kinds of pooled investment vehicles—it is important that we decide that if they are important to investor protection, if they are important to the financial system, that they be brought under the Federal regulatory umbrella with the support, obviously, in multiple areas of State regulators as well, and that those gaps basically be filled by a functional regulator.

I think there is also a role for a systemic risk regulator, again, whether it is done by an individual institution that has responsibility for monitoring exposures and working on prudential regulatory standards and working with a resolution regime or with a college of regulators, there has to be heightened sensitivity to these components of the financial system that have not been regulated.

Senator TESTER. In an ideal system, you are right. But what happens when you have a lack of resources? How anxious are you to jump on some other regulatory financial mechanism out there if you can say, well, gosh, this really is not my job anyway, and I am limited in financial resources, we will let somebody else take care of it?

Ms. SCHAPIRO. It is really our responsibility, and we should not be in these roles if we are not willing to come to Congress and say this is a problem, we need your help, we need legislation, we need resources.

Senator TESTER. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

Madam Chairwoman, I wanted to follow up on a question that Senator Johanns had asked regarding the Madoff situation, and that is not really where I was going, but I heard your response, and it sparked the old lawyer in me. I just wanted to ask, when you said that if not resources, it was not resources that prevented the SEC from more aggressively pursuing the Madoff matter, then you went into a series of more technical issues involved in that. But if it was not resources, that goes to some other motivation. What do you attribute that to?

Ms. SCHAPIRO. What I intended to say is that I do not lay the problems with Madoff solely at the foot of a lack of resources. The information came into the agency over a period of years. It is not

clear to me yet—and we have, obviously, an Inspector General review ongoing right now—whether it was people who received the information did not understand the import of it and, therefore, did not pursue it, or they did not send it to the right people who could understand it and analyze the data that was contained therein.

We have very disparate processes throughout the agency around the country in all of our offices for how we handle the massive amounts of data that come into the agency. Whether it fell through the cracks or somebody just did not understand what they were doing, I cannot—I do not know. I would tell——

Senator MARTINEZ. So you do not know at this point. You are still undergoing an investigation. You have not reached a conclusion.

Ms. SCHAPIRO. No.

Senator MARTINEZ. You just do not think it was a lack of resources as such. It was more about either an understanding of it or an unwillingness to understand it or it just did not get to the right person.

Ms. SCHAPIRO. It is one of those things, and my view is that we will fix all of those things, on the assumption that it is one of those things that has caused the agency not to pursue that information when it came in the door.

Senator MARTINEZ. The issue I really wanted to get to is the issue of systemic risk. I know there has been some commentary from the Secretary of the Treasury about this as part of this new regulatory situation, and I wondered if you could define for us how you view systemic risk.

In the old days of, you know, Fannie and Freddie concerns, obviously their size was a concern, and view them by size alone as perhaps posing a systemic risk. I think that has been proven all too much to be true. And also their capital requirements were fairly thin, which I think also made them, again, a systemic risk.

How do you define what is the systemic risk that we need to be looking for?

Ms. SCHAPIRO. That is probably the $64,000 question, because I think how you define it matters very much in how we ultimately structure any kind of a systemic risk regulator. Certainly, size would be a component. Relationship to other important financial institutions within our economy or——

Senator MARTINEZ. Interlink between those?

Ms. SCHAPIRO. Interdependency or interlinkage; the amount of leverage. I think it matters very much how we define it, because there are a lot of criteria that can go to this issue, and how we define it will define how we regulate it. And whether we have a monolithic approach, a college of regulators approach, or a functional approach with some kind of overlay of systemic risk oversight that monitors exposures, perhaps requires the reduction of leverage, requires other prudential capital or other standards to be put in place, those definitions matter greatly.

Senator MARTINEZ. How do you think we will come to a definition? Is this something that the Secretary of the Treasury is going to define for us? Or is that part of what we——

Ms. SCHAPIRO. Well, I hope the Congress will be very much engaged in coming to that definition and that the other regulatory

agencies that have profound responsibilities for components of the financial regulatory system will be engaged in that process as well.

Chairman DODD. Let me say something. We had a witness the other day that said something that I think was very important. I think we talk about this in the singular, and I think that is sometimes where we are narrowing ourselves. He called it "systemic risks." And I think that is a more appropriate wording, because there are—there are numerous risks. It could be the size of the operation, the practices and products of the—there are a lot of systemic risks that we ought to be looking at. Hence, one of the reasons why I am gravitating toward this college idea or commission idea rather than a single regulator idea, so that we have the ability to understand the risks that are posed to our system in a sense.

I do not know if you agree with that.

Ms. SCHAPIRO. I do agree with that. I think there are many, many small risks that, accumulated, become systemically threatening, and so I think——

Chairman DODD. I did not mean to interrupt. I apologize.

Senator MARTINEZ. No, that is fine. I appreciate it.

Ms. SCHAPIRO. ——the definition process is very, very difficult here.

Senator MARTINEZ. But as a result of having a regulator in place that would be strong enough to then monitor these entities that we will have defined, we will then be able, going forward, to probably have a better handle on this. How do we at this point regulate those entities that appear to be systemically risky or provide systemic risks? Is there anything we can do at the moment going forward prior to a regulatory system being redeveloped?

Ms. SCHAPIRO. Well, what I think we have seen develop over the last year is a bit of a patchwork and an ad hoc approach to dealing with institutions like Lehman Brothers and Bear Stearns and obviously, as is playing out very much right, AIG where it is an effort on the part of multiple regulators to use whatever tools they have available to them to try to reduce the risk or resolve the issues with respect to particular institutions.

Senator MARTINEZ. But is there a coordinating—I know my time is up. But is there a coordinating point, is there someone—I mean, in other words, it seems to me that with AIG, you know—is it Treasury?

Ms. SCHAPIRO. It has largely evolved to be the Treasury working most closely with the Federal Reserve, in some instances with the FDIC, in some instances with the SEC.

Senator MARTINEZ. But that is my concern, that it is not clear to me when something like bonuses go out the door—which may, by the way, be perfectly a legal obligation that the company had. But there does not seem to be a clear understanding of who was at the end of the day providing the oversight that would have known precisely what was happening. And we are talking so many billions of dollars that it seems to me that needs to be defined before we get to a more permanent regulator.

Ms. SCHAPIRO. I agree.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Madam Chairlady, I appreciate your statement, particularly where you said if there ever was a time when investors needed and deserved a strong voice and a forceful advocate in the Federal Government, that time is now. And you went on to make a series of positive statements that I think are very powerful, and I appreciate that.

In pursuit of those statements and in pursuit of what I asked you during your confirmation process, could you tell me what since your confirmation—and I understand it has been about 2 months or so—what steps you have taken within the Securities and Exchange Commission to increase enforcement and investor protections?

Ms. SCHAPIRO. I am happy to do that. We have announced the appointment of a new enforcement Director who begins on Monday, a long-time Federal prosecutor who also ran the Commodities and Securities Task Force in the Southern District of New York. We have retained the Center for Enterprise Modernization to help us overhaul tips and complaints as they come into the agency so that we can have a better handle on and pursue those tips and complaints that are most likely to produce important investor protection enforcement cases for the agency.

I ended the penalty pilot program which required that the Commission's enforcement staff pre-negotiate with the Commission before they could suggest a fine against a public company. We have speeded up dramatically the process which authorizes the staff to issue subpoenas in enforcement investigations.

We have instituted new training programs. Our hiring now is focused on bringing in people with new skill sets that are in forensic accounting, financial analysis, and trading and operations. We are working on our technology. We have a long way to go there. And we have been very fortunate to have sufficient resources this year to actually do some hiring in the enforcement program, which had declined, as you may know, by about 5 or 6 percent over the last couple of years.

So we have a new sense of urgency, and we have started to put into place tools that I think will really result in much more aggressive, much faster enforcement.

Senator MENENDEZ. Well, I appreciate that you were ready for my question.

Ms. SCHAPIRO. I remember the confirmation hearing.

Senator MENENDEZ. And I am happy to hear your answer, to be very honest with you, so I appreciate your progress there.

You know, I have told some of those in the investor community that you have only been there 2 months and give it time. Some of them are worried that you will not take the tougher steps that are necessary, and particularly on proxy access. I saw that you mentioned that in your statement. I think Senator Schumer asked you a question on this, and I appreciate what you said.

I just want to visit with you on that issue. Is this something that you still remain committed to offering investors, a path to nominate their own candidates for board seats on company proxy ballots? And if so, give us a sense of your timeline for addressing what is a very important investor issue.

Ms. SCHAPIRO. I remain very much committed to that, and it is my expectation that—I believe we are tentatively scheduled, the Commission, to consider this issue in May—if not May, June, but certainly in the first half of this year.

Senator MENENDEZ. Let me ask you one other question. Have you had the chance to look at the question that many in the Enforcement Division of the SEC move on to be employed by Wall Street firms? And there is some concern that there may be a conflict of interest there. Is that a revolving door, or is that something that you feel is OK?

Ms. SCHAPIRO. It is a revolving door. We talked about this at my confirmation hearing, and I made a commitment to talk with the bank regulators who actually have in place some limitations on their examination staff's ability to move freely from the agency to an entity that was otherwise examined by the agency.

My counterbalancing concern is that I want to attract the best and the brightest people to the SEC, and if I make it too hard for them to leave, I may not get them in the first place. So from my perspective, it is a balancing act, but it is something that I continue to be committed to looking at and hopefully will get to before terribly long.

Senator MENENDEZ. Finally, let me ask you, in light of the recent intense pressure from financial services lobbyists on accounting standard setters over fair value accounting, what will you and the Commission do to ensure that accounting standard setters remain independent so that they can fulfill their mission of serving the needs of investors rather than the short-term interests of some of the industry?

Ms. SCHAPIRO. Well, I completely agree that that is a critical function for the SEC to help protect the independence of FASB and the accounting standard setters. And I understand there is tremendous emotion and concern about fair value accounting right now and any impact that it may be having. But our guiding light on this is that investors have told us that fair value accounting is important to them. It is important to their understanding of financial statements and their confidence in the honesty of those statements, and that is critical for them to make decisions about the allocation of capital.

So we will continue to be vocal proponents of the independence of FASB. I think it is one of the tremendous strengths of our corporate disclosure system, which is unsurpassed in the world, and largely as a result of having an independent, highly expert body that sets accounting standards.

Senator MENENDEZ. All right. Well, so far so good. Thank you, Madam Chairlady.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman, and, Madam Chairman, Mr. Joseph, we welcome you here and appreciate your public service and the efforts that you are doing, and yours, Mr. Joseph, is public service too, even though you are not on the Federal payroll.

Mr. JOSEPH. Senator, I am here for you.

Senator BENNETT. We are grateful for people who serve who are not on the Federal payroll.

Madam Chairman, you talked about balance, and as I listened to all of this, I think balance is a word we need to keep very much in front of us—the balance to get the good people and at the same time try to keep our eye on potential conflict of interest.

In times of crisis, the impulse is always to go absolutely in the direction of protection against everything else, and the ultimate protection of investors to make sure that they do not lose any money would be to shut down the market, because as long as there is no market, nobody is going to lose anything. And, obviously, we do not want to do that because it is the power of the American market that has allowed entrepreneurs to make America not only very profitable but truly unique.

I have done business around the world. I have owned businesses in other countries and done business with companies from other countries. And the American entrepreneurial spirit is indeed unique and the driving force, I think, behind our long-term prosperity.

So striking the balance between regulation that will find the Bernie Madoffs and get rid of them, which the public clearly needs to do, and allowing the markets to work is, I think, philosophically your biggest challenge.

Ms. SCHAPIRO. I could not agree more.

Senator BENNETT. Do you want to respond to that? Have you had any late-night thoughts in a quiet room about that? Or have you been so overwhelmed with the details you have not gotten around to thinking about it?

Ms. SCHAPIRO. It is a question we confront really every single day, in small issues and large. How do we keep the balance right? How do we do exactly as you say, assure the protection of investors, the integrity of the marketplace, but not regulate everything within an inch of its life so that we do not have any more innovation and we do not have any more opportunity for people with great ideas to bring them to the marketplace?

I do not have any wisdom, certainly no more wisdom than you have on this. I just think it is something we have to think about as we approach every single issue. And it is one reason I like very much to have a broad and diverse group of people within the agency and on my personal staff to consult with me on issues, because they bring those different perspectives and they will tell me to slow down, not to get caught up in the moment, and think about the implications of each and every thing we are doing. And I hope we will bring that very deliberative process to all of the issues—which is not to say we will not have lots of disagreements with different constituencies, but we will always try to get the balance right.

Senator BENNETT. That is my concern, one of my concerns with respect to the proposals that we have before us to restructure our whole regulatory system. Systemic risk, let us give that to the Fed; safety and soundness, let us give that to FDIC; and then transparency and business practices, let us give that to the SEC, and you will all see to it that there is no problem of any kind anywhere else.

I was a new Member of this Committee right after the RTC circumstance, and there was an overreaction to the question of making sure every institution is safe and sound. I remember sitting in this room as Members of this Committee were beating up bankers about you are not making enough loans, you are not making any money available to people. And the reaction of the bankers was: Are you kidding? What we have just been through where we were beaten up for being too open in making money available to people who went out and lost it? You are darn right we are not making any loans because the regulators will kill us if we do. We are threatening safety and soundness if we make loans.

You are now in an atmosphere very similar to that atmosphere where the populist reaction to things is shut everybody down, and my only concern is that if we overreact and do shut everybody down, we make the recession longer, we hurt the country, and all of the rest of it.

One last quick comment. I understand before I came in you did speak about the uptick rule and looking at the locator. You and I have had these conversations. I am very grateful to you that you have now gone public with our private conversations because I still believe the issue of naked short selling is a genuine issue that too many people have said for too long does not really exist, and if it does, it does not really matter because it is really very small. And to those investors who have seen their companies destroyed as a result of it, it is a big deal.

Mr. Joseph, did you want to comment on the short-selling thing? You looked expectant there, and I did not want to cut you off.

Mr. JOSEPH. No, I agree, Senator. Naked short selling should be curtailed, period, end of story.

Senator BENNETT. Good. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Bennett.

I would note before I turn to Senator Bayh, I think Senator Corker raised the issue, we have as well, that sense of balance is critical. I have been here as a Member of this Committee—not as Chair of the Committee but as a Member of this Committee—during those periods we talk about. And there can be an exuberance of the moment, overreactions. Someone once said to me, to pick up on your point, why have we done as well as we have? Putting aside, obviously, the recent crisis we are in. We are very good. This country has been very good, very creative at creating wealth. But, second, and as importantly, it has been safe, that if you park your resources here, your hard-earned money, that the system and structure are safe. You may lose. There is no guarantee of winning. But you do not have to worry about your system. It is pretty good. We have lost that reputation. And it is striking that balance about being creative and imaginative and creating wealth and being safe. And it is not always easy to strike that perfect balance that we talk about, but that is the goal. If we lose that reputation of being a safe place to be because we have a system in place that will not allow fraud and deceit and deception to occur, and simultaneously to encourage the kind of imagination and thoughtfulness that goes into wealth creation is a challenge. Always will be a challenge. We are not going to resolve it. I think one of the things—we are raising expectations maybe here, that somehow we are going to take care

of every and all problems that will ever happen again. We are not. There is someone out there right now imagining how they can circumvent this system. And the job of this Committee, this Congress, and succeeding ones will be to be vigilant as these new ideas emerge to make sure they just do not end up in the marketplace without someone putting the brakes on and saying: What are you doing with this? What does it really do? And what are the implications of it and what risk does it pose?

I appreciate the Senator from Utah raising that sense of balance. It is important. Senator Corker raised it earlier, and I agree with him.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman, and thanks to both of you.

Chairman Schapiro, I have two questions. One we discussed in my office prior to your confirmation and it relates to the importance of accurate information for investors making decisions and for markets to function, and that implicates the role of the rating agencies, which is what I would like to ask you about. With the benefit of hindsight, it appears that many of the more exotic instruments were rated too highly. The ratings were not adjusted in a timely manner. And some have raised questions about the way in which the rating agencies are compensated for making their ratings, paid by the issuers of the securities as opposed to those who purchased them or by the government itself.

I would like to ask you, do you have any thoughts or can we take any additional steps to promote accurate ratings of financial instruments so that investors can make decisions in accordance with their risk tolerance and not be unpleasantly surprised by buying AAA-rated instruments that turn out to be anything but?

Ms. SCHAPIRO. I think accurate information is absolutely the lifeblood of our markets, and whether it is corporate disclosure or ratings, they are incredibly important to investors.

The SEC over the last couple of years, since Congress gave it authority in the Credit Rating Reform Act in 2006, has done a number of things to try to bolster the regulatory regime around rating agencies. I am not sure that we have gone far enough, and on April 15, we are actually holding a roundtable to discuss further rating agency reform. We will have rating agencies there to talk about what went wrong and why. We will have large users of ratings, institutional and other investors to talk about it. And we will have people there who are going to talk about some of the more creative ideas we have heard about how to change the model of issuer pays to try to alleviate some of the conflicts of interest, and there have been some very creative ideas expressed.

So we expect to have a very public day-long session talking about all of these issues, the goal of which is to inform the Commission's next steps with respect to either rulemaking or the potential to come back and ask the Committee for further legislation.

Senator BAYH. I would encourage you in this direction. I mean, a big part of what we are trying to do now is to reinstall confidence in a whole number of ways, and if people simply don't believe the information they are receiving, if they think they are buying instruments that are AAA-rated and they turn out to be anything but

that, what are they to do going forward in terms of making decisions? It really undermines confidence, and so I look forward to getting the benefit of your further input on that. I would really encourage you to focus on that.

Second, and my final question has to do with, in addition to accurate information making markets function efficiently, incentives are important in terms of human behavior. And I think again, with the benefit of hindsight, we can see that a lot of the incentives for people who are running publicly held companies promoted short-term decisionmaking and there was a decoupling of the potential rewards of running risks and bearing the full consequences of those risks, which does lead to skewed decisionmaking, let us just put it that way.

I mean, for example, executives at some firms levered up highly. If the thing held together—and they ran significant risks—if it held together for just a year or two, they became fabulously wealthy, could take some of the chips off the table. And then if the wheels came off, well, it was the shareholders who ended up holding the bag. So, I mean, there was a decoupling. There was short-term decisionmaking as opposed to long-term decisionmaking and a decoupling of risk and the consequences of running those risks, which perverts the kind of decisions that are made.

So my question to you, in terms of the incentives that exist, what can we do to promote long-term decisionmaking and real adding of value as opposed to this sort of short-term gambling mentality that took hold there for a period of time and has now come back to haunt us?

Ms. SCHAPIRO. I think there are really multiple avenues for us to pursue in that regard. One is much better disclosure about how risk is tied to compensation. We talked a lot about compensation for performance, but noticeably absent has been a real discussion about how compensation has been tied to risk taking and the implications of that.

Senator BAYH. Well, if I could just interject, I mean, it is tied in some cases to short-term performance, which then comes back to haunt us——

Ms. SCHAPIRO. Right.

Senator BAYH. ——because short-term can fluctuate up and down.

Ms. SCHAPIRO. Exactly right, and risk taking reveals itself over the longer run, and so the compensation decisions need to be tied to that longer-run perspective. I think, also, we need better disclosure of risk of holding certain financial instruments and just generally better risk disclosure for investors.

And finally, and the piece we talked about a bit is the ability of shareholders to influence more directly who serves on corporate boards and tying the responsibility of boards. Board compensation clearly resides there, but making boards explain how they closed the circle with risk taking and compensation. But giving investors greater access to determining who sits on corporate boards is an important component of that, as well.

Senator BAYH. Thank you, Madam Chairman.

Mr. Joseph, I hope you don't feel slighted that my time has run out, but I thank you for being here, as well. Thank you.

Chairman DODD. Senator Bayh, thank you very, very much, and let me thank both of you.

Mr. Joseph, let me just tell you, we have got a series of questions to submit to you, because obviously what—and some of your proposals raise issues, as well, regarding resources and tools. There is a valuable role to be played by the States. In fact, as you point out in your opening statement, because you are as close to the investor community as you are at that level, it provides an avenue for people to be able to express themselves and bring matters to the public attention. So we see a real value in what you do. I think we all have some questions about various proposals and raising from 25 to 100 million and so forth, what that involves. Obviously, the compatibility, as well, between the SEC and the States are very important.

I regret we didn't get to spend more time with you, but obviously having a Chairperson here obviously focused a lot of attention on these current issues before us. So we will submit some questions to you and look forward to having you back before the Committee, as well.

Mr. JOSEPH. Thank you, Mr. Chairman.

Chairman DODD. And Madam Chair, we thank you very much.

Ms. SCHAPIRO. Thank you.

Chairman DODD. As you have heard, we have got a lot of interest in the subject matter, so we will have you back up formally and informally, as well.

Ms. SCHAPIRO. Thank you.

Chairman DODD. Let me quickly invite our next panel, and they have been very patient and had the benefit of sitting and listening to all of this, as well, so they may want to add some addendums to their own testimony.

But I am very honored and pleased to present three witnesses who are very familiar with this Committee, have been before us, some of us here on the Committee over the years.

Richard Breeden served as Chairman of the Securities and Exchange Commission between 1989 and 1993. In July of 2002, Mr. Breeden was appointed to act as the corporate monitor of WorldCom on behalf of the U.S. District Court overseeing the case involving history's largest corporate fraud and largest bankruptcy.

Arthur Levitt, Junior, is the 25th and longest serving Chairman of the SEC, from 1993 to 2001. As Chairman, he created the Office of Investor Education and Assistance, established a Web site which allowed the public free and easy access to corporate filings and investor education materials.

Both Chairmen assisted our work, by the way, in Sarbanes-Oxley, going back, and I know both these individuals very, very well. If you needed to have examples, if you wanted to just say, give me an example of good public servants, I offer up the names of Arthur Levitt and Richard Breeden and a look at their work would define, I think, what has been remarkable public service, and successful in the private world, as well. So you bring a wonderful wealth of experience from both sides of the equation. You heard Senator Bennett use the word "balance" and others talk about how we strike those balances of wealth creation and having safe and sound financial institutions and a regulatory process.

Paul Atkins is the former Commissioner of the Securities and Exchange Commission. He served from 2002 to 2008, and we thank you very much, as well, for joining us and we thank you for your service on the Commission during those years.

I guess we begin on a seniority basis here. By seniority, I guess you were the earliest serving, Mr. Breeden, so unless you have worked out something else, we will begin with you and then move right down the line. Thank you all very much, and thank you for your patience in listening to the first panel.

STATEMENT OF RICHARD C. BREEDEN, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. BREEDEN. Thank you very much, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for the opportunity to offer my views on enhancing investor protection and improving financial regulation. These are really, really critical subjects and it is a great pleasure to have a chance to be back before this important Committee.

I was privileged to serve as SEC Chairman from 1989 to 1993. My views here today reflect that experience at the SEC as well as my White House service in 1989, when we had to craft legislation to deal with an earlier banking crisis, that involving the savings and loans. In subsequent years, my firm has worked on the restructuring of many, many companies that encountered financial difficulties, most notably WorldCom in the 2002 to 2005 range. Today, I am an investor and my fund manages approximately $1.5 billion in equity investments in the United States and Europe on behalf of some of the Nation's largest pension plans.

By any conceivable yardstick, our Nation's financial regulatory programs have not worked adequately to protect our economy, our investors, or our taxpayers. In little more than a year, U.S. equities have lost more than $7 trillion in value. Investors in financial firms that either failed or needed a government rescue have alone lost about $1 trillion in equity. These are colossal losses without any precedent since the Great Depression.

After the greatest investor losses in history, I believe passionately that we need to refocus and rededicate ourselves to putting investor interests at the top of the public policy priority list. We have badly shattered investor confidence at a time when we have never needed private savings and capital formation more. There is much work to be done to restore trust, and I must say, in the public policy debates, we seem to worry endlessly about the banks that created this mess and I believe we need to focus a little more on the investors who are key for the future to get us out of it.

Many people today are pointing at gaps in the regulatory structure, including systemic regulatory authority. But the Fed has always worried about systemic risk. I remember back in the Bush task force back in 1982 to 1985, the Fed talking about its role as the lender of last resort and that it worried about systemic risk. And they have been doing that and we still had a global banking crisis.

The problems like the housing bubble, the massive leverage in the banks, the shaky lending practices and subprime mortgages, those things weren't hidden. They were in plain sight, except for

the swaps market, where I agree with the previous witnesses that there is a need for extending oversight and jurisdiction. But for the most part, the banking and securities regulators did have tools to address many of the abusive practices but often didn't use their powers forcefully enough.

Creating a systemic or super-regulator, in my view, is a giant camel's nose under the tent. It is a big, big step toward industrial planning, toward central planning of the economy, and I think the very first thing that creating a systemic regulator will do is to create systemic risk. I fear very much that if you are not extremely helpful, we will have more "too big to fail," more moral hazard, and more bailouts, and that is not a healthy path for us to move forward.

I am very concerned that we not shift the burden of running regulated businesses in a sound and healthy manner from management and the boards of directors that are supposed to do that. Unfortunately, in the wake of this crisis, we have seen boards of directors that failed miserably to control risk taking, excessive leverage, compensation without correlation to performance, misleading accounting and disclosure, overstated asset values, failure to perform due diligence before giant acquisitions. These and other factors are things that boards are supposed to control. But over and over again in the big failures, the boards at AIG, Fannie Mae, Lehman Brothers, CitiGroup, Bank of America, Wachovia, WAMU, in those cases, boards were not doing an adequate job.

So my view is that we need to step back as part of this process and look and say, why are boards not doing what we need them to do? I think one of the important answers is that we have too much entrenchment of board members, too many staggered boards, too many super voting shares, too many self-perpetuating nominating committees, and a very, very high cost to run a proxy contest to try and replace directors who are not doing their jobs.

So I think one of the important things that Congress can look at, and I hope you will look at in the future, is to enact a shareholder voting rights and proxy access act that would deal with proxy access, uninstructed votes by brokers, which is corporate ballot stuffing, majority vote for all directors every year, one share, one vote. There are a number of things where if we give a little more democracy to corporate shareholders, we can bring a little more discipline to misbehavior in corporations and not put quite so much on the idea that some super uber-regulator somewhere is going to save us from all these problems.

Thank you very much.

Chairman DODD. Thank you.

Mr. Levitt.

STATEMENT OF ARTHUR LEVITT, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Thank you, Chairman Dodd and Ranking Member Shelby, for the opportunity to appear before the Committee this morning. Thank you for your kind words. It is good to be back with former friends and colleagues.

When I last appeared before this Committee, I focused my remarks on the main causes of the crisis we are in and the signifi-

cant role played by deregulation. Today, I would like to focus on the prime victim of deregulation, investors. Their confidence in fair, open, and efficient markets has been badly damaged, and not surprisingly, our markets have suffered.

Above all the issues you now face, whether it is public fury over bonus payments or the excesses of companies receiving taxpayer assistance, there is none more important than investor confidence. The public may demand that you act over some momentary scandal, but you mustn't give in to bouts of populist activism. Your goal is to serve the public not by reacting to public anger, but by focusing on a system of regulation which treats all market actors the same under the law, without regard to their position or their status.

Many are suggesting we should reimpose Glass-Steagall rules. For six decades, those rules kept the Nation's commercial banks away from the kinds of risky activities of investment banks. While it would be impossible to turn back the clock and reimpose Glass-Steagall, I think we can borrow from some of the principles and apply them to today's environment. The principles ensured are regulation's need to match the market action. Entities engaged in trading securities should be regulated as securities firms, while entities taking deposits and holding loans to maturity should be regulated as depository banks. Regulation, I think, is not one-size-fits-all.

Accounting standards must be consistent. The mere mention of accounting can make the mind wander, but accounting is the foundation of our financial system. Under no circumstances should accounting standards be changed to suit the momentary needs of market participants. This is why mark-to-the-market accounting should not be suspended under any condition.

The proper role of a securities regulator is to be the guardian of capital markets. Of course, there is an inherent tension at times between securities regulators and banking supervisors. But under no circumstances should securities regulators, especially those at the SEC, be subordinated. You must fund them appropriately, give them the legal tools they need, and hold them accountable to enforce the laws you write.

And finally, all such reforms are best done in a complementary, systemic way. You can't do regulation piecemeal.

Allow me to illustrate how these principles can be put to work in specific regulatory and policy reforms. First, some have suggested that you create a super-regulator. I suggest you take a diverse approach using the existing strengths of our existing regulatory agencies. For example, the Federal Reserve is a banking supervisor. It has a deep and ingrained culture that is oriented toward the safety and soundness of our banking system.

Ultimately, the only solution to the tension is to live with it. when I was at the SEC, there was tension between banking regulators and securities regulators all the time. While this was frustrating for the regulators and the financial institutions themselves, I think it served the overall purposes of reducing systemic risk. Regulatory overlap is not only inevitable, I think it may be desirable.

Second, mark-to-the-market or fair value standards should not be suspended. Any effort that seeks to shield investors from understanding risk profiles of individual banks would, I believe, be a mistake and contribute greatly to systemic risk. The Chairman of the Federal Reserve, the heads of the major accounting firms maintain that maintenance of mark-to-the-market standards is essential.

Third, this Committee and other policymakers seek to mitigate systemic risk. I suggest promoting transparency and information discovery across multiple markets, specifically credit rating agencies, municipal bond issuers, and hedge funds. For years, credit rating agencies have been able to use legal defenses to keep the SEC from inspecting their operations even though they dispense investment advice and sit at a critical nexus of financial information and risk. In addition, these rating agencies operate with significant protections from private rights of actions. These protections need to be reconsidered.

In the same manner, the SEC should have a far greater role in regulating the municipal bond market, which consists of State and local government securities. Since the New York City crisis of 1975, this market has grown to a size and complexity few anticipated. It is a ticking time bomb. The amount of corruption, the amount of abuse, the amount of pain caused to municipal workers and will be caused to municipal workers in an environment that is almost totally unregulated is a national scandal.

Because of the Tower amendment, many participants, insurers, rating agencies, financial advisors, underwriters, hedge funds, money managers, and even some issuers have abused the protection granted by Congress from SEC regulation. Through multiple scandals and investment debacles hurting taxpayers, we know self-regulation by bankers and brokers through the Municipal Services Rulemaking Board simple does not work. We must level the playing field between the corporate and municipal markets, address all the risks to the financial system.

In addition, I would also recommend amending the Investment Advisers Act to give the SEC the right to oversee specific areas of the hedge fund industry and other pockets of shadow markets. These steps would require over-the-counter derivatives market reform, the outcome of which would be the regulation by the SEC of all credit and securities derivatives. To make this regulation possible and efficient, it would make sense, as my predecessor, Chairman Breeden, has said so often, to combine the resources and responsibilities of the SEC and CFTC. Under no condition should the SEC lose any of its current regulatory authority. The Commission is the best friend investors have.

The resulting regulatory structure would be flexible, effective in identifying potential systemic risk and supportive of financial innovations and investor choices. Most importantly, these measures would help restore investor confidence by making sure rules are enforced equally and investors are protected from fraud and outright abuse.

As we have seen in the debate over mark-to-market accounting rules, there will be strong critics of a strong and consistent regulatory structure, but someone must think of the greater good. That

is why this Committee must draw on its heritage of setting aside partisanship and the concerns of those with single interests and affirm the rights of investors whose confidence will determine the health of our markets, our economy, and ultimately our Nation.

Thank you.

Chairman DODD. Thank you very much, Mr. Levitt. We thank you for being here.

Mr. Atkins, we welcome you to the Committee.

STATEMENT OF PAUL S. ATKINS, FORMER COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. ATKINS. Thank you very much, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for inviting me here today to the hearing. It is a great honor for me to be here today, and especially appearing today with two great public servants whom I know very well and admire.

This Committee has had a long history of careful study and analysis of matters relating to the financial markets and the financial services industry, and as you have already heard in your hearings, there are multiple, complex, and interrelated causes to the current situation in global financial markets. I believe that these causes are more than the competence or incompetence of individuals in particular roles, but have more to do with fundamental principles of organizational behavior and incentives.

Your topic for today is rather broad, so I would like to touch on a few specific items that go to the heart of an agency that I know very well, the Securities and Exchange Commission.

With respect to the subject of regulatory reform——

Chairman DODD. Mr. Atkins, can you pull that microphone a little closer to you?

Mr. ATKINS. I am sorry.

Chairman DODD. Thank you very much. I appreciate it.

Mr. ATKINS. With respect to the subject of regulatory reform, your hearings have so far been a very good start and I would suggest that you ask some very hard questions in subsequent hearings. For example, why was the SEC in the course of the last dozen years or so has the SEC experienced such catastrophic failures in basically every one of its four competencies—rulemaking, filing review, enforcement, and examinations? What led to the failures of the SEC and other regulatory agencies, both in the United States and globally, to discern the increasing risk to financial institutions under their jurisdiction? What led the failures at financial institutions to recognize the inadequacy of their own risk management systems and strategy in time to avert a collapse? How did so many investors get lulled into complacency and not adequately do their own due diligence? What is the proper role of credit rating agencies, and has regulation, in fact, fostered an oligopoly by recognizing the opinions of a few as being more privileged than those of the rest?

These are hard questions, and if there are to be changes to the Federal securities laws, I think they need to be made carefully through a robust analysis of the costs and benefits of various potential actions and how those actions might affect human behavior in the market.

The current situation is certainly no time to wing it or to act on gut instincts because investors ultimately pay for regulation. And if Congress doesn't get it right, severe consequences could be in store for the U.S. Once on the books, laws, especially in this area, seem to be very hard to change and unintended consequences live on.

Prior to the recent crisis, the subject of regulatory balance was being discussed. Senator Schumer, Mayor Bloomberg, the U.S. Chamber of Commerce, and others cited many reasons why the U.S. as a marketplace was not so competitive. In fact, in 2006, the value of Rule 144A unregistered offerings in the U.S. for the first time exceeded that of public offerings. 2006 seems like a long time ago, but it still is very much a valid concern, especially once the global financial system recovers.

The worrisome thing to me is that if care is not taken to have solid analysis, the wrong lessons may be gleaned from this latest crisis and that will ultimately hurt investors. It takes a long time, as I said, to change legislation in this area. So what we need is an analysis to determine how we can effectively and efficiently promote honesty and transparency in our markets and ensure that criminality is not tolerated.

For example, I disagree with the assertion that deregulation in the past four, eight, ten, or what have you years has led to the current problems in the financial markets. One can hardly say that the past eight to 10 years have been deregulatory with the adoption of new laws and rules, such as Sarbanes-Oxley. More regulation for regulation's sake is not the answer What we need is smarter regulation.

The global crisis has primarily affected regulated versus nonregulated entities all around the world, not just in the supposedly deregulatory United States. The question is, how did so many regulators around the world operating under vastly different regimes with differing powers and differing requirements all get it wrong? Indeed, how did so many firms with some of the best minds in the business get it wrong?

During the past dozen years, the SEC has experienced catastrophic operational failures in its four core functions of filing review, rulemaking, enforcement, and examinations. ENRON's corporate filings were not reviewed for years in the 1990s. Tips were not pursued regarding Bernie Madoff and regarding the late trading of mutual funds in 2003. It took literally an Act of Congress led by this Committee to get transparency and a reformed SEC process with respect to credit rating agencies.

These mistakes, I think, were a long time in the making and were caused by failures of the system of senior staff management. First, management applied faulty motivational and review criteria, and second, since resources are always limited, there is an opportunity cost in choosing to spend time and resources on one thing because then, of course, there is less time and less resources to spend on other things.

With respect to opportunity costs, I believe that the SEC, especially in the years 2003 to 2005, was distracted by controversial, divisive rulemaking that lacked any grounding in cost-benefit analysis during this very crucial period right when many instruments,

like CDOs and CDSs, took off and established their trajectory. Because these rules and the arguments for them were ultimately invalidated by the courts after both long litigation and much distraction for the agency and the industry, a lot of essential time was wasted.

Because life is full of choices, if you devote resources to one thing, you have less to devote to another, and the one risk that you haven't focused on just may blow up in your face. That is, in fact, exactly what happened to the SEC, and it was really through back office processes and documentation that weren't attended to that led to the current crisis.

There are other things that I would be happy to talk about that I put into my written testimony. With respect to that, I have mentioned in my written testimony an article on enforcement and the processes at SEC. I ask that I be able to submit that for the record.

Chairman DODD. Consider that done. That will be certainly true of both Mr. Breeden and Mr. Levitt, as well, any additional comments and thoughts.

And obviously, I have already had conversations with Richard Breeden and Arthur Levitt and I expect I will have a lot more in the coming weeks, and we invite, Senator Shelby and I and Members of the Committee, as we work our way through this, and we are very conscious, both Senator Shelby and I are, of the importance of the matter and how well we handle this. So we are very interested in getting as much counsel and advice, particularly from people who have been through this and been around over the years to watch a lot of what is occurring.

Let me ask you, if I can, to start out with, to get the panel's views on two proposals from the current administration, the proposal to establish a resolution authority of nonbank institutions. And I would also like to ask you to comment on the public–private plan to purchase toxic assets. You have all got tremendous experience in this area as well and a little afield.

The first regarding the resolution authority, and it was the first question I raised with Chairwoman Schapiro. Arthur Levitt noted, and I quote, that regulation needs to match market action, and that if an entity is engaged in trading securities, it should be a regulated securities firm. And that is certainly almost a self-evident statement, but nonetheless, deserves being repeated.

So, obviously, it begs the question, if we are going to have a resolution operation of nonbanks, to what extent, then, are we going to involve the agency or agencies that are bringing the most expertise and background to the issues so they would have some ability to manage that kind of an event? Then, second, what should the role of the securities regulator be in the orderly resolution of these securities entities.

And, then, I would like you to describe, if you could, briefly, what features are necessary in the public–private plan to protect taxpayers and restore public confidence in the banking system. It seems to me—I think, like many, my general reaction to this, with all of its shortcomings, is an idea that I think they needed to pursue. Whether or not this is exactly right or not, I do not know; time will tell. But I like the thrust of it, it seems to me, because I hear the view that unless you get rid of these assets, this is going to con-

tinue to clog up the system and the credit freeze will continue. And then the only answer, seems to me, is to pour capital back in institutions, and we have just run out of patience and resources to do that. So you have to try something else to move this along.

While there are questions, legitimately, about what valuation will be on these, whether or not sellers will sell, buyers will buy, it seems not trying to do something like this is a far greater mistake, in my view, than trying something.

So at least my general reaction is a positive one. That does not mean I am buying into every dotted I and crossed T, but I would be very interested, given all your background and experience, to comment on that as well.

So, Richard, do you want to start?

Mr. BREEDEN. Yes, sir. Let me start with the resolution question. There is an old saying that you cannot really have Christianity without the devil, and capitalism does not work if you do not have failures. I mean, we have a competitive system, and some people win and some people lose. And if we close the door—one of the things that has traditionally been one of the greatest strengths of the U.S. economy has been Chapter 11 and our willingness to let companies fail and then restructure them.

I went through the largest one in history of this country, WorldCom, where we took a company that had $35 billion a year in revenues, 75,000 employees, a mere $85 billion worth of missing assets, and all kinds of problems, a catalog longer than anybody could dream of, and over a 3-year period, we restructured it. It came out of bankruptcy with 66,000 employees still there, the business in tact. And what it was worth when it went down, probably three or 400 million, was eventually sold for 12 billion, and creditors came out with a very good recovery. If you can fix WorldCom, you can fix anything.

Our problem in the financial space—so I think when you talk about nonfinancial institutions, airlines, car companies, whatever, bankruptcy is there. It is a good workable structure. And we have a problem that we seem to have policymakers who either do not understand it or are afraid to use it. And that is why we have the courts and they can restructure companies; it is a very, very good thing.

In the financial world, we have been afraid to use it. And one of the thing I suggested in my testimony was that Congress think about something like the national securities surveillance courts you have created, over in the terrorism side; create a court composed of senior judges who have actually handled big, multi-billion dollar collapses and restructuring, and have expedited processes so that an AIG could—that there would be a structure to handle it.

Throwing it into bureaucracies, whether it is the Treasury or the Fed, to me is the wrong approach because you are going to get ad hoc decisions. And, frankly, part of the reason we had so much panic in the market, loss of confidence, last fall was that every Sunday night you would get out of the blue a decision coming out of one of the administrative agencies about how they were handling Fannie Mae and Freddie Mac, Bear Stearns, Lehman Brothers and so on. And every one of them was different. There was no consistency.

One of them preferred stock to be wiped out, the next one to be protected. One of them the debt is OK; the next one, it would be wiped out. And there was no real way to predict it. And when investors cannot predict what is going to happen, then you are not going to lend credit because you cannot make a sensible decision.

So I think the rule of law is a very, very healthy thing in the resolution area. And creating a court aimed at handling large financial institution failures, with lots of input from the Fed and the Treasury and SEC, but where it is done in a judicial context, would be very helpful.

Mr. Chairman, we had failure of Drexel Burnham when I was at SEC, and we also had a restructuring of Solomon Brothers, two of the largest securities firms of the time.

Drexel had a regulated broker-dealer and its holding company was off doing everything under the sun. When they got in trouble, we seized the broker-dealer, we sold it to PaineWebber, and we took the unregulated holding company and we sent them down to the local bankruptcy court. And they spent the next three to 4 years sorting it out, and it was just fine. The market was not interrupted in any way.

The same technique could have been used at AIG. You could have taken the regulated insurance companies, sold them to other companies instead of sitting there with them, and put the unregulated activities, swaps or anything else, put them into a bankruptcy proceeding and wind them down. And that would be a much better mechanism for dealing with all the issues that come along.

So I think the topic of having a resolution mechanism that works for a big financial institution is a good topic, but I would urge that we spend a little more time looking at the range of alternatives rather than just throwing them into the Treasury Department, where I am not sure they have the institutional knowledge to make good decisions.

Chairman DODD. Let me jump—Arthur Levitt and Mr. Atkins, quickly, on this subject matter.

Mr. LEVITT. Generally speaking, I associate myself with Richard's views, although in this case, because of the nature of the crisis is so different than it was at the time of Drexel Burnham or elsewhere, morphing over into economic Darwinism I think is a mistake.

We are operating in a polarized environment, highly polarized. And because of that, the notion of these public–private partnerships will be met with a measure of skepticism in terms of what the government may extract once more from any private sector entity that wants to deal with the bureaucracy.

I agree that the approach has to be more comprehensive, less at the edges, more directly, in terms of determining who is going to make it and who is not going to make it. And the notion of adding bureaucratic layers of control and judgment and dispensation I think will slow the process and slow the eventual outcome.

Chairman DODD. Let me just ask you—because, Richard, you were one of the architects of the Resolution Trust Corporation in the 1980s. And there, there was—being a bit of a devil's advocate. Certainly your approach is interesting, but there, there was the

creation and it did work. We did not get everything back, but we got a lot back, and your idea had great value and merit.

Given Arthur's point here, this is arguably a time when the tentacles are far more far reaching in many ways. The issues are not sort of stovepiped, not that they were then either, but nonetheless.

Is that a change of view? If you had to go back to the 1980s, would you be sitting here offering something different than what you suggested at the time?

Mr. BREEDEN. Thank you, Mr. Chairman. I have thought a lot about our experiences, creating the RTC and dealing with the savings and loan crisis as I have watched the current crisis unfold.

In a nutshell, our philosophy back then was no bailouts but fast funerals, and it worked pretty darn well.

Chairman DODD. That is an Irish expression.

Mr. BREEDEN. It worked pretty darn well.

There is similarity in the public–private partnership, that the Treasury is trying to establish for the troubled assets, and the RTC. RTC was an entity that just stripped all the assets out of everything that failed and then repackaged them and tried to sell them back out to the market as quickly as you possibly can. These assets do not get better when they are owned by the government; get them back in private hands where they can be managed effectively.

I think that is what Treasury's public–private partnership is trying to do without creating an agency, if you will, to do it. And I think it will work. They are on the right path. I have not looked at all the details of it. It is critical that you have price exposure, that you let people bid on these packages, that they not be directed to individual purchasers. It is important that you have transparency. And the key to all of it is that—and the big difference between the current plan is we were dealing with debt institutions. They were closed, and then we took the assets out and repackaged them.

Chairman DODD. Right.

Mr. BREEDEN. So they did not care what price they got because they were not in existence anymore. We, on the other hand, would sell assets to maximize recovery for the taxpayers, and we got a lot of it back.

The whole—this plan, one of the critical issues will be, at what price will a bank, that is still doing business, that is carrying stuff on its books at 60, that maybe is worth 15, are they going to be willing to sell it into one of these public–private partnerships——

Chairman DODD. I agree.

Mr. BREEDEN. ——that is at a realistic price.

Mr. LEVITT. That is absolutely critical. And in a globalized electronic market, the margin of error is so much narrower than it has ever been in the history of commerce. A mistake now is measured in milliseconds.

Chairman DODD. Right. But let me ask—I mean, I agree with that. And I am going to turn to Senator Shelby.

I agree with that. I think it is a very good point, not Madoff enough. Everyone is wondering whether there will be buyers. I think the issue is whether or not there will be sellers. That is really going to be the issue, will you sell.

I am just imagining this. And, again, I am just listening to some folks, and we have a panel coming up who can maybe shed some more light on this.

My guess is if you are a board of a bank, and you are sitting there, and someone is saying, we think this thing is worth more than what they are offering, my reaction might be, you know what, get rid of this stuff; let's move along. The credit markets are not going to open up until we get this unclogged. And while you may be right, and I am sure it is worth more than what they are offering here, let's move along.

I have to believe that thinking may have some influence on the decision of sellers to move the product along. I know it affects balance sheets, though. But the larger good here is, get this moving. So I do not know whether that is going to be the case or not, but that is the counter argument I have heard about whether or not sellers will sell.

I do not mean to dwell on all of this, but it is an interesting point.

Let me turn to Senator Shelby. I have taken way too much time.

Senator SHELBY. Thank you.

Mr. Breeden, you were chairman of the SEC from 1989 to 1993. Mr. Levitt, you were chairman of the SEC from 1993 to 2001. We know Mr. Atkins was a commissioner there for some 8 years, I believe it was.

In looking back at your time at the SEC, what could each of you have done differently that would have helped to prevent the roots of the current crisis from growing?

Mr. Breeden? You were there a while back, I know that.

Mr. BREEDEN. We did everything we could, and I suppose you can always do more——

Senator SHELBY. Sure.

Mr. BREEDEN. ——to maintain market discipline. I have a deep faith that continues to this very day, that markets do a better job disciplining risk than bureaucrats do. So I did not want the SEC trying to figure out if Drexel Burnham would say—should stay in business or not. I wanted the market to decide that.

We tried to draw the line and make clear that too big to fail did not include the securities industry; that if you extended credit to a securities firm, do it on the basis of their creditworthiness because we were not going to bail you out if you got it wrong.

I wish we had established that principle more clearly, because to the extent that anybody out there thought Lehman Brothers or Bear Sterns were inside a taxpayer protection umbrella that would have allowed them to borrow more money, get more credit than their own balance sheet warranted—and I think we get into so many problems of distortion in the marketplace. You saw it with Fannie and Freddie, you see it with any area where you have moral hazard where people are thinking, well, I can lend money here because if it goes wrong, taxpayers, the government, will somehow step in and bail it out.

We did the right things when I was there to try and make sure we drew the line and said, in the securities industry, you are on your own, but I suppose we could have done it better.

Senator SHELBY. Mr. Levitt.

Mr. LEVITT. A day does not go by when I do not think about this very question. The first mistake I made was not pressing harder for an immediate resolution of the issue of expensing stock options. We are now entering a decade or transparency, where every rule, every regulation, every judgment will be judged by the metric of how transparent it is. That was a case in point.

Second was maybe the most important issue of all. There came a time when the chairwoman of the CFTC came to the President's Working Group and said, it is time to regulate swaps. Alan Greenspan, Bob Rubin and others said, that is impossible. You cannot do it. We have trillions of dollars of outstanding contracts. It is the wrong thing to do; do not do it.

I went along with it. I went along with it without taking the additional step of saying, wait a second. Maybe we have those contracts out there. Let's grandfather them, and going forward, let's regulate them, mandate them to go on an exchange, give them transparency. I did not call for a mandated central clearing facility, and that was a mistake that I will regret as long as I think about these things.

Senator SHELBY. But there is nothing like transparency in anything, is there?

Mr. LEVITT. Absolutely.

Senator SHELBY. And confidence to bring trust back to the market.

Mr. LEVITT. Essential.

Senator SHELBY. Essential.

Mr. Atkins.

Mr. ATKINS. Thank you, Senator Shelby. You know that commissioners can be literally the fifth wheel at the SEC, but——

Senator SHELBY. But you are part of the system.

Mr. ATKINS. Definitely, and I tried to ring the gong down through the years.

I think one thing is that the SEC probably became a little bit too focused on the equity markets and, to a lesser extent, the options markets, and did not pay enough attention to the debt side, including as Chairman Levitt was just talking about, munis. And the real question is do the equity markets still function as the primary price discovery mechanism because a lot of that has shifted to the debt side. So I think there needs to be new types of skill sets at the SEC.

Second was maybe not speaking out more loudly and often about some of the backoffice and documentation issues for CDOs and the CDSs down through the years.

Then, finally, with respect to the enforcement program at the SEC, I think what has happened over the years is that the senior staff has tendeding to chase headlines rather than to look at real cases that hurt real investors, Ponzi schemes and stock manipulations, really disparaging them as "slip and fall"—or unimportant—cases.

Senator SHELBY. Mr. Breeden, you know, as well as everybody does, the Federal Reserve is not only the central bank but it is the regulator of our holding companies, our largest banks. I believe myself that they have utterly failed as a regulator, utterly, because most of our Wall Street banks that got in trouble, and some of

them are in trouble today, still, were regulated by the Federal Reserve. So that causes me great heartburn when we start talking about the Federal Reserve as the systemic risk regulator, you know, the all powerful thing.

Explain your concerns about having the Fed serve in the role as a systemic regulator.

Mr. BREEDEN. Well, Senator, I think this is a terribly important subject, and I really hope people stop and think about this. The Fed does, as lender of last resort—and I hope we will always have a central bank, not the world's largest hedge fund, over at the Federal Reserve. But as lender of last resort, well, you can only cram so many—every time the Fed buys everybody else's broken assets, you are not really fixing those assets, you are just moving them over to the Federal Reserve. And there are limits to how you do that.

Senator SHELBY. They seem to be keeping a lot of them too long.

Mr. BREEDEN. Well, they do not get more valuable as you hold them.

Senator SHELBY. I know.

Mr. BREEDEN. So this lender of last resort role has always given the Fed a stature and an importance in the system, and it is quite genuine; central banks do play a critical role. But their primary role is, of course, monetary policies, stability of the currency, and you will always pick Fed chairmen and Fed Governors to get good economists who will do that role well.

Regulation is kind of off on the side. Who really runs regulation in the Fed, I am not sure anybody ever really knows.

Senator SHELBY. Maybe they did not have anybody running it.

Mr. BREEDEN. Well, bottom line, there is probably $800 billion in equity losses at Citicorp, B of A, WaMu, Wachovia, all institutions, which, as you point out, were regulated by the Fed.

So the idea that we are now going to add to their plate GE and IBM and General Motors and every other—United Technologies, and anybody else who makes something important—well, they make elevators, and elevators is certainly systemically important; we cannot get around without them. Who knows what ends up in that——

Chairman DODD. Just be careful of the names you use here, you are throwing out.

Mr. BREEDEN. Well, I thought you might notice, Mr. Chairman.

So I worry you are creeping very far into industrial policy. And I go back to my comment earlier. You cannot stop everybody from failing. You have to have a mechanism where the people who were unsuccessful get taken over and replaced by people who are successful.

So the farther we go into saying the Fed will oversee everybody big in the economy—their expertise is looking at banks, not other kinds of firms. So you are putting people who do not have the experience and do not have the expertise in charge of regulating people, and you will get bad regulation. You will have the illusion of regulation, but maybe not the successful outcome.

Senator SHELBY. You said their expertise was looking at banks. Now, that is very debatable today——

Mr. BREEDEN. At best.

Senator SHELBY. ——because if they are the regulators I said earlier, and they are, of our holding companies, and our banks, so many of our big banks failed under their supervision, that says a lot to me about the Fed's inadequacies.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I think Senator Shelby asked a very good question in terms of what mistakes were made, and I appreciate the candor of the witnesses.

I do think that one of the things Mr. Atkins said that struck home to me, as somebody who has been around the markets for some time, is over the last 10, 15-plus years, the enormous focus on the equity side as opposed to the debt side. And as the debt side got more and more complicated, I think it even got, perhaps, less focused. So I think a very valid point.

Following up on the chairman's comment as well, about whether we are going to have willing sellers, I do think there is—and I know you have had these meetings, Senator Shelby. Senator Corker has had these meetings as well where you have got the hedge fund community saying everything is melting down and the banks saying, no, we are actually fine. Maybe the stress test will give us, if they are applied with some rigor, some winnowing out process and push those who fall below into this sales procedure.

I have just got word that the Budget Committee is, which I am on, is in the markup. So let me just ask a question and not be able to stay for the answer. But I would like to start with Chairman Levitt, I guess.

Earlier, we had Chairman Schapiro in, and we were asking about say on pay. I would be curious to have you and your colleagues' comments on say on pay. And I would also love to hear just your more general comments. Nobody thinks we are going to unscramble the eggs post-Glass-Steagall, but I would like your comments about what should be some of the underlying principles.

Should we acknowledge that all institutions are going to be able to do all things on a going-forward basis, and what challenges and opportunities does that present us in terms of a new regulatory structure?

Again, my apologies to the Members that I have to go down and vote in this markup.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Warner.

Senator Corker.

Senator WARNER. There was a question there, Mr. Chairman.

Senator SHELBY. Oh. I see. I thought you were walking out, so I apologize.

Mr. LEVITT. With respect to say on pay, what I would say about this, this sounds like an easy call. How can you be against it? And I am not. But I think it is simplistic. It can be a check the box kind of mentality, which businesses can easily incorporate and just move on.

I urge any legislation to allocate to the SEC the responsibility of defining exactly what that means under what circumstances, how it is done, how far down it goes, what the details should be, what

the explanation should be, what the history should be. Not simply pass a rule because, I assure you, it looks differently than if you refine it in a way that I think the Commission should be charged with doing.

Mr. BREEDEN. Just on say on pay, real briefly, I am chairman of the Board of H&R Block, and we put say on pay in voluntarily last year. It works fine. It is good to let shareholders express their views. If they do not like your pay policies, then you ought to find out about it sooner rather than later. And we did the same thing at Zale Corporation, where I am on the board. We put it in voluntarily. I think the American business community has been resisting something that is simple, easy and an appropriate step to take.

I share Arthur's concern that say on pay alone is not going to fix our compensation problems. You really have to have some ability—if compensation committees do outrageous things—and we have all seen examples of profligate compensation that can get seriously out of whack. You have to go beyond that and have either majority voting every year where shareholders can try and withhold votes or voting against members of a compensation committee. And, ultimately, you have to have the threat that if boards do not do a good job managing compensation policy, that they could be replaced. And until you do that, an advisory vote that just every year says you are doing a terrible job is not going to solve the problem.

Chairman DODD. Yes. Well said.

Mr. ATKINS. With respect to say on pay, I am an advocate for federalism. I think that Congress needs to be, or should be, a little bit leery of wading into this issue. We do not have a Federal corporate code or anything like that. I think once you start wading into it, the question becomes, where do you stop? And, maybe Congress should concentrate, like you did in Sarbanes-Oxley, on empowering the SROs, the stock exchanges and others, and then maybe leave it to the states to do what they deem appropriate—states acting and the shareholders acting within the ambit of the state laws and regulations as best suits the individual situation.

Chairman DODD. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I think this testimony you all have given I think has been outstanding this morning.

I could not agree more with you, Mr. Breeden, about the boards. I think there is a lot of reforms that need to take place to strengthen boards' responsibility to oversee and to give, I think, shareholders some powers that they now do not have. We have had numbers of conversations regarding that. I could not agree more.

Mr. Levitt, it is amazing to me, this fascination where somehow another changing accounting rule actually changes the status of an entity. While I do think there should be some degree of judgment, which I know the SEC ruled upon, anyway, several months ago—it has not had the uptick from the public accounting entities yet. But I think your comments are right-on. And it is amazing to me that people would think that an accounting rule would actually change the actual status of an entity, but I thank you for that.

Then, Mr. Chairman, I do think the seller issue you talked about is real. I think the securities will fly out the door because they have already been marked to market, and people sort of know

what—they have marked them down realistically. I think on the whole loans or the assets, we are going to have a serious problem. And I think that piece has got to be worked through. And, certainly, if those assets are sold below where they are—of course, there is a different set of accounting standards that go there. We are talking about, in combination with the stress test, additional capital going into these entities, right? And it could be coordinated in a way that I think could be very helpful.

But let me go back to Mr. Breeden. You mentioned having this special court to deal with some of these complex entities. And then on the other hand, there is the whole issue of protecting citizens for those that are not ready to go into that. So a resolution entity of some kind may be necessary, even if you had a structure for entities to move into Chapter 11.

Is that true or false?

Mr. BREEDEN. Senator, I would say if you had the right Chapter 11 mechanism, you would not need an intermediate step. Companies would operate as long as they could get the liquidity and the credit to operate. If they got to a point where they could not, bang, you would make a filing that—like Chapter 11 does, you stop the ability of people to shut an entity down while it goes through this reorganization process.

So I do not think you would need an agency as a sort of warming tent for a special court. I think if you did it right, that court would be able to do things earlier. And one of the problems with Chapter 11 and financial institutions is it is loaded under current law toward liquidation, and that is what I think you have got to fix.

Mr. LEVITT. I would like to add one point to that, and it goes to the general tone of all of this testimony. Whether we have a court, whether we have a resolution, whether we have new rules, and whether we have a systemic regulator, do not under any circumstances allow that to diminish the investor protections offered by the SEC. The consequence of that kind of action, no matter how nice it sounds, not matter how pretty its dressing may look, would be to turn that agency into a Betty Crocker kind of agency, which does nice things for investors, but has no bite, has no power, has no authority. It just stands up there as an empty symbol. That is the danger of creating these systems of oversight and systemic risk and whatever it is that you call it. Do not allow investors to be hurt by this process.

Senator CORKER. Thank you very much. Let me move on. This economic Darwinism that Mr. Levitt referred to earlier, we see—I think we are going to have a task force report on the automotive industry that is going to come out, and they are going to lay out what futuristic things need to occur.

Does the fact that debtor in possession financing is difficult to get today, does that in any way affect your view of economic Darwinism, if you will?

Mr. BREEDEN. Senator, I——

Senator CORKER. Meaning that if somebody goes into Chapter 11—under the WorldCom scenario, you had the ability to finance assets that were of value. There are people that I think would argue very strongly, and probably have a great point as we see what is happening, that there is not financing available for that

kind of thing. Does that in any way affect your thoughts on entities like that?

Mr. BREEDEN. Senator, I think you have put your finger on a terribly important issue, the availability of debtor in possession financing, and that is an area where a resolution authority might be able to—finding liquidity for those facilities, particularly if you suddenly need a giant one to deal with an AIG or something of that magnitude, would be an area that could conceivably be very helpful in working out with the Federal Reserve what form of public–private financing, if we are having inadequate liquidity in debtor in possession financing, Because without that, reorganization does not work.

You know, Arthur was being a little critical of my economic Darwinism, but I am really unrepentant on that. If companies fail, you need to let them fail, and you need to let them be replaced by people who do a better job of managing. It does not mean that they will disappear from the face of the Earth. What we call Bank of America today really was once North Carolina National Bank. And a lot of other banks failed, and they got put together, and it grew and grew.

Well, you can put these institutions together by acquisitions, and you can also take them apart by divesting things, making them smaller and more manageable, and arguably you sometimes make companies a lot better and a lot more valuable when they get back to a more manageable focus and size.

So you do need the DIP financing. That is a critical role——

Senator CORKER. So you would advocate then potentially, instead of all the activism that we have had through Treasury and TARP and certainly now a Treasury Secretary, it appears, who wants to codify TARP, you would actually argue instead that we consider as a body creating a debt in possession financing mechanism that would allow people to go into an orderly Chapter 11 and have the ability to finance out in lieu of that. Is that what you are arguing?

Mr. BREEDEN. You have done a better job than I could of articulating that, but I think that coupled with having the ultimate decisions not made by a Cabinet Secretary but made by somebody wearing a black robe, I think having the courts be involved—because then you have the ability to deal with contracts for bonuses and to deal with the fact that the entity has more obligations than it has money to pay for them. And so they all need to be restructured, and doing that through the rule of law rather than every Sunday night somebody in an administrative agency makes a decision and announces it, if it stuns the market, I really like the protections as an investor. I like the protection knowing if I make an investment, what rights do I have, and who is going to back them up, and that that is going to be done through the judicial system ultimately.

So I would marry up your suggestion of a DIP financing facility, if you will, with the judicial oversight, and I think we would then have something that would be very workable.

Senator CORKER. Mr. Chairman, I know my time is up. I want to say that Mr. Breeden's opening comments to me were pretty clairvoyant and somewhat chilling in light of what we see happening. We have this Trojan horse. You know, it looks really pretty

and it sounds really pretty, and I am talking about the systemic regulator being an entity.

Chairman DODD. That is not going to happen.

Senator CORKER. I know that you, for what it is worth, have looked at—I know you talked with Susan Collins the other day about something she has put forth. I have to tell you, based on what I sense and feel, I think it would be one of the worst mistakes we could possibly make to put in one person's hands that ability. I do think very quickly we would move into industrial policy issues, things way beyond—I mean, we will never define properly systemic risk. I mean, it could move into all kinds of things, like WorldCom or other things.

I thank you for pursuing that route. I see Senator Shelby nodding. But I hope we will resist any move—any move—that gives anybody that kind of power and basically renders almost every other entity in Government useless.

Chairman DODD. One of the things we learned, going back in Richard Breeden's day, is that you cannot have the regulator in a sense also be responsible for the resolution of these matters. What I said the other day is an entity that only talks to itself is dangerous in a sense when you get to these matters. And so that is why I, for one—again, I want to make it clear as well. I have not written anything, I have not—I am just listening, as we all are, to these various ideas and what make sense. And I like Richard Breeden's idea of this one, whether or not you can do this kind of a thing, but I agree with him the notion of getting—so you get resolution. I mean, the whole idea of calling it resolution is to get to a resolution on these matters.

Mr. BREEDEN. Absolutely, Mr. Chairman.

Chairman DODD. And so we need to think carefully how we do it, but I agree with you, Senator, that this has got to be one that is thought out and has balance to it. These are complicated institutions today, either by design or acquiescence, and so, therefore, to look at them and how you unwind requires a lot more eyes on this than would come from one single entity. The danger of doing that seems to me to only complicate the problem to some degree. So I think we sort of agree on that.

I just want to make—and we have got to go to that. Jack Reed has shown up who has done a terrific job as the Chairman of the subcommittee on Securities, and I invoked your name earlier without your permission, and that is, there is a lot of interest in Chairman Schapiro's testimony today and suggested that maybe the subcommittee would continue, formally or informally, following up the conversations with the SEC.

I wanted to mention a subject matter, and just because it has come to my attention, and that is, this resetting or repricing of options. I have been reading some stories about how, obviously, with the decline in the price of various stocks, where options were taken on them, on the assumption, of course, their value would continue to increase—and it has done exactly the opposite. But whether or not certain people at a certain level are resetting the option at the lower price at the expense of shareholders who do not have that same ability raises some serious issues, in my view. And I was going to raise it with Jack, may draft a letter, in fact, to the SEC

and others to find out what is going on with this. Again, I am reading news reports about it, so I want to be careful about suggesting something is absolutely the case. But, nonetheless, it is disturbing to me that that may be happening. And so we may want to look at that. We will draft something along those lines and get some answers very quickly.

I do not know if you have seen anything like that. I do not know if either of our witnesses have seen any reports on the resetting of options at a certain level. Have you seen this as well?

Mr. LEVITT. Through the years, this is part of the compensation issue, and it is something——

Chairman DODD. Well, it is huge. You go from something that was $100 and it moves to $5 or $10 more, that is value. If you are going from $100 down to $10 and all of a sudden that stock goes to $20, and you have reset it at $10 for a handful of people, that makes some of these other issues pale by comparison.

Mr. LEVITT. Some companies have set and reset and reset and reset and reset again.

Chairman DODD. Well, I do not know how my colleagues feel, but it is something we ought to look at.

Senator SHELBY. Absolutely.

Mr. BREEDEN. Mr. Chairman, it is another area where having large shareholders being able to be on the board—I guarantee that in companies where our fund sits on the board of directors, there will be no repricing of options. And, you know, shareholders are the ones who are hurt by that because nobody repriced for us the cost of our shares. And so management, yes, going forward there may be new options granted each year at different prices.

Chairman DODD. That is another matter.

Mr. BREEDEN. But it is really a terrible abuse when people go back and reprice from the past. It was an incentive to make the stock worth more, grow value for the shareholders, and really, you are jumping off the train and saying I am going to go give myself a special deal. That is a very serious problem.

Chairman DODD. Well, I am hearing sort of——

Mr. ATKINS. One note of caution there is that this issue is not just a monolithic type of thing. Every company is different. Every situation might be different. I think you will probably hear that if you write the letter to the SEC. The response will be in various situations, it sometimes might be justifiable and the shareholders might have approved it.

Chairman DODD. Well, again, it is certainly worthy of quick examination because this is the kind of thing that, again, in a week or two from now we will pick up our newspapers and discover that this has gone on and no one has paid attention to it. It will pale—if you think you had a furor over what happened last week, watch this one. And so let me just use this forum as an opportunity to send a message, before we get a letter written, that someone ought to be looking at it immediately, and I would like to hear back what steps, if any, are being taken to deal with it. They will respond accordingly, and maybe we will get some people in front of us to talk about it. And you are right, there may be different circumstances. I am not trying to have a sweeping statement here, but, nonethe-

less, you are hearing from witnesses and others, this is troubling, to put it mildly. So we will take a look at it.

Anyway, we are going to keep the questions open. We could have you here virtually all day, the three of you, and it is so valuable. I cannot thank you enough for appearing this morning, and we will submit some additional questions. There is an awful lot to ask you. We are just doing the securities field. There are a number of issues. I appreciate, by the way, Arthur, your comment on the muni issue, the bond issue. This is very important. Your language was very strong. In our private conversations, you have expressed this to me as well. And certainly this Committee will take a look at it, a completely very unregulated area and one that poses some real risks, and I appreciate you bringing that point up.

Mr. LEVITT. Thank you.

Chairman DODD. With that, this panel will be excused, and we thank you for coming.

I am going to introduce the next panel, and I am going to thank them for their testimony in advance. I want to thank Jack Reed for his willingness to chair. I am not going to be here for all of this. I will be here for a few minutes of it, anyway, but let me begin and I will introduce them.

Richard Ketchum is the Chairman and CEO of FINRA. He is also Chairman of the World Federation of the Exchanges' Regulatory Committee.

Ronald Stack has served on the Municipal Securities Rulemaking Board since 2006 and is Managing Director of Barclays Capital, with responsibility for the firm's national public sector investment banking effort.

Richard Baker is President and Chief Executive Officer of the Managed Funds Association, a former colleague of ours, served in the other body, previously a member of the U.S.—as I mentioned, a member of the House of Representatives, Chairman of the subcommittee on Capital Markets for 12 years.

Jim Chanos is Chairman of the Coalition of Private Investment Companies. Mr. Chanos is also President of Kynikos Associates, a New York private investment management company.

Barbara Roper is the Director of Investment Protection for the Consumer Federation of America.

David Tittsworth is the Executive Director and Executive Vice President of the Investment Adviser Association.

Dan Curry is the President of DBRS' U.S. affiliate. Previously he spent 22 years at Moody's Investor Service.

And Rita Bolger, our last witness, is the Senior Vice President of Global Regulatory Affairs, Associate General Counsel for Standard & Poor's, and has served as the head of Global Regulatory Affairs.

Senator SHELBY. Mr. Chairman, can I say something?

Chairman DODD. Yes, you certainly may. Let me thank all of you, and we are packing you in here. I apologize. I hope you found this morning interesting. At least you have been sitting here and listening to the Chairmen of the Securities and Exchange Commission and then our last panel, so I am sure you would have been paying very close attention had you not been asked to be here. But having you in the room, I kept on looking out to see how you were

reacting to some of the things that were being said. I saw some commonality of interest being expressed on certain matters and some dismay at others, I guess, along the way. So I was watching the nodding heads along the process.

Let me turn to Senator Shelby for some comments quickly, and then we will get to our panel and ask you to share some thoughts with us on the subject matter before us.

Senator SHELBY. Mr. Chairman, I appreciate these hearings that you are putting together, and, gosh, we could be here all week and learn a heck of a lot.

I have reviewed this testimony of the third panel. A very, very impressive panel. A lot of you I know. And all of your testimony is interesting.

Jim Chanos' testimony I think goes right to the heart of a lot of things of what is wrong, and I think we ought to pay particular attention to that.

The reason I am bringing this up, I, too, have got a luncheon I have got to speak at. You know, I am not leaving yet, but I might miss some of you. But I want to thank you, like Senator Dodd did, for your contribution. And as we go through this trying to find out what went wrong and trying to do what should be right in the future, I think we are going to be very careful and very comprehensive.

Chairman DODD. I thank you for that. Richard Baker, a former colleague. You got to be on this side of the dais and now that side of the dais. For 12 years you were on this side, so I have gotten to know Richard very, very well, and he does a fine job on behalf of the people he represents as well. And Jim Chanos I know, and like all of us here, many of you we know and worked with in the past at various times. So we thank you for coming before us.

Jack, any opening comments you want to make?

Senator REED. No.

Chairman DODD. Well, let us get right to it. Again, we will just hear from Mr. Ketchum. We thank you. We will take your full testimony, if you will try and move along.

STATEMENT OF RICHARD G. KETCHUM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FINANCIAL INDUSTRY REGULATORY ASSOCIATION

Mr. KETCHUM. Chairman Dodd, thank you, and it was a morning well spent, so it was good to be here.

Chairman DODD. Thank you.

Mr. KETCHUM. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify, and I commend you, Mr. Chairman, for having today's hearing on the critically important topic of reforming our regulatory structure for financial services.

As someone who has spent the great majority of my career as a regulator, dedicated to protecting investors and improving market integrity, I am deeply troubled by our system's recent failures. The credit crisis and scandals of the last year have painfully demonstrated how the gaps in our current fragmented regulatory sys-

tem can allow significant activity and misconduct to occur outside the view and reach of regulators. FINRA shares this Committee's commitment to identifying these gaps and weaknesses and improving the system for investors.

Let me briefly talk about FINRA and our regulatory role.

FINRA regulates the practices of nearly 4,900 securities firms and more than 650,000 registered securities representatives. As an independent regulatory organization, FINRA provides the first line of oversight for broker-dealers. FINRA augments and deepens the reach of the Federal securities laws with detailed and enforceable ethical rules and a host of comprehensive regulatory oversight programs. We have a robust and comprehensive examination program with dedicated resources of more than 1,000 employees. FINRA has the ability to bring enforcement actions against firms and their employees who violate the rules.

Mr. Chairman, as I said earlier, the topic of today's hearing is critical. The failures that have rocked our financial system have laid bare the regulatory gaps that must be fixed if investors are to have the confidence to re-enter the markets. Our current system of financial regulation leads to an environment where investors are left without consistent and effective protections when dealing with financial professionals. At the very least, our system should require that every person who provides financial advice and sells a financial product be licensed and tested for competence, that advertising for products not be misleading; that every product marketed to an investor is appropriate for that particular investor; and that comprehensive disclosure exists for services and products.

I would like to highlight the regulatory gap that, in our view, is among the most glaring examples of what needs to be addressed—the disparity between oversight regimes for broker-dealers and investment advisers.

The lack of a comprehensive, investor-level examination program for investment advisers impacts the level of protection for every person that entrusts funds to an adviser. In fact, the Madoff Ponzi scheme highlighted what can happen when a regulator like FINRA has only free rein to see one side of the business.

Let me be clear. I mention this example not because FINRA is sanguine with its role in the Madoff tragedy. Any regulator who had any responsibility for oversight for Madoff must accept accountability and search diligently for lessons learned. But the way to identify fraud, just as with sales practice abuse, is not through the fog of jurisdictional restrictions. Fragmented regulation provides opportunities to those who would cynically game the system to do so at great harm to investors, and it must be changed.

The regulatory regime for investment advisers should be expanded to include an additional component of oversight by an independent regulatory organization, similar to that which exists for broker-dealers. The SEC and State securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. But it is clear that dedicating more resources to regular and vigorous examination and day-to-day oversight of investment advisers could improve investor protection for their customers, just as it has for customers of broker-dealers.

Broker-dealers are subject to rules established and enforced by FINRA that pertain to safety of customer cash and assets, advertising, sales practices, limitations on compensation, and financial responsibility. FINRA ensures firms are following the rules with a comprehensive exam and enforcement regime. Simply put, FINRA believes that the kind of additional protections provided to investors through its model are essential.

Does that mean FINRA should be given that role for investment advisers? That question must ultimately be answered by Congress and the SEC, but we do believe FINRA is uniquely positioned from a regulatory standpoint to build an oversight program quickly and efficiently.

In FINRA's view, the best oversight system for investment advisers would be one that is tailored to fit their services and role in the market, starting with the requirements that are currently in place for advisory activity. Simply exporting in wholesale fashion the broker-dealer rulebook or current governance would not make sense.

We stand ready to work with Congress and the SEC to find solutions that fill the gaps in our current regulatory system and create a regulatory environment that works properly for all investors.

Thank you, Mr. Chairman. I would be happy to answer any questions.

Chairman DODD. Thank you very much, and we will look forward to some questions for you, too.

Mr. Stack.

STATEMENT OF RONALD A. STACK, CHAIR, MUNICIPAL SECURITIES RULEMAKING BOARD

Mr. STACK. Thank you very much. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I am Ronald Stack, Chair of the Municipal Securities Rulemaking Board. By way of background, I have been involved in the municipal market since 1975 when I was a member of the staff of Governor Hugh Carey during the New York City fiscal crisis.

I am pleased today to testify on behalf of the MSRB at the Committee's second hearing on Enhancing Investor Protection and the Regulation of the Securities Markets.

The MSRB was created by the Congress in 1975 to write rules for municipal securities dealers, at that time many of whom were unregulated, unsupervised, and not even registered by the SEC. Our mission was set in statute, and it remains clear and unambiguous, and that is, to protect the investing public and to promote a fair and efficient market for municipal securities. This is a $2.7 trillion municipal market, and it is fundamental to financing our Nation's infrastructure. Indeed, over 55,000 entities issue $400 billion in municipal securities each year. We are absolutely committed to preserving municipal access to capital, the municipal market's integrity, and investor protection. This is our mission, this is our commitment.

We believe one of the important ways to protect investors and preserve market integrity is through a culture of transparency, one that makes information available to all. Historically, access to public disclosure about municipal bonds has been hindered by a se-

verely fragmented disclosure system that was cobbled together over the years. This system did not promote public access to disclosure documents, and it did nothing to shine a light on the disclosure practices of issuers, good or bad. So what have we done?

The MSRB has developed a comprehensive Web site that is transforming municipal disclosure and transparency for all investors, large and small, institutional and retail. It is called the Electronic Municipal Market Access system, which we call it EMMA, and it is so advanced that we believe it exceeds disclosure systems for any other fixed-income market, and that includes corporate bonds. With EMMA, all investors have free access on the Web to an incredible amount of information about municipal securities.

We have had real-time trading information up since 2005. We have added official statements and information about auction rates. Starting next week, we will add information about variable rates, and finally, in July of this year, pursuant to a rule amendment that was passed by the SEC in December, we will be including what is called "continuing disclosure filings," which are up-to-date material changes from bond issuers.

Our new system of making continuing disclosure available easily and on the Web will be a vast improvement over the current system. EMMA will serve as a red flag for poor disclosure by issuers, just as it reveals good disclosure practices.

But good, timely dissemination of disclosure is only one of our myriad responsibilities. We require municipal securities dealers to observe the highest professional standards in their dealings with investors: full disclosure, suitability, fair pricing. We are the only Federal regulator that has successfully implemented a ban on "pay to play." If you are a municipal securities professional, you cannot do business with an issuer if you have contributed to one of its officials. We test professionals' qualifications and we require them to take continuing education courses. We have a complete set of rules regulating municipal dealers that we constantly review, modify, and change as necessary. And I emphasize all of our rules are sent out for comment and then are subject to strict review and approval by the SEC itself.

Unfortunately, we continue to read reports—and I think this is something which I think Chairman Levitt was referring to—about other municipal market participants who engage in "pay to play" and similar activities. Some are alleged and some are still under investigation, but whatever the outcome, the market suffers from an appearance problem, and that is not good for the muni market or for any market.

Earlier this year, we wrote to you and your colleagues in the House Financial Services Committee about the potential for regulation of some or all of these other market participants. They serve critical roles in many of the complex financing and related derivative transactions that have become commonplace. They advise State and local governments, big and small, on how to structure a bond issue, how to sell it, how to market it, what type of securities to sell, how to invest bond proceeds, whether to use swaps or other related derivatives.

We believe these and other similar market participants should be registered with the SEC and regulated by the MSRB with rules

similar to those already applied to dealers. Many of these people are fiduciaries, and they should be subject to the standards of professional conduct. "Pay to play" should be prohibited, just like it was prohibited for dealers by the MSRB in 1994.

I want to emphasize that I know many of these participants, and many of the individuals are ethical and well qualified, but, unfortunately, not all of them are and activities of a few can taint the entire market if not by fact, by appearance. That is something we cannot afford, especially in the current crisis.

During this time of stress, it is crucial that we have clear guideposts and that investor confidence in the municipal securities market is not undermined by questionable practices.

Also, as Treasury seeks to find solutions to assist the municipal bond market through the crisis, ensuring that all market participants adhere to the highest professional standards is essential.

The MSRB looks forward to working with the Committee, as well as other regulators and market participants, to ensure that the level of investor protection provided in the municipal market is second to none.

Senators, thank you for inviting the MSRB to participate in this very important hearing.

Chairman DODD. Thank you very much, Mr. Stack.

Richard Baker, we welcome you to the Committee.

STATEMENT OF RICHARD BAKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MANAGED FUNDS ASSOCIATION

Mr. BAKER. Thank you, Mr. Chairman, Ranking Member Shelby, Members. I am indeed delighted to be back after the prohibited period from my engagement with policymakers, and for the record to reflect, I did not engage anyone during the prohibited period. It is delightful to be here today.

The MFA represents a majority of the world's largest hedge funds and is the primary advocate for sound business practices for industry professionals. We appreciate the opportunity to be invited and to comment today about the systemic risk concerns, and we are committed to being a constructive participant in the discussion going forward.

Hedge funds do provide liquidity and price discovery to markets, capital to companies to allow them to grow or turn their businesses around, and sophisticated risk management tools for investors such as pensions, to allow them to meet their obligations.

To perform these market functions, we require sound counterparties and stable market structures. The current lack of certainty regarding financial conditions of major financial institutions has limited the effectiveness of the stabilization efforts, and this uncertainty inhibits investors' willingness to put their capital at risk or transact with these firms.

The relative size and scope of the industry helps explain why we believe hedge funds do not pose significant systemic risk despite the current market environment. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the $9.4 million mutual fund industry or the $13.8 trillion banking industry.

Because many hedge funds use little or no leverage, contrary to many public comments, their losses did not pose the same potential systemic concerns that losses at more highly leveraged institutions presented. One recent study found that 26.9 percent of hedge funds do not deploy leverage at all, and a recent 2009 report by the FSA, the Financial Services Authority, indicated that the leverage of hedge funds was, on average, less than 3:1.

Mr. Chairman, the hedge fund industry was not the root cause of the ongoing difficulties in our financial markets, but we have a shared interest with all other market participants in re-establishing a sound financial system. To that end, restoration of stability can be accomplished through a careful, deliberate approach toward the goal of a smart financial regulatory construct, one which would include investor protections as well as a systemic risk analysis.

Smart regulation means improving the overall functioning of the financial system through appropriate, effective, and efficient regulation, while encouraging adoption of industry best practices which promote efficient capital markets, integrity, investor protections, and enabling better monitoring of potential systemic risk events.

We believe that a single systemic risk organization—and I have not been absent during the preceding discussions. I would merely want to point out that an organization charge with this responsibility would be better than multiple systemic regulators which would likely have difficulty because of jurisdictional conflicts, unintended regulatory gaps, inefficient and costly redundancies. So to the extent a regulatory shop can be constructed, it should be a single entity to have that responsibility.

We do support confidential reporting to that systemic regulatory structure by entities the regulator deems to be of systemic relevance any information the regulator deems necessary or advisable for it to assess systemic risk potential. It is important for this authority to allow the regulator to be forward-looking and adaptable to ever-changing market conditions. It is critical that reported information be granted full protection from public disclosure, which we believe can be done without inhibiting the ability of the regulator to protect the overall system.

In our view, the mandate of this entity should be protection of the financial system and not include investor protection or market integrity, a role that already exists in the hands of multiple existing regulatory bodies.

With respect to that mandate, because systemically relevant firms likely would not pose the same risk in all circumstances, we also believe the regulators should not focus on preventing the failure of a particular firm but, rather, only in the event that firm's failure would be likely to bring about adverse financial system consequences.

We strongly believe the systemic risk regulator should implement its authority in a way that avoids competitive concerns and moral hazards that could result from a firm having an ongoing established Government guarantee against its failure. Therefore, we believe a systemic risk regulator would need authority to seek to prevent systemic risk in a forward-looking manner, address systemic concerns once they have arisen in the manner it deems ap-

propriate, the ability to ensure that a failing firm does not threaten the financial system, and we know that policymakers are also contemplating concurrently a notion of a prudential regulatory framework, including mandatory registration.

We believe that well-advised regulation should be based on the following principles: regulation that is tailored to meet identified needs, not nebulous in construct; second, ongoing public–private exchange with notice, comment, and implementation so that appropriate comment may be made on proposed regulatory interventions; reporting of appropriate information, which could be left to the regulator, with confidentiality of sensitive and proprietary always being protected. Regulatory distinctions to be recognized between the various nature of the differing market participants, and encouragement of strong industry practices and robust investor diligence.

I would like to mention just briefly one other area I know of concern. Short selling facilitates price discovery, mitigates asset bubbles, and increases market liquidity. It is a critical risk management tool for investors which allows them to take long positions in the market. There are absolute solutions to address the stated concerns about short-selling that would enable us to continue in our current market practices without jeopardizing the important market benefits.

We look forward to a continued discussion and answering any questions you may choose to pose. Thank you, Mr. Chairman.

Senator REED [presiding]. Thank you, Congressman Baker.

Mr. Chanos.

STATEMENT OF JAMES CHANOS, CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

Mr. CHANOS. Thank you. Good afternoon, Mr. Chairman, Senator Shelby, and Members of the Committee. My name is Jim Chanos. I am here today testifying as Chairman of the Coalition of Private Investment Companies. I thank you for the opportunity to testify on this important subject today.

The damage done by the collapse of global equity credit and asset-backed markets has been staggering in scope. The plain truth is that there is not a single market participant, from banker to dealer to end user and investor, that does not have to absorb some degree of responsibility for the difficulties we are confronting today. And while there is plenty of blame to spread around, there is little doubt that the root cause of the financial collapse lay at the large global diversified investment and commercial banks, insurance companies, and government-sponsored enterprises under direct regulatory scrutiny.

Notably, hedge funds and investors have generally absorbed the painful losses of the past year without any government cushion or taxpayer assistance. While hedge funds and other types of private investment companies were not the primary catalyst for our current situation, it is also true that these private pools of capital should not be exempt from the regulatory modernization and improvement that will be developed based on lessons learned from the financial calamities of the past 20 months.

CPIC believes that there are a few key principles that should be followed in establishing a regulatory regime for monitoring sys-

temic risk. First, regulatory authority should be based upon activities and not actors. The same activities should be treated similarly, regardless of where it takes place. Proprietary trading at a major bank should not receive less scrutiny than the trading activity of a hedge fund.

Second, the system should be geared to size, meaning overall size or relative importance in a given market and complexity.

Third, all companies performing systemically important functions, such as credit rating agencies and others, should be included in this regime.

Fourth, accuracy of required disclosures to shareholders and counterparties should be considered systemically significant.

Fifth, the regulatory regime should be able to follow activities at systemically important entities regardless of the affiliated business unit in which the entity conducts these activities.

Sixth and finally, the regulatory regime itself should be clear and unambiguous about the criteria that brings an entity under the new oversight regime.

Increasing the financial regulation of hedge funds and other private investment companies carries both risks and benefits. I would like to chat about that for a few seconds. Relying on the fact of direct regulation in lieu of one's own due diligence will undermine those parts of the private sector that continue to work well and thus hamper the goal of restoring market strength and confidence.

While it is clear that a regulator should have the ability to examine the activities of significant pools of capital to help mitigate against activities that would disrupt the markets, simply trying to wedge hedge funds and other private investment funds into the Investment Company Act or Investment Advisers Act is not likely to achieve that goal. If direct regulation is deemed necessary, Congress should consider a stand-alone statutory authority for the SEC or other regulator that permits the Commission to focus on marketwide issues that are relevant to managers of institutional funds while not undermining essential investor due diligence.

Perhaps the most important role that hedge funds play is as investors in our financial system. To that end, CPIC believes that maximum attention should be paid to maintaining and increasing the transparency and accuracy of financial reporting to shareholders, counterparties, and the market as a whole. Undermining accounting standards may provide an illusion of temporary relief, but will ultimately result in less market transparency and a much longer recovery.

Private investment companies play important roles in the market sufficiency and liquidity. They help provide price discovery, but they also play the role of financial detectives. Government actions that discourage investors from being skeptical, from being able to hear from differing opinions, or to review negative research ultimately harms the market. Indeed, some say that if Madoff Securities had been a public entity, short sellers would have blown a market whistle long ago.

Honesty and fair dealing are at the foundation of investor confidence our markets have enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the compa-

nies, asset managers, and others with whom they invest their money and until they believe that regulators are effectively safeguarding them against fraud. CPIC is committed to working diligently with this Committee and other policymakers to achieve that difficult but necessary goal.

Thank you very much.

Senator REED. Thank you very much.

Ms. Roper.

STATEMENT OF BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

Ms. ROPER. Thank you for the opportunity to testify here today regarding the steps that the Consumer Federation of America believes are necessary to enhance investor protection and improve regulation of the securities market.

My written testimony describes a dozen different policies in a dozen different areas. Out of respect for the length of today's hearing, I will confine my oral comments to just two of those, bringing the shadow banking system within the regulatory structure and reforming credit rating agencies.

Before I get into the specifics of those issues, however, I would like to spend a brief moment discussing the environment in which this policy review is taking place. For nearly three decades, regulatory policy in this country has been based on a fundamental belief that market discipline and industry self-interest could be relied on to rein in Wall Street excesses. That was the philosophy that made the Fed deaf to warnings about unsustainable subprime mortgage lending. It was the philosophy that convinced an earlier Congress and administration to override efforts to regulate over-the-counter derivatives markets. And it is the philosophy that convinced financial regulators that financial institutions could be relied on to adopt appropriate risk management practices. In short, it was this misguided regulatory philosophy that brought about the current crisis and it is this philosophy that must change if we are to take the steps needed to prevent a recurrence.

In talking about regulatory reform, many people have focused on creation of a Systemic Risk Regulator, and that is something CFA supports, although, as others have noted, the devil is in the details. We believe it is at least as important, however, to directly address the risks that got us into the current crisis in the first place, and that includes bringing the shadow banking system within the regulatory structure.

Overwhelming evidence suggests that a primary use of the shadow banking system, and indeed a major reason for its existence, is to allow financial institutions to do indirectly what they would not be permitted to do directly in the regulated market. There are numerous examples of this in the recent crisis, including, for example, banks holding toxic assets through special purpose entities for which they would have had to set aside additional capital had they been held on balance sheets, or AIG offering insurance in the form of credit default swaps without any of the protections designed to ensure their ability to pay claims.

The main justification for allowing these two systems to operate side by side, one regulated and one unregulated, is that sophisti-

cated investors are capable of protecting their own interests. If that was true in the past, it is certainly not true today, and the rest of us are paying a heavy price for their failure to protect their interests.

To be credible, therefore, any regulatory reform proposal must confront the shadow banking system issue head on. This does not mean that all financial activities must be subject to identical regulations, but it does mean that all aspects of the financial system must be subject to regulatory scrutiny.

One focus of that regulation should be on protecting against risk that could spill over into the broader economy, but regulation should also apply basic principles of transparency, fair dealing, and accountability to these activities in recognition of two basic lessons of the current crisis: One, protecting investors and consumers contributes to the safety and stability of the financial markets; and two, the sheer complexity of modern financial products has made former measures of investor sophistication obsolete.

Complex derivatives and mortgage-backed securities were the poison that contaminated the financial system, but it was their ability to attract high credit ratings that allowed them to penetrate every corner of the market. Given the repeated failure of the credit rating agencies in recent years to provide timely warnings of risk, it is tempting to conclude, as many have done, that the answer to this problem is simply to remove all references to credit ratings from our financial regulations. We are not yet prepared to recommend that step.

Instead, we believe a better approach is found in simultaneously reducing, but not eliminating, our reliance on ratings; increasing the accountability of ratings agencies, by removing First Amendment protections that are inconsistent with their legally sanctioned status; and improving regulatory oversight.

While we appreciate the steps Congress and this Committee in particular took in 2006 to enhance SEC oversight of ratings agencies, we believe the current crisis demands a more comprehensive response.

As I said earlier, these are just two of the issues CFA believes deserve Congressional attention as part of a comprehensive reform plan. Nonetheless, we believe these two steps would go a long way toward reducing systemic risk, particularly combined with additional steps to improve regulatory oversight of systemic risks going forward.

Bold plans are needed to match the scope of the crisis we face. CFA looks forward to working with this Commission to craft a reform plan that meets this test and restores investors' faith both in the integrity of our markets and in the effectiveness of our government in protecting their interests.

Senator REED. Thank you very much.

Mr. Tittsworth.

STATEMENT OF DAVID G. TITTSWORTH, EXECUTIVE DIRECTOR AND EXECUTIVE VICE PRESIDENT, INVESTMENT ADVISER ASSOCIATION

Mr. TITTSWORTH. Thank you, Senator Reed. We really appreciate the opportunity to testify today.

The Investment Adviser Association represents the interests of SEC-registered investment advisers. The advisory profession serves a wide range of clients, including individuals, trusts, families, as well as institutions such as endowments, foundations, charities, State and local governments, pension funds, mutual funds, and hedge funds. There are about 11,000 SEC-registered advisers. Most of these are small businesses. About 7,500 employ ten or fewer employees, and 90 percent employ fewer than 50.

Our statement outlines our views on broad regulatory reform topics, but I am just going to emphasize one point, the need to address true regulatory gaps in two situations.

First, we continue to support the registration, regulation of hedge fund managers by the SEC. We believe that investors and the markets will benefit from the disclosure, compliance protocols, recordkeeping, examinations, and other requirements that accompany SEC registration. We also support regulation of credit default swaps and other derivatives. Action must be taken to ensure that they can no longer exist outside of the regulatory system.

Our testimony also addresses two issues that directly relate to the Investment Advisers Act. The first is the so-called harmonization of broker and adviser regulation. This idea seems to be predicated on the notion that brokers and advisers do exactly the same thing and that one set of laws and regulations should apply to both. We respectfully disagree.

There are differences between most broker-dealer and most investment advisers. Brokers, or the sell side, typically execute securities transactions and sell financial products. Investment advisers, the buy side, provide advisory services, including managing client portfolios. Brokers often are compensated by commissions from selling products or executing trades and any related financial advice is nondiscretionary, that is, requires customer consent to buy or sell. In contrast, advisers generally are compensated by fees and provide ongoing discretionary management of client assets. Finally, brokers generally have custody of customer assets, whereas most investment advisers use the services of independent third-party custodians.

Because of these and other differences, it doesn't make sense to impose rules on investment advisers that are tailored to produce sales.

In recent years, brokers have migrated toward the investment advisory business, blurring some of the traditional lines and creating investor confusion. Accordingly, we believe that fiduciary standards should apply to anyone who offers investment advice. This week, we joined with the State securities organization, NASAA, and the Consumer Federation of America in a joint letter to the Committee to underscore this very important point.

The second issue addressed in our testimony is the proposed creation of a self-regulatory organization, or SRO, for investment advisers, which we oppose. Our statement outlines drawbacks to an SRO, including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs and bureaucracy. We particularly oppose the idea of FINRA as the SRO for investment advisers, given its governance structure, costs, track record, and its bias favoring the broker-dealer regulatory model.

In closing, we believe the SEC has the expertise and experience to best regulate our profession and it should have appropriate resources to do its job. Instead of creating an SRO for investment advisers, the following alternatives should be pursued.

First, the SEC should be fully funded and Congress should examine alternatives to allow it to achieve long-term and more stable funding, including self-funding mechanisms.

Second, as NASAA testified, the SEC should increase the $25 million threshold that separates SEC and State-registered advisers.

Third, the SEC should improve its inspection program to better leverage and focus its resources.

We would be pleased to work with the Committee and the SEC to explore additional ways to ensure the appropriate and effective regulation and oversight of investment advisers and I would be happy to respond to any questions. Thank you.

Senator REED. Thank you very much.

Ms. Bolger.

STATEMENT OF RITA M. BOLGER, SENIOR VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, GLOBAL REGULATORY AFFAIRS, STANDARD & POOR'S

Ms. BOLGER. Thank you, and good afternoon——

Senator REED. Could you make sure that is on and bring it closer to you?

Ms. BOLGER. Is that better?

Senator REED. I think so, yes. I am kind of deaf.

Ms. BOLGER. I would like to state at the outset that we at S&P appreciate the seriousness of the current dislocation in the capital markets and the challenges it poses for the American and global economies. Restoring confidence is critical, and workable solutions will involve both governmental action and private initiative.

S&P has a long tradition of and a strong cultural commitment to integrity and professionalism. We recognize, however, that a number of our recent ratings in the structured finance area have not performed in line with our historical standards. We have reflected on these events and we have made a number of changes to enhance our processes.

Recent calls for increased regulation of credit rating agencies have arisen in large part out of the poor performance of structured finance securities issued between the middle of 2005 and the middle of 2007, the years in which subprime lending was at its peak. From a regulatory perspective, it is important to point out that the world in which virtually all of these structured finance ratings were issued is not the world that we live and find ourselves in today.

NRSROs, such as S&P, are now subject to a robust regulatory regime. That regime starts with the Credit Rating Agency Reform Act, which went into effect in June 2007, and the rules promulgated by the SEC under it. Those rules deal with important topics such as resources, potential conflicts of interest, misuse of nonpublic information, and potentially abusive and unfair practices.

The SEC also has broad enforcement powers over NRSROs. Not only does the SEC have extensive examination and inspection authority, but it can take disciplinary action against NRSROs. Those

include censure, fines, or even revocation of registration if it deems such action to be in the interest of investors.

From my perspective as a participant in the process, the SEC has been an extremely active regulator in exercising its oversight authority. Last year, the SEC conducted an extensive examination of S&P focused on our structured finance ratings. The exam, which lasted several months, involved dozens of meetings and interviews, production of a significant volume of documents, and resulted in a number of recommendations that we are implementing.

While the current regime has accomplished much in the short time it has been in place, we do believe additional measures could play a meaningful role in restoring investor confidence. Appropriate regulation can provide a level of comfort to investors that policies are being enforced and that there is consistency and integrity in the rating process.

I also do want to note that we are pleased to be participating in the SEC's April 15 roundtable on rating agencies, which Chairman Schapiro referenced this morning.

We also believe in an end-to-end approach for legislation and regulation. That is, it should be designed to cover all aspects of the capital markets that when taken together contribute in a systemic way to their functioning, with particular regard to ratings. Such an approach would include not just oversight of rating agencies, but also appropriate measures for those involved in generating the information that is used in the analysis, the sale and the marketing of the rated securities, and the use of ratings.

For example, an important factor in ratings quality is the quality of information available to be analyzed. That information is not generated by rating agencies but by others, such as in the RMBS area, mortgage originators, and lenders. In our view, oversight of these entities and the roles they perform should be part of any regulatory approach.

As detailed in my written statement, earlier this month, S&P published an article reflecting our thoughts on what a regulatory framework for rating agencies might look like. I have included a copy of that for the record. I would like to highlight here just two particular features.

The first is analytical independence. For the markets to have confidence in ratings, they must be made independently. That means, of course, that the judgments must be free of conflicts of interest and undue commercial considerations. We are fully committed to that principle. It also means that the judgments must truly reflect the substantive views of the analysts making them and not directives by a regulator or other external authority.

The second point is the need for international regulatory consistency. Ratings are issued and used globally. A rating produced under one set of regulations may not mean the same thing or address the same risks as one produced under another if those regulations are not compatible. Inconsistent ratings regulation could actually promote uncertainty in the markets at a time when it can be least afforded.

In short, the focus should be on promoting consistency and integrity in the ratings process. Many of the steps we have outlined and the measures we have taken are aimed at precisely that goal.

Thank you for the opportunity to participate in the hearing. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and all governments worldwide. I would be happy to answer any questions.

Senator REED. Thank you.

Before I introduce Mr. Curry, I must excuse myself and Senator Akaka will take the gavel and kind of conclude the hearing. Thank you, Senator Akaka. Thank you, ladies and gentlemen.

Mr. Curry.

STATEMENT OF DANIEL CURRY, PRESIDENT, DBRS, INC.

Mr. CURRY. Thank you, Senator Reed. Thank you, Senator Akaka. Good afternoon. My name is Dan Curry and I am the President of DBRS, Inc. I am pleased to have the opportunity to present DBRS's views on the regulation of credit rating agencies and investor protection, but first, I would like to give you some background on our firm.

DBRS is a Toronto-based credit rating agency established in 1976 and still owned by its founders. With a U.S. affiliate located in New York and Chicago, DBRS is a full-service rating agency that maintains ratings on more than 43,000 securities in 35 countries.

DBRS is committed to ensuring the objectivity and integrity of its ratings and the transparency of its operations. DBRS was designated as an NRSRO in 2003, the first non-U.S.-based rating agency to attain that designation. DBRS is now registered under the Credit Rating Agency Reform Act, which Congress passed in 2006.

Now I would like to turn my attention to the important issue of competition. It is no secret that the credit rating industry in the United States is dominated by three large agencies. The market you see today was fostered by a regulatory system that gave special treatment to NRSRO credit ratings, yet made the process of attaining that designation opaque and hard to navigate. Although the Credit Rating Agency Act has made more competition possible, the actual competitive landscape has been slow to change. We believe that the continued dominance of the three largest rating agencies contributed to the recent turmoil in the structured finance market when changes in the assumptions underlying their rating models led to rapid and dramatic rating downgrades.

As the markets struggle to regain their footing, more needs to be done to open this industry to competition. Although the government can be a catalyst for change, the opposite seems to be occurring.

Recognizing that the securitization markets have ceased to function, the Federal Reserve has created the Term Asset-Backed Securities Loan Facility, or TALF. In order to be eligible for this program, the security must receive a AAA rating from Standard and Poor's, Moody's, or Fitch, which the Fed calls "major" NRSROs. The result of this approach is that DBRS, with over 30 years of experience as a rating agency and more than six as an NRSRO, is unable to rate TALF-eligible securities, even though several issuers have asked it to do so.

For the foreseeable future, the TALF is likely to be the entire securitization market in the United States. Therefore, by excluding all but the three largest rating agencies from this program, the government may be further entrenching the historic oligopoly for years to come.

The long-term efficiency of the capital markets requires that rating agencies be allowed to compete on the quality of their work, not their size or their legacy. DBRS urges Congress to take whatever steps are necessary to make the Rating Agency Act's promise of competition a reality.

The next issue I would like to address is that of uniform regulation. Ensuring that NRSRO regulation treats all business models equally is critical to investor protection. This is especially true in the area of ratings transparency. There has been much debate about the relative accuracy of ratings determined under the issuer-pay model and subscriber-pay model. This debate cannot be resolved so long as investors and other market participants are unable to verify the accuracy claims made by subscriber-based ratings providers. Anecdotal discussions by these firms of where they got it right are no substitute for an objective, independent analysis of the universe of their ratings. DBRS urges policymakers and regulators to recognize the importance of transparency for all rating agencies.

Finally, I would like to address the need for stable regulation. DBRS sees no need to abandon the regulatory regime established under the Rating Agency Act because this regime is barely 18 months old and no superior alternative has been identified. Moreover, DBRS sees no benefit in transferring jurisdiction over rating agencies from the SEC, which has overseen this area for 34 years, to a regulator that has no experience. Interposing a self-regulatory body between rating agencies and the SEC would be the worst idea of all, since this would lead to a duplicative regulation by a costly private bureaucracy that may or may not know anything about the industry. A better approach would be to ensure that the SEC has the necessary resources to effectively examine NRSROs and to enforce the existing laws and rules.

My written statement addresses some additional issues. I would be happy to answer any questions you may have. Thank you.

Senator AKAKA [presiding]. Thank you very much, Mr. Curry.

I want to thank all of you for your patience and also to tell you that your full statements will be placed in the record.

I would like to ask my first question to one who has been an advocate, one that I have been with before, and I want to ask Ms. Roper as an advocate, as an independent entity within the Internal Revenue Service, the National Taxpayer Advocate has evolved into an essential organization that has protected and assisted taxpayers. I have highly valued the dedicated efforts of the National Taxpayer Advocate and Ms. Nina Olson and her staff.

Using the Taxpayer Advocate organization as a model and creating an Investor Advocate at the Securities and Exchange Commission has the potential to be an extremely valuable addition to assist and protect taxpayers. So my question to you is, what is your evaluation of creating an Investor Advocate at the SEC?

Ms. ROPER. Thank you, Senator. Ideally, it would be superfluous to have an Investor Advocate at the SEC. The SEC portrays itself as the investor advocate. My experience working on these issues as an external investor advocate for over 20 years now is that there are many times when we would have benefited from having an advocate on the inside to carry investors' case. I can see several different areas where I think this would be particularly useful.

As investor advocates, we have often been frustrated that our view is not addressed in the agency policymaking from the outset, that it is something that ends up being incorporated, at best, later during the comment period, often with very little effect. Having an internal advocate who could ensure that investors' views are integrated into the rulemaking process, conduct research outreach, I think would be extraordinarily useful.

Senator AKAKA. Also, Ms. Roper, we share an interest in protecting mutual fund investors. Mutual funds are what average investors rely on in their retirement, savings for their children's college education, as well, and other financial goals and their dreams. I have advocated for strengthening the independence of mutual fund boards and improving relevant and meaningful disclosures for investors' transparency. My question to you is, what must be done to better protect and inform mutual fund investors?

Ms. ROPER. Thank you again, Senator. As you know, we have endorsed your legislation on mutual fund and share those goals. And I very much look forward to a time when our primary priorities are helping average retail investors make better informed decisions and have better protection in the marketplace. That hasn't been at the top of our agenda with the global economy in crisis. But I think—and because the damage that has been done to investors has been sort of done indirectly through the failure of a system as a whole.

There was a robust mutual fund reform agenda that was put on the table at the SEC in the wake of the mutual fund trading scandals and then was allowed to sort of fall by the wayside. I think it would be extraordinarily useful to bring back some of the ideas that were under discussion at that time, including better point of recommendation disclosures, independence governance, as you have suggested, and not just limited to mutual funds, but the entire issue of broker-dealer compensation and how that creates a set of incentives that operate against investor interest, I think, are extraordinarily important issues that it would be nice to be able to get back to at some point in the near future.

Senator AKAKA. Thank you for your responses.

I would like to ask the next question to Mr. Richard Ketchum. Our modern complex economy depends on the ability of the consumers to make informed financial decisions, and as you know, we have been supporting trying to move financial literacy in our country. Without sufficient understanding of economics and personal finance, individuals will not be able to appropriately evaluate credit opportunities, successfully invest for long-term financial goals, or be able to manage difficult financial situations. My question to you is, what must be done to ensure that investors have the knowledge and skills necessary to make informed investment decisions?

Mr. KETCHUM. Well, thank you, Senator. It is a great question.

Senator AKAKA. Before you do that, let me say that FINRA has been doing a good job already, and I know that. Thank you.

Mr. KETCHUM. Well, I appreciate that. As you know, the FINRA Investor Education Foundation is the largest foundation solely focused on investor education, and given that we both feel good about the progress we have made and recognize the enormity of the task, we have tried to, as best we can, both through placing a rich series of informative efforts on our Web site at finra.org and efforts to try to attract investors to look at those various different pieces of information, efforts to identify everything from questions to ask with respect to complex products to things to be concerned about with respect to potential scams, as well working very closely with some of the most vulnerable constituencies, particularly from the standpoint of our seniors, our military, *et cetera.*

I think the only answer with respect to investor education is to keep on going on with more and more resources and more and more cooperation between enterprises that have constituencies and concern with respect to this area. And you are right. It can't just be with respect to investors that exist today. It has to be a strong effort from the standpoint of our schools, as well.

But we are very much committed to be part of that process. It is something that deserves more attention from a governmental standpoint and more attention across any of us that cares deeply about the quality of our securities markets.

Senator AKAKA. Thank you very much for that.

I want to pose this next question to a person that I knew in the House, Representative Baker. I think you left there, or you were there when I left there, in the House and moved to the Senate. But it is good to see you again.

Mr. BAKER. Thank you, Senator.

Senator AKAKA. Chairman Breeden said, and I am quoting, "The disasters we have seen did not arise due to lack of resources for the Federal Reserve, the SEC, or any other agencies that did not perform as well as needed to do, or because of outdated laws from the 1930s."

The banking and securities regulators generally had tools to address the abuse of practices but did not use their powers forcefully enough or ask for new authority promptly when they needed it.

My question to you, how would you recommend addressing this problem so that the regulators will be more effective in the future?

Mr. BAKER. Thank you, Senator. It is a tremendously difficult question in that if you would go back in time, perhaps 24 months, and look at market conditions and the tremendous profitability that had existed for some number of years, and the expectation by many that it would continue into the foreseeable future, there was at the same time columns of regulatory authority that were constructed.

Within each column, there may have been particular skill sets which could have been deployed, but because of the lack of information flows between those columns, complex instruments were created that did not fit neatly within a column and remained outside the transparency required for someone to make an informed decision.

I would say that there were people in the market who exercised analytical skills and who did, in fact, predict that some of these very unfortunate circumstances possibly would occur. They, for the most part, were in the private sector, who were skilled analysts looking at the financial bubble that was growing in significant size.

How we could construct a new systemic regulatory structure and enable a single person to be able to see the entire view of the market and come to an appropriate and timely decision would probably be almost impossible. Having an organization of some sort—there has been discussion this morning as to concerns about the SEC, the Federal Reserve, the existing entities. But I think we should be cognizant of the fact that none of those entities had access to the level of transparency that would have enabled them to make that collective, almost omniscient, insight into the coming storm.

So I believe that, as we suggested in our testimony, the construction of a regulatory entity—I have been very careful not to say a particular agency—that has access to market information in a timely manner, while at the same time protecting the privacy of that disclosure by the registered entity, would perhaps—I am not sure it would guarantee—enable that entity to be able to take steps early on and perhaps limit the scale and scope of damage.

Certainly, we would like to be a participant in that discussion going forward. We have specific ideas at the appropriate time that may be appropriate to consider. But we recognize that it is a very difficult problem. I am glad you are where you are, Senator, and I am glad I do not have that decision any longer.

Senator AKAKA. Thank you very much, Representative Baker.

I want to direct my next question to Mr. Stack.

In our last hearing on securities regulation, Thomas Doe, a former member of your board, stated, and I am quoting, that "the 34-year era of the municipal industry self-regulation must come to an end."

In advocating this position, Mr. Doe emphasized that MSRB structure, two-thirds of which is comprised of either bank dealers or securities dealers, has led to a situation of industry capture, where the issuers and other writers are then responsible for regulating their own conduct.

What is your evaluation of these comments?

Mr. STACK. Senator, I take extreme exception to Thomas Doe's comments. I believe that the MSRB, which was the first SRO upgrade in 1975, has worked extraordinarily well.

The measure of an SRO, such as the MSRB, is, first, do we protect investors? How we do that is through our ability to ensure immediate and clear disclosure to both retail, institutional, small and large investors. We have established a new electronic system on the Web to ensure up-to-date investor information.

We also regulate, up to the extent that the statute allows, very clearly all of the municipal dealers and brokers in very strong terms. For example, we are the only group that prohibits a pay to play; that is, that you cannot do municipal securities financings with an issuer if you contribute to somebody running for office who is an official of that issuer. No one else has done that. Interestingly enough, because we are an SRO, we can do something even tougher

than what we call our parent body, the SEC, because we have the ability to set very, very strong rules.

Another thing I would like to say is that all of our rules governing our brokers and their dealers are sent out for comment to the public, to investors, to everybody around, and then we present our proposed rules to the SEC. So it is not that we are off in the ether land, just kind of somewhere out there making our own rules for brokers. All of our rules go to the SEC for review, and the SEC decides whether or not to approve them.

Finally, some of the problems I mentioned in my testimony that we have encountered are that there are many participants in our market who right now are unregulated: financial advisors, swap advisors, investment advisors. They are not registered with the SEC, and we have no power to regulate them.

We have written the House Committee and have written your Committee and asked for the ability—asked for Federal regulation of these groups in order that they can have professional standards, in order that they can meet the kind of stringent requirements that we have for brokers and dealers, including and specifically pay to play. We think if we can regulate those participants, that the market will operate well.

In conclusion, we believe the SRO system does work well and it is a way of using the expertise of the market participants to come up with rules to govern it. I have read the Senate Committee report when the MSRB was set up in 1975, and that was the Committee's intent. These rules, as I say, can be tougher, and then those rules are submitted to the SEC. And the SEC then approves whether or not those rules go into effect.

So we think that the SRO is actually a very tough way to organize and to supervise dealers. The SEC is not limited, but it sticks pretty much to antifraud issues. We can go much further and pay to play is a perfect example of where we have.

Senator AKAKA. Well, I thank you so much for that. You know of it personally. I would rather that we not craft laws just to try to deal with these. In this particular case, the MSRB should just move—as you said, what you mentioned, I wish we could do at this time. But thank you so much for your comments on that.

Mr. STACK. Thank you, Senator.

Senator AKAKA. Let me direct the next question to Mr. Tittsworth, and is Chanos or Chanos?

Mr. CHANOS. Chanos, Senator.

Senator AKAKA. Chanos. Thank you.

And I am looking for an important recommendation, so I would like to hear from both of you.

Which is one recommendation that you feel is the most important legislative or regulatory initiative that this Committee must undertake in the modernization of financial market regulation?

Mr. TITTSWORTH. I will take it very quickly, Senator.

As I said at the top of our testimony, it is closing what I would call true regulatory gaps, not the perceived regulatory gap that some have talked about between investment advisers and broker-dealers, which is totally nonexistent. True regulatory gaps. And by that, I mean products or services that are unregulated and are out-

side the regulatory system. And the two I mentioned are hedge fund managers and credit default swaps and derivatives.

Senator AKAKA. Thank you very much.

Any other comment?

Mr. CHANOS. Senator, I would use my answer to just point out our overriding viewpoint on regulation, current and future. And that is that the current and expected regulatory framework regulates and examines the activities, not the actors. That is, they focus on that which is going on in the marketplace across different corporate and private and public investment lines, and not just be hamstrung, for example, for the Fed to look at bank holding companies; the SEC to look at securities firms.

We need to really focus on how our markets have changed down through the years and have morphed beyond the view of the 33 and 34 and 40 acts, and come up with smart regulation as someone said earlier, not necessarily more regulation.

Senator AKAKA. Thank you very much.

I wanted to be certain that we would offer every one of you a chance to make comments, so let me direct this question to Ms. Bolger and Mr. Curry.

The *Wall Street Journal* reported that despite the failure of ratings agencies' models during this financial crisis, Moody's, S&P and Fitch have "made few fundamental changes to the way they assess debt."

Please tell us what you think went wrong in your original assessment of these assets and why we should trust your agencies to rate these same assets again, now that taxpayer money is at risk.

Ms. BOLGER. Thank you, Senator. And, actually, before answering, I would respectfully request that the white paper on regulation, I mentioned it in my remarks, that that be placed in the record. Thank you.

Ms. BOLGER. I think certainly in terms of some of the ratings and structured finance, just stepping back, we have almost a hundred year history of rating a tremendous amount of securities and a very good track record. But in connection with some of those securities, I think the performance that we have seen, that the market has seen, has not been consistent with that historical track record. Some of the assumptions that we use simply were not borne out.

However, we have stepped back. We have taken a very serious look at our processes and we have made a number of changes, changes both that have been required in connection with two, now two—and, actually, today is the conclusion of a final draft period for SEC rulemaking, so we have made changes in connection with their requirements.

We have also made some changes on our own initiative. And we think moving forward, it is important, again, picking up on the theme of smart regulation, that we focus on regulation that preserves our analytical independence and also that is globally consistent in connection with some of these actions we have taken.

Senator AKAKA. Thank you.

Mr. Curry.

Mr. CURRY. Thank you, Senator.

I think that the root of the problem in the structured securities was the reliance on the decisions of just a few people using models

to determine these ratings. At the same time, the securities became so complex that investors were really unable to exercise enough judgment around the risks that they were taking. And we are going through the flip side of that process, I think, right now, where there are some very substantial changes to assumptions, again, in these models made by a few people, that lead to massive rating downgrades, but still a lack of understanding of fundamentally what is behind this analysis.

Given that the current Rating Agency Reform Act does not extend to the substance of ratings, I think that transparency becomes very critical, and that is going to be a big challenge in how that is managed. I still do not think that the transparency is adequate and I worry that a lot of the changes that have taken place are more administrative and do not really prevent us from ending up in this same situation again seven or 8 years down the road.

Senator AKAKA. Thank you very much, Mr. Curry.

Without question, all of you have been very helpful to the Committee. We are looking forward to improve whatever needs that in our Nation. I want to thank all the witnesses for being here. And I want you to know that we appreciate the significant time that you witnesses have spent with us today.

This hearing record compiled today will, without question, help us develop policies to better protect investors and improve the regulation of the securities market. We look forward to continuing to hear from you, and with much hope, we are looking at an improvement in our Nation's crisis that we are in at this time.

This hearing record will remain open for a week for Members to submit any additional statements or questions that they may have. Again, thank you very much, and this hearing is adjourned.

[Whereupon, at 1:35 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION

MARCH 26, 2009

I. Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: Thank you very much for inviting me to testify as we face a critical juncture in the history of our Nation's financial markets. I am here today testifying on behalf of the Commission as a whole. The Commission agrees that our goal is to improve the financial regulatory system, that we will work constructively to that end, and that we all are strongly dedicated to the mission of the SEC. In light of the economic events of the past year and their impact on the American people, I believe this Committee's focus on investor protection and securities regulation as part of a reconsideration of the financial regulatory regime is timely and critically important.

Thank you also for giving me an opportunity to talk about the historic mission of the Securities and Exchange Commission, what we do for the Nation's investors and capital markets, and how our critical mission is a necessary foundation for a modernized financial regulatory structure. These are matters that have been the central focus of my entire professional career.

I strongly support the view that there is a need for system-wide consideration of risks to the financial system and for the creation of mechanisms to reduce and avert systemic risks. I am convinced that regulatory reform must be accomplished without compromising the quality of our capital markets or the protection of investors. I am also convinced that getting it right will require hard work, attention to detail, and an over-riding commitment—not to engage in bureaucratic turf wars—but to further the public interest. All of that is well within our grasp.

In my testimony this morning, I will explain some general principles that I believe should guide this effort. These principles are: first, an integrated capital markets regulator that focuses on investor protection is indispensable; second, that regulator must be independent; and third, a strong and investor-focused capital markets regulator complements the role of a systemic risk regulator, resulting in a more effective financial oversight regime. Included as an Appendix to my testimony is an overview of the major functions of the SEC, a summary of recent activity, and the resources allocated to each function.

II. A Capital Markets Regulator Devoted to Investor Protection Is Indispensable

All economic activity starts with capital. Small businesses need money to start up, and all companies need capital to innovate, compete, create jobs, and thrive. This capital comes from a variety of sources. Ultimately, capital comes from investors—people who invest directly in companies; people who invest in financial institutions that lend capital; people who invest in mutual funds and other pooled vehicles that in turn invest in America's businesses; people who buy municipal securities to help fund the operations of state and local governments; and people who look to the capital markets to save, put away money for their kids' education, and prepare for retirement. Markets that attract this capital are critical to America's economic future. And a strong, focused, vibrant, and nimble market regulator is critical to getting investors back into the market and to maintaining their trust and confidence in the future. Such a regulator is fundamental to the future growth of our economy.

That's where the SEC comes in. Let me review some of the core functions of the SEC. These functions are interdependent: remove one function and the agency's capacity to do the others is diminished.

A. Regulation of the Integrity of Markets

Investor protection starts with fair and efficient capital markets. In these tumultuous economic times, despite record volumes and enormous volatility, the markets that the SEC oversees have priced, processed, and cleared trillions of dollars in customer orders in an orderly and fair way. The dollar value of average daily trading volume was approximately $251 billion a day in February 2009 in stocks, exchange-traded options and security futures. By comparison, the average daily trading volume for such securities was approximately $87 billion a day in February 1999, and $10 billion a day in February 1989.

The securities laws and our rules, and the rules of the exchanges and the national securities association we supervise, prohibit fraudulent trading practices, manipulation of securities prices, insider trading and other abuses. These laws and rules require trades to be executed at fair prices, require market participants to keep

records of their activities, and require prompt dissemination of pricing information. We regulate transfer agents and clearing agencies, so that transactions are effected seamlessly and without interruption. In overseeing the markets, the Commission is guided by its professional staff, which has extensive knowledge and expertise developed over decades of overseeing our Nation's dynamic capital markets.

Innovation has completely transformed our securities markets over the last decade. The shouts on the trading floors of the Nation's securities exchanges have largely given way to the whir of computers. Transactions that took minutes to execute now take well under a second. In an instant, traders can search within markets and across markets to locate counterparties willing to pay the very best price. Spreads—that is the price differences in transactions captured by intermediaries rather than investors—have narrowed dramatically over the past decade. This has been due in part to the SEC's rules requiring intermediaries acting for customers to trade at the very best prices as well as rules permitting securities prices to be quoted in pennies. In many instances, spreads in stocks have shrunk from 12 cents to less than a penny. According to a 2005 GAO study, decimalization of stock quotes alone cut trading costs by 30–50 percent. We've achieved similar results in the options markets.

These pro-investor changes have been possible because of a regulatory regime that focuses on competition—one that does not pick winners and losers but instead, one that removes barriers to new entrants. It is a regime that requires a focus on the needs of investors and their welfare, allowing market participants to innovate and compete for their customers' business. While it is a regime that works well, it is one that requires a regulator to keep up with the breakneck pace of change in our ever-evolving markets.

This is not to say that our markets always function perfectly. There are practices that are contrary to fair and orderly markets; abusive short selling, for example, would fall into that category. To target potentially abusive "naked" short selling in certain equity securities, the Commission has tightened up the close-out requirements and adopted a new antifraud rule specifically aimed at abusive short selling when it is part of a scheme to manipulate the price of a stock. And, early next month, the Commission will consider proposals to re-institute the uptick rule, or something much like it.

B. Regulation of the Integrity of Market Information

However well structured, markets fail without timely and reliable information. Accurate information is the lifeblood of the securities market. A big part of the SEC's mission is to safeguard the markets' blood supply. We operate from the premise that our markets work best when investors are fully informed. Our job is to make sure investors get full and complete information. It involves setting meaningful disclosure standards, monitoring compliance with them, and, when appropriate, enforcing the law against those who fail to comply. It also involves programs to equip investors with tools to understand and analyze the market information they receive.

SEC rules require complete and accurate disclosure of information that investors need to make informed investment and voting decisions. Companies cannot raise capital from the public without first filing with us comprehensive disclosures about their business, their performance, and their prospects. One of our major accomplishments over the last few years has been to streamline this process so that potential issuers of securities can raise money more quickly, while providing investors with more, and more current, information.

Registrants file extensive disclosures about their business performance annually and update them quarterly, and—because today's markets demand immediate information—whenever certain specified events occur. We review these filings on a selective basis, and work closely with reviewed companies to improve the quality of their disclosure. In fiscal year 2008, our staff reviewed the filings of nearly 5,000 reporting companies in addition to more than 600 new issuers.

Accurate information, of course, encompasses both words and numbers, and we work to protect the integrity of both. We play a special role in the formation of accounting standards for public companies and other entities that file financial statements with the Commission. We oversee the process by which they are set to ensure that professional, independent standard-setters include those whose primary concern is the welfare of investors, that the deck is not stacked against investors, and that the outputs of the process are fair and appropriate.

There is a delicate balance here. We have authority to set standards, and we use this authority prudently. Sometimes we prod the standard-setters to act more quickly, and we often give them the benefit of our views. But we are convinced that ac-

counting standard-setting should be the product of an independent, expert body that is organized to act in the public interest and with appropriate due process.

While the Commission rarely sets accounting standards, we deal with accounting matters every day. We and our staff provide guidance about how accounting standards should be applied in particular situations; our staff reviews corporate filings to determine whether companies are applying standards properly; and where the accounting is wrong, we ask companies to fix it. Our rules, given new vigor by the landmark Sarbanes-Oxley Act that emerged from this Committee in 2002, promote the independence of those who audit the financial statements of public companies.

Investors need accurate and comprehensive information not only when they trade but also when they vote, whether it is to elect directors, adopt compensation plans, approve transactions, or consider shareholder proposals. And so we have a variety of means to promote fair corporate voting.

Speaking for myself, I believe the SEC has not gone far enough in this latter area. And so I intend to make proxy access—meaningful opportunities for a company's owners to nominate its directors—a critical part of the Commission's agenda in the coming months.

C. Regulation and Oversight of Financial Intermediaries and Market Professionals

For our markets to be fair and efficient and to operate in the best interests of investors, those who control access to our capital markets must be competent, financially capable, and honest. That brings me to a third core function of the SEC: regulation and oversight of financial intermediaries and other market professionals, including approximately 5,500 broker-dealers, over 11,000 investment advisers, stock and option exchanges, clearing agencies, credit rating agencies and others. Exchanges and clearing agencies are an essential part of the plumbing of our financial system. Their smooth operation is something that many Americans take for granted, but that the Commission takes very seriously and works to ensure. Brokers, advisers and credit rating agencies are the entities that Americans turn to for guidance and technical assistance when accessing our Nation's financial markets. It is essential that these firms—and the people who work in them—be held to the high standards expected of professionals.

The SEC's regulatory role, along with its oversight of the various self-regulatory organizations with respect to financial intermediaries and market professionals, focuses on helping to ensure that investors are treated fairly and that the institutions managing and processing their investments are subject to meaningful controls to protect investor assets. Our statutes and rules require that brokers and advisers tell investors the truth, that brokers recommend to their customers only those products that are suitable for them to buy, and that advisers act in accordance with their fiduciary duties. In the same way, we require that investment advisers manage any potential conflicts of interests and fully disclose them to investors.

Our capital requirements go a long way to ensuring that customer funds entrusted with a broker-dealer are safe in the event the broker-dealer gets in financial trouble. Again, our focus is not to insulate broker-dealers from competition and the risks of failure, but to protect investors in the event that failures do occur. We conduct examinations of these firms to assess their compliance with laws and regulations. And when we find violations or deficiencies, we direct that corrective action be taken.

Since 2006, with the authority provided by the Congress, we have adopted significant reforms related to credit rating agencies. Given the critical role of ratings in our capital markets, it is essential that we stay active in this area. We have rule proposals outstanding and are convening a public roundtable on possible further reforms to be held next month.

Some of our rules regulating financial intermediaries need to be modernized, and the Commission is considering what, if any, legislation to ask for from the Committee. Among other things, we are considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves. We are studying whether to recommend legislation to break down the statutory barriers that require a different regulatory regime for investment advisers and broker-dealers, even though the services they provide often are virtually identical from the investor's perspective. We also are carefully considering whether legislation is needed to fill other gaps in regulatory oversight, including those related to credit default swaps and municipal securities. It is time for those who buy the municipal securities that are critical to state and local funding initiatives to have access to the same quality and quantity of information as those who buy corporate securities. I will lead the Commission to continue to focus efforts in this area in 2009.

In addition, I have asked the staff to develop a series of reforms designed to better protect investors when they place their money with a broker-dealer or an investment adviser. I have asked the staff to prepare a proposal for Commission consideration that would require investment advisers with custody of client assets to undergo an annual third-party audit, on an unannounced basis, to confirm the safekeeping of those assets. I also expect the staff to recommend proposing a rule that would require certain advisers to have third-party compliance audits to review their compliance with the law. And to ensure that all broker-dealers and investment advisers with custody of investor funds carefully review controls for the safekeeping of those assets, I expect the staff to recommend that the Commission consider requiring a senior officer from each firm to attest to the sufficiency of the controls they have in place to protect client assets. The list of certifying firms would be publicly available on the SEC's Web site so that investors can check on their own financial intermediary. In addition, the name of any auditor of the firm would be listed, which would provide both investors and regulators with information to then evaluate the auditors.

D. Regulation of Mutual Funds and Other Pools of Investor Money

Most retail investors participate in the capital markets through pooled investment vehicles, the most common of which are mutual funds. The size of these investments is astonishing: mutual funds hold over $9 trillion in assets—representing the investments of approximately 92 million Americans. As part of its oversight functions, the SEC focuses on ensuring that funds are run to benefit investors and not insiders. SEC rules also seek to ensure that fund investors are provided accurate, timely and complete information about their funds in a form that is investor-friendly. The SEC requires that funds comply with investor-oriented prohibitions against complex capital structures, excessive leverage and preferential treatment for certain shareholders. In addition, the SEC examines the actions of independent fund directors and chief compliance officers to evaluate whether they are fulfilling their critical responsibilities on behalf of fund investors.

A particular focus of the Commission in coming weeks will be proposals to enhance the standards applicable to money market mutual funds, which are widely used by both retail and institutional investors as a cash management vehicle. The SEC has been closely monitoring money market funds and their investments, since we permitted the first money market fund in the early 1970s. Over that time, we have built up significant money market fund expertise. We will bring that expertise to bear as we act quickly this spring to strengthen the regulation of money market funds by considering ways to improve the credit quality, maturity, and liquidity standards applicable to these funds. These efforts will be aimed at shoring up money market fund investments and mitigating the risk of a fund experiencing a decline in its normally constant $1.00 net asset value, a situation known colloquially as "breaking the buck."

E. Enforcement of the Securities Laws

Finally, there's enforcement. We are an integrated regulator of the country's capital markets with an important focus on law enforcement. We enforce the securities laws aggressively and intelligently, without fear or favor. Enforcement is one of our core competencies and a central part of our heritage as an agency.

In the past year alone, the SEC has brought enforcement actions related to subprime abuses, market manipulation through the circulation of false rumors, insider trading by hedge funds and other institutional investors, Ponzi schemes, false corporate disclosures, and penny stock frauds. This past year we brought the biggest foreign bribery case ever. We also required securities violators to disgorge illegal profits of approximately $774 million and to pay penalties of approximately $256 million, and we distributed over $1 billion to injured investors.

Enforcement is integrated with our regulation of the capital markets for the benefit of investors. We enforce the securities laws and the rules we promulgate. We understand markets because we regulate them. We understand disclosure because we regulate it. Our regulatory functions add nuance and sophistication to our enforcement efforts, and enforcement adds backbone to our rules. It is all one piece.

We have work to do to stay one step ahead of the predators and sharp practices that prey on investors. It is a never-ending struggle, and it requires never-ending energy and ingenuity. As part of this effort, I expect to come to you in the near term with a request for authority to compensate whistleblowers who bring us well-documented evidence of fraudulent activity. Currently, we have the authority to compensate sources in insider trading cases. I would like to see this authority extended so that the SEC can further encourage individuals to come forward with helpful information.

III. A Capital Markets Regulator Devoted to Investor Protection Should Be Independent

As we look to the future of securities regulation, we believe that independence is an essential attribute of a capital markets regulator that protects investors. There are other agencies of government that touch on what we do, just as what we do touches on other agencies of government. But Congress created only one agency with the mandate to be the investors' advocate. Other agencies have had, as part of their responsibilities, the protection of important financial institutions and, as part of those responsibilities, customer protection. But, as Justice Douglas pointed out long ago, only the SEC has the mission, and the privilege, of serving as "the investors' advocate."

We are a creature of the Congress. The vision of the Congress when it created an independent SEC was to make sure that there was one agency of government focused single-mindedly and without dilution on the well-being of America's investors. That independence has allowed us to build expertise and a culture of investor protection, which benefits the public and the economy. And it has been a tremendous success as U.S. capital markets lead the world.

If there were ever a time when investors need and deserve a strong voice and a forceful advocate in the federal government, that time is now. Individual investors may not be the strongest political force; they are disparate in their backgrounds and not always well-organized or funded. They are typical Americans—our families, friends, and fellow citizens. These investors expect and deserve a strong and independent regulator dedicated to providing for fair financial dealings, timely and meaningful disclosure of information, and protection from unscrupulous actors.

Congress made us independent precisely so we can champion those who otherwise would not have a champion, and when necessary take on the most powerful interests in the land. Regulatory reform must guarantee that independence in the future.

IV. A Strong and Independent Capital Markets Regulator Is Important to Systemic Risk Oversight

An independent, investor-first capital markets regulator is vital to a revamped regulatory structure that pays due attention to overarching systemic risk. Investor protection enhances the mission of controlling systemic risk. More than that, financial services exist to serve investors and our markets, and a focus on investors is absolutely essential to any credible regulatory restructuring. The SEC, as the independent capital markets regulator with unique experience and competencies, must continue to be the primary regulator of important market functions, and would be a critical party in contributing to any systemic risk regulator's evaluation of risks. Appropriate regulation must safeguard both investor protections and important market functions.

The SEC, as a strong independent regulator with market expertise, can perform its critical capital markets and investor protection functions without compromising the oversight of systemic risk. Even as attention focuses on reconsidering the management of systemic risk, investor protection and capital formation—both of which are fundamental to economic growth—cannot be compromised as a product of any reform effort. The SEC stands alone as the government agency responsible for both protecting investors and promoting capital formation for the past 75 years.

To the extent the activities of the SEC touch systemically significant institutions, there is rarely a risk of inconsistency between the SEC and other regulators focused on systemic risk. No one, for example, argues that major financial institutions should be permitted to lie, cheat, or steal as a means of avoiding systemic risk. To the extent those issues do arise, and have arisen in the past, any tensions have been creative, and well-meaning regulators can and have been able to resolve them.

There are questions that need to be answered in the months ahead. Among others, there is a need to identify or create the appropriate systemic regulatory regime; determine how such a regime can identify systemic risks without creating additional ones; and determine how much and how heavily any systemic risk regulator should touch the other participants in the system of financial regulation. We will need to figure out what should be consolidated, what should be split off, what should be added, and what should be subtracted. As it has since it was formed, the Commission stands ready to assist.

We view regulatory reform as vital. We will give Congress, our fellow regulators, and other parts of the government the benefit of our insights. It is critical that the reform is done right, and the Commission will actively engage with all stakeholders throughout the process.

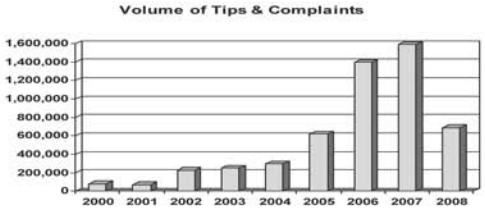
V. Conclusion

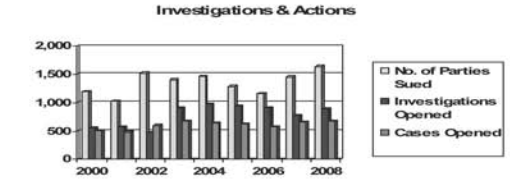
When I returned to the SEC as Chairman in January, I appreciated the need to act swiftly to help restore investor confidence in our capital markets. In less than 2 months, we have instituted important reforms to reinvigorate our enforcement program, better train our examination staff and improve our handling of tips and complaints. In the near term, I will ask the Commission to consider taking action related to short selling, money market fund standards, investor access to public company proxies, credit rating agencies, and controls over the safekeeping of investor assets. But, speaking personally, much more needs to be done. Everyday when I go to work, I am committed to putting the SEC on track to serve as a forceful capital markets regulator for the benefit of America's investors. Today, more than ever, the SEC's core mission of capital markets oversight and investor protection is as sound and fundamentally important as it ever was, and I am fully committed to ensuring that the SEC carries out that job in the most effective way it can.

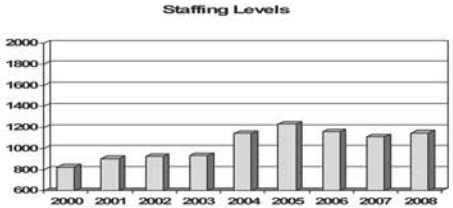
Thank you again for the opportunity to share the SEC's views. We look forward to working with the Committee on any financial reform efforts in the months ahead, and I would be pleased to answer any questions.

SEC Enforcement

- The Commission's law enforcement arm
  - Investigates securities law violations, and recommends and prosecutes civil actions
  - Obtains evidence from many sources, including market surveillance, investor tips and complaints, other SEC divisions and offices, SROs, other securities industry sources, other financial regulators, and media reports
- In 2008, brought 671 actions; 2nd highest in SEC history
  - Sought director and officer bars against 132 defendants; filed 39 emergency TRO actions to halt ongoing fraud; sought 46 asset freezes; halted trading in 189 issuers for inadequate disclosure
  - Cases included: 157 financial fraud; 121 securities offerings; 52 market manipulation; and 61 insider trading
- In past year, filed 9 cases involving subprime issues; many others under active investigation
  - Subjects of investigations include lenders; investment banks and other large financial institutions; securitizers; credit rating agencies; home builders; and companies that provided mortgages to investors to enable them to finance securities purchases
- Between 2004 and 2008, ordered $8.2 billion in disgorgement and $4.7 billion in penalties against wrongdoers
- In 2008, distributed over $1 billion to injured investors through Fair Funds; expect significant distribution in 2009
  - $800 mm (AIG); $375 mm (Invesco/AIM); $320 mm (Alliance)
- Working with other regulators, over the past year helped to provide tens of thousands of ARS investors with over $67 billion of liquidity
  - In recent settlement with largest broker-dealers in ARS market, many aggrieved investors (including retail customers, small businesses and charitable organizations) will have right to receive 100 cents on the dollar
- Other Enforcement Working Groups focusing on:
  - Hedge Funds: manipulation, short-selling and collusion; insider trading; offering frauds; other misconduct
  - Rumors and Market Manipulation: reviewing data obtained through September 2008 Section 21(a) SEC Order directed at hedge funds, broker-dealers and institutional investor trading and market activity

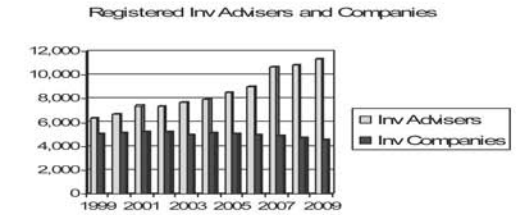


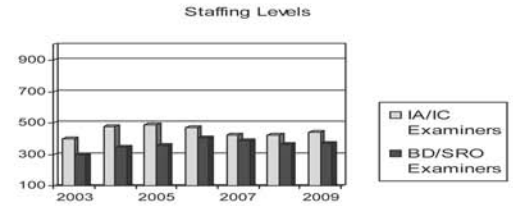




SEC Compliance & Examinations

- Goals: examine for compliance with the securities laws; encourage compliance with those laws; and obtain information about areas of potential risk in the securities industry
- Tools: routine, oversight, cause and "sweep" examinations
- In 2008, using risk-based targeting, conducted examinations of:
  - 1,521 investment advisers (14% of registered universe of 11,300 registered investment advisers)
  - 219 fund complexes (23% of universe of 950 fund complexes)
  - 135 transfer agents (22% of universe of 600 registered transfer agents)
  - 720 broker dealer firms (together with FINRA, 55% of universe of 5500 registered broker dealers examined)
- Recently examined controls over safekeeping investor assets at over 100 securities firms; currently examining hedge funds that have indications of aberrational performance returns
- Recent focus areas (partial list):
  - Risk of theft and misappropriation of investor money
  - Falsification of performance results
  - Valuation of illiquid or difficult to price securities
  - Manipulative rumors
  - Controls over non-public information and insider trading
  - Suitability of sales of complex structured products to retail investors

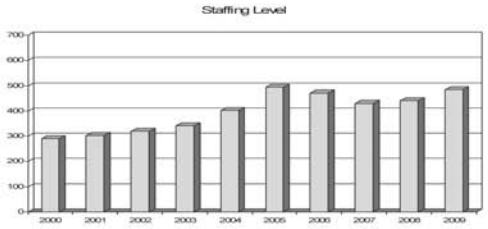




Appendix

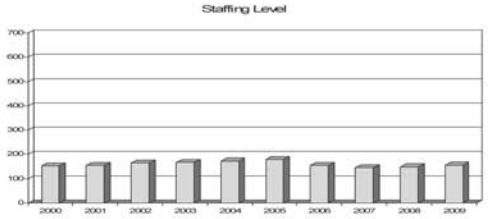
SEC Corporation Finance

- Administers the Securities Act of 1933, the Securities Exchange Act of 1934 and the Trust Indenture Act of 1939, as they relate to public companies
  - Reviews offering, merger, disclosure and proxy materials for 12,500 public companies; in 2008, reviewed annual filings of nearly 5,000 companies and more than 600 new issuers
- Anticipated 2009 activities include:
  - Recommendations relating to reconsideration of shareholder nominations of directors; shareholder advisory votes on executive compensation (for TARP companies); and enhanced proxy disclosure concerning board oversight of risk management, compensation consultant conflicts of interests, and director qualifications



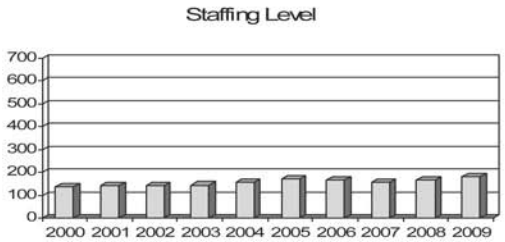
SEC Investment Management

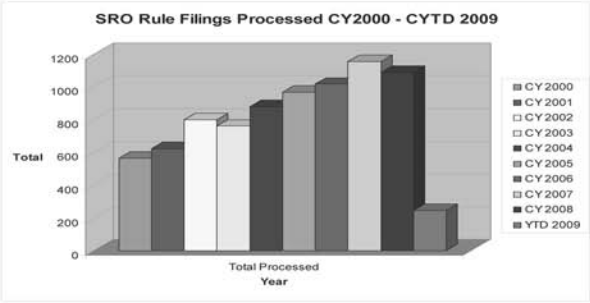
- Administers the Investment Company and Investment Advisers Acts of 1940
  - Reviews disclosures for 4,600 investment companies (representing 36,500 portfolios): in 2008, reviewed 2,085 new portfolios; performed 4,485 SOX reviews
  - Provides formal and informal guidance: in 2008, fulfilled 1,105 requests for guidance
- Anticipated 2009 activities include:
  - Enhancing investor adviser custody and compliance requirements; strengthening money market fund regulation; and, working with staff from Trading & Markets, harmonizing investment adviser/broker-dealer obligations



SEC Trading & Markets

- Administers the Securities Exchange Act of 1934 as it relates to financial participants and the securities markets
  - Establishes standards for the securities markets and major market participants, including broker-dealers, exchanges, other self-regulatory organizations (e.g., FINRA, MSRB), clearing agencies, transfer agents, and credit rating agencies
- Anticipated 2009 activities include:
  - Considering further regulation of short sales and NRSROs
  - Through a new Broker-Dealer Risk Office, focusing on broker-dealers that are part of a holding company
  - Considering proposing to amend rules so that the Commission has information to assess the risk that an affiliate's business activities (particularly unregulated activities) pose to the broker-dealer
  - Harmonize investment adviser and broker-dealer obligations





Appendix

PREPARED STATEMENT OF FRED J. JOSEPH

PRESIDENT,

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

MARCH 26, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am Fred Joseph, Colorado Securities Commissioner and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I am honored to be here today to discuss legislative and regulatory changes that are most relevant to the millions of Main Street Americans who are looking to regulators and lawmakers to help them rebuild and safeguard their financial security. At this critical time in the Nation's history, it's imperative that our system of financial services regulation be improved to better protect investors, markets, and the economy as a whole. I commend the Banking Committee for its deliberative approach of holding comprehensive hearings, briefings and meetings to determine how best to modernize our financial regulatory system.

In November 2008, NASAA released its Core Principles for Regulatory Reform in Financial Services and subsequently issued a pro-investor legislative agenda for the 111th Congress that responds to universal calls for increased responsibility, accountability, and transparency, and offers a series of positive and proactive policy recommendations to better protect investors and restore confidence in our financial markets. Today, I would like to highlight the recommendations that we feel are most vital to sound regulatory reform and strong investor protection.

State Securities Regulatory Overview

The securities administrators in your states are responsible for enforcing state securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, pursuing cases of suspected investment fraud, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are independent commissions and others, like me are appointed by their Governors and Cabinet officials. We are often called the "local cops on the securities beat," and I believe that is an accurate characterization.

NASAA's Core Principles for Regulatory Reform in Financial Services

The unique experiences of state securities regulators on the front lines of investor protection provide the framework for NASAA's Core Principles for Regulatory Reform, which I want to discuss today. We believe Main Street investors deserve a regulatory structure that is collaborative, efficient, comprehensive, and strong and we have developed specific recommendations to help achieve those objectives.

We urge you to consider and implement the following five guiding principles, which we believe will create a strong and practical foundation for an enhanced regulatory framework that better serves investors and our markets as a whole.

- Preserve the system of state/federal collaboration while streamlining where possible.
- Close regulatory gaps by subjecting all financial products and markets to regulation.
- Strengthen standards of conduct, and use "principles" to complement rules, not replace them.
- Improve oversight through better risk assessment and interagency communication.
- Toughen enforcement and shore up private remedies.

Congressional Action That Will Advance the Core Principles

Implementing NASAA's Core Principles will require a broad range of actions, both legislative and regulatory, but at the heart is a call for decisive Congressional leadership. Here are our specific legislative recommendations, set forth in the context of our core principles.

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 States, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico, and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Core Principle One: Preserve State/Federal Collaboration While Continuing To Streamline the Regulatory System Where Appropriate

With so much at stake for investors and the United States' economy, NASAA's top legislative priority is to protect investors by preserving state securities regulatory and enforcement authority over those who offer investment advice and sell securities to their residents. In some areas, the states' authority should be increased.

Support a Strong State Regulatory Structure for Capital Markets

State regulation is an essential component of our current regulatory structure and it must be preserved. In the area of securities regulation, the states bring experience, resources, and passion to the job of licensing professionals, conducting examinations, and bringing enforcement actions—both civil and criminal—against those who prey on our Nation's citizens. The states also serve as a local resource that investors can turn to for help when they have been exploited.

Our proximity to individual investors puts us in the best position, among all law enforcement officials, to deal aggressively with securities law violations. State securities regulators respond to investors who typically call them first with complaints, or request information about securities firms or financial professionals. They work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because they are closest to the investing public, state securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations. The $60 billion returned to investors to help resolve the demise of the Auction Rate Securities (ARS) market is the most recent example of the states initiating a collaborative approach to a national problem.

Attached to my testimony is a chart, "States: On the Frontlines of Investor Protection," which illustrates many examples where the states initiated investigations, uncovered illegal securities activity, then worked with federal regulators or with Congress to achieve a national solution.

These high profile national cases receive greater public attention, but they should not obscure the more routine and numerically much larger caseload representing the bulk of the states' enforcement work, which affects everyday citizens in local communities across the country. In the past three months alone, the Washington State Division of Securities, working with the Federal Bureau of Investigation and the IRS Criminal Investigation Division, broke up a $65 million oil and gas investment Ponzi scheme; Hawaii's securities commissioner, with the assistance of the SEC and CFTC, shuttered a suspected Ponzi scheme targeting the deaf community in Hawaii, parts of the mainland and Japan; an investigation by the Texas State Securities Board resulted in a 60-year prison sentence for a Ponzi scheme operator who stole at least $2.6 million from investors; and the Arizona Corporation Commission stopped a religious affinity fraud ring and ordered more then $11 million returned to investors. Since January 1, 2009, the Alabama Securities Commission has announced the conviction of nine different individuals convicted of securities fraud.

Just one look at our enforcement statistics shows the effectiveness of state securities regulation. During our three most recent reporting periods, ranging from 2004 through 2007, state securities regulators have conducted investigations that led to more than 8,300 enforcement actions, which led to $178 million in monetary fines and penalties, more than $1.8 billion ordered returned to investors, and jail sentences totaling more than 2,700 years.

Last year, in my own State of Colorado, my office conducted investigations that led to 246 administrative, civil and criminal actions, resulting in $3 million ordered to be returned to investors and 434 years of prison time for fraudsters. And just last month, a Ponzi scheme investigation launched by my office resulted in a prison sentence of 132 years for the main perpetrator and a court order to repay investors $3.4 million.

In light of the demonstrable value of state securities regulation, we urge Congress to reject any attempts to preempt or otherwise restrict the role of state securities regulators.

Restore the Authority of State Securities Regulators Over Offerings under Rule 506 of Regulation D

In thinking about the role of state and federal enforcement authorities, it is instructive to look back at the regulatory responses to the major financial scandals over the past decade. From the investigation into the role of investment banks in the Enron fraud, to exposing securities analyst conflicts of interest, "market timing" in mutual funds, and the recent auction rate securities cases, state securities regulators have consistently been in the lead.

Because we are the local cop on the beat, state securities regulators are often first to discover and investigate our Nation's largest frauds. Also, it has been shown that in cases where state and federal regulators work cooperatively, the actions of state securities regulators cause a significant increase in the penalty and restitution components of the federal regulator's enforcement efforts.[2]

And yet, over a number of years there has been a concerted assault on state securities regulation, targeting both regulatory and enforcement activities. For example, in 1996, the National Securities Markets Improvement Act (NSMIA) preempted much of the states' regulatory apparatus for securities traded in national markets, and although it left state antifraud enforcement largely intact, it limited the states' ability to address fraud in its earliest stages before massive losses have been inflicted on investors.

A prime example is in the area of private offerings under Rule 506 of Regulation D. Even though these securities do not share the essential characteristics of the other national securities offerings addressed in NSMIA, Congress nevertheless precluded the states from subjecting them to regulatory review. These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no regulatory scrutiny. Thus, for example, NSMIA has preempted the states from prohibiting Regulation D offerings even where the promoters or broker-dealers have a criminal or disciplinary history. Some courts have even held that offerings made under the guise of Rule 506 are immune from scrutiny under state law, regardless of whether they actually comply with the requirements of the rule.[3]

As a result, since the passage of NSMIA, we have observed a steady and significant rise in the number of offerings made pursuant to Rule 506 that are later discovered to be fraudulent. Further, most hedge funds are offered pursuant to Rule 506, so state securities regulators are prevented from examining the offering documents of these investments, which represent a huge dollar volume. Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all "covered" securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors. In light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)4(D) of the Securities Act of 1933.

Broaden the States' Regulatory and Enforcement Authority Over Investment Advisers

Recent scandals have highlighted the need for more examination and enforcement in the area of investment adviser regulation. The Madoff case illustrates the horrific consequences we face when an investment adviser's illegal activity goes undetected and unchecked for an extended period. NASAA recommends two changes to enhance the states' role in policing investment advisers. First, the Securities Exchange Commission (SEC) should expand the class of investment advisers that are subject to state registration and oversight. In NSMIA, adopted in 1996, Congress provided that the states would regulate investment advisers with up to $25 million in assets under management, while the SEC would regulate the larger investment advisers. Congress further intended that the SEC would periodically review this allocation of authority and adjust it appropriately. The $25 million "assets under management" test should now be increased to $100 million. This adjustment is appropriate in light of changes in the economic context. Today, even small investment advisers typically have more that $25 million under management. In addition, this increase will reduce the number of federally registered investment advisers, thereby permitting the SEC to better focus its examination and enforcement resources on the largest advisers.

Congress should also increase the states' enforcement authority over large investment advisers. Currently, a state can only take enforcement action against a federally registered investment adviser if it finds evidence of fraud. This authority should be broadened to encompass any violations under state law, including, dishonest and unethical practices. This enhancement will deter all forms of abuse by the large investment advisers, without interfering with the SEC's exclusive authority to register and oversee the activities of the large investment advisers.

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[2] Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations,* 2003–7, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091035.*

[3] See, *e.g., Temple v. Gorman,* 201 F. Supp. 2d 1238 (S.D. FL. 2002).

Core Principle Two: Close Regulatory Gaps by Subjecting All Financial Products and Markets to Regulation

An enormous amount of capital is traded through esoteric investment instruments on opaque financial markets that are essentially unregulated. Our system must be more comprehensive and transparent, so that all financial markets, instruments, and participants—from derivatives to hedge funds—are subject to effective regulation through licensing, oversight, and enforcement.

Increase Transparency of Derivative Instruments

The lack of regulation governing the over-the-counter derivatives market is a regulatory gap that Congress must close. The hands-off approach to these financial instruments can be traced largely to the Commodity Futures Modernization Act, passed by Congress in 2000, which specifically exempted swaps from regulatory oversight. This lack of oversight was a contributing cause of the financial crisis and must be addressed.

NASAA believes that Congress, at a minimum, should pass legislation to subject derivatives to much more comprehensive regulation. NASAA supports recent efforts to provide clearing services for certain credit default swap contracts, but suggests that Congress explore the necessity of imposing a much broader range of regulatory safeguards over the derivative markets. Regulatory requirements that deserve careful consideration include mandatory exchange trading, licensing of market participants, capital requirements, recordkeeping obligations, conduct standards, enforcement remedies, and even prohibition, where appropriate.

Authorize Regulation of Hedge Funds

NASAA has long supported regulation of hedge fund advisers in a manner that will provide greater transparency to the marketplace while not overburdening the hedge fund industry. Advisers to hedge funds should be subject to the same standards of examination as other investment advisers.

Because they qualify for a number of exemptions to federal and state registration and disclosure laws, hedge funds remain largely unregulated today. The SEC has attempted to require hedge fund managers to register as investment advisers, but that attempt has been rejected.[4] Therefore, Congress should give the SEC explicit statutory authority to regulate hedge fund advisers as investment advisers. In addition, Congress should grant the SEC authority to require hedge funds to disclose their portfolios, including positions, leverage amounts, and identities of counterparties to the appropriate regulators.

Core Principle Three: Strengthen Standards of Conduct, and Use "Principles" To Complement Rules, Not Replace Them

At the heart of any regulatory system are strong and clear standards of conduct. In the area of securities regulation, we should impose the fiduciary duty—in addition to existing standards—on all securities professionals who dispense investment advice, including broker-dealers. We must also recognize that a "principles-based" approach to regulation is no substitute for a clear and strong system of prescriptive rules. Broadly framed standards of conduct can serve as helpful guides for industry as well as useful enforcement tools for regulators, but standing alone, they leave too much room for abuse.

Impose the Fiduciary Duty on Broker-Dealers as Well as Investment Advisers

Over the last two decades, broker-dealers have increasingly engaged in services traditionally rendered by investment advisers. The conduct of investment advisers, broker-dealer agents and financial planners has become increasingly blurred in recent years, and most investors do not understand the legal obligations that each have to their clients. The financial services industry today continues to expose investors to vast differences in competency exam requirements, education requirements, product knowledge, regulatory structures, and investor protections—including vast differences in the standard of care owed to the client.

The primary purpose of the Investment Advisers Act of 1940 was to protect the public and investors from unscrupulous practices by those who dispense investment advice about securities for compensation. Congress set out to accomplish this goal in large part by establishing a federal fiduciary standard to govern the conduct of investment advisers. The fiduciary duty is the obligation to place the client's interests first, to eliminate any conflicts of interest and to make full and fair disclosure to clients. NASAA urges Congress to apply the fiduciary duty standard of care to all financial professionals who give investment advice regarding securities—broker-

[4] See *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

dealers and investment advisers alike. This step will enhance investor protection, eliminate confusion, and even promote regulatory fairness by establishing conduct standards according to the nature of the services provided, not the licensing status of the provider. We urge Congress to ratify the highest standard of care. For all financial professionals, the interests of the client must come first at all times. Investors deserve no less.

Core Principle Four: Improve Oversight Through Better Risk Assessment and Interagency Communication.

Enhancing our ability to detect and manage risk in all financial markets is one of our most important—and difficult—challenges. The single most effective remedy for excessive risk accumulation is closing regulatory gaps, as set forth in Core Principle Two. If we ensure that every financial product is subjected to strong oversight by competent regulators, we will have taken a major step toward better risk assessment and control. Some additional steps are necessary, however. Congress should establish an independent risk assessment body, and it should eliminate fundamental conflicts of interest that have undermined the objectivity and reliability of our credit rating agencies.

Establish an Independent Body To Monitor the Accumulation of Risk and Recommend Corrective Measures

NASAA believes that Congress should establish an independent risk assessment body comprised of representatives from the state and federal agencies that regulate securities, banking, and insurance. Their task would be to monitor the accumulation of risk in all financial markets, to advise the regulators who have primary jurisdiction over those markets, and to recommend decisive corrective measures when necessary. They would also be charged with identifying the emergence of new financial products that require regulation. This approach is preferable to vesting broad risk assessment authority in an existing federal agency. A new body with diverse and balanced representation offers more expertise, more objectivity, and greater resistance against industry influence or "regulatory capture."

On a more informal level, to facilitate communication and coordination on all financial services issues, NASAA believes the President's Working Group on Financial Markets should be expanded to include representatives from the state agencies that regulate banking, insurance, and securities.

Eliminate Conflicts Within Nationally Recognized Statistical Rating Organizations ("NRSROs")

Nationally Recognized Statistical Rating Organizations ("NRSROs"), or credit rating agencies, play a vital role in our capital market. Their evaluations of the creditworthiness of companies and securities help hedge funds, mutual funds, pension funds, and individual investors make their investment decisions, and their ratings are used for a variety of regulatory purposes as well. As our financial markets have become more complex, the role of NRSROs has grown in significance. However, it is now clear that NRSROs contributed to the turmoil in our credit markets with inaccurate ratings due in large part to a faulty business model. NASAA regards the SEC's recently finalized rules, which were intended to curb conflicts of interest and increase transparency and accountability, as a constructive first step, but they may not go far enough. Also, the SEC's upcoming roundtable should yield additional proposals to enhance oversight of the ratings industry. Still, Congress must examine the models that rating agencies use and the assumptions they rely upon in determining ratings to ensure that they accurately reflect risks. Congress should also examine the issuer-pay business model that contains inherent conflicts of interest and that lends itself to "ratings shopping," and should consider legislative solutions that are beyond the reach of the SEC's regulatory authority.

Core Principle Five: Toughen Enforcement and Shore Up Private Remedies

Enforcement is one of the most effective tools for deterring lawless behavior in our markets, but for years, it has received far less support than it deserves. We should toughen punishments for those who violate the law and increase enforcement budgets for state and federal regulators, including the SEC. We must remember that the private rights and remedies of injured consumers are an essential complement to government enforcement efforts aimed at deterring fraud. The pendulum has swung too far in the direction of limiting private rights of action, and now Congress should legislatively reverse some of the Supreme Court's most ill-conceived and anticonsumer decisions.

Reexamine and Remove Some of the Hurdles Facing Private Plaintiffs Who Seek Damages for Securities Fraud

Private actions are the principal means of redress for victims of securities fraud, but they also play an indispensable role in deterring fraud and complementing the enforcement efforts of government regulators and prosecutors. Congress and the courts alike have recognized this fact. The Senate Report accompanying the Private Securities Litigation Reform Act of 1995 (PSLRA) described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted] [5]

The problem, of course, is that over the last 15 years, Congress and the U.S. Supreme Court have restricted the ability of private plaintiffs to seek redress in court for securities fraud. These restrictions have not only reduced the compensation available to those who have been the victims of securities fraud, they have also weakened a powerful deterrent against misconduct in our financial markets.

For example, in the PSLRA, Congress imposed stringent pleading requirements and other limitations on plaintiffs seeking damages for fraud under the securities acts. The intent of the Act was to protect companies from frivolous lawsuits and costly settlements. Many observers, however, believe that PSLRA has placed unrealistic burdens on plaintiffs with meritorious claims for damages.

The Supreme Court has compounded the problem by issuing decisions that further limit the rights of private plaintiffs in two important ways. The Court has narrowed the class of wrongdoers who can be held liable in court, and at the same time, it has expanded the pleading burdens that plaintiffs must satisfy to survive immediate dismissal of their claims. As Justice Stevens lamented in his dissent in Stoneridge, the Court has been on "a continuing campaign to render the private cause of action under Section 10(b) toothless." [6]

In short, the pendulum has swung too far in the direction of limiting private rights of action. Congress should therefore hold hearings to examine whether private plaintiffs with claims for securities fraud have fair access to the courts. In that process, Congress should re-evaluate the Private Securities Litigation Reform Act and should furthermore consider reversing some of the Supreme Court's most anti-investor decisions. One case that undoubtedly deserves to be revisited is the Court's holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S.Ct. 1439 (1994). The Court ruled that the private right of action under Section 10(b) of the Securities Exchange Act of 1934 cannot be used to recover damages from those who aid and abet a securities fraud, only those who actually engage in fraudulent acts. The Court's decision insulates a huge class of wrongdoers from civil liability for their often critical role in support of a securities fraud.

Other cases that warrant legislative re-evaluation include *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 128 S. Ct. 761, 779 (2008) (severely limiting the application of Section 10(b) in cases involving fraudulent conduct); and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 127 S. Ct. 2499 (2007) (establishing burdensome requirements for pleading scienter).

It bears repeating that removing excessive restrictions on access to the courts would not only provide more fair and just compensation for investors, it would also benefit regulators by restoring a powerful deterrent against fraud and abuse: the threat of civil liability.

Restore Fairness and Balance in the Securities Arbitration System

Every year thousands of investors file complaints against their stockbrokers. Almost every broker-dealer presently includes in their customer agreements a predispute mandatory arbitration provision that forces those investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration.

If these disputes are not settled with a given firm, investors are left with only one avenue to pursue their claims—arbitration—and for all practical purposes only

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[5] See S. Rep. No. 104-98, at 8 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 687; see also *Basic Inc. v. Levinson,* 485 U.S. at 230–31 (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements").

[6] *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 128 S. Ct. 761, 779 (2008).

one arbitration forum. This system, which is administered by an affiliate of FINRA, should be revised to ensure it is fair and transparent to all.

The first step toward ensuring fundamental fairness is to make arbitration optional. Members of Congress have seen that the scales of justice have tilted away from consumers in arbitration proceedings. In an attempt to rectify this situation, the "Arbitration Fairness Act of 2007," was introduced. S. 1782, offered last year by Senator Russ Feingold (D-WI), had seven cosponsors and its House counterpart, H.R. 3010, introduced by Congressman Hank Johnson (D-GA), is currently supported by 43 cosponsors. This proposal makes predispute mandatory arbitration agreements to arbitrate employment, consumer, franchise, or civil rights disputes unenforceable. NASAA supports this legislation and suggests that it be amended just to make clear that its provisions extend to securities arbitration.

Even if the decision to participate in arbitration becomes truly voluntary, other changes are necessary to ensure that the arbitration process is fair. NASAA believes a major step toward improving the integrity of the arbitration system is the removal of the mandatory industry arbitrator. This mandatory industry arbitrator, with their industry ties, automatically puts the investor at an unfair disadvantage. State securities regulators believe Congress should also review other aspects of arbitration, to determine, for example, if there is sufficient disclosure of potential conflicts by panel members; if the selection, qualification, and composition of the panels is fair to the parties; if arbitrators receive adequate training; if explanations of awards are sufficient; and if the system is fast and economical for investors. Where deficiencies are found, Congress should act to ensure that the system is improved.

Conclusion

State securities regulators believe that enhancing our securities laws and regulations and ensuring they are being vigorously enforced is the key to the restoring investor confidence in our markets. NASAA and its members are committed to working with the Committee to ensure that the Nation's financial services regulatory regime undergoes the important changes that are necessary to enhance Main Street investor protection, which state securities regulators have provided for nearly 100 years.

States: On the Frontlines of Investor Protection

PROBLEM: $2 billion/yr. Losses in Penny Stocks	
State Initiative	**1989:** States determined penny stock offerings by newly formed shell companies to be per se fraudulent. These "blank check" companies had no business plan except a future merger with an unidentified company.
National Response	**1990:** Congress passed Penny Stock Reform Act, which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of shares in blank check companies (SEC Rule 419).
PROBLEM: $6 billion/yr. Losses in Micro-cap Stocks	
State Initiative	**1996-97:** 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low priced securities to individual investors. States found massive fraud in firms' manipulation of shares of start-up companies, most of which had no operating history.
National Response	**1997-98:** Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). **2002:** Congress passed Sarbanes-Oxley Act, which made certain state actions a basis for federal statutory disqualification from the securities industry.
PROBLEM: Risks of Securities offerings on the Internet	
State Initiative	**1996-97:** States issued uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.
National Response	**1998:** SEC issued interpretative guidance based on the States' Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.
PROBLEM: Risks of Online Trading	
State Initiative	**1999:** In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.
National Response	**2001:** SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.
PROBLEM: Risks of Day Trading	
State Initiative	**1999:** In a report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.
National Response	**2000:** SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors. **2001:** SEC approved new NASD and NYSE rules governing margin extended to day traders.
PROBLEM: Research Analyst Conflict of Interest	
State Initiative	**2002-03:** States investigated and helped focus attention on conflicts of interest between investment analysts and major Wall Street firms.
National Response	**2002-03:** The SEC, NASD, NYSE, and states reached a landmark $1.4 billion global settlement and firms agree to reform practices.
PROBLEM: Illegal Mutual Fund Trading Practices	
State Initiative	**2003:** States uncovered illegal trading schemes that had become widespread in the mutual fund industry.
National Response	**2003-2004:** SEC, NASD and NYSE launch investigations; reform legislation introduced in Congress but fails to gain support; SEC initiates wide-ranging effort to reform certain fund regulations.
PROBLEM: Senior Investment Fraud	
State Initiative	**2008:** After calling attention to widespread fraud against senior investors, NASAA members approved a model rule prohibiting the misleading use of senior and retiree designations and numerous states have adopted the model through legislation or regulation.
National Response	**2008:** Sen. Herb Kohl, chair of the U.S. Senate Special Committee on Aging, introduced legislation that would provide grants to states to enhance the protection of seniors from being misled by false designations.
PROBLEM: Auction Rate Securities	
State Initiative	**2008:** Based on investor complaints, states launched a series of investigations into the frozen market for auction rate securities. The investigations led to settlements with 11 major Wall Street firms to return $50 billion to ARS investors.
National Response	**2006:** SEC looked into underwriting and sales practices of auction rate securities. While it did discover and try to remedy certain manipulative practices, the SEC failed to identify or correct fundamental conflicts of interest and self dealing that pervaded the auction rate market.

SOURCE: North American Securities Administrators Association
Updated: January 2009

PREPARED STATEMENT OF RICHARD C. BREEDEN

FORMER CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION

MARCH 26, 2009

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee for the opportunity to offer my views on enhancing investor protection and improving financial regulation. These have been issues of concern to me for many years.

In offering observations to the Committee today, I am drawing on past experience as SEC Chairman from 1989–1993, as well as my service as an Assistant to the President in the White House under President George H.W. Bush. During the savings and loan and banking crisis in the 1980s, which involved more than $1 trillion in bank and thrift assets, I was one of the principal architects of the program to restructure the savings and loan industry and its regulatory system. That effort was extremely successful, and became the model for many other countries including the Nordic countries in dealing with later banking sector meltdowns.

Early in my White House tenure, in 1982–1985 when the future President Bush was Vice President, I was staff director of a 3-year study of how to improve the effectiveness and efficiency of the entire federal financial regulatory system. We looked carefully at many ideas for improving the effectiveness of federal financial regulation, including possible consolidation of banking agencies, SEC/CFTC merger and other topics.

From 2002–2005 I served as the "corporate monitor" of WorldCom, after being appointed to that position by the Hon. Jed S. Rakoff of the U.S. District Court for the Southern District of New York. Among other things, it was my job on behalf of the District Court to evaluate and approve or veto all compensation payments by WorldCom to any of its 66,000 employees in more than 50 countries. We didn't call it an "AIG Problem", but Judge Rakoff was determined to prevent exactly the type of compensation abuses that have occurred in AIG. Even though taxpayer funds were not injected into WorldCom, Judge Rakoff did not believe that a company that had destroyed itself through fraud should be free to pay corporate funds to insiders without strict monitoring and controls. I ultimately blocked hundreds of millions in proposed compensation payments that could not be justified, while allowing the company to do what it needed to do to compete for critical personnel and to emerge successfully from bankruptcy.

Over the years I have served on many corporate boards, including the boards of two major European corporations as well as U.S. companies. Today I serve as non-executive Chairman of the Board of H&R Block, Inc., and as a director of two other U.S. public companies.[1] As a board chairman and as a director, I have personally had to grapple with the issues of corporate governance, including accountability for performance and excessive compensation, that helped cause so many of our recent financial institution collapses.

Of all my prior experiences, however, perhaps the most relevant is my experience as an investor. For the past few years my firm, Breeden Capital Management, has managed equity investments that today total approximately $1.5 billion in the U.S. and Europe. Our investors are for the most part major pension plans, and we indirectly invest on behalf of several million retired schoolteachers, firemen, policemen, civil servants and others. Their retirement security is dependent in part on how successful we are in generating investment returns. While I was pretty intense about investor protection as SEC Chairman, I can assure you that there is nothing like having billions on the line in investments on behalf of other people to make you really passionate on that subject.

I. Overview

By any conceivable yardstick, our Nation's financial regulatory programs have not worked adequately to protect our economy, our investors, or our taxpayers. In little more than a year, U.S. equities have lost more than $7 trillion in value. Investors in financial firms that either failed, or needed a government rescue, have had at least $1.6 trillion in equity wiped out. These are colossal losses, without any precedent since the Great Depression. Millions of Americans will live with reduced retirement incomes and higher taxes for many years as a result of misbehavior in our

[1] The views expressed here today are solely my own. They do not represent the views of any investors in investment funds managed by Breeden Capital Management, or of any companies on whose boards I serve.

financial firms, failed oversight by boards of directors, and ineffective government regulation.

To restore trust among investors in our financial system and government, we will need to make significant improvements in our existing regulatory programs. We also must make sure that "new" regulatory programs will actually be "better" than current programs. Any "reforms" worth the name must demand more effectiveness from government agencies, including the Federal Reserve and the SEC, that have responsibility for "prudential supervision" of banks and securities firms.

It is worth noting that the disasters we have seen did not arise due to lack of resources for the Federal Reserve, the SEC or any of the other agencies that didn't perform as well as they needed to do. The U.S. regulatory system is enormous and powerful, and it generally has adequate, if not perfect, resources. When it comes to regulation, bigger doesn't mean smarter, better or more effective. Indeed, when agencies have too many resources they tend to become unwieldy, not more vigilant or effective.

The problems also did not arise because of "outdated laws from the 1930s" or, except in limited circumstances, from "gaps" in statutory authority in the banking or securities sectors. The fact is that some of the laws enacted in the 1930s in the wake of the Depression, like the Glass-Steagall Act, helped prevent leverage or conflict problems. When they were repealed in order to allow the creation of Citigroup, and to permit other financial firms to expand across traditional legal barriers, we may have gone too far in "modernizing" our system without incorporating adequate alternative limits on conflicts and leverage. Other laws from the 1930s, such as the Securities Act of 1933 and the Securities Exchange Act of 1934, have been regularly updated over the years to maintain their relevance in modern markets.

Many people are today pointing at "gaps" in the regulatory structure, including "systemic risk authority". If the Fed hasn't been worried about systemic risk all these years, then people really should be fired. The problems we have experienced grew in plain sight of all our regulators. For the most part, we lacked adequate leadership at major regulatory agencies, not legal jurisdiction. The banking and securities regulators generally had the tools to address the abusive practices, but just didn't use their powers forcefully enough or ask for new authority promptly when they needed it. Oversight of derivatives and swap markets is probably the major exception where firms like AIG were operating far outside of anyone's oversight authority. That is a good reason to refuse to bail out swap counterparties of AIG in my opinion, but we also ought to put formal oversight into place if we are going to force taxpayers to make good on defaulted swaps.

Part of the problem was an excessive faith by some regulators in enlightened self interest by banks and securities firms, and an underestimation of the risks posed by compensation practices that encouraged unsustainable leverage. Short term profits went home with the CEOs, while long term risks stayed with the shareholders. There also was a too trusting acceptance of "modern" bank internal risk models, which were used to help rationalize dangerous levels of leverage. Some regulators acquiesced to stupid things like global banks running off balance sheet "SIVs" in order to try to boost profits and compensation, even if they involved serious potential liquidity risks. Unfortunately, the risk-adjusted Basle capital rules for banks proved too simplistic and ineffective. To be fair, the SEC at the highest levels could have cracked the whip harder on Bear, Lehman, and Merrill, but didn't do so.

Rather than simply calling for more authority for people who didn't use the authority they already had, we need to reexamine why our regulators missed so many of the risks staring them in the face. My purpose is not to fault regulators who weren't perfect. I also don't want to obscure the fact that the greatest responsibility for the devastation of our economy should rightly fall on the executives of the firms engaging in wildly risky practices, and the boards that failed to provide effective oversight. However, we will never design sensible reforms if we aren't candid in acknowledging the performance failures all across the system. We can't fix things until we have a good handle on what went wrong.

It isn't enough for regulators to write rules and give speeches. More time needs to be spent conducting examinations, analyzing results, discovering problems and, where necessary putting effective limits in place to prevent excessively risky activities. Directors and regulators need backbone, and a willingness to shut down a party that gets out of control. Regulators can't catch all the frauds any more than police can catch all the drug dealers. Nonetheless, when failures happen it shouldn't be acceptable to just ask for more resources without making the necessary corrections first. Regulators need accountability for performance failures just as much as any of us.

While we need to demand better effectiveness from regulators, we must not shift the burden of running regulated businesses in a sound and healthy manner from

management and the boards of directors that are supposed to oversee their performance. Excessive leverage, compensation without correlation to long term performance, misleading (or fraudulent) accounting and disclosure, wildly overstated asset values, failures to perform basic due diligence, wasteful capital expense and other factors contributed to the financial collapses that devastated investors and undermined confidence in the entire economy. These are all issues that boards are supposed to control, but over and over again boards at AIG, Fannie Mae, Lehman Brothers, Bank of America and other companies didn't address them adequately.

In my experience, excessive entrenchment leads many directors to believe they don't need to listen to the shareholders they represent, and who have the most at stake if the board fails to do a good job. The national disaster of self-indulgence in compensation has been opposed by many shareholders, but too many boards feel free to disregard their concerns. It is frankly almost incomprehensible how few directors of firms requiring taxpayer assistance have been forced to step down, even after investors and taxpayers lost billions because directors didn't act prudently. If you allow your CEO to spend $35 billion on an acquisition without meaningful due diligence, for example, you should be replaced as a director without delay. The failure of boards to provide informed and independent oversight badly needs to be addressed both by Congress and the SEC.

Taxpayers may have to protect our banking system, but they don't have to protect the bankers who caused their firms to fail or the directors who let them do it without proper oversight. Executives who gambled with the solvency of their firms and failed should be out of a job, and the same is true for the boards that didn't act as required. That is certainly how we handled the failures of the savings and loans. People who gambled and failed found new lines of work. There are few things today that would go farther to produce prudent behavior in the future than forcing the resignation of CEOs and directors when their firms have to take public funds to keep their doors open. It is long overdue to put accountability and personal responsibility front and center back into the system.

Since we are going to need vast amounts of future savings and investment, the Committee's efforts to help develop answers to the many tough issues affecting our system could not be more important. I will try to address the issues raised by the Committee's thoughtful letter of invitation, as well as several of my suggestions for reform.

A. Investor Protection

With $7 trillion in investor losses, it would appear that we have not done enough in the area of investor protection. This was ironically once one of the preeminent strengths of the U.S. market. Investors from around the world invested in the U.S. because we had stronger and better accounting rules, more timely and detailed disclosure, a commitment to openness in corporate governance and above all enforcement of the rules and liability for those that committed illegal practices. Over time our governance standards have come to be weaker than those of many other countries, and our commitment to accuracy in accounting and disclosure has slipped considerably. The SEC's enforcement program in recent years has not been as effective as the times demanded, with too many smaller cases and not enough focus on the largest problems. We frankly spent too much time worrying about the underwriting fees of Wall Street and not enough time worrying about protecting investors from false and misleading information.

Investors, those quaint people worried about their retirement, need to stop seeing the savings they worked hard to accumulate wiped out because executives took irresponsible gambles. If we care about generating a higher national savings rate, we need to start paying more attention to the interests of individual and institutional investors and spend less time listening to the CEOs of the very banks who created this mess. We shouldn't ever ignore opportunities to reduce unnecessary regulatory costs, but we can't lose sight of the fact that people who lie, cheat and steal from investors belong in jail. We expect the cops on the beat to arrest street criminals, and we should equally expect the financial cops on the beat to use their muscle to protect the investing public.

The record of the SEC in recent years has not been perfect. The Madoff case is a tragic situation that should have been caught sooner, for example. Chairman Schapiro has made a good start to reinvigorating the agency's enforcement programs, and she deserves strong support in beefing up the agency's programs.

The SEC is a critical institution, and Congress should not throw away 75 years of SEC experience by stripping the agency of its responsibilities under the guise of creating a "systemic regulator" or for any other reason. Make no mistake, as great as it is (and the Fed really is a great institution), the Federal Reserve is not equipped to protect investors. Transferring SEC accounting, disclosure or enforce-

ment programs to the Fed would be a recipe for utter disaster. A strong and effective SEC is good for investors, and good for the health of our economy. If the agency stops behaving like a tiger for investors we need to fix it, not abandon it.

There are many things that go into "investor protection". To me, the most critical need is for timely and accurate disclosure of material information regarding the performance of public companies. That means issuers should provide robust disclosure of information, and scrupulously accurate financial statements. Overstating the value of assets is never in investor interests, and if the system doesn't require accurate values to be disclosed investors will simply withdraw from the market due to lack of confidence. There must be serious consequences if you falsify asset values and thereby mislead investors no matter how big your company.

Good disclosure includes marking liquid securities to market prices, whether or not a bank wishes to hide its mistakes. While care is needed in marking positions to models where there isn't a liquid market, in general the people who try to blame mark to market for the problems of insolvent institutions are simply wrong. The problem is that people bought stuff without considering all the risks, including a collapse of demand or liquidity. That isn't the problem of the yardstick for measurement, it is a problem of incompetent business decisions. If I bought a share of stock at $100 and it falls to $50, that dimunition of value is real, and I can't just wish it away. We need accuracy in accounting, not fairy tales.

"Transparency" of results to investors is the touchstone of an efficient market, and a vital protection to make sure that investors can accurately evaluate a company and its condition if the information is there and they are willing to do the work. It should never be allowable to lie or mislead investors, and people who do it should expect to be sued no matter what might happen to them in other countries. In my opinion there can be no "opt-out" of accountability for fraud and deliberate misstatements of material information. This is a bedrock value of our system and has to be defended even if business lobby groups find accurate disclosure inconvenient.

Choice is another core protection for investors. Government shouldn't try to make investment choices for investors, or allocate capital as it might wish. Particularly when it comes to sophisticated pension funds and other institutional investors, they need the right to manage their portfolios as they believe will generate the best returns without artificial limitations. Historically some states have tried to impose "merit" regulation in which bureaucrats made investment choices for even the most sophisticated investors. Investment choice is a vital right of investors, subject of course to basic suitability standards, even though we know that investors will sometimes lose.

Healthy corporate governance practices are also vital to investors. This means accountability for performance, enforcement of fiduciary duties, maintaining checks and balances, creating sensible and proportionate incentives and many other things. One area of weakness today is excessive entrenchment of boards, and the consequent weakening of accountability for boards that fail to create value. Better corporate governance will over time lead to a stronger companies, and more sustainable earnings growth and wealth creation.

B. Systemic Risk and Supervision of Market Participants

There appears to be momentum in Washington for creating a "systemic risk" regulator, whether the Federal Reserve or some other agency. To me, this is a bad idea, and one that will weaken the overall supervisory system as well as damaging Congressional oversight.

There is no single person, and no single agency, that can be omniscient about risk. Risk crops up in limitless forms, and in the most unexpected ways. Risk is as varied as life itself. To me, our system is stronger if every agency is responsible for watching for, and acting to control, systemic risk in its own area of expertise. It needs to be every regulator's responsibility to control risks when they are small, before they get big enough to have "systemic" implications.

Our current system involves multiple federal and state decisionmakers, and multiple points of view. Like democracy itself, the system is a bit messy and at times leads to unproductive debate or disagreement, particularly among the three different bank regulators. However, Congress and the public have the benefit of hearing the different points of view from the Fed, the Treasury, the FDIC or the SEC, for example. This allows informed debate, and produces better decisions than would be the case if those different points of view were concealed from view within a single agency expressing only one "official" opinion.

The alternative in some countries is a single regulator. Japan's Ministry of Finance, for example, traditionally brought banking, securities and insurance regulation under one roof. However, Japan still has had as many problems as other mar-

kets. Making agencies bigger often makes them less flexible, and more prone to complacency and mistakes. This can create inefficiency. More importantly, it can create systemic risk because if the regulatory "czar" proves wrong, every part of the system will be vulnerable to damage. Some regulators prove more effective than others, so a system with only one pair of eyes watching for risk is weaker than a system in which lots of people are watching. What counts is that somebody rings an alarm when problems are small enough to fix, not who pushes the button.

Of course risk often comes about not just by the activity itself, but how it is conducted. Ultimately any economic activity can be conducted in a manner that creates risk, and hence there can be "systemic" risk anywhere. It won't work to try to assign planning for every potential risk in the economy to a single agency unless we want a centrally planned economy like the old Soviet Union. This is an area where interagency cooperation is the better solution, as it doesn't create the enormous new risks of concentration of power and the dangers of a single agency being asleep or flat out wrong as would a "systemic risk" supervisor.

Supervision of market participants is best left in the hands of agencies that have the most experience with the particular type of activity, just as doctors and dentists need to be overseen by people who understand the practice of medicine or dentistry. It is particularly hard for me to see a case that any single group of regulators did such a good job that they deserve becoming the Uber Regulator of the country. The bank regulators missed massive problems at Wachovia, WaMu, Citicorp and other institutions. Insurance regulators missed the problems at AIG. The SEC missed some of the problems at Bear, Lehman and Merrill. There have been enough mistakes to go around, and I don't see evidence that putting all supervision under a monopoly agency will improve insight or judgment. Unfortunately, the reverse effect is more likely.

C. Common Supervisory Rules

During my time as SEC Chairman, I was pressured (mostly by foreign regulators) to agree to a new "global" capital rule that would have reduced the SEC's limits on leverage for the major U.S. securities firms by as much as 90 percent. The proposed new "global" capital rule on market risks represented a good theoretical endeavor, but it was too simplistic and unreliable in practice. It would have allowed firms that were long railroad stocks and short airline stocks to carry zero capital against those positions, even though they were not a true hedge.

The "netting" arrangements in the proposed global rule weren't economically realistic, and as a result the rule itself was largely a rationalization for allowing firms to lever themselves to a much greater degree than the SEC allowed at that time. In addition, the rule didn't distinguish at all between securities firms that were marking securities portfolios to market, and banks that were using cost accounting, which meant that the capital required would vary dramatically from firm to firm for identical portfolio positions. The SEC staff and I believed that this new standard would have undercut the stability and solvency of the major U.S. securities firms. We didn't object to banking authorities adopting whatever standards they thought were appropriate, but we weren't willing to be stampeded into adopting something that we didn't believe would work.

At the time, much of the force for pushing through a new rule came from the Basle banking committee, who wanted to be seen to be doing something relevant to market risk even if the proposed rule had problems. It was my rather contrarian view then, and remains so today, that adopting a "global" rule that is ineffective is worse than no global rule at all. This is because if all the world's major markets adopt the same rule and it fails, then financial contagion can spread throughout the world, not just one country.

Global harmonization of standards creates some economic benefits by making operations in multiple countries more convenient and less complicated for global banks. These benefits must however be weighed against the risks that a "one size fits all" global rule may not work well in many individual markets because of differences in volatility, market size, the nature of the investor base or other economically relevant factors. Countries where the local regulator goes beyond the "global" norms to impose tougher standards on local banks, as the Bank of Spain did with reserves for derivatives and certain types of loans in the past few years, are better protected than those that have only a "global" standard that was worked out in international horse trading.

When we back tested this proposed new lower capital standard against historic trading data from the 1987 Crash, the SEC staff found that the theoretical asset correlations didn't always work. As a result, firms that had followed the proposed rule would have failed (unlike the actual experience, where major firms did not fail

because the SEC capital standards gave enough buffer for losses to prevent failures) when the market came under unexpected and extreme stress.

My colleagues and I simply said "No" and kept our capital standards high in that case because we didn't believe the proposed new standard was ready for use. Here my fellow Commissioners and I believed in the KISS principle. It is a certainty that over time markets will encounter problems of liquidity or valuation that nobody anticipated. If you have enough capital and are conservatively financed, you will survive and won't risk massive loss to your investors, clients or taxpayers.

This experience illustrates to me the very real risks that will be created by a "systemic" regulator if we try to do that, as well as from further "globalization" of regulation that makes the job of writing rules targeted narrowly to control specific risks more cumbersome. Active coordination across agencies and borders is vital to make sure that information and perspectives on risk are effectively communicated. Colleges of regulators work, and add real value.

However, going beyond that to impose uniformity, especially on something like "systemic risk" that isn't even defined, quite possibly will end up making regulation more costly, less flexible and potentially weaker rather than stronger. An agency will adopt rules that sound great, but just may not work for one of a million reasons. That is a particular danger if the "systemic" regulator is free to overrule other agencies with more specific knowledge. The first thing a czar of "systemic risk" is likely to do is to create new systemic risk because whatever that agency chooses to look at may take on immediate "too big to fail" perceptions, and the moral hazards that go with that status. My preference would be to have a unified or lead banking supervisory agency, and active dialogue and discussion among agencies rather than putting the entire economy in one agency's straightjacket.

There will inevitably also be risks to the independence of the Fed if it performs a systemic regulator's role, because you cannot allow an agency to impose needless costs on the entire economy without political accountability. When they fail to do anything about the next subprime issue, inevitably the Fed's stature will be tarnished. To me, we would lose a great deal from distracting the Fed's focus from monetary policy and stability of prices to have them traipsing around the country trying to figure out what risks GE or IBM pose to the economy.

D. Reorganization of Failed Firms

As SEC Chairman, I handled the 1990 closure and bankruptcy filing of Drexel Burnham Lambert, then one of the largest U.S. securities firms. We were able to prevent any losses to Drexel customers without cost to the taxpayers in our closure of Drexel. We froze and then sold the firm's regulated broker dealer, transferring customer funds and accounts to a new owner without loss. Having protected the regulated entity and its customers, we refused to provide assistance to the holding company parent that had a large "unregulated" portfolio of junk bonds financed by sophisticated investors (including several foreign central banks that were doing gold repos with Drexel's holding company parent).

Though there were those who wanted us to bail Drexel out, we forced the holding company into Chapter 11 instead, and let the courts sort out the claims. A similar approach would work today for AIG and its unregulated derivative products unit, which could be left to sort out its claims from swaps customers in bankruptcy without taxpayer financing. This approach of stopping the safety net at regulated subsidiaries can be very helpful in unwinding failed firms where there are both regulated and unregulated entities at less cost and less damage to market disciplines than excessively broad bailouts.

E. Risk Management

Risk management is an important responsibility of every firm, and every regulator. However, a dangerous by-product of belief that we can manage risk in a very sophisticated manner is a willingness to tolerate higher levels of risk. After all, as long as risk is being "managed" it ought to be ok to have more of it. Ultimately unanticipated problems arise that cause even highly sophisticated models to fail to predict real life accurately.

Every risk management system, and every risk adjusted capital rule, needs a minimum standard that is simple and comprehensive. Tangible capital as a percentage of total assets is a more comprehensive, and more reliable, measure of capital than the highly engineered "Tier One" Basle capital standards. I believe Congress should seriously study mandating that U.S. banking regulators establish a minimum percentage of tangible capital to total assets even if international capital rules might allow a lower number. Creating a "solvency floor" would have prevented at least some of the failures we have experienced.

F. Credit Rating Problems

The credit rating agencies failed in evaluating the risk of "structured products". In part this reflects inherent conflicts of interest in the "for profit" structure of the rating agencies and their reliance on fees from people seeking ratings in order to generate their own earnings growth. Unfortunately a "AAA" rating acts as an effective laughing gas that leads many investors to avoid necessary due diligence or healthy levels of skepticism. If the structured mortgage instruments that devastated the economies of the western world had been rated BBB, or even A-, a great many of the people (including boards and regulators) who got clobbered would have looked more carefully at the risks, and bought less. There is a serious issue of conflict of interest in getting paid to legitimize the risk in a highly complex "structured" product laced with derivatives.

G. Levered Short Selling

Short selling doesn't have the same benefit to the public as normal long investing. While short selling creates liquidity and shouldn't be prohibited, it doesn't have to be favored by regulators either. In my opinion the SEC should never have eliminated the uptick rule, which inhibits to some degree the ability of short sellers to step on the market's neck when it is down. Beyond that, I believe that regulators should seriously consider imposing margin requirements as high as 100 percent on short positions. Leveraging short positions simply creates extreme downward pressure on markets, and may seriously impair market stability.

H. Credit Default Swaps

The CDS market is large, but it lacks transparency. It may also involve unhealthy incentives to buy securities without adequate capital or study on the false presumption that you can always buy "protection" against default later. We don't appear to have enough capital for our primary financial institutions such as banks, insurance companies and brokerage firms, and there surely isn't enough capital available to "insure" every risk in the markets. But if the risks aren't really insured, then what are the swaps?

Another thing that is troubling is the ability to use the CDS market for highly levered speculative bets that may create incentives to manipulate other markets. I can't buy fire insurance on my neighbor's house due to obvious concerns about not inciting arson. Yet hedge funds that didn't own any Lehman debt were free to hold default swap positions which would prove highly profitable if Lehman failed, and also to engage in heavy short selling in Lehman shares. I am concerned about allowing that much temptation in an unregulated and very opaque market, especially if taxpayers are supposed to underwrite it (although I can't comprehend that either).

This is a market that certainly would benefit from greater oversight and transparency, particularly as to counterparty risk. It would be worthwhile for an interagency group to consider appropriate limits on issuance or reliance on credit default swaps by regulated firms within the "official" safety net. There are huge and very murky risks in this market, and it might be prudent to consider limiting the dependence of regulated firms on this opaque corner of the markets.

I. Regulatory Reform

Immediately prior to my service as SEC Chairman, I served as Assistant to the President in the White House under President George H.W. Bush where I helped lead the Administration's highly successful 1989 program to deal with the +$1 Trillion savings and loan crisis. This program was embodied in legislation called FIRREA that was passed by Congress in the summer of 1989. As some of you will remember, the savings and loan crisis, like our current crisis, had grown for years without effective government intervention to defuse the mortgage bomb of that era. Among other things, we created the Resolution Trust Corporation to take hundreds of billions in toxic mortgage assets out of bankrupt institutions, repackage them into larger and more coherent blocks of assets, and sell them back into private ownership as quickly as possible.

We designed our intervention in the banking system to operate swiftly, and to recycle bad assets as quickly as possible rather than trying to hold assets hoping they would ultimately go up in value. Generally, troubled assets go down, not up, in value while under government ownership. Believing that the ice cube is always melting, we designed our intervention for speed. We also didn't believe that any zombie banks should be allowed to linger on government life support competing with healthier firms that had not bankrupted themselves. We didn't give bailouts to anyone, but we did provide fast funerals.

One thing President Bush (41) was adamant about was that the taxpayers should never have had to divert hundreds of billions of dollars in tax revenues to paying

for the mistakes and greed of bankers. I quite vividly remember his unambiguous instructions to me to design regulatory reforms to go along with the financial intervention so that "as much as humanly possible we make sure this doesn't happen again." As part of that mandate, we imposed strict capital and accounting standards on the S&Ls, merged the FSLIC into the FDIC and beefed up its funding, established important new criminal laws (and the funding to enforce them), and abolished the former regulatory body, the Federal Home Loan Bank Board, which had failed in its supervisory responsibilities.

Hopefully the Treasury's newly announced Public–Private Program for purchasing distressed bank assets will work as well as the RTC ultimately did. The principles of using private sector funding and workout expertise are similar, and this is an encouraging attempt to help unlock the current system. Hopefully we will also eventually look to marrying taxpayer TARP money with greater accountability and more effective oversight as we did then.

II. Specific Reforms

In response to the Committee's request, set forth below are several specific changes in law that I believe would improve the current system of investor protection and regulation of securities markets.

1. Merge the SEC, CFTC, and PCAOB into a single agency that oversees trading in securities, futures, commodities and hybrid instruments. That agency should also set disclosure standards for issuers and the related accounting and audit standards. Most importantly, this agency would be primarily focused on enforcing applicable legal standards as the SEC has historically done. These closely intertwined functions have nothing to do with bank regulation, but a great deal to do with each other. I do not suggest a merger out of any lack of respect for each of the three agencies. However, a merger would help eliminate overlap and duplication that wastes public resources, and also reduces effectiveness. If a similar consolidation occurred of the bank supervisory programs of the Fed, the Treasury and the FDIC, then we would have a strong agency regulating banks, and another strong agency regulating public companies, auditors, and trading markets.

2. Allow the five (or ten) largest shareholders of any public company who have owned shares for more than 1 year to nominate up to three directors for inclusion on any public company's proxy statement. Overly entrenched boards have widely failed to protect shareholder interests for the simple reason that they sometimes think more about their own tenure than the interests of the people they are supposed to be protecting.

This provision would give "proxy access" to shareholder candidates without the cost and distraction of hostile proxy contests. At the same time, any such nomination would require support from a majority of shares held by the largest holders, thereby protecting against narrow special interest campaigns. This reform would make it easier for the largest shareowners to get boards to deal with excessive risks, poor performance, excessive compensation and other issues that impair shareholder interests.

3. Reverse or suspend the SEC decision to abandon U.S. accounting standards and to adopt so-called "International Financial Reporting Standards" for publicly traded firms headquartered in the U.S. At a time of the greatest investor losses in history and enormous economic stress, forcing every company to undergo an expensive transition to a new set of accounting standards that are generally less transparent than existing U.S. standards is not in investor's interests. This will avoid considerable unproductive effort at a time businesses need to minimize costs and focus on economic growth, not accounting changes. Investors need more transparency, not less, and the SEC should not abdicate its role of deciding on appropriate accounting and auditing standards for firms publicly traded in the U.S.

4. Broaden the ability of shareowners to put nonbinding resolutions on any topic related to a company's business on its annual proxy statement, including any proposal by shareholders relating to the manner of voting on directors, charter amendments and other issues. Legislation would clarify the confusing law relating to the ability of shareholders to hold a referendum on whether a company should adopt majority voting for directors, for example. Shareholders own the company, and in the internet age there is no reason to limit what shareholders can discuss, or how they may choose to conduct elections for directors. SEC resources should no longer be devoted to arbitrating whether shareholders should be allowed to vote on resolutions germane to a company's business.

5. Prohibit "golden parachute" payments to the CEO or other senior officers of any public company, in the same way that Sarbanes Oxley prohibits loans to such executives. Golden parachutes have proven to be extraordinarily abusive to shareholders, and boards have proven themselves unable to control excessive payouts. Eliminating

supercharged severance will not unduly prejudice any company's ability to recruit since no company will be able to offer or make abusive awards to failed executives. This provision would NOT prohibit signing bonuses or annual bonuses, as it would solely apply to payouts to executives who are departing rather than continuing to work. The fact is that paying failed executives to walk out the door after damaging or destroying their company is wrong, and it is part of the culture of disregard of shareholder interests that needs to change.

6. Split the roles of Chairman of the Board and CEO in any company that receives federal taxpayer funds, or that operates under federal financial regulation. The traditional model of a Chairman and CEO combined in one individual weakens checks and balances and increases risks to shareholders compared with firms that separate those positions. Splitting these roles and requiring a prior shareholder vote to reintegrate them would reduce risks and improve investor protection.

7. Eliminate broker votes for directors unless any such vote is at the specific direction of a client. Brokers should not cast votes on an uninstructed basis to avoid unwarranted entrenchment of incumbents or tipping the outcome of elections under federal proxy rules. Indeed, it may be time to consider a broader Shareholder Voting Rights Act to address many barriers to effective shareholder exercise of the vote.

8. Establish a special "systemic bankruptcy" court composed of federal District or Circuit Court judges with prior experience in large bankruptcy or receivership cases similar to the Foreign Intelligence Surveillance Court. This new Systemic Court would handle the largest and systemically important bankruptcies with enhanced powers for extraordinary speed and restructuring powers. Use of such a Systemic Court would help limit *ad hoc* decisions by administrative agencies including the Fed or Treasury in handling large financial institution failures and treatment of different types of classes of securities from company to company.

Utilizing a court with enhanced and expedited reorganization powers would allow reorganization or conservatorship proceedings rather than nationalization, and would facilitate the ability to break up and reorganize the largest failed firms under highly expedited Court supervision. Fed and Treasury officials would be able to focus on liquidity assistance under the aegis of the Systemic Court, which would allow enhanced priorities for taxpayer funds and control of compensation and other nonessential expenses. The Systemic Court should be authorized to appoint a corporate monitor in any case pending before it to control compensation expense or other issues.

9. Establish effective and meaningful limitations on leverage in purchases of securities and derivative instruments where any person or entity is borrowing from a federally supervised bank or securities firm, or where such firms are establishing positions for their own account.

10. Establish a permanent insurance program or liquidity facility for money market funds. Given recent experience, the uninsured nature of MMFs is an uncomfortably large risk to market stability.

11. Establish strict liability for any rating agency if it awards a AAA or comparable other top rating grade to a security of a nonsovereign issuer that defaults within 3 years of issuance. While I would not create private rights of action for any other rating decisions, rating agencies should appreciate that awarding a AAA overrides many investor's normal diligence processes, such that liability is warranted if the agency proves to be wrong. The SEC should generally revoke commercial ratings as an element of its disclosure or other regulations.

12. Eliminate the deductibility of mortgage interest and replace it with deductibility of mortgage principal payments with appropriate overall limits. This would create incentives for paying off family debt, not perpetuating the maximum possible level of mortgage debt. At the same time, such a provision would result in significant new liquidity for banks as borrowers repaid performing mortgage loans. Middle class families would see real wealth increase if deductibility allows the effective duration of home mortgage loans to be reduced from 30 years to 15 years, for example, saving an average family hundreds of thousands of dollars in interest. Federal assistance would help families reduce the level of their debt, thereby strengthening the economy and boosting savings.

Thank you for your consideration of these views and ideas.

PREPARED STATEMENT OF ARTHUR LEVITT

FORMER CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION

MARCH 26, 2009

Thank you, Chairman Dodd and Ranking Member Shelby, for the opportunity to appear before the Committee at this critical moment facing our markets, our economy, and our Nation.

When I last appeared before this Committee, I focused my remarks on the main causes of the crisis we are in, and the significant role played by deregulation. Today, I would like to build upon that testimony and focus your attention on the prime victim of deregulation—investors. Because of failures at every level of our financial system, investors no longer feel that they receive correct information or enjoy meaningful protections. Their confidence in fair, open, and efficient markets has been badly damaged. And not surprisingly, our markets have suffered from this lack of investor confidence.

Above all the issues you now face, whether it is public anger µoverµbonus payments or the excesses of companies receiving taxpayer assistance, there is none more important than investor confidence. The public may demand that you act over some momentary scandal, but you must not give in to bouts of populist activism. Your goal is to serve the public not by reacting to public anger, but by focusing on a system of regulation which treats all market actors the same under the law, without regard to their position or status.

In coming months, you will adopt specific regulatory and policy solutions to the problems we face, yet none of that work will matter much unless we find a way to restore investor confidence. If at the end of the process you don't place investor confidence at the heart of your efforts, no system of regulation and no amount of spending on regulatory agencies can be expected to succeed.

Core Principles

You are focusing now on the issue of systemic risk, and therefore whatever response you take must be systemic as well. Specifically, some have suggested that we should re-impose Glass-Steagall rules regarding the activities and regulation of banks. Those rules kept the Nation's commercial banks away from the kinds of risky activities of investment banks. But by 1999, the law no longer had the same teeth—multiple workarounds had developed, and it no longer was practical to keep it in place. Perhaps we were too hasty in doing away with it, and should have held onto several key principles that made Glass-Steagall an effective bulwark against systemic risk in America's banking sector. That does not mean we should pursue "turn-back-the-clock" regulation reforms and re-impose Glass-Steagall. The world of finance has changed greatly since 1999 and we have to change with it. But we can borrow some important principles from Glass-Steagall, apply them to today's environment, as we address the serious weaknesses of our current system of financial regulation.

Those principles, in short, are:

Regulation needs to match the market action. If an entity is engaged in trading securities, it should be regulated as a securities firm. If an entity takes deposits and holds loans to maturity, it should be regulated as a depository bank. Moreover, regulation and regulatory agencies must be suited to the markets they seek to oversee. Regulation is not one size fits all.

Accounting standards serve a critical purpose by making information accessible and comprehensible in a consistent way. I understand that the mere mention of accounting can make the mind wander, but accounting is the foundation of our financial system. Under no circumstances should accounting standards be changed to suit the momentary needs of market participants. That principle supports mark-to-market accounting, which should not be suspended under any condition.

The proper role of a securities regulator is to be the guardian of capital markets. There is an inherent tension at times between securities regulators and banking supervisors. That tension is to be expected and even desired. But under no circumstance should the securities regulator be subsumed—if your goal is to restore investor confidence, you must embolden those who protect capital markets from abuse. You must fund them appropriately, give them the legal tools they need to protect investors, and, most of all, hold them accountable, so that they enforce the laws you write.

And finally, all regulatory reforms and improvements must be done in a coordinated and systemic way. The work of regulation is rarely done well in a piecemeal

fashion. Rather, your focus should be to create a system of rules that comprise a complete approach, where each part complements the other, and to do it all at once.

Specific Reforms

Allow me to illustrate how these principles can be put to work, in specific regulatory and policy reforms:

First: Some have suggested that you create a single super-regulator. I would suggest that a more diverse approach should be adopted, taking advantage of the relative strengths of our existing regulatory agencies. For example, the Federal Reserve, as a banking supervisor, has a deep and ingrained culture that is oriented towards the safety and soundness of our banking system. But when banks—or any financial institution—engage in securities transactions, either by making a market in securities, or by securitizing and selling loans, or by creating derivatives backed by equities or debt, they fundamentally require oversight from trained securities regulators.

What serves the health of banks may run exactly counter to the interests of investors—and we have seen situations where bank regulators have kept information about poorly performing assets from the public in order to give a bank time enough to dispose of them. In that case, banking regulators will work at cross-purposes with securities regulators.

Ultimately, the only solution to that tension is to live with it. When I was at the SEC, there was tension between banking regulators and securities regulators all the time. This creative tension served the ultimate goal of reducing overall risk to our economy, even if it occasionally was frustrating for the regulators and the financial institutions themselves. And so we should not be surprised if regulatory reforms yield a bit of regulatory overlap. That is both natural, considering the complexity of financial institutions, and even desirable.

Second: Mark to market or fair value standards should not be suspended under any circumstance. Some have come forward and suggested that these are unusual times, and we need to make concessions in our accounting standards to help us through it. But if we obscure investor understanding of the value of assets currently held by banking institutions, we would exacerbate the crisis, and hurt investors in the bargain. Unfortunately, recent steps taken by the FASB, at the behest of some politicians, weaken fair value accounting.

Those who argue for a suspension of mark-to-market accounting argue this would punish risk-taking. I strongly disagree. Our goal should be to make sure risk can be priced accurately.

Failure to account for risk, and failure to present it in a consistent way, makes it impossible to price it, and therefore to manage it. And so any effort that seeks to shield investors from understanding risk profiles of individual banks would, I believe, be a mistake, and contribute to greater systemic risk.

I would add that mark-to-market accounting has important value for internal management of risk within a firm. Mark-to-market informs investment bank senior managers of trading performance, asset prices, and risk factor volatilities. It supports profit and loss processes and hedge performance analyses, facilitates the generation and validation of risk metrics, and enables a controlled environment for risk-taking. If treated seriously by management, mark-to-market is a force for internal discipline and risk management, not much different than a focus on internal controls. Yes, valuing illiquid or complex structured products is difficult. But that doesn't mean the work should not be done. I would argue that it has to be done, both inside the firm and by those outside it, to reduce risk throughout our system.

And so I agree with the Chairman of the Federal Reserve, and the heads of the major accounting firms, that the maintenance of mark-to-market standards is essential.

Third: As this Committee and other policymakers seek to mitigate systemic risk, I would suggest taking a broad approach to the challenge. It would be a mistake, I believe, to designate only one agency to focus on systemic risk, because systemic risk emanates in multiple ways. You may find the task best accomplished by enacting a series of complementary regulatory enhancements aimed at promoting transparency and information discovery across multiple markets.

Those remaining pockets of financial activity covered by self-regulation and protected from litigation should be brought in under a more vigorous regulatory structure with fully independent regulators and legal remedies. For years, credit ratings agencies have been able to use legal defenses to keep from the SEC from inspecting the way they do their ratings the way the PCAOB is empowered to examine the way audits are done, even though these agencies dispense investment advice and sit at a critical nexus of financial information and potential risk. In addition, these ratings agencies cannot be fined by the SEC and they operate with significant pro-

tections from private rights of action. These protections from regulatory review and legal remedies need to be reconsidered. The credit ratings agencies have an abysmal record of performance in recent years and their failure has had an outsized impact on the health of our entire financial system. They are not merely expressing views that would ordinarily receive legal protections. They are playing a much larger role, and their activities should be treated in the same way as other market actors who are subject to SEC review and regulation.

In the same manner, the SEC should have a far greater role in regulating the municipal bond market, which consists of state and local government securities. This is the market where Wall Street and Main Street collide. Since the New York City crisis of 1975, this market has grown to a size and complexity that few anticipated.

It now includes not-for-profit institutions and even for-profit business corporations who sell securities through government conduit entities. The debt and derivative products sold are substantially the same as those sold in the corporate market. Small investors make up a substantial part of this market and because of the Tower Amendment many participants—insurers, rating agencies, financial advisors to issuers, underwriters, hedge funds, money managers and even some issuers—have abused the protection granted by Congress from SEC regulation.

This market has shown that self-regulation by bankers and brokers through the Municipal Services Rulemaking Board all too often has come at the expense of the public interest. The New York City debacle in 1975, the San Diego pension fund fraud in 2006, the Orange County California derivatives crisis in 1994, the Washington Public Power System defaults in 1980, the auction securities settlements of 2008, and the current investigations into derivatives, bid rigging, pay to play and other scandals—this is an industry prone to scandal.

In recent months, we have even seen several well-documented scandals where small municipalities and public agencies were encouraged to float bonds even though the money was not to be spent on public purposes, but rather used as an investment pool. We may not want to treat municipals like we do other securities—but we do need to level the playing field between the corporate and municipal markets and address all risks to the financial system. Municipal issuers are ill-equipped and some are reluctant to do this on their own. We may have to develop ways protect small municipal issuers from over regulation just as we do for small corporations, so long as we do not develop a double standard for principles of disclosure, transparency, finance and compliance with market rules. Former Chairman Cox has suggested granting the SEC authority to regulate the municipal bond industry to promote integrity, competition and efficiency, and I agree.

In addition, I would also recommend amending the Investment Advisers Act to give the SEC the right to oversee specific areas of the hedge fund industry and other pockets of what some have called the "shadow markets"—those areas of finance beyond the oversight of regulators. In particular, I would urge that you require banks and hedge funds create an audit trail and clearinghouse for all trades, to create a better awareness of investment products that could pose risks to overall markets. I would also recommend placing hedge funds under SEC regulation in the context of their role as money managers and investment advisors.

There will be some who argue that SEC oversight of some aspects of hedge funds will come at the expense of financial market innovation. In fact, such regulation could help improve the environment for financial innovation. For example, we know that new investment vehicles can be a source for risk even as they supply investors with a desired financial product. How do we balance those competing qualities? Perhaps the SEC could increase the margin requirement for the purchase of new products, until those products are road-tested and have developed a strong history of performance in different economic conditions.

Nor are all forms of regulation going to simply involve more disclosure requirements. I could see a greater focus on better disclosure, so that investors and regulators receive information that has more value. For example, a system that allows financial institutions to make their own risk assessments, or relies on credit rating agencies for purposes of determining how much capital they should have, lacks adequate independence and credibility. At the same time, adopting a one size fits all approach is likely to be shortsighted and ineffective.

As SEC Chairman, I favored risk-based principles for regulation, and think greater application of those principles is needed. Such a system should be forward-looking, independent and free of bias in its assessment of risks and liquidity needs within an entity, overseen by a regulator with a mission, culture and necessary resources to do the job, and finally, be fully transparent not only to regulators but also to investors, taxpayers and Congress. Such a system would be far more useful

than our current system. And it would contribute greatly to our awareness of potential sources of systemic risk.

These steps would require OTC derivative market reform, the outcome of which would be the regulation by the SEC of all credit and securities derivatives. To make this regulation possible and efficient, it would make sense to combine the resources and responsibilities of the SEC and CFTC. In today's financial markets, the kinds of financial instruments regulated by these two agencies share much in common as economic substitutes, and this change would allow regulators to share their skillsets, coordinate their activities, and share more information, thus providing a deeper level of understanding about risk.

Supporting all these activities will require an appropriately funded, staffed and empowered SEC. Under the previous administration, SEC funding and staffing either stayed flat or dropped in significant areas—enforcement staff dropped 11 percent from 2005 to 2008, for example. We have seen that regulators are often overmatched, both in staffing and in their capacity to use and deploy technology, and they can't even meet even a modest calendar of regular inspections of securities firms. Clearly, if we are to empower the SEC to oversee the activities of municipal bond firms and hedge funds, we will need to create not only a stronger agency, but one which has an adequate and dedicated revenue stream, just as the Federal Reserve does.

My final recommendation relates to something you must not do. Under no condition should the SEC lose any of its current regulatory responsibilities. As the primary guardian of capital markets, the SEC is considered the leading investor representative and advocate. Any regulatory change you make that reduces the responsibility or authority of the SEC will be viewed as a reduction in investor protections. That view will be correct, because no agency has the culture, institutional knowledge, staff, and mission as the SEC to protect investors.

Conclusion

These actions would affirm the core principles which served the Nation's financial markets so well, from 1933 to 1999—regulation meeting the realities of the market, accounting standards upheld and strengthened, regulators charged with serving as the guardians of capital markets, and a systemic approach to regulation. The resulting regulatory structure would be flexible enough to meet the needs of today's market, and would create a far more effective screen for potential systemic risks throughout the marketplace. Financial innovations would continue to be developed, but under a more watchful eye from regulators, who would be able to track their growth and follow potential exposure. Whole swaths of the shadow markets would be exposed to the sunlight of oversight, without compromising the freedom investors have in choosing their financial managers and the risks they are willing to bear.

Most importantly, these measures would help restore investor confidence by putting in place a strong regulatory structure, enforcing rules equally and consistently, and making sure those rules serve to protect investors from fraud, misinformation, and outright abuse.

These outcomes won't come without a price to those who think only of their own self-interest. As we have seen in the debate over mark-to-market accounting rules, there will be strong critics of strong, consistent regulatory structure. The self-interested have reasons of their own to void mark-to-market accounting, but that does not make them good reasons for all of us. Someone must be the guardian of the capital market structure, and someone must think of the greater good. That is why this Committee must draw on its heritage of setting aside partisanship and the concerns of those with single interests, and maintain a common front to favor the rights of the investor, whose confidence will determine the health of our markets, our economy, and ultimately, our Nation.

PREPARED STATEMENT OF PAUL S. ATKINS

FORMER COMMISSIONER,
SECURITIES AND EXCHANGE COMMISSION

MARCH 26, 2009

Thank you very much, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for inviting me to appear today at your hearing. It is an honor and privilege for me to provide information for your deliberations on possible legislation regarding the U.S. financial markets. This Committee has a long history of careful

study and analysis of matters relating to the financial markets and the financial services industry.

There are multiple, complex, and interrelated causes to the current situation in the global financial markets. These causes have been decades in the making. Those who would tell you otherwise are simply misguided, have ulterior motives, or are unaware of the intricacies of global finance. These causes are more than the competence or incompetence of individuals in particular roles, but have more to do with fundamental principles of organizational behavior and incentives.

Your topic for today is rather broad, so I would like to touch on a few specific items that go to the heart of an agency that I know very well—the Securities and Exchange Commission. I have been working in and around the SEC for all of my professional career. I have spent almost 10 years as a staff member and as a Commissioner. In 15 years of private practice I have applied the Commission's regulations in transactions and in real business situations. In the course of my work, I have interacted with every one of the SEC's divisions and offices in one way or another.

With respect to the subject of regulatory reform, I would suggest that you ask very hard questions in subsequent hearings: For example, why has the SEC in the course of the past dozen years or so experienced catastrophic failures in every one of its four core competencies—rulemaking, filing review, enforcement, and examinations? What led to failures at the SEC and other regulatory agencies—both in the United States and globally—to discern the increasing risk to financial institutions under their jurisdiction? What led to failures at financial institutions to recognise the inadequacy of their own risk management systems and strategy in time to avert a collapse? How did many investors get lulled into complacency and not adequately do their own due diligence? What is the proper role of credit rating agencies, and has regulation fostered an oligopoly by recognizing the opinions of a few as being more privileged than the rest?

Your challenge in formulating laws and regulations is that every action leads to a reaction, just as in physics. Just as investors should know that there is no riskless or easy way to make money, policymakers should know that there is no riskless or easy way to oversee the financial markets. I respectfully submit that changes to the securities laws should be made carefully and with the knowledge that modern financial services is a quickly evolving industry. Sooner or later the markets will stabilize, depending on what actions governments take. The goal should be a balance, using the facts as they best can be discerned, through a robust analysis of the costs and benefits of various potential actions and how those actions might affect human behavior. The current situation is certainly no time to "wing it" or act on "gut" instinct. The weighing of costs and benefits is vital, because investors ultimately pay for regulation. If regulations impose costs without commensurate benefits, investors suffer the costs of lack of effectiveness and efficiency, not only through higher prices but also through constrained investment opportunities. That ultimately hurts them in their investment performance, because it means less opportunity for diversification.

Why should we care about the capital markets? Despite all of the recent gloomy and tragic news of the past couple of years, we must not forget that one of the most important underlying purposes of our capital markets is to allow entrepreneurs with great new ideas to make their dreams possible by raising capital, thereby helping the economy grow by creating jobs, improving the lives of consumers through producing innovative products, and providing a return to investors who have risked their savings to help finance that entrepreneur's dream. This is the role—and genius—of the United States capital markets that has helped our economy to be the engine of the world's growth and made our standard of living the best in the world.

Notwithstanding the current economic conditions, I feel confident that the role of the United States capital markets will return to what it was, barring ill-advised legislation or regulatory actions. An example of legislation that had a detrimental effect on the attractiveness of U.S. markets was the so-called Interest Equalization Tax, a short-lived tax imposed in 1963 on borrowing by U.S. and foreign companies in the U.S. The goal was to encourage capital to stay in this country and to equalize the costs between selling debt and equity securities. It essentially backfired when U.S. companies found that they could issue dollar-denominated debt in London, avoiding the tax and increasing yields. The London markets, which had yet to fully recover after World War II, experienced a boom in size and credibility that eventually led them to eclipse the U.S. in some benchmarks by 2007.

We should not forget that just prior to the recent problems in the credit markets, which began more or less in June 2007 when a small fund was closed to redemptions, setting off a world-wide reassessment of the creditworthiness of U.S. housing-related debt securities, public offerings of securities in the United States were on

the decline, compared to offerings in the private markets. In fact, in 2006, the value of Rule 144A unregistered offerings in the U.S. for the first time exceeded the value of public offerings.

All of this is to suggest that Congress be especially deliberative and pragmatic in legislating in this area. The worrisome thing to me is that if care is not taken to have solid analysis, the wrong lessons may be gleaned from this latest crisis that hurt investors. It takes a long time to change legislation in this area. We still have not dug ourselves out of some of the mistakes and false premises that drove the decision making during the 1930s and 1940s. For example, it took 40 years for Congress and the SEC to end fixed commissions for brokerage services that were essentially imposed by law in the 1930s, and we still have many aspects of the so-called "managed competition" philosophy that led to that policy. We still have the alphabet soup of regulators and self-regulatory organizations in the financial services industry, with all of the distortions and inefficiencies that have contributed to the current crisis and become so painfully evident to the world. Many have complained about this situation for years, but others have opposed any restructuring as "dangerously deregulatory," and ignored the inherent systemic risks, overlapping jurisdiction, turf wars, and wasted resources of the current structure.

In the wake of the stock market crash of 1929, over the next decade this Committee and others held many hearings and explored the abuses in the marketplace including conflicts of interest, shady transactions with affiliates, less-than-adequate disclosure, and squirrelly valuations. Congress responded by passing the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 ("PUHCA"), the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, among other laws.

Many provisions of these laws were helpful to the market and to investors and stood the test of time. But, as time passed, it became clear that some laws were counter-productive. For example, by the end of the 20th century, PUHCA was cited as a reason for a relative paucity of investment in the electric and gas utility industry. In fact, for the first 25 years of its existence, the SEC's main task was to break up interstate investor-owned electric and gas utilities by using PUHCA. This was the investment management division's primary job, and more people were devoted to this mission than any other at the SEC for more than 20 years. By the end of the 1950s, this mission was mostly accomplished. Finally, Congress repealed PUHCA in 2006.

What lesson can we draw from PUHCA? Congress passed the Act because of the self-dealing and manipulation concerning interstate utility holding companies in the1920s. Instead of focusing on the problematic practices and addressing them directly, Congress reshaped the entire industry. What were the unintended consequences? After repeal, for example, alternative energy technologies are easier to finance. In addition, What would our power industry be like today if a different legislative strategy had been pursued originally? What would our capital markets be like today if the SEC had spent more of its energy for those three decades focusing on more general problems of the capital markets?

Forthright Analysis Needed

Certainly, many mistakes were made by business people, investors, and regulators during the past decade, but too many these days are looking in hindsight to pass judgement or blame. What we need is an analysis to determine how we can efficiently and effectively promote honesty and transparency in our markets and ensure that criminality is not tolerated.

For example, some have claimed that "deregulation" over the past 4, 8, or 10 years has led to the current problems in the financial markets. One can hardly say that the past 8 to 10 years have been deregulatory. The enactment of the Sarbanes-Oxley Act in 2002 led to the promulgation by the SEC of more rules in a shorter amount of time than ever before. In addition, the last 7 years have seen many new SEC and self-regulatory organization rules regarding compliance and trading, which have certainly been very regulatory. The Financial Accounting Standards Board, the Public Company Accounting Oversight Board ("PCAOB"), and the Municipal Securities Rulemaking Board have promulgated a host of new rules, standards, and interpretations.

This attitude that blames our current problems on "deregulation" is not only completely wrong, but dangerous because it is off the mark. If that is what policy makers think is the reason for the current situation, then they will have learned the wrong lesson and their solutions will cause more problems than they will solve.

More regulation, for regulation's sake, is not the answer. We need smarter regulation. Some say that we need to trust less in the marketplace and more in the capabilities of regulators, including a putative ability to foresee bubbles and intervene

to stop them. That is much easier said than done. This assertion ignores the reality that what may seem to be a bubble to one person may be another person's honest livelihood. What if the regulator is wrong? How will you ever know the opportunity cost to individuals or to society as a whole for curtailing some particular activity? It is always easier in hindsight to say what should have been done. How can you build public policy for years in the future on hoped-for brilliance or luck of individual, fallible human beings, especially if they are independent, nonelected, and essentially unaccountable?

This global crisis has primarily affected regulated (versus nonregulated) entities all around the world, not just in the supposedly deregulatory United States. How did so many regulators operating under vastly different regimes with differing powers and requirements all get it wrong? Indeed, how did so many firms with some of the best minds in the business get it wrong? The housing bubble occurred in the US as well as the United Kingdom, Ireland, and Spain. Heavily regulated financial institutions had problems with their housing-related investments not only in the US but also in Germany, Switzerland, France, Belgium, Netherlands, Ireland, the United Kingdom, and many others.

We must recognize that businesses ultimately are better than governments at business, because both can and do make mistakes. In addition, by removing risk management from firms and placing it in the hands of government, there is a danger that firms will become careless and take on additional risk, believing regulators are protecting them. If they believe that the government is backstopping their losses, then they may take greater risks, reap the rewards of taking those risks, and avoid the consequences if things go awry. This is the moral hazard that we all try to avoid. Regulators have a legitimate interest in setting capital standards to control this risk taking, but the ultimate risk management function must remain in the hands of the firms that face the risk.

What Caused the SEC's Operational Failures?

During the past dozen years, the SEC has experienced catastrophic operational failures in its four core functions of filing review, rulemaking, enforcement, and examinations. Enron's corporate filings were not reviewed for years in the late 1990s; Congress addressed this issue in Sarbanes-Oxley by mandating that the SEC review each issuer's filings on a periodic basis. In enforcement and examinations, tips were not pursued regarding Bernard Madoff and late trading of mutual funds. In rulemaking, the Commission proposed in December 1997 and again in April 2005 regulations regarding credit rating agencies, but never adopted any. This Committee led the effort to reform the SEC's approach to nationally recognized statistical rating organizations ("NRSROs") that culminated in the Credit Agency Reform Act of 2006, but unfortunately this statute came too late to affect the crisis in the financial markets and the 30-year history of NRSRO regulation.

The SEC to its credit and benefit has attracted many hard-working, bright, energetic staff members over its history. But, these mistakes were caused by failures of senior management, rather than by staff members. First, management applied faulty motivational and review criteria. Second, since resources are always limited, there is an opportunity cost in choosing to spend time and resources on one thing, because there is less time and fewer resources to spend on other things. Unfortunately, the SEC suffered from poor prioritization decisions during the critical years of 2003–2005 when the market for collateralized debt obligations and credit default swaps started to explode and its trajectory could have been diverted.

Some argue that low pay or poor morale contributed to these failures. Thanks to this Committee through the Sarbanes-Oxley Act, pay caps were removed from SEC staff pay in 2002. When I left the SEC, more than half of the 3,500 employees earned more than I did as a commissioner and many earn more than the chairman. Today, a staff attorney or accountant (SK-14) earns nearly $168,000 in Washington, DC ($177,000 in New York), and senior managers earn well in excess of $200,000.

As with anyone else, I am sure that SEC employees would like more pay, but how much should they be paid? As much as PCAOB board members, who earn more than the President? As with most government employees, the vast majority of SEC employees go to work because they like their job and they are committed to the agency's mission. In addition, they have job security and other benefits that cannot be duplicated in the private sector.

Management Failures. Management philosophies like Total Quality Management and Six Sigma teach that in any organization, measurement drives human behavior because the incentive is to try to meet the measurement criteria ("You get what you measure").

Essentially, Enron was not reviewed for years because review personnel were judged by how many filings they reviewed, not necessarily by the quality of their

review. The incentive was to postpone review of the complicated Enron filing because one could review many others in the time it would take to review Enron. By the late 1990s, this focus on numbers more than quality had decreased staff morale so much that employees began to organize to form a union. Despite management's campaign to thwart it, in July 2000 SEC employees voted overwhelmingly to unionize the workforce.

The emphasis on numbers over quality also affects behavior in the enforcement division and examination office. Every enforcement attorney knows that statistics (or "stats") help to determine perception and promotion potential. The statistics sought are cases either brought and settled or litigated to a successful conclusion, and amount of fines collected. These statistics do not necessarily measure quality (such as an investigation performed well and efficiently, but the evidence ultimately adduced did not indicate a securities violation). Thus, the stats system does not encourage sensitivity to due process.

In addition, the stats system tends to discourage the pursuit of penny stock manipulations and Ponzi schemes, which ravage mostly retail investors. These frauds generally take a long time and much effort to prove—the perpetrators tend to be true criminals who use every effort to fight, rather than the typical white-collar corporate violator of a relatively minor corporate reporting requirement who has an incentive to negotiate a settlement to put the matter behind him and preserve his reputation and career. Thus, over the years several staff attorneys have told me that their superiors actively discourage them from pursuing Ponzi schemes and stock manipulations, because of the difficulty in bringing the case to a successful conclusion and the lack of publicity in the press when these cases are brought (with the exception of Madoff, these sorts of cases tend to be small). Some senior enforcement officers openly refer to these sorts of cases as "slip-and-fall" cases, which disparages the real effect that these cases have on individuals, who can lose their life savings in them. Because of the interstate and international aspect of many of these cases, if the SEC does not go after them, no one can or will.

During my tenure as commissioner, I emphasized the need to focus from an enforcement perspective on microcap fraud, including Ponzi schemes, pump-and-dump schemes, and other stock manipulations. I was a strong advocate for the formation of the Microcap Fraud Group in the Enforcement Division, which as finally formed in 2008. I also strongly support the good efforts of the Office of Internet Enforcement, established under Chairman Levitt in the late 1990s, which works closely with other law enforcement agencies to tackle internet and other electronic fraud.

There are many intelligent, competent, dedicated, hard-working people at the SEC. It is the management system and how it determined priorities over the past decade that has let them down. Last year in an article published in the Fordham Journal of Corporate and Financial Law,[1] I called for the SEC to follow the example from 1972 of Chairman William Casey, who formed a committee to review the enforcement division—its strategy, priorities, organization, management, and due-process protections. Thirty-seven years later, and especially after the Madoff incident, this sort of review is long overdue.

The Opportunity Cost of Misplaced Priorities. I believe that the SEC was distracted by controversial, divisive rulemaking that lacked any grounding in cost-benefit analysis during a critical period. In 2003–2005, the agency pushed through three controversial rules regarding mutual fund governance, hedge fund registration, and the so-called National Market System rules. In these cases, the SEC did not conduct an adequate analysis of the costs versus the benefits of these proposed rules. The hedge fund and mutual fund rules were invalidated by the courts after long litigation and much distraction for the agency and the industry. In each of these cases, former Commissioner Cynthia A. Glassman and I offered alternatives and compromises, but we were presented with a take-it-or-leave-it choice that left no alternative but dissent.

These controversies now sound rather trivial in light of the current situation in the financial markets. However, important legal principles were involved, including lack of authority to promulgate the hedge fund rule and lack of observing a legislative mandate for analyzing costs and benefits in connection with the mutual fund governance rule. Hedge funds ultimately were not the problem in the current financial crisis; risk management at regulated entities was the problem. Moreover, Regulation NMS cost the securities industry more than $1.5 billion to try to implement a rule to address a theoretical problem that did not exist. Ultimately, after much

[1] See Paul S. Atkins and Bradley J. Bondi, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," 8 *Fordham Journal of Corp. & Fin. Law* 367 (2008).

effort and distraction, many exemptions and exceptions have been issued by the SEC staff that effectively have gutted the rule.

Because life is full of choices, if you devote resources to one thing, you have less to devote to another. And, the one risk that you have not focused on just may blow up in your face.

That, in fact, is just what happened to the SEC. During this critical 2003–2005 time period when so much effort was wasted on these quixotic detours, the market for collateralized debt obligations (CDOs) and credit default swaps (CDSs) was taking off.

What might the SEC have done, had it not been so distracted by other false priorities? Sometimes the issues are a lot more basic than we think. With respect to CDOs and CDSs, the SEC did not have jurisdiction to regulate them as instruments. But, one of the critical factors that developed as market interest in them grew was the inadequate documentation for these OTC derivatives. While the SEC was trying to devise complex solutions to nonexistent problems, it neglected a real risk management issue in the fundamental infrastructure that enables the markets to work smoothly. For example, in the failure of the hedge fund Amaranth in 2006, I was told that it took a couple of hundred people several weeks to sort through the OTC derivatives documentation issues and figure out valuation. One of the primary difficulties has been the lack of standardized documentation, which has often resulted in lengthy confirmations. At the time, I and others had called for this to be addressed. I am happy that the industry and regulators are making progress in this area.

The incomplete and inaccurate documentation in this area was a legitimate risk management issue, especially since no centralized, automated trade processing existed for these instruments. As we have witnessed over the past year, valuation is a challenge, because these instruments are complicated and not standardized. Novations create a huge challenge to follow the chain of ownership.

Proposals for Financial Services Reform

Several general proposals have been made recently for structural reforms to the financial services regulatory framework. Since these have not yet become concrete proposals, I have a few general comments in this regard.

Systemic Risk Regulator. This concept was raised last year in the Treasury Department's Blueprint for a Modernized Regulatory Structure. As a theory, it has some general appeal, but as a practical matter it raises many questions. Just who would be the systemic risk regulator? The Treasury, the Federal Reserve, some newly created entity, or a council of regulators (such as the President's Working Group)? What would its powers be? Would it be a merit regulator of new products? If it is the Treasury, what would its role be with respect to other independent agencies?

Issues of systemic risk can be raised in many different contexts. For example, in the 1990s, the Federal Reserve and the SEC disagreed over the levels of loan loss reserves taken by certain banks. The Fed argued on the basis of safety and soundness concerns, and the SEC was worried about earnings management and disclosure.

Merit regulation of new products is always problematic, because a government agency is making determinations for investors as to appropriateness. What standards would the systemic regulator use to vet the new products? The time for review adds to the cost of the new products and adds to uncertainty

Although the federal rules with respect to public offerings of securities are based on disclosure, some states have a merit-regulatory regime. An illustrative example of how government officials can make incorrect determinations, with the best intentions of investor protection, is the initial public offering of Apple Computer. The SEC approved Apple's registration statement under the federal Securities Act, but Massachusetts prohibited the offering of Apple shares because they were "too risky." Texas approved the sale after an extensive review, but its securities regulator called his decision "a close call," and Apple did not even bother to offer its shares in Illinois due to strict state laws on new issues. The subsequent performance of Apple stock is a matter of history.

With respect to CDOs and CDSs, would a systemic regulator have identified the potential problems of documentation and trading?

Merger of the SEC and CFTC. If this merger is to be effected, it should be done with care. The statutes and rules governing the securitie

s and futures markets are different, and the approaches that the two agencies take are different. The futures markets are mostly dealer markets, while the securities markets have a large retail investor component. A merger cannot simply be the combining of two agencies under one roof; it would be a complicated task.

Short of merger, Congress could help by laying out guidelines for the two agencies to resolve conflicts regarding products that have indicia of both securities and futures. This issue has existed since the 1980s, and the two agencies have periodically tried to address the conflicts. In fact, this issue would still exist even if the agencies were combined, just as issues exist between SEC divisions.

Credit Rating Agencies. Thanks to the hard work of this Committee, Congress passed the Credit Rating Agency Reform Act of 2006, which set out a regulatory regime for the SEC's staff-designated NRSROs through a frustratingly slow process that had the effect of limiting competition in issuing credit ratings. The 2006 legislation made the application process speedier and more transparent.

The subprime problems made it clear that many investors relied on credit ratings without performing their own due diligence. Government agencies relied on credit ratings to their detriment as well. Even if conflicts of interest are addressed and fully disclosed, we still have the problem that opinions of certain institutions are given great regulatory weight. Thus, few realized the great systemic risk inherent in the holdings of CDOs by financial institutions, because they were deemed to be the highest-rated instruments. Over the past 30 years or so, references to NRSRO ratings have become embedded in many federal and state statutes and SEC and other agency rules. Has this created a perception that the government endorses the process by which NRSROs produce their ratings? That would be an incorrect perception; the SEC or any government agency can never be equipped to assess the quality of NRSRO ratings or the procedures by which they are devised. I would argue that it would be a mistake to ask any government agency to attempt to do so. Is it time to remove these ratings from our statutes and rulebooks? Can we create alternatives to this flawed system that accords undue weight to informed, albeit potentially flawed, opinions?

The rating agency industry over the years had become an oligopoly—three large firms control 90 percent of the market, and two of them control 80 percent. This concentration was a direct result of a nontransparent, arcane SEC oversight system.

The consequence was a lack of competition and lack of new entrants. For example, a non-U.S. rating agency waited 16 years before its application was finally approved. The 2006 enactment of the Credit Rating Agency Reform Act directed the SEC to open up the process, encourage competition, and increase transparency and oversight of the credit rating firms to protect against conflicts of interest. Would more voices in the rating industry have averted the problems with ratings of structured products?

SEC Strategic and Risk Assessment. Congress should encourage Chairman Schapiro to engage in a thorough strategic and risk assessment, especially if the agency is to receive more resources and authority. In the past 10 years, the agency's budget has more than doubled and its staffing has increased commensurately. However, the internal organization and management structure is essentially the same.

Would today's crisis have occurred if the SEC had had a real risk evaluation capability? Former Chairman Harvey Pitt undertook an extensive review of the SEC's organization and functionality in 2001 with a view to modernize it. He conceived of a risk assessment office that would work closely with the operating divisions. The plan was to give it its own personnel, but also to have personnel seconded to it in order to generate buy-in from the operating divisions. Unfortunately, when his successor established the office, it did not have adequate resources and it did not have any secondments. Thus, the group was not integrated into the flow of the agency's operations and became an orphaned group filling a niche role with very limited effectiveness.

In addition, should the examination function continue in its current form? In the aftermath of the Madoff affair, the structure and function of the Office of Compliance Inspections and Examinations should be reviewed. If Congress chooses to require that hedge funds and private equity firms register as advisors under SEC oversight, the burden added to the agency's examiners would be enormous. The current paradigm of periodic inspections of funds by government examiners cannot endure, unless the agency increases tremendously in size, inevitably leading to more managerial problems. One solution could be to re-integrate the examination function into the operating divisions and to establish the opportunity for registered advisors to submit to independent reviews, which would be overseen by the SEC.

In conclusion, regulation of financial markets needs to be modernized and rationalized. But, it must be done in an informed way, taking into account costs and benefits and being mindful of potential unintended consequences. Financial markets are global, integrated, and quickly changing, and the legislative process is not as responsive. I stand ready to assist the Committee going forward as you deliberate these issues and if you develop any legislation.

Thank you again for extending me the privilege of appearing before you today. You have a momentous task before you. I wish you all the best in your work.

ARTICLES

EVALUATING THE MISSION: A CRITICAL REVIEW OF THE HISTORY AND EVOLUTION OF THE SEC ENFORCEMENT PROGRAM

By Paul S. Atkins and Bradley J. Bondi[*]

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The United States Securities and Exchange Commission (the "SEC" or "Commission") is nearing its seventy-fifth anniversary, a milestone that will be marked by reflection on the past and contemplation of the future.[1] During this time of introspection, the Commission should take the opportunity to examine the manner in which it has reacted to the growth and changes in its regulatory authority and in the capital markets. One constant throughout its history has been the SEC's need to balance competing interests. The SEC's stated mission reflects this tension. Today, that mission is composed of three objectives: "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[2]

Historically, the SEC's mission has focused on investor protection. As the SEC and its regulatory powers have grown in response to the ever more complex and international financial services markets, the seemingly straightforward mission of investor protection has become more intricate and multidimensional, prompting questions such as, "Who are the investors that should be protected?" and "How should they be protected?" After all, investors range in sophistication, size, activity, goals, needs, and other attributes. They include traditional individual and institutional investors in the securities markets, traders, and foreign entities seeking to invest in the United States.[3] Choices that the SEC makes in its rulemaking and other activities can favor or disfavor one group of investors over another. A rule beneficial for one investor may be detrimental to another, depending on an investor's investment strategy or changing circumstances. Indeed, because investors ultimately pay for inefficiencies arising from regulatory mandates

1. The SEC was created on July 2, 1934 during a period of heated debate over the country's economic turmoil. That day was literally heated: 93 degrees Fahrenheit, to be exact. The Federal Trade Commission met in an unairconditioned, temporary building in Washington, D.C., located on the present site of the Federal Reserve Building, to vote the SEC into existence pursuant to the Securities Exchange Act of 1934. Frank V. Fowlkes, *Agency Report/Congress Prods SEC To Get Firmer Grip on Nation's Securities Industry*, NATIONAL JOURNAL, Feb. 20, 1971, at 385.

2. U.S. SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 5, *available at* http://www.sec.gov/about/secpar/secpar2006.pdf [hereinafter 2006 REPORT].

3. One group of foreign investors, sovereign wealth funds, has received much attention by the press in recent years. Sovereign wealth funds are estimated currently at $2.5 trillion and expected to grow to $10 to 15 trillion by 2015. Robert M. Kimmitt, *Public Footprints in Private Markets*, FOREIGN AFFAIRS, Jan./Feb. 2008, at 1-2, *available at* http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html.

through direct or indirect costs, diminished returns, and reduced choice, the rules must be made with careful analysis and deliberation. Congress acknowledged this potential harm in 1996 when it revised the SEC's statutory mandate to expressly require the SEC "to consider or determine whether an action is necessary or appropriate in the public interest" and to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[4]

This multidimensional aspect of investor protection applies not only to rulemaking, but also to enforcement matters. Each enforcement matter involves in some degree a balancing of competing interests, some at a pragmatic, case-specific level and others at a higher policy level. For example, in distributing money recovered in an enforcement action against a bankrupt company, the SEC conceivably could decline a distribution to all investors and instead choose a distribution that favors one class of investor over another, such as common stockholders over senior debtholders, which by virtue of their preferred position may have had greater recovery per dollar invested than did common stockholders, but still fell short of their desired recovery. In its overall enforcement program, the SEC's decisions about resource allocation, charges to be brought, and relief to be sought may enhance the protection of one group of investors at the potential cost of another. Advancing a novel legal theory may protect the group of investors in a particular case, but have unintended detrimental consequences to investors as a whole.[5]

The enforcement decisions of the SEC must be guided by the multidimensional nature of the SEC's mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation. The difficult choices of balancing conflicting interests must be guided by the transcendent principles of predictability, fairness, and transparency, culminating in the rule of law. These principles are the defining characteristics of the U.S. markets.

In order to assess the SEC's application of these principles to its enforcement decisions, this Article investigates the shifting focus of the SEC's enforcement program from its inception to the present day. The Article explores the development and usage of the SEC's statutory enforcement powers in the context of due process and fairness. Finally,

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4. Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (2006).

5. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, – U.S. –, 128 S.Ct. 761 (2008).

the Article calls for the Commission to appoint an independent advisory committee to conduct a detailed review and evaluation of the policies and procedures of the enforcement program in light of the changes in the SEC's statutory authority over the course of the last three decades.

THE ORGANIZATION OF THE SEC

The SEC is governed by five commissioners, all of whom are appointed by the President with the advice and consent of the Senate.[6] One of the commissioners is designated as chairman by an executive order of the President.[7] To ensure bipartisanship, Congress specified that only three of the five commissioners can belong to the same political party.[8]

The SEC is organized into four primary operating divisions and nineteen "offices," or special service units, each of which is headquartered in Washington, D.C. The SEC's staff, numbering approximately 3500, is located in Washington, D.C. and throughout its eleven regional offices.[9] The SEC's largest division—and the focus of

6. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (2006).

7. *See* Reorganization Plan No. 10 of 1950, 15 Fed. Reg. 3175 (1950), *reprinted in* 5 U.S.C. 901 *et seq.* (2006), *and in* 64 Stat. 1265 (1950); *see also* 2006 REPORT, *supra* note 2, at 7. This power of the President to designate (or remove) the chairman by executive order does not apply to similar agencies. For example, the chairmen of the Board of Governors of the Federal Reserve and the Commodity Futures Trading Commission are separately nominated and confirmed to their positions as chairmen, although they have separate terms as governor or commissioner, respectively. *See* 12 U.S.C. § 242 (2008) and 7 U.S.C. § 2(a)(2)(B) (2008).

8. Securities Exchange Act of 1934 § 4. The first five commissioners were Democrats Joseph P. Kennedy, James M. Landis and Ferdinand Pecora, and Republicans George C. Mathews and Robert E. Healy. The commissioners elected Joseph P. Kennedy to serve as the first chairman. *See* Fowlkes, *supra* note 1, at 385.

9. *See* U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 2, *available at* http://www.sec.gov/about/secpar/secpar2007.pdf [hereinafter 2007 REPORT]. The SEC has grown tremendously since its inception. In 1942, the SEC had a staff of 1700 employees. In order to make room for wartime agencies, the SEC was forced to relocate to Philadelphia in 1942. By the time it returned to Washington in 1948, the staff had decreased to 1150. By 1955, there were only 666 employees. Fowlkes, *supra* note 1, at 383.

this Article—is the Division of Enforcement, which has more than 1100 employees, and has grown by more than 40% in the past fifteen years.[10]

THE SEC'S AUTHORITY UNDER THE FEDERAL SECURITIES LAWS

Today, the SEC is charged with administering the Securities Act of 1933,[11] the Securities Exchange Act of 1934,[12] the Trust Indenture Act of 1939,[13] the Investment Company Act of 1940,[14] the Investment Advisers Act of 1940,[15] and certain provisions of the Sarbanes-Oxley Act,[16] some of which fall outside of the earlier securities laws.[17]

The Commission is vested with statutory authority to conduct any investigation it deems necessary to determine whether a person has violated federal securities laws and the rules and regulations

10. The Enforcement Division is currently the largest of the divisions and offices of the SEC, with more than 1100 personnel. *See* Christopher Cox, Chairman, Opening Remarks to the Practising Law Institute's SEC Speaks Series (Feb. 9, 2007), *available at* http://www.sec.gov/news/speech/2007/spch020907cc.htm. According to information provided by the SEC to Congress, the total number of employees in the Enforcement Division at the end of fiscal year 2008 is expected to be 1124—up from 781 in 1992.

11. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006).

12. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2006); *see generally* Securities and Exchange Act of 1934, http://www.sec.gov/about/laws.shtml#secexact1934 (last visited May 8, 2008) (discussing some of the many powers granted by the 1934 Act, including regulating corporate reporting, proxy solicitations and tender offers).

13. Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (2006) (focusing on debt securities such as bonds, debentures, and notes that are offered for public sale).

14. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to a-64 (2006) (regulating the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public).

15. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to b-21 (2006) (regulating investment advisors).

16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) (mandating a number of reforms to enhance corporate responsibility and financial disclosures and to combat corporate and accounting fraud). The Sarbanes-Oxley Act also created the Public Company Accounting Oversight Board to oversee the activities of the auditing profession..

17. On February 8, 2006, the repeal of the Public Utility Holding Company Act of 1935 took effect, relieving the SEC of what once arguably was its primary focus. The Act provided for the regulation of multi-state utilities by the SEC. Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (repealed 2006).

promulgated thereunder.[18] As part of this investigative authority, the Commissioners—and any officer to whom the Commissioners' authority is delegated—have the power to "administer oaths and affirmations, subpena [sic] witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry."[19] The Commission has delegated these tasks to the Director of the Division of Enforcement, who undertakes them pursuant to formal orders that the Commission grants in individual matters.[20] If the Commission concludes that a securities law has been violated, the Commission may bring an action in federal court or in an administrative proceeding against the purported violators.

THE ESTABLISHMENT OF THE ENFORCEMENT DIVISION

Among its various other roles, the SEC acts to enforce the federal securities laws,[21] and it has built a strong reputation for professionalism and effectiveness in its enforcement program. At the time the Commission was established in 1934, the Commission's "Legal Division" was responsible for conducting investigations pertaining to federal securities law violations.[22] Within the first two years, the Commission assigned that duty to its regional offices.[23] For the next four decades, the regional offices were primarily responsible for conducting investigations and bringing enforcement actions while the Commission's Trading and Markets Division "played a largely supervisory and coordinating role supporting the regions and referring criminal cases to the Justice Department for prosecution."[24] By 1944,

18. *See e.g.*, Securities Act §§ 8(e), 20(a); Securities Exchange Act § 21(a); Investment Company Act § 42(a); Investment Advisers Act § 209(a).

19. Securities Exchange Act § 21(b). Congress has granted similar authority in other provisions of the federal securities laws. *See* Investment Company Act § 42(b); Investment Advisers Act § 209(b).

20. 17 C.F.R. § 200.30-4(a)(1) (2008).

21. 2007 REPORT, *supra* note 9, at 2.

22. DANIEL M. HAWKE, A BRIEF HISTORY OF THE SEC'S ENFORCEMENT PROGRAM 1934-1981, at 2 (SEC Historical Society 2002), *available at* http://www.sechistorical.org/collection/oralHistories/roundtables/enforcement/enforcementHistory.pdf.

23. *Id.* A copy of the 1939 organization chart of the SEC is *available at* http://www.sechistorical.org/collection/papers/1930/1939_SEC_OrgChart.pdf.

24. *Id.* During the SEC's first decade, the Justice Department had a 95% conviction rate from the indictments that it brought based on referrals from the SEC. *Id.*

after only a decade of existence, the SEC had gathered information "concerning an aggregate of 44,399 persons against whom Federal or State action had been taken with regard to securities violations" and had obtained permanent injunctions against 1,057 firms and individuals.[25]

The second decade of the SEC's existence was marked by World War II and its aftermath. During the war, the SEC's headquarters moved temporarily to Philadelphia to make room for wartime operations in Washington, D.C.[26] When the SEC finally returned to Washington in 1948, it occupied temporary buildings that were erected during the war.[27] Despite the inconveniences caused by the war and post-war budget cuts, the SEC continued to bring a constant number of enforcement actions during this time.[28]

Beginning in the late 1950s and continuing through the 1960s, the enforcement program underwent a remarkable transformation, and the enforcement resources in the SEC's Washington, D.C. headquarters increased. With the added resources, the headquarters began to bring more actions for violations of the securities laws. During the *entire decade* of the 1950s, the home office brought a total of approximately fifty cases. Yet during the 1960s, that number escalated substantially – the home office brought approximately forty cases *per year*.[29]

The 1960s witnessed landmark decisions in the field of securities law in cases brought by the SEC, such as *SEC v. Texas Gulf Sulfur Co.*[30] and *SEC v. VTR, Inc.*[31] In *Texas Gulf Sulfur*, the Second Circuit adopted the SEC's application of Rule 10b-5 to insider trading cases by requiring insiders in possession of material, nonpublic information either to abstain from trading on such information or to disclose such information

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at 13 (quoting TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 3).

25. *Id.* at 13 (citing TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 2-3).

26. *Id.* at 14.

27. *Id.*

28. *Id.*

29. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 360-61, 363 (3d ed. 2003). The impetus for the transformation was the enforcement staff's massive investigation into fraudulent practices by the American Stock Exchange. *See* HAWKE, *supra* note 22, at 2-3.

30. *See* SEC v. Tex. Gulf Sulfur Co., 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

31. *See* SEC v. VTR, Inc., 410 F. Supp. 1309 (D.D.C. 1975).

before trading.[32] In *VTR*, the SEC persuaded a federal district court to approve as a remedy for the securities law violation the appointment of independent directors and to order restitution.[33] The *VTR* decision marked the beginning of a long series of civil cases obtaining ancillary relief in addition to an injunction against further misconduct.[34]

The growth in the number of actions being brought by the SEC sparked discussions, led by Chairman William J. Casey, about "concentrat[ing] resources by focusing all enforcement and investigative activity in one division."[35] In August 1972, the Commission reorganized the operating structure of its divisions by combining the enforcement programs of the divisions of Trading and Markets, Corporation Finance, and Investment Management into a newly created, stand-alone division.[36] The new "Division of Enforcement" would oversee all enforcement actions brought by the SEC.[37]

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32. *See Tex. Gulf Sulfur*, 401 F. 2d at 848-52.

33. *See VTR, Inc.*, 410 F. Supp. 1309.

34. SELIGMAN, *supra* note 29, at 362.

35. U.S. SEC. & EXCH. COMM'N, THIRTY-EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION xxvii (1972), *available at* http://www.sec.gov/about/annual_report/1972.pdf. It has been suggested that this reorganization was initially resisted on the

> belief that enforcement responsibility should not be separated from the divisions of the Commission that deal with substantive regulation. The belief was that as the regulators developed new principles of regulation, if enforcement became too separate from such development, it might reflect the uncertainties of the rules and the appropriate nature of regulation.

Symposium, *Securities Law Enforcement Priorities*, 17 SETON HALL LEGIS. J. 7, 9 (1993) (statement by Leonard M. Leiman).

36. HAWKE, *supra* note 22, at 3. In 1971, there were 40 lawyers in the enforcement group of the Division of Trading and Markets. Fowlkes, *supra* note 1, at 380. The Commission, on November 14, 2007, restored the name of the "Division of Market Regulation" to the "Division of Trading and Markets." *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Renames Division of Market Regulation as Division of Trading and Markets (Nov. 14, 2007), *available at* http://www.sec.gov/news/press/2007/2007-229.htm. The Commission changed the name of the "Division of Corporate Regulation" to the "Division of Investment Management" in 1972. *See* Interview by Richard Rowe with Allan Mostoff (Oct. 30, 2002), *available at* http://www.sechistorical.org/collection/oralHistories/interviews/mostoff/mostoff100202Transcript.pdf.

37. HAWKE, *supra* note 22, at 3.

THE WELLS COMMISSION AND ITS RECOMMENDATIONS

On January 27, 1972, in a speech to the New York State Bar Association underscoring the importance of cooperation and collaboration between the Commission and the securities bar, Chairman Casey announced the creation of an advisory committee[38] to "review and evaluate the Commission's enforcement policies and practices and to make such recommendations as they deemed appropriate."[39] Chairman Casey called upon the private securities bar to contribute to improving the enforcement program by developing procedural safeguards to protect against abuses of the rights of prospective defendants.[40] Stressing the value of input from the private sector, Chairman Casey explained:

> [I] consider it essential for the Commission to redouble its efforts to keep in touch with the best thinking on investor protection at the private bar, in the accounting profession, and in the financial community generally. As one step — and I hope that it will prove a significant step — toward that end, I have created a special committee of three highly experienced practicing lawyers who will at my request examine the SEC's enforcement policy and practices, engage in frequent dialogue with the members of the Commission and with our staff, seek and sift the suggestions of the bar and make recommendations to the Commission for worthwhile improvements to our time-honored ways.[41]

Although the official name of the committee was the "Advisory Committee on Enforcement Policies and Practices," it is better known as the "Wells Committee" after its chairman, John A. Wells, a prominent lawyer and partner at the New York law firm of Royall, Koegel &

38. William J. Casey, Chairman, U.S. Sec. & Exch. Comm'n, Address to the New York Bar Association (Jan. 27, 1972), *available at* http://www.sec.gov/news/speech/1972/012772casey.pdf [hereinafter Casey Speech].

39. U.S. SEC. & EXCH. COMM'N, REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES (June 1, 1972), *reprinted in* ARTHUR F. MATHEWS ET AL., ENFORCEMENT AND LITIGATION UNDER THE FEDERAL SECURITIES LAWS 1973, at 275 (Practicing Law Institute 1973) [hereinafter WELLS COMMITTEE ADVISORY REPORT]; Memorandum from John A. Wells et al., Chairman, SEC Advisory Committee on Enforcement Policy and Practices (Mar. 2, 1972), *available at* http://www.sechistorical.org/collection/papers/1970/1972_0302_Casey.pdf [hereinafter Wells Memo].

40. Casey Speech, *supra* note 38, at 4-5.

41. *Id.*

Wells.[42] The Wells Committee also included former SEC chairmen Ralph H. Demmler and Manual F. Cohen, both of whom had taken an active interest in the workings of the enforcement program.[43] Howard G. Kristol, who served as special counsel to Chairman Casey, acted as a liaison to, and unofficial member of, the Wells Committee.[44]

The Wells Committee's stated mandate[45] was: first, "to advise on how the SEC's enforcement objectives and strategies may be made still more effective;"[46] second, to assess the due process implications of the enforcement practices;[47] third, to evaluate the enforcement policies and procedures;[48] fourth, "to make recommendations on the appropriate blend of regulation, publicity and formal enforcement action and on methods of furthering voluntary compliance;"[49] and fifth, "to make recommendations on criteria for the selection and disposition of enforcement actions and on the adequacy of . . . sanctions imposed in Commission proceedings."[50]

The Wells Committee was composed of three of the brightest minds of the securities bar, but the Committee did not conduct extensive, independent research and analysis. Instead, the Committee solicited comments from persons outside the Commission who were affected by the SEC's enforcement activities to "determine whether fairness could be more certainly assured, consistent with the need for effective enforcement."[51] The Wells Committee started its work in January 1972 and published a detailed report with forty-three recommendations for the Commission in June of the same year—an impressive achievement by any measure.[52] The report represented a candid and honest assessment of the enforcement program and reflected the substantial input the Committee received from the private bar.

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42. *Id.* at 5-6. John Wells later formed a well-known law firm called Rogers & Wells.

43. *Id.*

44. Howard G. Kristol—Biography, *available at* http://www.duanemorris.com/attorneys/howardgkristol.html (last visited May 9, 2008).

45. Wells Memo, *supra* note 39.

46. *Id.* at 1.

47. *Id.*

48. *Id.*

49. *Id.* at 2.

50. *Id.*

51. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 3.

52. *Id.* at ii-viii.

The Wells Committee Recommendations

The most significant recommendations, from the perspective of a person defending against an SEC enforcement proceeding, are numbers 16, 17 and 20 of the report:[53]

> 16. Except where the nature of the case precludes, a prospective defendant or respondent should be notified of the substance of the staff's charges and probable recommendations in advance of the submission of the staff memorandum to the Commission recommending the commencement of an enforcement action and be accorded an opportunity to submit a written statement to the staff which would be forwarded to the Commission together with the staff memorandum.
>
> 17. The procedures whereby a prospective defendant or respondent is permitted to present to the Commission his side of the case prior to authorization of an enforcement action should be reflected in a rule or published release.
>
> * * *
>
> 20. The Commission should adopt procedures permitting discussions of settlement between the staff and the prospective defendant or respondent prior to the authorization of a proceeding.[54]

These three recommendations became the impetus for what is now known as the "Wells Submission."

Providing prospective defendants with notice of potential charges and allowing them to respond, as reflected in Recommendations 16 and 17, was not a novel concept within the walls of the SEC. Even prior to the report of the Wells Committee, the SEC, under Chairman Hamer Budge, had afforded prospective defendants an opportunity to be heard by the Commission. A September 1, 1970, internal directive of the Commission[55] required the Enforcement staff to include within its

53. Harvey L. Pitt et al., *SEC Enforcement Process, Internationalization of the Securities Markets – Business Trends and Regulatory Policy*, C489 ALI-ABA 109, 238 (1989).

54. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

55. *See* Fowlkes, *supra* note 1 (describing the positions of the commissioners). It should be noted that this directive was supported by commissioners of both political parties.

memoranda recommending action by the Commission "any arguments or contentions as to either the facts or the law . . . which have [been] advanced by the prospective respondents and which countervail those made by the staff . . . ."[56] The purpose of the procedure was "to afford the Commission an opportunity to consider the position of the prospective defendant or respondent on any contested matters prior to authorization of a proceeding."[57]

The Wells Committee observed that "[a]s a practical matter, only experienced practitioners who are aware of the opportunity to present their client's side of the case have made use of [such] procedures."[58] The Committee felt that the process of providing notice to prospective defendants and allowing them to respond to the allegations before the Commission formally charged them was critical to protecting their rights and ensuring overall fairness.[59] The Committee recommended that the Commission codify the procedure through formal rulemaking.[60]

Unlike Recommendations 16 and 17, Recommendation 20 of the Wells Committee—to allow the staff to engage in preliminary settlement negotiations with a prospective defendant before the Commission authorized a proceeding[61]—was a significant departure from then-existing procedure. The 1970 internal directive required the staff to seek approval from the Commission to bring an action or proceeding prior to discussing its settlement.[62] Under the 1970 internal directive, the Enforcement staff could allow a defendant or respondent to present proposals and arguments prior to Commission authorization, so long as that person initiated the discussions.[63] The staff, however, was precluded from negotiating settlement terms or disclosing to the defendant or respondent the "recommendation it intend[ed] to make to the Commission."[64] This process, which itself represented a departure from prior procedure for negotiating settlements, grew out of a concern

56. This 1970 directive was made public solely as a result of pretrial discovery in *SEC v. National Student Marketing Corporation*. *See* SEC v. Nat'l Student Mktg. Corp., 68 F.R.D. 157, 166 appx. A (D.D.C. 1975) [hereinafter 1970 Internal Directive].

57. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 31.

58. *Id.* at 31-32.

59. *Id.*

60. *Id.* at 32.

61. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

62. 1970 Internal Directive, *supra* note 56, at 165.

63. *See id.* The staff was permitted to discuss the facts and nature of the alleged violations. *Id.*

64. *Id.*

by the Commission that "its discretionary authority regarding the institution of proceedings [would be] substantially impaired."[65] According to Commissioner A. Sydney Herlong, the 1970 internal directive was designed to prevent the staff from "bludgeoning" companies into consent settlements by using the threat of public proceedings that might never be approved.[66] Commissioner Herlong, who was one of two Democrats on the Commission, explained:

> The staff sometimes is overly zealous and they sometimes want quick settlements to clear up their files. Sometimes they would beat people over the head for a consent decree. We had reports from some people who weren't pleased with the treatment.[67]

Responding to comment letters, the Wells Committee recommended that the Commission withdraw this mandate and return to the prior procedure of allowing staff leeway to negotiate settlements with prospective defendants prior to having the authority to commence an action or proceeding.[68] The Wells Committee believed that "frank discussions between the staff and opposing counsel concerning the staff's conclusions and probable recommendation to the Commission would encourage settlements."[69] To address concerns with abuse, the Committee proposed that the Director of Enforcement or a regional administrator be responsible for supervising settlement negotiations and that the proposed defendant or respondent be shown the evidence that the staff has assembled in support of its case.[70] As the Wells Committee observed, "When the staff refuses to disclose its evidence or the theory of its case to the respondent's attorney before the hearing, the attorney,

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65. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35. Philip A. Loomis, then general counsel of the SEC, explained that the Commission abandoned the practice of considering settlements negotiated without prior Commission authorization because the Commissioners felt hindered by a pre-decided result. *See* Fowlkes, *supra* note 1, at 381. Commissioner Richard B. Smith "offered essentially the same reason, saying that he missed the opportunity to hear industry's side of a case and that it struck him as bad administrative procedure." *Id.*

66. Fowlkes, *supra* note 1, at 381.

67. *Id.*

68. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35.

69. *Id.*

70. *Id.* at 35-36.

not knowing what his client faces, may be unable or reluctant to recommend a settlement."[71]

The Wells Committee recommendation of a return to the pre-1970 procedure of allowing staff to negotiate settlements prior to Commission approval was met with favor by many members of the securities bar. In a May 23, 1972 letter to the Wells Committee concerning the proposed change, Arthur F. Mathews, a former SEC enforcement lawyer, wrote:

> [T]he changed enforcement policy has, although unintended, worked to the severe detriment of many defendants and prospective defendants who wish to achieve an acceptable consent settlement in lieu of litigation and who are not concerned that the Staff might "bludgeon" them. Rather, such persons usually are concerned with the continuing blasts of adverse publicity showering upon them, first by public institution of charges by the Commission, and later upon the conduct of a hearing or the announcement of the terms and conditions of a settlement subsequently negotiated. Such continuous publicity may be extremely unfair, particularly where serious allegations publicized upon institution of an action, are dropped subsequently by Staff and the Commission in accepting a consent settlement of the action.[72]

The notable aspect of this debate is that both sides were concerned with fairness and due process. Those in support of requiring Commission approval prior to settlement were concerned with the uneven negotiating position of the Commission's staff and the prospective defendant. Those in support of allowing informal settlement procedures prior to Commission approval believed that fairness would be advanced by limiting the time under which a prospective defendant could be exposed to adverse publicity. The ultimate conclusion of the Commission, however, emphasized the due process concerns of Commission oversight.

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71. *Id.* at 37. Today, there are no specific guidelines concerning the amount and type of information that staff must share with a prospective defendant, so practices vary among the staff and across the regional offices.

72. Letter from Arthur F. Mathews of Wilmer, Cutler & Pickering, to the Advisory Committee on Enforcement Policies and Practices 30 (May 23, 1972). Stanley Sporkin, then an associate director, agreed, stating that "it saved everybody a lot of bother and was welcomed by many of the people we regulate because it gave them a means of settling quickly." Fowlkes, *supra* note 1, at 381.

The Commission's Response to the Wells Recommendations

The recommendations of the Wells Committee were met with mixed responses within the agency. Although the private securities bar generally applauded the recommendations from the Wells Committee, the SEC staff disagreed with many of them, and the commissioners were reluctant to adopt formal rules.[73] With respect to Recommendations 16 and 17, the Commission "agree[d] that the objective [was] sound," but "concluded that it would *not* be in the public interest to adopt formal rules for that purpose."[74] The Commission apparently felt hamstrung by the mandatory-sounding nature of the phrase "except where the nature of the case precludes." The Commission believed that the formal adoption of the proposals "could seriously limit the scope and timeliness" of enforcement actions and inject issues "irrelevant to the merits."[75] As a result, the Commission indicated that, where "practical and appropriate," it would allow, on an informal basis, prospective defendants to provide written submissions before a charging decision was reached by the Commission.[76]

Although it did not immediately embrace Recommendations 16 and 17, the Commission eventually adopted the substance of these recommendations in procedural rules in November 1972, formulating today's Wells submission process. The process as adopted provided a proposed defendant or respondent with the opportunity to respond to charges.[77] The Commission notified the public of the opportunity for prospective defendants or respondents to "submit a written statement to the Commission setting forth their interests and positions in regard to the subject matter of the investigation."[78] SEC procedural rules directed the staff, in its discretion, to advise prospective defendants or respondents "of the general nature of its investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the

73. *See* Pitt et al., *supra* note 53, at 63.

74. Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigation, Securities Act Release No. 5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,010, at 82,183-86 (Sept. 22, 1972) (emphasis added) [hereinafter SEC Release No. 5310].

75. *Id.* at 2.

76. Stephen A. Glasser, *SEC Adopts Rules Changes in Areas of Enforcement*, N.Y.L.J., Sept. 29, 1972.

77. *See* 37 Fed. Reg. 23,829 (Nov. 9, 1972) (codified at 17 C.F.R. § 202.5(c)).

78. 17 C.F.R. § 202.5(c) (2006).

presentation of a staff recommendation to the Commission for the commencement of an administrative or injunctive proceeding."[79] The Commission, however, explained that a prospective defendant's opportunity to submit a response was not absolute, and the Commission expressly reserved the right to take any action while awaiting a submission by a proposed defendant or respondent.[80]

The Commission rejected Recommendation 20 of the Wells Committee, which would have permitted settlement discussions prior to authorization from the Commission to commence an action or proceeding.[81] Apparently, the Commission continued to harbor concerns that its discretionary authority regarding the institution of proceedings would be substantially impaired.[82] Irving Pollack, then director of the Division of Enforcement, explained the reason for rejecting the recommendation as two-fold: first, it would be difficult for the Commission to reject a settlement already reached between staff and a prospective defendant; second, there was concern that settlement discussions prior to Commission approval would give the staff the leverage to threaten prospective defendants into submission.[83] Therefore, the procedure described in the 1970 internal directive of requiring the staff to seek Commission approval to bring an action prior to negotiating settlement of it remained in effect.

In 1979, the Commission, under Chairman Harold Williams,[84] formally adopted in the SEC procedural rules the requirement that the enforcement staff must have Commission authorization before engaging in settlement discussions.[85] The Commission reasoned that its involvement in settlement discussions was critical to ensuring a fair process and to protecting the rights of defendants.[86]

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79. *Id.*

80. *See* SEC Release No. 5310, *supra* note 74, at 2.

81. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 34.

82. *Id.* at 35.

83. Glasser, *supra* note 76.

84. Harold M. Williams—Biography, http://skadden.com/index.cfm?contentID=45&bioID=848 (last visited May 8, 2008). During his tenure, Chairman Williams increased the Office of the General Counsel from approximately a dozen attorneys to more than forty attorneys as an alternative source of advice to the Commission on issues such as enforcement matters.

85. *See* 17 C.F.R. § 202.5(f) (2006).

86. John M. Fedders, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks to the 1981 SEC Accounting Conference Foundation for Accounting

Although the Commission did not adopt all of the forty-three specific recommendations, the most obvious legacy of the Wells Committee was the adoption of the "Wells Process," a process whereby prospective defendants or respondents are afforded an opportunity to submit a writing—essentially a brief—to the Commission and its staff after the staff's investigation is completed, but before the staff has made a recommendation to the Commission. Under this procedure, a prospective defendant or respondent enjoys due process—a hallmark of our Anglo-American judicial system.

THE EVOLUTION OF THE ENFORCEMENT PROGRAM AND ITS PHILOSOPHY

Prior to 1990, the SEC's statutory purpose for enforcing the securities laws was to provide remedial relief for aggrieved investors and to deter future violations.[87] The enforcement program began by serving primarily a remedial purpose, through the Commission's injunctive powers and the disgorgement remedies that the Commission fashioned.[88] In the decades following the Wells Committee, the Commission's enforcement actions began to shift from remedial to punitive in nature. This shift of emphasis arose from the new powers that Congress gave the SEC, such as the authority to impose officer and director bars, penalties against individuals and registered entities, and censures in administrative actions.

In 1984, the SEC staff, in response to a congressional request, prepared a review of the adequacy of enforcement sanctions and remedies.[89] The resulting report stated that "[t]he federal securities laws are presently viewed by the courts as remedial rather than punitive" and

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Education: New York State Society of Certified Public Accountants 3-6 (Nov. 16, 1981).

87. *See, e.g.*, Memorandum from John S.R. Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Rep. Timothy E. Wirth, Chairman, Subcomm. Telecomms., Consumer Prot., & Fin. of the H. Energy and Commerce Comm. 350 (Feb. 22, 1984) [hereinafter Memorandum to Chairman Wirth].

88. *See, e.g.*, *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972) ("The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illegal profits."); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate investors. . . . [I]t is a method of forcing a defendant to give up the amount by which he was unjustly enriched.").

89. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

that the SEC's non-monetary remedies were "effective in most cases" in providing that remedial relief.[90] The staff reported that, aside from the area of insider trading, which Congress was addressing at the time,[91] "the Commission has been unable to identify a serious need for additional remedies to deter a specific type of conduct."[92]

The report asserted that "the advantages of seeking additional civil penalties appear to be marginal" and "must be balanced against a number of potentially serious disadvantages."[93] Chief among those identified disadvantages was the concern that giving the SEC the authority to seek or impose civil monetary penalties for violations of the federal securities laws would "change the character of the enforcement program from remedial to punitive, [and] might lead the judiciary to be less receptive to the SEC's injunctive actions."[94] Traditionally, the Commission relied on the Department of Justice to exercise these remedies through its criminal authority.[95]

By the late 1980s, these philosophical views substantially changed. In a memorandum in support of the Securities Enforcement Act of 1989, the Commission stated that "variable-penalty provisions are appropriate to *penalize and deter the broad range of conduct* for which these penalties will be assessed."[96] The Commission conceded that moving to remedies that were more punitive in nature could result in one of two things: increased difficulty in obtaining settlements as a result of defendants' unwillingness to settle cases involving large civil penalties, thereby potentially harming aggrieved investors, or a greater likelihood of settlement by defendants hoping to avoid much larger civil monetary penalties after litigation.[97] The Commission's asserted need in 1990 to penalize a broad range of conduct was a significant departure from its

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90. *Id.*

91. Congress was considering proposed legislation that eventually became the Insider Trading Sanctions Act of 1984. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

92. Memorandum to Chairman Wirth, *supra* note 87, at 350.

93. *Id.*

94. *Id.*

95. *Id.*

96. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, *reprinted in* H.R. No. 975, 101st Cong., at 7 (emphasis added) [hereinafter SEC Memorandum in Support of Remedies Act].

97. Memorandum to Chairman Wirth, *supra* note 87, at 350-51.

representation to Congress only six years earlier that its existing remedies were effective.[98]

In 1990, former Director of Enforcement Gary Lynch, who had recently left the SEC, testified before the Senate Subcommittee on Securities. Although he testified in favor of providing additional penalty powers to the Commission, he cautioned:

> I think it is important for the Commission to maintain its historical focus on achieving remedial relief, rather than taking punitive action in every case, and that the Commission should still continue to judge the effectiveness of the Commission's enforcement program based on what it actually accomplishes, as opposed to what the dollar amount is that is ordered in a particular case.[99]

Congress provided the SEC with enhanced enforcement remedies, including expanded remedial powers and new penalty authority. These powers were included in the Insider Trading Sanctions Act of 1984,[100] the Insider Trading and Securities Fraud Enforcement Act of 1988,[101] and the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990.[102]

As a result of these laws, the SEC gained three significant new sets of powers: (1) the ability to seek civil monetary penalties against persons and entities that may have violated federal securities laws; (2) the authority to bar directors and officers of public companies from serving in those capacities if they violated federal antifraud provisions; and (3) the authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement of ill-gotten profits to violators of federal securities laws. These significant powers and laws enabling them are discussed in more detail below.

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98. *Id.* at 350.

99. *The Securities Enforcement Remedies Act of 1989: Hearing Before the Sec. Subcomm. of the S. Banking, Hous., & Urban Affairs Comm.* (Feb. 1, 1990) (statement of Gary G. Lynch, Fmr. Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n).

100. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

101. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 1, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

102. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

In connection with its enhanced enforcement efforts with respect to insider trading,[103] the SEC submitted proposed legislation to Congress on September 27, 1982, that would authorize the SEC to seek (and a United States District Court to impose) civil monetary penalties of up to three times the profit realized or loss avoided in insider trading cases.[104] At the time of the proposal, the SEC's primary weapons "against insider trading [were] injunction[s] requiring a defendant to comply with the law in the future, and ancillary equitable relief in the form of disgorgement of illegal profits."[105] Previously, the power to seek "penalties" in the form of prison sentences, criminal fines and restitution resided solely in the Department of Justice ("DOJ") and state authorities.

As a result of the growing number of insider trading cases, the Commission believed that its existing tools of injunctions and disgorgement were inadequate to deter persons from trading on material, nonpublic information. Injunctions, the Commission explained, merely order a defendant prospectively to comply with existing law, and do "not penalize the defendant for the illegal conduct for which the injunction was imposed."[106] The Commission viewed the remedy of disgorgement as likewise inadequate because it merely "strips the defendant of the fruits of his unlawful trading and returns him to the position he was in before he broke the law."[107] Apparently discounting the possible criminal sanctions and the reputational harm associated with injunctive and ancillary relief, the Commission explained to Congress, "[A]n insider who is caught improperly profiting from the use of material information is placed in no worse a position than the honest man who refuses to act."[108]

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103. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2293 [hereinafter SEC Memorandum in Support of Insider Trading Sanction Act].

104. Letter from John Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Hon. Thomas P. O'Neill, Jr., with accompanying memorandum (Sept. 27, 1982), *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2292.

105. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 24.

106. *Id.*

107. *Id.*

108. *Id.* (quoting HARVEY J. GOLDSCHMID, REPORT FOR THE U.S. ADMINISTRATIVE CONFERENCE: AN EVALUATION OF THE PRESIDENT AND POTENTIAL USE OF CIVIL

In response, Congress passed the Insider Trading Sanctions Act of 1984 ("ITSA"), which was signed into law on August 10, 1984. ITSA authorized treble damages in insider trading cases[109] and increased the maximum criminal fine for Exchange Act violations to $100,000.[110] ITSA was the first significant legislation that provided the SEC with the authority to penalize, and it was premised on the Commission's limited belief that penalties in the form of monetary sanctions were necessary to deter the specific securities law violation of insider trading.[111] At that time, the Commission believed that existing remedies were effective against other securities law violations.

Insider Trading and Securities Fraud Enforcement Act of 1988

After the passage of ITSA, Congress continued to evaluate whether the legislation was sufficient to deter insider trading.[112] In the mid-1980s, insider-trading scandals dominated the financial news and involved such high-profile Wall Street traders as Ivan Boesky, Michael Milken, and Dennis Levine.[113] Insider trading became the focus of Congressional hearings in June and July 1986 and continued to be the focus of hearings for the next several years.[114]

In 1988, members of the House Committee on Energy and Commerce introduced additional legislation "[a]fter learning of an increasing number of serious insider trading cases."[115] The new

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MONEY PENALTIES AS A SANCTION BY THE FEDERAL ADMINISTRATIVE AGENCIES 36 (1972)).

109. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

110. *See id.* § 3. Previously, the maximum criminal fine for Exchange Act violations was $10,000. *Id.*

111. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

112. *See* Thomas J. Woo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s* (The Berkeley Electronic Press, Working Paper No. 941, 2006), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=4566&context=expresso.

113. *Id.* at 7.

114. *Id.*

115. Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989); *see also* H.R. REP. No. 100-910, 100th Cong., at 7 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 ("The Insider Trading and Securities Fraud Enforcement Act of 1988 represents the response of [the House Committee on Energy and Commerce] to a series of revelations over the

legislation, the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), was prompted by an "unstated premise that broker-dealers in particular, and others in general, were not doing enough to detect and deter insider trading."[116]

Congress passed ITSFEA and President Reagan signed it into law in November 1988. The new law extended the SEC's authority to impose penalties on persons who control a person who trades on material nonpublic information in violation of the law,[117] and it required broker-dealers and investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information."[118] ITSFEA extended the DOJ's criminal authority by: (1) increasing maximum criminal fines for Exchange Act violations to $1,000,000 for individuals and $2,500,000 for non-natural persons;[119] (2) increasing the maximum duration of imprisonment to ten years;[120] and (3) authorizing the payment of a reward to those "persons who provide information leading to the imposition of [a] penalty."[121] ITSFEA also vested private plaintiffs with authority to assist in the deterrence effort by creating an express private right of action against insiders who trade on material nonpublic information.[122]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990

In October 1987, prior to the passage of the ITSFEA, the National Commission on Fraudulent Financial Reporting—dubbed the "Treadway Commission" after its chairman, former SEC Commissioner James C. Treadway, Jr.—published a comprehensive report that identified causes of financial reporting fraud and issued recommendations for their

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last two years concerning serious episodes of abusive and illegal practices on Wall Street.").

116. Kaswell, *supra* note 115, at 156.

117. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C). The penalty authorized for such control persons could not exceed the greater of three times the profit realized or loss avoided or $1,000,000. *Id.*

118. *Id.*

119. *Id.* § 4.

120. *Id.*

121. *Id.* § 3.

122. *Id.* § 5.

reduction.[123] The Treadway Commission Report recommended the creation of additional SEC enforcement remedies, namely the imposition of fines outside the limited context of insider trading cases, cease-and-desist orders and corporate officer and director bars or suspensions.[124] The stated purpose of these proposals was to afford the Commission "[t]he ability to tailor enforcement actions more precisely to particular facts[,] [thereby] enabl[ing] the SEC to maximize its enforcement effectiveness."[125] In response to the Treadway Commission Report, the chairman directed the staff to develop legislative recommendations in response to the conclusions of the Treadway Commission.[126]

Although the House Committee on Energy and Commerce anticipated taking up the SEC's legislative proposals in response to the Treadway Commission at the same time the House Committee considered ITSFEA,[127] the SEC was unable to complete its proposals in time for inclusion in that legislation.[128] To prompt the SEC to submit additional legislative proposals, Congress added section 3(c) to ITSFEA, which directed the Commission to submit to Congress "any recommendations the Commission considers appropriate with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines."[129]

After ITSFEA was passed, but before it was signed into law, the Commission submitted to Congress its first recommended legislative response to the recommendations of the Treadway Commission.[130] The Commission initially asked for the authority to seek civil penalties in all administrative proceedings, including in proceedings against issuers under explicit, limited circumstances.

In a memorandum to Congress, the Commission, under Chairman David Ruder, set forth the factors that should be considered in determining whether to seek a civil penalty against an issuer in an

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123. *See* NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987), *available at* http://www.coso.org/Publications/NCFFR.pdf.

124. *See id.* at 64-67.

125. *Id.* at 64.

126. Kaswell, *supra* note 115, at 171.

127. *Id.*

128. *Id.*

129. Insider Trading and Securities Fraud Enforcement Act § 3.

130. *See* H.R. REP. No. 101-616, 101th Cong., at 15 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379.

administrative proceeding.[131] First, the SEC underscored that the proposed law would not "dictate" that the Commission must seek or impose a civil penalty against an issuer.[132] Instead, as the Commission explained, the Commission could proceed against culpable individuals and exercise discretion in *not* seeking an issuer penalty.[133] Second, the Commission stressed that it "may properly take into account its concern that civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations."[134] The Commission explained that penalties should be assessed against issuers only in the rare situation where the issuer received a "direct economic benefit" from the fraud:

> In a typical case of financial fraud in which a[n] issuer overstates it[s] earnings and revenues, for example, the only shareholders who reap *a direct economic benefit* are those who sell their shares at an inflated price before the fraud is exposed. By the time that an enforcement action is brought, a large percentage of the shareholders may consist of persons who purchased shares at a price that was artificially inflated as a result of the fraud. *To assess a civil penalty in such a case against the issuer, as opposed to the individual officers who were responsible for the fraud, would appear to be inequitable.*[135]

The Commission further elaborated in a footnote on the limited instances where shareholders of a company might have received a direct economic benefit from fraud:

> The lack of a direct economic benefit to shareholders differentiates financial fraud from other types of violations for which public companies may be fined under other statutes. For example, if a corporation violates environmental standards relating to emissions control, it generally realizes a cost saving that is ultimately realized by shareholders.[136]

Third, the Commission stated that a civil penalty should be imposed on an issuer "only where the violation resulted in an improper benefit to

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131. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 4.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* (emphasis added).

136. *Id.* at 4 n.5

shareholders," but that, even under those circumstances, the passage of time and resulting shareholder turnover may weigh against imposing a penalty.[137]

Central to the Commission's analysis of the propriety of seeking a penalty against an individual or an issuer was whether the penalty would serve a "public interest."[138] To that point, the Commission outlined several additional factors it would consider to determine if the penalty was in the public interest:

- whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
- the harm to other persons resulting either directly or indirectly from such act or omission;
- the extent to which any person was unjustly enriched, *taking into account any restitution made to persons injured by such behavior*;[139]
- whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;
- the need to deter such person and other persons from committing such acts or omissions; and
- such other matters as justice may require.[140]

In its February 1, 1990, "modified proposal" to Congress, the Commission removed its request for the authority to seek civil monetary

137. *Id.* at 5.

138. *Id.* at 9.

139. *Id.* (emphasis added); *compare* Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006) (omitting this clause), *available at* http://www.sec.gov/news/press/2006-4.htm.

140. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 9.

penalties against issuers in administrative proceedings.[141] The Commission also removed its prior request for authority to impose officer and director bars in administrative proceedings.[142] The modified proposal added provisions that expressly authorized the SEC to issue cease-and-desist orders and to order disgorgement in administrative proceedings, and allowed federal courts to bar persons from serving as directors or officers.[143] The Commission's "modified proposal" eventually became law through the "the Securities Enforcement Remedies and Penny Stock Reform Act of 1990," commonly referred to as "The Remedies Act."

As enacted, the Remedies Act significantly expanded the permissible enforcement remedies the Commission may seek in civil proceedings or impose in administrative proceedings.[144] The Remedies Act formulated a three-tiered penalty framework, which sets forth the amount of a fine based on the number and nature of violations.[145] At each tier, the fine may not exceed the higher of the gross pecuniary gain or the maximum statutory amount.[146] This variable penalty framework was not in the original draft of the Remedies Act but was later included to reflect the Commission's belief that variable penalties would aid in

141. *See The Securities Law Enforcement Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.*, 101st Cong. 31 (1990) (statement by Richard C. Breeden, Chairman, U.S. Sec. & Exch. Comm'n).

142. *Id*.

143. *Id*.

144. For a general discussion of each class of remedies created by the Remedies Act, *see* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What is its Relevance Today?*, 1 N.Y.U J. L. & BUS. 587, 589-95 (2005).

145. *See* The Securities Law Enforcement Remedies Act of 1990, S. REP. No. 101-337, 101st Cong. (1990). Originally, there were three tiers of maximum penalty amounts separated according to the gravity and extent of harm caused by the violation, and each penalty is per violation. For SEC administrative proceedings, the first tier penalty was $5,000 for natural citizens and $50,000 for any other person. The second tier maximum penalty was $50,000 for natural persons and $250,000 for any other person and applies to violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. The third-tier penalty for natural persons was $100,000 and $500,000 for any other person and applies to violations that either resulted in substantial losses to other persons or created the risk of such losses. These amounts have been increased by subsequent regulation. *See* 17 C.F.R. 201.1001, *et seq*. (citing the Debt Collection Improvement Act of 1996).

146. *See id.*

tailoring the size of the penalty to fit the circumstances of individual cases.[147]

The Remedies Act further gave the SEC the power to seek (and an administrative law judge to impose) civil penalties through administrative proceedings against specified persons and entities directly regulated by the Commission, such as broker-dealers and investment advisors, when a penalty would be in the "public interest."[148] The Remedies Act also gave the SEC the power to seek civil monetary penalties against issuers, but only in federal court proceedings. Although Congress understood that imposing civil monetary penalties on issuers would harm shareholders,[149] Congress expected that the SEC would exercise discretion and seek civil monetary penalties against issuers *only* when a violation resulted in improper benefits to shareholders.[150]

Congress took comfort in the fact that federal judges would operate as an independent check to the Commission's decision to seek an issuer penalty and the amount sought to be recovered. The concern among members of Congress and internally at the SEC was that if the same remedies were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own

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147. *See* SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 49; *see also* S. REP. No. 101-337, 101st Cong. (1990)

148. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 202, 104 Stat. 931 (1990) (for certain Exchange Act violations); *id.* § 301 (for certain Investment Company Act violations); *id.* § 402 (for certain Advisers Act violations).

149. *See The Securities Law Enforcement Remedies Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.*, 101st Cong. 85 (1990) (statement by Sen. John Heinz) ("Doesn't the imposition of a fine against a publicly held company penalize the shareholder?").

150. *See* S. REP No. 101-337, 101st Cong. 16-17 (1990). Echoing the Commission's intent, the Senate Committee on Banking, Housing, and Urban Affairs stated that it

> intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issue[r]s will ultimately be paid by shareholders who were themselves victimized by the violations.

Id. at 17.

administrative proceedings, rather than before a federal district court judge. The final legislation did not include penalty authority in administrative proceedings precisely because there would be no oversight by Article III judges as there would be in civil proceedings. In practice, however, public companies seldom choose to litigate with the SEC, and *settled* injunctive actions rarely receive any detailed judicial scrutiny. To guarantee the safeguards that normally accompany a judicial determination of a penalty, commissioners must exercise sufficient, policy-level scrutiny, such as the "public interest" analysis described above, in evaluating a penalty recommendation.[151]

After the Remedies Act was signed into law in 1990 and before the SEC's April 2002 Xerox case,[152] the Commission brought only four issuer-penalty cases, totaling less than $5 million.[153] The Xerox case, in which the company paid a $10 million penalty, is viewed by many as the beginning of the "corporate penalty era" at the Commission. Between the Xerox case and the date this Article was written, the Commission has imposed penalties against approximately sixty issuers, totaling billions of dollars.

THE CORPORATE SCANDALS AT THE BEGINNING OF THE 21ST CENTURY

In the first years of this century, the investing public was scarred by major corporate scandals leading to the demise of several large companies such as Enron Corp.[154] and WorldCom Inc.[155] that were

151. In January 2006, the Commission issued a statement outlining the parameters under which it would consider seeking penalties against issuers. *See infra*, text accompanying notes 178-181.

152. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002).

153. There were large penalties against registered entities during this period. *See, e.g.*, Press Release, Department of Justice and SEC Enter $290 Million Settlement with Solomon Brothers in Treasury Securities Case, *available at* http://www.usdoj.gov/atr/public/press_releases/1992/211182.htm. These penalties are not discussed in this Article because they were levied against registered entities for defrauding their customers or the market, as opposed to defrauding their shareholders.

154. At the time that it declared bankruptcy in 2001, Enron was the seventh largest company on the Fortune 500 list by revenues. *See* Matt Moore, *Bankrupt Enron No. 5 in Fortune 500 List*, HOUSTON CHRONICLE, Apr. 4, 2002, *available at* http://www.chron.com/disp/story.mpl/special/enron/1327642.html.

155. Until the financial problems of WorldCom became acute in spring 2002, the bills under consideration in the Senate and House were not given much chance of passage. *See* Peter J. Wallison, *Sarbanes-Oxley as an Inside-the-Beltway Phenomenon*,

viewed previously as paragons of industry. Congress reacted to the new spate of corporate scandals in the same way that it did in response to the insider trading scandals of the 1980s—it provided the SEC with significant authority to enforce new and existing laws.[156] The Sarbanes-Oxley Act of 2002 imposed significant, additional requirements on corporations and their officers and directors.[157] The Sarbanes-Oxley Act greatly expanded the Commission's enforcement powers and the criminal penalties for violating the federal securities laws.[158]

Section 1105 of the Sarbanes-Oxley Act permits the SEC to obtain officer and director bars in administrative proceedings, and section 305(a) amended 15 U.S.C. § 78u(d)(2) and 15 U.S.C. § 77t(e) by lowering the standard for obtaining a bar from "substantially unfit" to "unfit." Prior to the adoption of the Sarbanes-Oxley Act, an officer and director bar was available only in civil injunctive actions after a showing that the officer or director was "substantially unfit" to serve in the position.[159]

Section 308(a) of the Sarbanes-Oxley Act contained a novel "Fair Funds" provision that allows the Commission to disperse the penalties obtained from wrongdoers to compensate harmed shareholders.[160] Section 308 had no counterpart in the Senate bill, because it was added

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AMERICAN ENTER. INST. FOR PUB. POLICY RESEARCH, June 2004, at 2, *available at* http://www.aei.org/publications/pubID.20582/pub_detail.asp. The collapse of WorldCom, relatively close to the 2002 congressional election, which both political parties acknowledged as a rematch of the very close presidential election of 2000, led to the eventual enactment of the Sarbanes-Oxley Act, with only three votes against it in the entire Congress. Some in Washington dubbed the Sarbanes-Oxley Act the "Bernie Ebbers Memorial Act" after the then-CEO of WorldCom.

156. In the intervening years following the Remedies Act, Congress did not adjust the SEC's enforcement authority to any great extent. The principal exception was the Private Securities Litigation Reform Act of 1995 §104, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. 78t(e)). The PSLRA amended the securities laws to allow the SEC to bring actions against secondary violators that aid and abet securities law violations. Congress wisely declined to extend that right to private parties, out of concern over abusive securities litigation.

157. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

158. The changes relevant to this Article are discussed below. The Sarbanes-Oxley Act included other provisions that are not discussed here.

159. Sarbanes-Oxley Act § 1105, 15 U.S.C. 7246 (2006).

160. *Id.* § 308(a).

during the conference process.[161] Accordingly, the Senate Banking Committee report does not discuss this provision.

Prior to Section 308(a), the Commission was permitted to remit amounts obtained in actions as *disgorgement* to injured investors, but was required to remit any *penalties* it received to the U.S. Treasury. Section 308(a) provided flexibility to the Commission to distribute both disgorgement and penalties through a Fair Fund, but the penalties cannot be dispersed absent disgorgement of ill-gotten gains.[162] Congress, joined by the Justice Department, wanted to avoid having penalties become a substitute for disgorgement. Disgorgement is the forfeiture of the ill-gotten gains received by the defendant; it is not inherently a mechanism to recompense aggrieved investors. By making disgorgement a prerequisite for adding penalties to the Fair Fund, Congress focused on depriving the defendant of its ill-gotten gains, not necessarily punishing wrongdoers.[163] Congress also may have been concerned with a possible windfall to investors if the defendant did not receive any ill-gotten gain from the wrongdoing.

Congress also required the SEC to study ways to improve the Fair Funds process. Section 308(c) of Sarbanes-Oxley instructed the SEC to review and analyze enforcement actions over the course of the five years prior to enactment "to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors . . . including methods to improve the collection rates

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161. *See* Press Release, Baker Proposes New Federal Investor Restitution Fund (July 17, 2002), *available at* http://web.archive.org/web/20031108035021/www.baker.house.gov/News/fair_fund.htm [hereinafter Baker I].

162. *See* Sarbanes-Oxley Act § 308(a). Within the first six months of having the authority, the Commission sought federal court approval of Fair Fund distributions on at least 12 occasions. Stephen Cutler, Dir. of Enforcement, U.S. Sec. & Exch. Comm'n, Testimony Concerning Returning Funds to Defrauded Investors Before the H. Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters., Comm. on Fin. Servs. 10 (Feb. 26, 2003) *available at* http://www.sec.gov/news/testimony/022603tssmc.htm [hereinafter Cutler Testimony].

163. *See* Press Release, Baker Statement to Open House-Senate Conference on Corporate Reform (July 19, 2002), *available at* http://web.archive.org/web/20030906035258/www.baker.house.gov/News/conf_corprfm.htm.

> How is it possible for anyone to sit idly by while watching a corporate official move into his $20 million mansion, with hundreds of millions of dollars in retirement benefits, having generated this lifestyle by manipulating the books and defrauding shareholders? With the adoption of the FAIR plan, we will make this much less likely to occur and offer the hope to investors for a small reduction in their loss.

Id.; *see also* Baker I, *supra* note 161.

for civil penalties and disgorgements."[164] Section 308(c) instructed the SEC to provide a report to Congress within 180 days of the enactment of the Act that included "a discussion of regulatory or legislative actions" that the SEC recommended or "that may be necessary to address concerns identified in the study."[165]

In response to Section 308(c), the Commission submitted a report to Congress on January 23, 2003.[166] In its report, the Commission described the limitations of the requirement in Section 308(a) for the SEC to obtain disgorgement before adding the penalty amount to the Fair Fund:

> Currently, the Fair Fund provision permits the Commission to add penalty money to distribution funds in limited circumstances. If a defendant is ordered only to pay a penalty, then that defendant's penalty amount cannot be added to the disgorgement fund. Moreover, if no defendants in a case are ordered to pay disgorgement, then no penalties may be distributed to injured investors. Some issuer financial fraud and reporting cases do not result in any disgorgement orders because no defendant received a tangible profit causally connected to the fraud.[167]

To alleviate these restrictions, the Commission recommended that Congress amend Section 308 to permit the penalties to be added to the Fair Funds even when no disgorgement is obtained. The Commission's report stated:

> By amending the Fair Fund provision to allow defendants' penalties to be distributed to investors irrespective of whether the defendant has been ordered to disgorge money, Congress could allow more monies to be returned to harmed investors.[168]

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164. Sarbanes-Oxley Act § 308(c).

165. *Id.*

166. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, *available at* http://www.sec.gov/news/studies/sox308creport.pdf.

167. *Id.* at 34.

168. *Id.*; *see also* Cutler Testimony, *supra* note 162.

> [I]t would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who are paying disgorgement) to harmed investors in that case . . . . We recommend making technical amendments to the Fair Fund provision to permit the Commission to use penalty moneys for distribution funds in these additional circumstances.

Id.

In response to the Commission's request, Chairman Richard Baker of the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises of the House Financial Services Committee introduced legislation in 2003 and 2006 to permit any penalty monies obtaining by the Commission to be added to a Fair Fund for the benefit of victims of the securities law violation.[169] Neither bill passed Congress.[170]

Proponents of corporate penalties argue that the Fair Funds provision of the Section 308 of the Sarbanes-Oxley Act alleviates the earlier concerns raised by the Commission in 1989 and Congress in 1990 about harm to shareholders, because any penalties collected are distributed to shareholders. This argument is premised on flawed, circular reasoning. When the Commission obtains penalties from a corporation, there is always one group of shareholders that must pay. The Commission is taking from one group of shareholders to recompense another.[171] Whatever its characterization, ultimately the costs of making this circular distribution are borne by shareholders.

There is no doubt that Section 308 was rooted in good intentions of attempting to help defrauded shareholders. Unfortunately, it has injected an element of uncertainty because penalties are inherently subjective, while disgorgement is rooted in the notion of illicit gain, which generally is quantifiable. In many instances, the SEC has avoided—some argue circumvented—the requirements of Section 308 by assessing a "nominal" disgorgement amount of $1 in order to obtain the "hook" to justify seeking a large corporate penalty to put into a Fair Fund for distribution.[172] As a result, the Fair Fund provision, which was

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169. *See* Fair Fund Improvement Act, H.R. 5956, 109th Cong. (2006); Securities Fraud Deterrence and Investor Restitution Act of 2004, H.R. 2179, 108th Cong. (2004); Dissenting Views to Accompany H.R. 2179, H.R. REP. No. 108-475 (Apr. 27, 2004); *see also* Press Release, Baker, Oxley Introduce Bill To Strengthen SEC Powers Against Securities Fraud, Return Funds To Defrauded Investors (May 21, 2003), *available at* http://web.archive.org/web/20030602
192406/www.baker.house.gov/News/fair_bill.htm.

170. The bills did not advance in Congress because of the general unwillingness to re-open the Sarbanes-Oxley Act of 2002.

171. The Fair Fund distribution thus creates a circular situation: the Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized.

172. *See, e.g.*, Bruce Carton, *When a Dollar (of Disgorgement) Is Worth Millions*, SEC. CLASS ACTION SERV., (Institutional S'holder Servs.), Dec. 3, 2004, *available at* http://scas.issproxy.com/Newsletter/issscasDecember2004.html#POVEditorial (discus-

designed to *protect* shareholders, has been used as a justification for obtaining large corporate penalties, which may *harm* shareholders. Therein lies the paradox: Fair Funds used to compensate injured shareholders are often funded largely through corporate penalties, which are paid by the corporation's current shareholders and result in additional adverse consequences for the company through depletion of its assets.

AN ERA OF INCREASING PENALTIES AGAINST SHAREHOLDERS

The size of the penalties imposed by the Commission has increased markedly in recent years.[173] For example, in 2002, the SEC obtained its first $10 million penalty against a public corporation in its settlement with Xerox Corporation.[174] Since then, the Commission has levied many civil penalties in that amount or larger. In 2003, the Commission obtained twenty penalties in that range or greater, while in 2004, it

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sing recent settlements such as Symbol Technologies ($1 disgorgement; $37,000,000 civil penalty), i2 Technologies ($1 disgorgement; $10,000,000 civil penalty), Royal Dutch Petroleum ($1 disgorgement; $120,000,000 civil penalty), Bristol-Myers Squibb Co. ($1 disgorgement; $150,000,000 civil penalty), and Qwest ($1 disgorgement; $250,000,000 civil penalty)). Disgorgement is a remedy that, if available, is supposed to be exhausted before the SEC seeks a penalty. Therefore, only in the rarest of circumstances should the SEC seek a penalty that accomplishes the goal of stripping away an ill-gotten benefit. Unfortunately, that has not been the case in many SEC penalty actions. Many of those actions have blurred the distinction between "benefit" and "restitution."

173. Not only have civil monetary penalties increased, the number of officer and director bars has also increased drastically over the last several years as has the involvement of criminal authorities, such as the Department of Justice, in securities law violations. In 2004, 170 director and officer bars were entered—more than three times as many as entered in 2001—and the DOJ brought criminal proceedings against 302 entities and individuals in SEC related matters. U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 25 (2006), *available at* http://www.uschamber.com/NR/rdonlyres/eodmudjqljq2lvttjhn56rn4uubva3yoyzeijj2sh4ugkxlo6xyrpu3cqismvuckpgea3o4gpn4utyo7uzs7ueqydmc/0603SECEnforcementStudy.pdf.

174. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002); *see* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REPORT (2003), *available at* http://www.sec.gov/about/gpra2004_2002.pdf.

obtained forty such penalties.[175] The total amount of issuer penalties in 2003 and 2004 was greater than the total amount of *all* penalties imposed by the SEC for the prior fifteen years combined. From 2003 through 2007, approximately $13.8 billion in disgorgement and civil penalties were ordered to be paid to the SEC, courts, or other appointed trustees.[176]

An essential consideration in deciding the appropriateness of any corporate penalty is determining who has profited from the illegal conduct. Sometimes, shareholders have benefited, as in cases of price fixing or bribery of foreign officials; without the bribe, the corporation would not have received a benefit. Regulated entities, such as broker-dealers or registered investment advisors, might increase profits or revenues, which in turn benefit shareholders, by failing to comply with regulatory requirements.[177] In the rare instances where disgorgement may be difficult to calculate, corporate penalties may be appropriate to reverse the ill-gotten benefit.

On the other hand, there are situations where the shareholders did not benefit from the securities law violation. In a typical financial fraud case, management misrepresented the corporation's financial performance to the owners of the corporation. In the typical case, the shareholders have suffered from management's deception and received no ill-gotten gain. When the fraud becomes public, often the market reacts by depressing the value of the stock. In addition, an investigation and ensuing litigation distracts management from the business, drains corporate resources, and harms the corporation's reputation. A penalty would add further to shareholder injury.

In the majority of SEC corporate penalty cases, the corporation has also been sued for the same transgressions in civil class action suits seeking restitution for allegedly harmed shareholders. Settlement proceeds from such private actions should be recognized by the Commission as an offset when determining whether to penalize a corporation in a financial fraud case. Indeed, by statute, the Commission must consider such restitution in its own administrative proceedings when a penalty is under consideration.

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175. *See* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE REPORT (2005), *available at* http://www.sec.gov/about/secpar/secpar04.pdf; U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 2003 (2004), *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf.

176. 2007 REPORT, *supra* note 9, at 26.

177. Penalty figures in this Article do not include regulated entities.

Another essential consideration in seeking and imposing a penalty is the effectiveness of the sanction. There is an inherent conflict of interest between management and shareholders of a corporation. If senior managers are faced with the threat of enforcement actions against them or their former colleagues, the senior managers might be motivated by their self-interest to settle the action against the corporation for a large corporate penalty. The penalty obtained in settlement with the corporation may satisfy the SEC's desire to garner public awareness (and thus enhance the "deterrent" effect), causing the SEC to forgo seeking large penalties against individual managers. This willingness to forgo seeking penalties against individuals increases when the evidence against the individuals is relatively weak (indicating a greater risk of losing at trial), or when the individuals have negligible assets or name recognition (diminished publicity and deterrence value).

Other potential conflicts of interest exist between management and shareholders that may interfere with the effectiveness of the sanction. New senior managers, who may have started after the departure of former employees tainted by the fraud, may feel compelled to settle the matter to minimize negative publicity from their being associated with the fraud. In addition, corporate boards, while exercising business judgment, may approve a settlement to avoid the costs and other negative effects of prolonged litigation with the SEC.

As both a philosophical and practical matter, the effectiveness of a corporate penalty as a means for deterrence is questionable. Corporations do not act; individuals do. Senior managers who commit fraud undoubtedly do so with the knowledge that their actions, if exposed, will cause reputational and economic harm to their corporation, such as a depressed stock price, loss of customers and business partners, shareholder litigation, and legal and investigative costs. Often, what motivates the wrongdoer to commit the fraud is the potential personal pecuniary gain of increased stock price, personal advancement within the corporation, or masking the negative effects of strategic or tactical management decisions on the performance of the company. If wrongdoers have little concern for their company and shareholders when they commit the fraud, it is doubtful that the behavior of potential wrongdoers will be altered by the threat of a corporate penalty on the company and shareholders that they are seeking to victimize. Are would-be fraudsters more likely to be deterred by headlines trumpeting a multimillion dollar corporate fine, or by hearing that a senior executive was fired, lost his savings, became barred from serving as an officer or a

director, suffered irreparable harm to his reputation, and perhaps faces incarceration?

Each of these considerations continues to be important when the Commission evaluates whether to seek a penalty against a corporation. In providing the SEC with the power to seek penalties against corporations, Congress recognized the need for the SEC to have the authority in limited and rare circumstances, and it trusted the SEC with the discretion to use that authority in accordance with the SEC's mission of protecting investors. In order to provide some transparency to the process, the Commission has issued guidance to the public concerning what factors the Commission considers and what prospective defendants may do to avoid a penalty or reduce the amount.

THE 2006 STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION CONCERNING FINANCIAL PENALTIES

Under a new chairman, the Commission on January 4, 2006, released a statement concerning the factors that the SEC would evaluate in assessing a monetary penalty.[178] In formulating the penalty statement, the Commission returned to first principles: it discussed the 1989 and 1990 Commission and Congressional statements regarding penalties and attempted to set up a hierarchy of balancing considerations to guide future deliberations. It stated unequivocally that penalties against corporations can harm shareholders, a point that previously had been in dispute within the Commission.

The Commission explained that the two most significant factors are: (1) the presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm shareholders.[179] The first key factor focused on unjust enrichment to the corporation, and thus to the shareholders. Any improper benefit would have to be balanced against the losses incurred by the shareholders as a result of the fraud.

The second key factor balances the possibility that the penalty will "recompense" investors with the injury that the penalty would do to them. In this factor, the Commission, unfortunately, was rather

178. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm [hereinafter 2006 Penalty Statement].

179. *Id.*

imprecise with its terms. In every case, current stockholders pay for the penalty. The purpose of this language was to cover the cases in which other classes of investors may have been harmed for the benefit of the stockholders—for example, fraudulently enhanced financial statements may have resulted in lower coupon interest rates or yields to bondholders, to the benefit of the corporation and its common stockholders.

The Commission also announced secondary factors for consideration. Those factors are: (1) "The need to deter the particular type of offense;" (2) "The extent of the injury to innocent parties;" (3) "Whether complicity in the violation is widespread throughout the corporation;" (4) "The level of intent on the part of the perpetrators;" (5) "The degree of difficulty in detecting the particular type of offense;" (6) "Presence or lack of remedial steps by the corporation;" and (7) "Extent of cooperation with Commission and other law enforcement."[180]

The penalty statement has served as a reminder of the fact that corporate penalties harm shareholders. Nevertheless, it has had some unintended consequences. In particular, the last factor—the extent of cooperation with the Commission and law enforcement—has been used along with other Commission guidance as a means to *credit* prospective defendants, particularly corporations, for waiving their attorney-client privilege and work-product protections.[181]

THE SEABOARD REPORT

The SEC's explicit willingness to credit cooperation, even if it involves the waiver of the attorney-client privilege and work-product protection, predates the 2006 Statement on Penalties and the Sarbanes-

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180. *Id.*

181. The New York Stock Exchange lists waiver of the attorney-client privilege as a factor in evaluating whether a Member has exhibited "extraordinary cooperation." *See* New York Stock Exchange, Information Memorandum No. 05-65 to All Members, Member Organizations and Chief Operating Officers 5 (Sept. 14, 2005). Members of the New York Stock Exchange are required as a condition for listing to cooperate and produce documents upon request by the Exchange, but that required cooperation does not include a mandatory requirement to produce attorney-client privileged information. FINRA (formerly NASD) Rule 8210 requires members and persons associated with members to produce non-privileged documents and provide testimony upon request by FINRA. *See* FINRA Rule 8210, *available at* http://finra.complinet.com. As a general matter, the SEC does not impose any similar mandatory requirements to cooperate in its investigations.

Oxley Act. On October 23, 2001, the Commission released an investigative report pursuant to section 21(a) of the Exchange Act, addressing the relationship of cooperation and agency enforcement decisions.[182] That report, called the "Seaboard Report" based on the name of the defendant at issue, marked the first time that the Commission announced the factors that it would evaluate in measuring cooperation and assessing whether to bring an enforcement action.

The Commission intended this report to encourage companies to cooperate with the SEC in investigations. In that respect, the report was a major improvement in the transparency of the SEC in its enforcement investigations. Lacking a public manual of policies and procedures, the SEC in effect encouraged an informal body of knowledge to develop among long-time SEC enforcement practitioners as to what was expected of potential defendants in dealing with the Commission.[183] The Seaboard report was a long-overdue attempt to open up the process.

Among other issues, the Seaboard Report discussed disclosures to staff of confidential information protected by the attorney-client privilege or work-product doctrine. In a footnote, the Seaboard Report stated:

> The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff.[184]

Waiver is not itself listed as one of the Seaboard criteria for determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. Nonetheless, the Enforcement Division and the Commission in the ensuing years often have misinterpreted the Seaboard Report as a basis for rewarding companies for waiving privilege. As a practical matter, rewarding companies for

182. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935.

183. The Wells Committee had the same concern with inexperienced practitioners being unaware of a prospective defendant's ability to provide written submissions that raised factual and legal defenses. *See supra*, text accompanying note 58.

184. *Id.* at n.3.

cooperating by waiving privilege has the same effect as punishing them for not waiving privilege—both effectively strip the attorney-client privilege, which is a fundamental component of our legal system.[185]

Another problem with a permissive approach to waiver is that waiver becomes mandatory in practice. Faced with concerns over their fiduciary duties and the expense and risk of litigation to the corporation, a corporation's board of directors may feel compelled to take full advantage of any cooperation credit available to it by waiving the attorney-client privilege and work-product protection. Indeed, shareholders likely would be unable to establish that the board of directors breached its fiduciary duty by waiving the corporation's privilege in exchange for cooperation credit if the corporation faced the threat of a large penalty.[186]

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185. *See, e.g.*, The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before the S. Comm. on the Judiciary (2006) (statement of Edwin Meese III, former Att'y Gen. of the United States and Chairman, Ctr. for Legal and Judicial Studies, Heritage Foundation), *available at* http://judiciary.senate.gov/testimony.cfm?id=2054&wit_id=5741.

> [E]xperience has shown that the [Thompson] Memorandum has resulted in the dilution of essential rights encompassed by the attorney-client relationship. . . . [T]he Thompson Memorandum itself pressures companies to fulfill its nine factors, including by waiving their attorney-client privilege and cutting off their employees' attorney fees. Even if no prosecutor ever mentions either factor to a company, the fact that the Thompson Memorandum requires federal prosecutors to take all nine of its factors into consideration when deciding whether to indict a business organization necessarily places great pressure on the company to take these two steps.

Id. For a discussion of the Thompson Memorandum and other Justice Department memoranda regarding waiver of attorney-client privilege and work-product protection, *see infra* note 187.

186. Just as with any individual, corporations must not obstruct government investigations and must comply with duly issued subpoenas and court orders. Individuals and corporations, however, owe no duty to abandon all potential defenses and privileges in the face of government investigations. In fact, under state law, the directors of a corporation owe fiduciary duties to their shareholders. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (discussing the duties of directors). Under most state laws, including Delaware General Corporate Law, the board of directors of a corporation owes to its *shareholders* a duty of care and loyalty. *See id.* In some instances, cooperating with the SEC or another regulator may be contrary to the fiduciary duties of the directors because cooperation may lead to the corporation's being susceptible to meritless governmental actions and frivolous shareholder litigation. In those circumstances, it may be appropriate for the board of directors, in fully evaluating the situation and exercising business judgment, to decline to waive their attorney-client privilege with respect to a government investigation.

The idea of crediting the waiving of the attorney-client privilege or work-product protection originated with the Department of Justice. Two years prior to the Seaboard Report, the DOJ published the first memorandum—of what would ultimately be several memoranda—illuminating on the meaning of cooperation and the general principles that the Department of Justice follows when investigating business organizations.[187] These DOJ memoranda stated explicitly that a corporation's willingness to waive the attorney-client privilege and work-product protection should be considered in determining whether a corporation has cooperated adequately with the government. Given the number of parallel investigations by the DOJ and SEC, the policies of one agency affect the conduct of the other's investigations and limit the possible range of choices available to a defendant.[188]

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187. The first memorandum was sent by Deputy Attorney General Eric Holder to all Department Component Heads and U.S. Attorneys on June 16, 1999 (the "Holder Memorandum"). The Holder Memorandum focused on the prosecution of corporate criminal activity and included a document called "Federal Prosecution of Corporations," which outlined factors and considerations to be taken into account when charging corporations. Memorandum from Eric Holder, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (June 16, 1999) (on file with the Department of Justice). The second memorandum, which was a response to the substantial controversy that arose over the Holder Memorandum, was sent by Deputy Attorney General Larry Thompson in January 2003 and included much of the same text from the Holder memo, with some changes to reflect findings of the Corporate Fraud Task Force. Memorandum from Larry D. Thompson, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. Mounting criticism regarding lack of policies and procedures in this regard led acting Deputy Attorney General Robert McCallum in 2005 to amend the U.S. Attorney's manual to require that U.S. Attorneys establish a written waiver review process for their respective districts. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Oct. 21, 2005), *available at* http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00163.htm.
Finally, the Justice Department, under the direction of Deputy Attorney General Paul J. McNulty, released a memorandum that attempted to draw distinctions on categories of privileged material. *See* Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf. The McNulty memorandum still gives entities credit for turning over attorney-client privileged material and attorney work product.

188. The implications extend to individuals as well. DOJ allows prosecutors to consider a company's willingness to punish employees who assert their constitutional rights and whether the company entered into joint-defense or information-sharing agreements with employees. This policy could cause an employee to face the difficult choice of losing his job or cooperating in an internal investigation without counsel and without constitutional protections. *See, e.g.*, *Proposed Amendment of Commentary on*

The practices of the SEC and DOJ to credit cooperation for waiving the attorney-client privilege or work-product protection have met with significant criticism. On February 5, 2007, the American Bar Association ("ABA") submitted to the SEC a proposed "Revised Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," which seeks to have the SEC revise the Seaboard Report with respect to the waiver of the attorney-client privilege and work-product protection.[189] The proposal amends the section of the Seaboard Report describing the factors by which cooperation may be measured to read: "provided, however, that a company shall not be required to take any of the foregoing actions to the extent that it would result in a waiver of the attorney-client privilege or work product doctrine."[190] The proposal also seeks to remove the ambiguous footnote 3 of the Seaboard Report that describes waiver as "a means (where necessary) to provide relevant and sometimes critical information to the Commission staff." The proposal adds a new paragraph and related footnote describing the importance of attorney-client privilege and work-product protection and the adverse consequences when staff seeks the waiver.[191] The new paragraph states in part:

> Commission staff shall not take any action or assert any position that directly or indirectly demands, requests or encourages a company or its attorneys to waive its attorney-client privilege or the protections of the work product doctrine. Also, in assessing a company's cooperation, Commission staff shall not draw any inference from the company's preservation of its attorney-client privilege and the protections of the work product doctrine. At the same time, the voluntary decision by a company to waive the attorney-client

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Section 8c2.5 of the Federal Sentencing Guidelines Regarding Waiver of Attorney-Client Privilege and Work Product Doctrine Before the United States Sentencing Commission (2006) (statement of Kent Wicker, Nat'l Ass'n of Criminal Def. Lawyers).

> This compelled waiver of the attorney-client privilege forced my client to give up the protection at the heart of our criminal justice system: The privilege under the Fifth Amendment against self-incrimination. It is not enough to say he could have just given up his job and retained his Fifth Amendment rights. This is a real person, with a real family to support.

Id.

189. Letter from Karen J. Mathis, President, American Bar Ass'n, to Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n (Feb. 5, 2007), *available at* http://www.abanet.org/poladv/letters/attyclient/2007feb05_privwaivsec_l.pdf.

190. *Id.* at 2.

191. *Id.* at 2-3.

> privilege and/or the work product doctrine shall not be considered when assessing whether the company provided effective cooperation. The Commission may consider, however, in assessing whether a company has provided effective cooperation, the degree to which the company has provided factual information to the Commission staff in a manner, to be worked out by the company and the Commission staff, that preserves the protections of the attorney-client privilege and work product doctrine to the extent possible.[192]

Similar criticisms by other groups have been, and continue to be, levied against using the Seaboard Report to encourage waiver of the attorney-client privilege or work-product protection.[193]

As the SEC and other Federal agencies press to have the attorney-client privilege waived as they undertake investigations, the entire privilege is gradually weakened. As knowledge of its weakening spreads, corporate employees may become less candid and forthcoming, corporate internal investigations will be less trustworthy, and shareholders and government investigators will be frustrated in their efforts to prevent misdeeds. Given those outcomes, revisiting Seaboard and the SEC's approach to the attorney-client privilege and work-product protection is long overdue.

A CALL FOR A NEW ADVISORY COMMITTEE

The SEC Enforcement Division is viewed with pride by Commissioners, staff, alumni, and many outsiders. The Division has a long history of stellar achievements and dedicated attorneys, accountants, and other staff. Thirty-six years after its creation, the Division is larger, stronger, and more visible than any member of the Wells Committee could have imagined. Thus, it makes sense that the

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192. *Id.* at 3. The proposal recognizes that there are limited, specific exceptions where the staff, after obtaining advance approval from the Director of Enforcement or his/her designee, may seek privileged or work-product materials. Those exceptions arise when the company asserts the advice of counsel defense or the SEC staff establishes the elements for the crime/fraud exception. *Id.*

193. *See, e.g.*, McLucas, Shapiro & Song, *The Decline of the Attorney-Client Privilege in the Corporate Setting*, 96 J. CRIM. L. & CRIMINOLOGY 621 (2006); Posting of Thomas O. Gorman, The Rolling Stones Test: SEC And DOJ Cooperation Standards, SEC Actions Blog, http://www.secactions.com/?p=190 (May 22, 2007, 01:07 EST) ("Conversely no cooperation credit should be given for what the government says it does not usually need –privileged material and waivers.").

Commission should consider whether it is time to convene a Wells-like committee to "bring to date" the best thinking on enforcement practices.

The new advisory committee's mission would be to conduct an independent review of the Commission's enforcement program from multiple, diverse perspectives, and to recommend to the Commission, if warranted, any needed changes. We propose that the new advisory committee adopt the same mandate as that of the Wells Committee in 1972. The tasks assigned to the Wells Committee are as important today as they were in 1972. If the same mandate is adopted, the new advisory committee would be charged with virtually the same tasks as the original Wells Committee, only slightly adapted to developments in the last three decades:

> (1) reviewing and evaluating the Commission's enforcement policies and practices in light of its statutory responsibilities and mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation;
> (2) advising how the SEC's enforcement objectives and strategies may be made more effective;
> (3) examining the Commission's enforcement practices and procedures from the point of view of due process,[194] respect for the prospective defendants' attorney-client privilege and work-product protection,[195] the relationship of enforcement action to notice of legal requirements, the attribution of responsibility for violations, and the

194. The Committee should consider the Commission's current procedure regarding authorization of cases implicating potential corporate penalties, under which the Commission authorizes the staff to negotiate a settlement, before the staff engages in any settlement discussions with the prospective defendant. At issue is whether the Commission, at the time of authorization of negotiations, should also authorize the staff to litigate if the settlement negotiations prove unfruitful, or whether the staff should return to the Commission to seek litigation authorization. The issues hearken back to those that animated the debate around the original Wells Committee Recommendation 20, namely whether authorizing staff to litigate before commencing settlement negotiations skews the negotiations through the implicit threat to litigate if no settlement is reached. *See supra* notes 61-72 and accompanying text.

195. Included in this task would be the need to re-evaluate the 2006 Statement Regarding Penalties and the 2001 Seaboard Report, particularly with respect to the expectation of waiver of attorney-client privilege and work-product protection as a determinant of cooperation.

> protection of reputation and rights of privacy of those with whom the Commission interacts;[196]
> (4) making recommendations on the appropriate blend of regulation, publicity, and formal enforcement action and on methods of furthering voluntary compliance with securities laws;
> (5) making recommendations on criteria for the selection and disposition of enforcement actions, in particular, providing timely notice to parties of the closing of an investigation; and
> (6) advising on the appropriate uses of penalties against corporations in light of the SEC's mission of protecting investors.

Among the many issues that would fall under this broad mandate would be the implementation of mechanisms to provide more efficacy, predictability and transparency to the enforcement program. The overall philosophy and management of the enforcement program should be examined to determine how best it can fulfill the SEC's mission, in light of resources and statutory authority.

Predictability and transparency provide for a fair process that respects the rights of all parties involved and ensures adherence to the rule of law.[197] Of course, the Commission's discretion should not be eliminated in favor of rote application of a mathematical formula for calculating penalties. Discretion plays an important role in forgoing certain theories of liability or not bringing an action at all. For example, a company and its shareholders may have been punished enough through

196. Beyond the scope of this Article is the ancillary issue of disclosure by issuers of the various stages of an SEC investigation. Although in large part a facts-and-circumstances determination as to materiality, guidance would be helpful to issuers and practitioners.

197. With the increasing emphasis on a more punitive enforcement approach, are sufficient safeguards in place to protect the rights of prospective individual defendants? At the time of the Wells Committee, the SEC lacked the power to seek punitive damages against individuals, so the potential costs to the individual defendant were not as pronounced as they are today. Individual defendants are faced with high costs of defending an SEC action and severe consequences if they lose. These consequences at times can be tantamount to criminal sanctions, including large monetary payments and loss of livelihood. Often, the only option is a pro-se defense. Will a Commission one day decide that it should establish a system to provide representation to individual defendants who cannot afford to hire private counsel?

other avenues or the securities law violation may have been merely an honest mistake. Indeed, the Wells Committee's Recommendation 14 discussed this type of discretion:

> The Commission should give due consideration in cases which appear to involve honest mistake or good faith efforts at compliance to exercising its discretion against bringing a formal enforcement proceeding notwithstanding the appearance of a violation.[198]

The ability of the Enforcement Division to recommend to the Commission that no action be taken in a particular matter should be encouraged and institutionalized. This will require, among other things, a re-evaluation of the incentives for bringing actions and obtaining large penalties (such as through promotions, awards, and public recognition). Statistics, such as the number of cases brought and the penalties recovered, should play only a minimal role in assessing individual performance. Instead, an evaluation system should focus on rewarding high quality efforts and professionalism regardless of the outcome of particular actions. A decision to forgo bringing an enforcement action should not be treated automatically as a loss, but it should be evaluated qualitatively alongside other enforcement decisions.

In some instances, exercising discretion may not be appropriate. There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division.

Another aspect that could be considered by the advisory committee is the implementation of a written and uniform "full-disclosure" policy for enforcement matters.[199] In criminal procedure, this is often referred to as an "open jacket" policy. Operating under such a policy, the enforcement staff would show defense counsel the evidence it has against the prospective defendant, which is the essence of due process. Some practicing lawyers have criticized the SEC Enforcement Division for failing to explain to defendants the allegations of wrongdoing and failing to share critical incriminating—and most importantly,

198. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv.

199. The Wells Committee proposed the institutionalization of a similar policy. *See supra* note 71 and accompanying text. Currently, there is not a uniform practice among the various units in the Enforcement Division.

exculpatory—evidence that the SEC has gathered.[200] Because no such policy is in place today, arguments in Wells Submissions often are based on defense counsel's best guess as to the conduct that enforcement staff has identified as violating federal securities laws. The sharing of information would promote the goal of fact-finding, which is paramount to due process and to the administration of justice.

With the advent of additional remedies in the SEC's arsenal in the decades after the Wells Committee and a shift in approach towards a more punitive focus, the idea of a full-disclosure policy is even more important than it was when the Wells Committee made its recommendations. The SEC staff should inform fully individuals and companies about the allegations and the evidence at the time of a Wells call or, at the very latest, before entering into settlement discussions. Corporate boards, in particular, must be sufficiently informed so that they can apprise their shareholders and exercise good business judgment in determining whether to settle a matter with the SEC.

Another aspect of the enforcement program that the new advisory committee should consider is the process for closing investigations. In a report to Congress by the General Accountability Office ("GAO"), the GAO harshly criticized the Enforcement Division for not closing investigations promptly and observed that the Division had a "potentially large backlog of investigations that are not likely to result in enforcement actions and for which closing packages have not been completed."[201] As a result, the GAO concluded that "the subjects of many aged and inactive investigations may continue to suffer adverse consequences until closing actions are completed."[202]

Enforcement Division officials told the GAO that their attorneys may believe that pursuing potential securities violations is a higher

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200. *See, e.g.*, Kevin J. Harnishch & Natasha Colton, *When the SEC Comes Knocking*, 15 A.B.A. SEC. BUS. L. 1 (2005), *available at* http://www.abanet.org/buslaw/blt/2005-09-10/colton.shtml.

201. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-830, SEC: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 22 (2007), *available at* http://www.gao.gov/new.items/d07830.pdf. For example, according to the GAO Report, one SEC regional office reported that as of March 2007 about 35% of its open investigations were "more than 2 years old, had not resulted in an enforcement action, and were no longer being actively pursued." *Id.* at 21. In response, the Enforcement Division has undertaken to review the backlog and streamline the closing process. *Id.* at 46.

202. *Id.*

priority than closing investigations.[203] Officials also cited a scarcity of time, administrative support, and incentives to comply with established procedures for closing investigations.[204] Although the GAO recognized that resolving the potentially large backlog of investigations would impose resource challenges for Enforcement Division,[205] the GAO recommended that the SEC chairman direct the Enforcement Division to "consider developing expedited procedures for closing investigations."[206]

When the Commission or its staff determines that an investigation should be closed or action is not warranted, the agency promptly should send a closing letter.[207] Closing letters should be sent not only to those who have made a Wells Submission, but also to any significant non-party that has provided documents, information, or testimony to the SEC. Similarly, if the enforcement staff views a person only as a witness or source of information in an investigation, staff should make that clear to the person.

In its proposed mandate to examine enforcement practices and procedures from the point of view of due process, the new advisory committee should consider ways to improve the cherished Wells process. One way in which the Wells process should be bolstered is through a mechanism to allow a proposed defendant to appear before the Commission to oppose a proposed enforcement proceeding. Although it would likely be both unnecessary and unmanageable to allow such an "oral Wells submission" in every situation, it may be beneficial to both the Commission and proposed defendants for the Commission to have a discretionary avenue to hear from proposed defendants prior to taking action. Matters that might be appropriate for this procedure would include complex factual cases, such as those necessitating expert witnesses, disputes concerning the level of cooperation, or cases in which character assessment and credibility is particularly important.[208]

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203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* at 7.

207. The Wells Committee in Recommendation 8 proposed that the "Commission adopt in the usual case the practice of notifying an investigatee against whom no further action is contemplated that the staff has concluded its investigation . . . ." and will not recommend an enforcement action. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 20.

208. For example, at both the Federal Trade Commission and the Federal Communications Commission, in-person presentations to commissioners and staff of

A review of the enforcement process would not be complete without a review of the costs to parties responding to an investigation. Responding to an SEC investigation is costly, particularly in the age of e-mails and electronic data. The SEC must ensure that its investigations and enforcement actions do not impose unnecessary costs. Overly broad subpoenas or document or interview requests add to a responding entity's costs, and not every responding entity becomes a defendant. Innocent parties pay the price of overly broad requests. Notices to preserve—and subsequent requests to produce—electronic data, including e-mails, voicemails, and server back-up tapes are particularly burdensome and costly to a company. While it is undoubtedly critical for the SEC to have certain electronic data to conduct an investigation and litigate a matter, preservation notices and requests for production are often generic and extend well beyond the boundaries of the existing investigation. It is difficult to justify imposing unnecessary costs on a company, particularly when the investigation may last many years and result in no action taken.

The new advisory committee should recommend ways to minimize costs through the formulation of detailed procedures to address preservation notices and production requests for electronic data. In recommending the procedures, the advisory committee should take into account the burden and expense of preserving certain kinds of records, such as electronic voicemail, and producing data stored in long-term media such as back-up tapes. Preservation notices should be reasonably related to the matters under investigation, and prospective preservation of information should be invoked only if misconduct is suspected or ongoing.[209] The use of generic preservation notices, covering data that the company might not otherwise preserve in the normal course of its operations, should be prohibited.

Production requests should be narrowly tailored and should first seek information that is readily accessible. Requests should not demand the production of data stored on back-up tapes unless unavailable through other sources. As a measure to guard against overbroad requests, the advisory committee should consider ways to incorporate in enforcement procedures pre-approval of document requests by a senior member of the Enforcement Division.

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evidence and advocacy positions in advance of potential enforcement actions are routine.

209. Subjects of investigation already have other legal obligations to preserve documents. *See, e.g.*, 18 U.S.C. § 1512 (2006).

The advisory committee also should explore the establishment of an ombudsman to review and evaluate complaints about the enforcement process and behavior of the Enforcement staff. An ombudsman would provide an avenue for persons to convey their grievances to the Commission without fear of reprisal. People should be able to make these complaints anonymously through a hotline.[210]

The new advisory committee should examine the usage, effects, amount, and appropriateness of issuer penalties in financial fraud cases. The committee should consider whether these issuer penalties are consistent with the SEC's mission of investor protection; maintaining fair, orderly, and efficient markets; and facilitating capital formation. For example, do penalties protect investors? Do they harm or benefit shareholders? Is the circularity of Fair Fund penalty distributions consistent with ensuring fair, orderly, and efficient capital markets? Is capital formation impeded by the threat of large, unpredictable issuer penalties?

The advisory committee also should evaluate the moral hazards associated with issuer penalties. One moral hazard is the possibility that managers of companies might agree to a large corporate penalty in order to avoid or soften actions against culpable individuals.[211] Are individuals deterred from wrongdoing if they expect that shareholders will pay the penalties for the misconduct?

The SEC also faces it own moral hazards when contemplating the assessment of issuer penalties. Does the prospect of large issuer penalties and the inevitable press coverage cause the SEC to misallocate

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210. The SEC's Office of Compliance Inspections and Examinations already has such a hotline. *See* U.S. Sec. & Exch. Comm'n, Office of Compliance Inspections & Examinations, Examination Hotline, http://www.sec.gov/about/offices/ocie/ocie_hotline.shtml (last visited May 9, 2008).

211. *See generally* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007). As Professor Langevoort explains:

> The corporate sanction avoids the need to attribute fault to any particular individual under circumstances where there is likely mutual finger pointing about who is to blame. For all these reasons, company sanctions are the path of least resistance; the SEC can claim its victory and move its resources to new matters that deserve attention. There is probably a publicity-related reason as well: sanctions against companies can be large enough to grab headlines, which is less likely to occur with respect to individual sanctions, even in the aggregate.

Id. at 654.

resources to build these cases to the detriment of other types of enforcement actions?

The Commission's 2006 penalty statement was a significant first step in setting forth a principled foundation for examination of many of these concerns.[212] In applying the penalty statement, the Commission has encountered areas not addressed by the statement, such as the determination of the amount of penalty and the appropriateness of imposing penalties on new shareholders.[213] Taking the Commission's experience into consideration, the new advisory committee should re-examine these issues with the input of economists, legal scholars, and practitioners.

These and any additional recommendations from the advisory committee that ultimately are approved by the Commission should be set forth in a publicly available Enforcement Manual. In 2007, the minority members of the Senate Finance Committee recommended that the SEC create such a manual, which would be similar to the U.S. Attorney Manual, "to address situations or issues likely to recur."[214] The public accessibility of the manual would ensure transparency and uniform application. The manual itself, and any later changes to it, should be reviewed and approved by the Commission. Deviations from the manual, while necessary in some instances, should be discouraged. The manual will serve as the governing guidelines for the Enforcement staff at headquarters and in the regional offices. An Enforcement Manual that reflects the recommendations of an advisory committee, as adopted by the Commission, could serve as a useful framework for the Commission's enforcement program in the years to come.

CONCLUSION

The SEC's enforcement program serves a critical function in ensuring proper compliance with the U.S. securities laws. Throughout

212. *See* 2006 Penalty Statement, *supra* note 178.

213. Many of these same concerns were raised by the Commission during the legislative debate over the Remedies Act of 1990. *See, e.g.*, SEC Memorandum in Support of Remedies Act, *supra* note 96.

214. *See* Staff of S. Fin. Comm., 110th Cong., Report on the Firing of an SEC Attorney and the Investigation of Pequot Capital Management 7 (Comm. Print 2007), *available at* http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20080307%20SEC.pdf.

its history, the SEC has protected investors and the general public from a wide array of fraudulent conduct. Given the importance of enforcement to the SEC's mission, a critical review of the enforcement program—similar to that done by the Wells Committee in 1972—is long overdue. This article is intended to start a list of items for consideration, but does not purport to identify all the areas that should be evaluated by a new Wells-like advisory committee. The members of the advisory committee undoubtedly will draw from their own experiences and expertise to develop a full agenda. The Commission should be receptive to considering any new ideas for improving the enforcement program and furthering the SEC's mission. We are confident that the result will be an enforcement program that is more transparent, better embodies principles of due process, and more effectively combats violations of the federal securities laws.

PREPARED STATEMENT OF RICHARD G. KETCHUM

CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
FINANCIAL INDUSTRY REGULATORY ASSOCIATION

MARCH 26, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

I commend you, Mr. Chairman, for holding today's hearing on the critically important topic of reforming our regulatory structure for financial services. As someone who has spent the great majority of my career as a regulator, dedicated to protecting investors and improving market integrity, I am deeply troubled by our system's recent failures.

The credit crisis and scandals of the last year have painfully demonstrated how the gaps in our current fragmented regulatory system can allow significant activity and misconduct to occur outside the view and reach of regulators. The fallout of this has been massive, and for many investors, tragic. Investor protection is the core of FINRA's mission, and we share your commitment to identifying existing regulatory gaps and weaknesses as well as changes to the regulatory framework that would close those gaps and improve the system for all investors.

FINRA

FINRA was created in 2007 through the consolidation of NASD and the member regulation, enforcement, and arbitration divisions of the New York Stock Exchange. With a staff of 2,800, FINRA regulates the practices of nearly 4,900 firms, about 174,000 branch offices and more than 650,000 registered securities representatives. As an independent regulatory organization, FINRA provides the first line of oversight for broker-dealers.

FINRA augments and deepens the reach of the federal securities laws with detailed and enforceable ethical rules and a host of comprehensive regulatory oversight programs. FINRA admits to and excludes from the industry both firms and individuals; adopts and enforces rules to protect investors and the financial markets; examines broker-dealers for compliance with its own rules as well as federal securities laws and rules of the Municipal Securities Rulemaking Board (MSRB); informs and educates the investing public; provides industry utilities and administers the largest dispute resolution forum for investors and registered firms. Significantly, FINRA is funded by regulatory fees—not taxpayer dollars. Yet FINRA's Board of Governors is comprised of a majority of nonindustry representatives. The uniquely balanced structure of our Board ensures a paramount focus on investor protection and the opportunity for input from a diverse variety of perspectives.

FINRA's Core Investor Protection Programs

Examinations

FINRA has a robust and comprehensive examination program with dedicated resources of more than 1,000 employees. Routine examinations are conducted on a regular schedule that is established based on a risk-profile model. This riskprofile model is very important: It permits us to focus our resources on the sources of most likely harm to average investors. We apply our risk-profile model to each firm, and our exams are tailored accordingly. In performing its risk assessment, FINRA considers a firm's business activities, methods of operation, types of products offered, compliance profile and financial condition, among other things.

During routine examinations, FINRA examines a firm's books and records to determine if they are current and accurate. Sales practices are analyzed to determine whether the firm has dealt fairly with customers when making recommendations, executing orders and charging commissions or markups and markdowns. Antimoney laundering, business continuity plans, financial integrity and internal control programs are scrutinized.

In addition, FINRA conducts more narrow examinations based on information that we receive, including investor complaints, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. In 2008, FINRA conducted almost 2,500 routine examinations and nearly 6,500 targeted examinations.

Enforcement

FINRA's Enforcement Department is dedicated to vigorous and evenhanded enforcement of the federal securities laws and FINRA and MSRB rules. FINRA brings

disciplinary actions against firms and their employees that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry. FINRA frequently requires firms to provide restitution to harmed investors and often imposes other conditions on a firm's business to prevent repeated wrongdoing.

In 2008, FINRA issued 200 formal complaints and 1,007 decisions were issued in formal disciplinary cases. FINRA collected over $28 million in fines, either ordered or secured agreements in principle for restitution in excess of $1.8 billion, expelled or suspended 19 firms, barred 363 individuals from the industry and suspended 321 others. Over the past decade, FINRA issued 12,158 decisions in formal disciplinary cases, expelled or suspended 208 firms and barred or suspended 7,496 individuals.

Registration, Testing, and Continuing Education

Persons employed by a broker-dealer that engage in a securities business must register with FINRA. As part of the registration process, applicants must disclose their prior employment and disciplinary history, since certain prior conduct may prevent registration. FINRA also develops and administers qualification examinations that securities professionals must pass to demonstrate competence in the areas in which they will work. FINRA further administers a continuing education program that every registered person must satisfy. FINRA administers 28 qualifications exams to over 275,000 people every year, including examinations that support the MSRB, States and National Futures Association programs.

FINRA maintains the Central Registration Depository (CRD), the central licensing and registration system for the U.S. securities industry and its regulators. CRD contains the qualification, employment and disciplinary histories of firms and brokers, making it the world's largest and most sophisticated online registration and reporting system.

FINRA's BrokerCheck system makes publicly available, free of charge, certain information about firms and brokers, including disciplinary histories that can inform an investor's decision as to which firm or broker to use.

FINRA also developed, for the SEC, the Investment Adviser Registration Depository, a utility that allows federal- and state-regulated investment advisers to satisfy mandated licensing requirements. FINRA makes information about investment adviser firms publicly available.

Under contract with the Conference of State Bank Supervisors, FINRA also developed the Nationwide Mortgage Licensing System (NMLS). NMLS is a webbased system that allows state-licensed mortgage lenders, mortgage brokers and loan officers to apply for, amend, update or renew licenses online for participating state agencies using a single set of uniform applications. Twenty-three states are currently participating in the NMLS system. Encouraged by the passage of the Housing and Economic Recovery Act of 2008, 10 additional states plan to participate in the system during 2009; 14 more have indicated plans to participate beginning in 2010.

Advertising

FINRA operates an extensive program to ensure that communications by firms to the public are not misleading. FINRA rules require that advertisements, Web sites, sales brochures and other communications present information in a fair and balanced manner. Some communications-those related to mutual funds, variable products and options, for example-must be filed with FINRA. In 2008, FINRA reviewed more than 99,000 pieces of communication and completed 476 investigations involving 2,378 separate communications.

Investor Education

Investor education is a critical component of investor protection and FINRA is uniquely positioned to provide valuable investor education primers and tools. FINRA sponsors numerous investor forums and outreach programs, and its Web site *(www.finra.org)* is a rich source of such material, including investor alerts, unbiased primers on investing and interactive financial planning tools.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education. Its mission is to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. The Foundation awards grants to fund educational programs and research aimed at segments of the public who could benefit from additional resources. Since the FINRA Foundation's inception in December 2003, it has approved more than $45 million in financial education and investor protection initiatives through a combination of grants and targeted projects. Many of those initiatives have focused on particularly vulnerable investors, such as seniors and military personnel and their families.

Gaps in the Current Regulatory System

While regulators continue to look back and attempt to unravel the events and scandals of the past year, all of us must move ahead to aggressively revamp and modernize the regulatory framework. The failures that have rocked our financial system have laid bare the regulatory gaps that must be fixed if investors are to have the confidence to re-enter the markets. There are critical questions that should be considered as part of any new regulatory approach.

First, what protections should be provided to investors? Our current system of financial regulation leads to an environment where investors are left without consistent and effective protections when dealing with financial professionals. Investors deserve a system where they can be confident they will receive certain basic protections regardless of what product they buy or what license their financial professional holds. At the very least, our system should provide investors with the following protections:

- every person who provides financial advice and sells a financial product should be tested, qualified and licensed;
- the advertising for financial products and services should be subject to requirements that it is not misleading;
- every product marketed to a particular investor is appropriate for recommendation to that investor; and
- there should be full and comprehensive disclosure for the services and products being marketed.

Unfortunately, not all financial products come with these important attributes or protections.

Second, what products, activities and services should be regulated, and how? There are a number of gaps across our system, both in terms of similar products and services being regulated quite differently. Where we can identify these regulatory gaps that compromise investor protection and pose risk to the financial system, they should be thoughtfully filled.

One example is hedge funds. Hedge funds play a significant role in the financial system, but they are an unregulated part of it. The absence of transparency about hedge funds and their investment positions is a concern. First, as we have seen from the recent redemptions by fund investors and the de-leveraging of funds in response, they have significant ability to directionally move markets. Secondly, such funds are significant traders of over-the-counter derivative products that are unregulated and system regulation requires an understanding of these positions by regulators. Finally, although these funds are generally marketed only to investors deemed sophisticated, public pension funds, endowments and other fiduciary-type funds have exposure to hedge funds and absent some level of regulation, we cannot gain comfort that only investors with the appropriate risk tolerances and sophistication are invested in these unregulated vehicles.

Apart from their use by any class of investor or type of fund, over-the-counter (OTC) derivatives need much greater regulatory consideration. As trading in the credit default swap market has demonstrated, derivative trading can have tremendous impact on the pricing of the underlying security or index. The lack of transparency and the potential impacts these products can have on regulated markets and the broader financial system is cause for concern. Some of these products allow substantial leverage that directly interacts with and impacts equity and debt markets. For instance, positions in OTC derivatives can impact the viability of broker-dealers through freezing their funding even when positions in those products are booked in other parts of the holding company. In addition, many OTC derivatives encounter great counterparty settlement risk because they do not clear through an established centralized clearing system that greatly reduces the risk of default in the settlement of contractual obligations. FINRA is pleased to have filed a proposed margining structure with the Securities and Exchange Commission that would enable its regulated firms that are members of the Chicago Mercantile Exchange to settle credit default swaps through that exchange's newly developed central clearing system for those products.

Finally, I'd like to highlight the regulatory gap that, in our view, is among the most glaring examples of what needs to be addressed in the current system-the disparity between oversight regimes for broker-dealers and investment advisers. The lack of a comprehensive, investor-level examination program for investment advisers impacts the level of protection for every member of the public that entrusts funds to an adviser.

In fact, the Madoff Ponzi scheme highlighted what can happen when a regulator like FINRA has only free rein to see one side of a business. Fragmented regulation

provides opportunities to those who would cynically game the system to do so at great harm to investors.

So what can be done to try to prevent this from happening in the future? The regulatory regime for investment advisers should be expanded to include an additional component of oversight by an independent regulatory organization, similar to that which exists for broker-dealers.

The SEC and state securities regulators play vital roles in overseeing both broker-dealers and investment advisers, and they should continue to do so. But it's clear that dedicating more resources to regular and vigorous examination and day-to-day oversight of investment advisers could improve investor protection for their customers, just as it has for customers of broker-dealers.

As the SEC has noted, the population of registered investment advisers has increased by more than 30 percent since 2005. Investment advisers now number 11,300-more than twice the number of broker-dealers. While the SEC has attempted to use risk assessment to focus its resources on the areas of greatest risk, the fact remains that the number and frequency of exams relative to the population of investment advisers has dwindled. Consider the contrast: FINRA oversees nearly 4,900 broker-dealer firms and conducts approximately 2,500 regular exams each year. The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms. The SEC has said recently that in some cases, a decade could pass without an examination of an investment adviser firm.

There are differences in the current rules and standards that apply to brokerdealers and investment advisers, reflective of some of the differences that exist in the services provided by each class of professionals. And while the two channels have converged over the years, there remain some differences that need to be taken into account when enhancing oversight and exams to make that oversight fit the activity and services in each.

Broker-dealers are subject to a very detailed set of rules established and enforced by FINRA that pertain to safety of customer cash and assets, advertising, sales practices, limitations on compensation, financial responsibility, and trading practices. FINRA ensures firms are following the rules with a comprehensive examination and enforcement regime.

Investment advisers are subject to provisions of the Investment Advisers Act of 1940 that pertain to registration, disclosure, record-keeping, custody and compensation. Importantly, investment advisers are also subject to a fiduciary standard with regard to their clients. In designing a more regular oversight and examination program for investment advisers, these rules and standards should be taken into account.

Simply put, FINRA believes that the kind of additional protections provided to investors through its model are essential. Does that mean FINRA should be given that role for investment advisers? That question ultimately must be answered by Congress and the SEC, but FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently. We have a strong track record in our examination and enforcement oversight, as well as in our other core programs. Certainly in the registration area, with regard to investment advisers and mortgage brokers, we have two success stories of adapting our infrastructure to meet needs in areas beyond the realm of broker-dealers.

In FINRA's view, the best oversight system for investment advisers would be one that is tailored to fit their services and role in the market, starting with the requirements that are currently in place for advisory activity. Simply exporting in wholesale fashion the broker-dealer rulebook or current governance would not make sense. That said, as I noted earlier, where applicable, we do believe that enhanced regulatory consistency is in the best interest of investors, especially in the four areas I mentioned-licensing, advertising, sales practice and disclosure.

We believe that regular and frequent exams are a vital component of effective oversight of financial professionals, and that the absence of FINRA-type oversight of the investment adviser industry leaves investors without that critical component of protection. In our view, it simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive. And quite simply, as we learned from the Madoff scandal, it would not make sense for two, separate independent regulatory bodies to oversee investment advisers and broker-dealers, especially when they exist in the same legal entity. Again, there would be no single regulator with a complete picture of the business.

One of the primary issues raised about investor protection differences between the broker-dealer and investment adviser channels is the difference between the fiduciary standard for investment advisers and the rule requirements, including suitability, for broker-dealers. As this the process moves forward, this is the kind of

issue that should and will be on the table as we all look at how best to reform our regulatory system and strengthen investor protections. In keeping with our view there should be increased consistency in investor protections across financial services, we believe it makes sense to look at the protections provided in various channels and choose the best of each.

We stand ready to work with Congress and the SEC in exploring whether a properly designed fiduciary standard could be applied to broker-dealers' selling activities, and if there are problems raised, make a strong effort to resolve those problems.

Conclusion

It has become painfully clear that the current regulatory structure is weakened by gaps and inconsistencies that should be remedied.

The individual investor is the most important player in the financial markets, and unfortunately, our system has not sufficiently protected these individuals. We need to earn back the confidence of those investors by closing the gaps in our current system and strengthening oversight.

As I have stated, FINRA believes that one of the most important gaps to close in terms of investor protection is the disparity in oversight between broker-dealers and investment advisers. The addition of a comprehensive and regular oversight program with more frequent exams and strong enforcement would enhance protections provided to all customers of investment advisers.

More broadly, investors deserve a consistent level of protection no matter which financial professionals or products they choose. Creating a system of consistent standards and vigorous oversight of financial professionals-no matter which license they hold-would enhance investor protection and help restore trust in our markets.

FINRA is committed to working with other regulators and this Committee as you consider how best to restructure the U.S. financial regulatory system.

PREPARED STATEMENT OF RONALD A. STACK

CHAIR,

MUNICIPAL SECURITIES RULEMAKING BOARD

MARCH 26, 2009

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I am Ronald Stack, Chair of the Municipal Securities Rulemaking Board ("MSRB" or "Board"). I am pleased to testify today on behalf of the MSRB at the Committee's second hearing on Enhancing Investor Protection and the Regulation of the Securities Markets. Part I of my testimony provides a summary of the MSRB's structure, authority, rules, information systems, and market transparency/ surveillance activities. Part II provides background on the municipal securities market. Part III is a discussion of what the MSRB is doing now to promote transparency in the municipal marketplace. Part IV points out significant gaps in the regulation of municipal market participants and discusses the manner in which the MSRB could further assist in enhancing investor protection and the regulation of the securities market, if its jurisdiction were expanded by the Congress. Finally, Part V is an executive summary of our major recommendations.

I. Background on the MSRB's Structure, Authority, Rules, Information Systems, and Market Transparency/ Surveillance Activities

A. MSRB Structure

The MSRB is a self-regulatory organization ("SRO") established by the Congress in the Securities Acts Amendments of 1975 to develop rules for brokers, dealers, and banks (collectively "dealers") engaged in underwriting, trading, and selling municipal securities. In furtherance of our investor protection mandate, the Board also operates information systems designed to promote transaction price transparency and access to municipal securities issuer disclosure documents. The MSRB stands as a unique SRO for a variety of reasons. The MSRB was the first SRO specifically established by Congress. Also unique is the fact that the legislation, codified in section 15B of the Securities Exchange Act ("Exchange Act"), dictates that the MSRB Board shall be composed of members who are equally divided among public members (individuals not associated with any dealer), individuals who are associated with and representative of banks that deal in municipal securities ("bank dealers"), and indi-

viduals who are associated with and representative of securities firms.[1] At least one public member serving on the Board must represent investors and at least one must represent issuers of municipal securities. Further, the MSRB was created as a product-specific regulator, unlike most other securities regulatory bodies. Members of the MSRB meet throughout the year to make policy decisions, approve rulemaking, enhance information systems and review developments in the municipal securities market. Day-to-day operations of the MSRB are handled by a full-time independent, professional staff. The operations of the Board are funded through assessments made on dealers, including fees for underwritings and transactions.[2]

B. MSRB Authority

The substantive areas of the MSRB's rulemaking authority are described in Section 15B(b)(2) of the Exchange Act, which lists several specific purposes to be accomplished by Board rulemaking with respect to the municipal securities activities of dealers in connection with their transactions in and provides a broad directive for rulemaking designed to:

> prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling and processing information with respect to and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

Like other SROs, the MSRB must file its proposed rule changes with the Securities and Exchange Commission ("SEC") for approval prior to effectiveness.

Although the MSRB was created to write rules that govern dealer conduct in the municipal securities market, the Exchange Act directs that inspection of dealers for compliance with, and the enforcement of, MSRB rules be carried out by other agencies. For securities firms, the Financial Industry Regulatory Authority ("FINRA"), along with the SEC, performs these functions. For bank dealers, the appropriate federal banking authorities, in coordination with the SEC, have this responsibility.[3] The MSRB works cooperatively with these regulators and maintains frequent communication to ensure that: (1) the MSRB's rules and priorities are known to examining officials; (2) general trends and developments in the market discovered by field personnel are made known to the MSRB; and (3) any potential rule violations are immediately reported to the enforcement agencies.

While Section 15B of the Exchange Act provides the MSRB with authority to write rules governing the activities of dealers in connection with their transactions in municipal securities, it does not provide the MSRB with authority to write rules governing the activities of other participants in the municipal finance market such as issuers and their agents (*e.g.,* independent financial advisors, swap advisors, guaranteed investment contract brokers, trustees, bond counsel, etc.). Municipal securities also are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 and are exempt from the registration and reporting requirements of the Exchange Act.

In adopting Section 15B of the Exchange Act, Congress provided in subsection (d) specific provisions that restrict the MSRB and the SEC from regulating the disclosure practices of issuers in certain ways. Paragraph (1) of subsection (d) prohibits the MSRB (and the SEC) from writing rules that directly or indirectly (*i.e.,* through dealer regulation) impose a pre-sale filing requirement for issues of municipal securities. Paragraph (2) of subsection (d) prohibits the MSRB (but not the SEC) from adopting rules that directly or indirectly require issuers to produce documents or information for delivery to purchasers or to the MSRB. Paragraph (2), however, specifically allows the MSRB to adopt requirements relating to such disclosure documents or information as might be available from "a source other than such issuer." The provisions of subsection (d) commonly are known as the "Tower Amendment."

C. MSRB Rules Overview

The MSRB has adopted a substantial body of rules regulating dealer conduct that reflect the special characteristics of the municipal securities market and its unique regulatory needs These rules require dealers to observe the highest professional

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[1] Under MSRB Rule A-3, the Board is composed of 15 member positions, with five positions each for public, bank dealer, and securities firm members.

[2] These fees are set forth in MSRB Rules A-12 through A-14.

[3] These federal banking authorities consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the U.S. Treasury Department through its Office of the Comptroller of the Currency and Office of Thrift Supervision, depending upon the specific bank dealer.

standards in their activities and relationships with customers. MSRB rules take into account the fact that rules for dealers in the municipal market—where issuers have significant discretion and nondealer market professionals are unregulated—must sometimes be crafted in ways that differ from rules for dealers in the corporate securities market, where bond issuers and other market participants are subject to regulation.

MSRB rules represent a balance between broad, "principles-based" rules and specific prescriptive rules, depending on the nature of the specific subject of regulation. MSRB rules can generally be categorized as (1) fair practice rules (*e.g.,* requirements for dealers to provide affirmative disclosures of material facts to investors; to ensure the suitability of dealer recommendations of municipal securities transactions; to price transactions fairly; to avoid conflicts of interest; and to publish fair and accurate advertisements and price quotations); (2) uniform practice rules (*e.g.,* rules to ensure that standard procedures are followed in underwriting, clearing, confirming, and settling transactions in municipal securities; helping to ensure the efficiency of market operations while accommodating the differences between municipal securities and other debt instruments); (3) professional qualification rules (*e.g.,* requirements for dealer personnel to pass tests demonstrating competency; continuing education requirement); (4) operational standards (*e.g.,* rules regarding recordkeeping; supervision of professionals); and (5) marketplace disclosure rules (*e.g.,* rules requiring dealer real-time reporting of trade prices; underwriter filing of issuer disclosure documents; and dealer disclosure of political contributions to the MSRB for public dissemination). These rules significantly exceed the general antifraud principles that are embodied in the federal securities laws.

Maintaining municipal market integrity is an exceptionally high priority for the MSRB as it seeks to foster a fair and efficient municipal securities market through dealer regulation. The MSRB engages in an on-going review of its rules and market practices to ensure that the Board's overriding goal of protecting investors and maintaining market integrity is not compromised by emerging practices. As an example, the MSRB implemented rules to remove the conflict of interest that can arise when political contributions may be used by dealers to obtain municipal securities business. We also seek to coordinate our rules with FINRA rules in cases where similar requirements make sense.

The MSRB also reminds dealers of its rules in times of market stress when the pace of events might cause some to lose sight of their significance. For example, during 2008, as bond insurer ratings were reduced frequently and significantly, we reminded dealers of their disclosure obligations concerning credit enhancement.[4] We also issued an interpretive notice on transactions in auction rate securities that reminded dealers of their obligation to recommend investments that are suitable to their customers[5] and provided guidance on reporting dealer buybacks of auction rate securities.[6] When many issuers rushed to convert their high yielding auction rate securities to variable rate demand obligations, we reminded dealers of restrictions on underpricing of credit and tying the provision of letters of credit to the provision of underwriting services.[7]

D. Information Systems and Market Transparency/Surveillance

In furtherance of our investor protection mandate, the MSRB also operates information systems to improve the availability of information in the market about municipal issues. These systems ensure that investors have information necessary to make investment decisions, that dealers can comply with MSRB rules, and that the inspection and enforcement agencies have the necessary tools to do their work.

Since 1990, the Municipal Securities Information Library ("MSIL") system has collected issuer primary market disclosure documents (*i.e.,* official statements and advanced refunding documents) from underwriters and made them available to the market and the general public. The MSIL system also accepts and disseminates certain secondary market information provided by municipal issuers and trustees pursuant to SEC Rule 15c2-12. In order to further increase the accessibility of municipal market information by retail investors, the MSRB has developed a free, centralized database, named the Electronic Municipal Market Access system or EMMA, which is discussed further below and which will shortly replace the MSIL system.

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[4] MSRB Notice 2008–04 on Bond Insurance Ratings (January 22, 2008).

[5] MSRB Notice 2008–09 on Application of MSRB Rules to Transactions in Auction Rate Securities (February 19, 2008).

[6] MSRB Notice 2008–36 on Transactions Reporting of Dealer Buybacks of Auction Rate Securities: Rule G-14 (September 2, 2008).

[7] MSRB Notice 2008–34 on Bank Tying Arrangements, Underpricing of Credit and Rule G-17 on Fair Dealing (August 14, 2008).

In 2005, the MSRB implemented a facility for real-time transaction reporting and price dissemination of transactions in municipal securities (the "Real-Time Transaction Reporting System" or "RTRS").[8] RTRS serves the dual role of providing transaction price transparency to the marketplace, as well as supporting market surveillance by the enforcement agencies. Surveillance data is made available to regulators with authority to enforce MSRB rules, including FINRA and the SEC. The market surveillance function of the MSRB's transaction reporting system provides enforcement agencies with a powerful tool in enforcing the Board's fair pricing rules. The MSRB offers a market-wide real-time feed of trade information and provides the data free of charge on EMMA, as discussed below. In addition, in January of this year, the MSRB implemented an enhancement to the system with the addition of free public access to interest rate reset information on municipal auction-rate securities, including information on the success or failure of individual auctions. Free interest rate and related information on variable-rate demand obligations will be added to the system next week. And, beginning July 1 of this year, continuing disclosure filings made by state and local governments will be available as well. Once completed in July, 2009, the MSRB's EMMA system will provide the most comprehensive and free database of municipal securities information as exists in any of the fixed income markets.

Currently, EMMA does not contain information about the credit ratings of municipal securities, although they are of considerable importance to investors. The MSRB would welcome the submission by the rating agencies of such ratings on a real-time basis. Given the large number of bond insurer downgrades in the last year, investors should have access to underlying ratings as well as ratings on the municipal securities themselves.

II. Background on the Municipal Securities Market

A. Market Overview

When Section 15B of the Exchange Act was adopted in 1975, yearly issuance of municipal securities was approximately $58 billion.[9] Much of this total represented general obligation debt, which reflected the simple, unconditional promise of a state or local government unit to pay to the investor a specific rate of interest for a specific period of time. The investors in these bonds tended to be commercial banks and property/casualty insurers interested in tax-exempt interest.

The municipal securities market has grown into a much larger and more complex market. Annual issuance of municipal securities has averaged $458 billion in recent years[10] and a total of $2.7 trillion in principal value is outstanding.[11] In addition to providing capital for governmental projects and operations, the municipal securities market helps to fund a variety of other public purposes, including transportation and environmental infrastructure, education, housing and healthcare.

Most municipal securities come to market with investment grade credit ratings, *i.e.,* with ratings that are "BBB-" or above.[12] Historically, investment grade municipal securities have been considered relatively safe investments, because of the very low rate of default. A 2002 report by Moody's Investor Service concluded that the default rate for investment grade municipal securities debt over a 10 year period was .03 percent, compared to 2.32 percent for investment grade corporate debt.[13] A low rate of default for investment grade municipal securities also has been observed in studies by Standard and Poor's and Fitch Ratings.

B. Issuers

Issuers of municipal securities include towns, cities, counties, and states, as well as other state and local government agencies and authorities that issue securities for special purposes (*e.g.,* hospitals and colleges). There are over 55,000 issuers of municipal securities that have outstanding approximately 1.23 million unique secu-

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[8] The MSRB's transaction reporting rules require dealers to report transactions in municipal securities within 15 minutes of the time of trade execution.

[9] See The Bond Buyer/Thomson Financial 2004 Yearbook at 10. Approximately half of this figure represents short-term debt maturing in less than 13 months.

[10] Source: Thomson Reuters (based on 2005–2008 data).

[11] December 2008 estimates. See Federal Reserve Flow of Funds (March 2009) available at *www.federalreserve.gov.* As a comparison, the outstanding principal value of marketable U.S. Treasury Securities was $5.8 trillion.

[12] Over 99 percent of rated long-term municipal securities coming to market in 2008 were rated investment grade by at least one rating agency.

[13] Moody's Rating Service, "Special Comment: Moody's US Municipal Bond Rating Scale" (November 2002), available at *http://www.moodys.com* (also noting increased default risks for nonrated issues).

rities. Major issuer types, with the associated volume of issuance in 2008, are shown in Figure 1.[14]

Figure 1

Issuer Type	2008 Issuance Volume ($ billions)[14]	Percentage of total volume
State Agencies	144.8	32%
Local Authorities	81.4	18
Districts	64.8	14
Cities/Towns	60.2	13
States	55.9	12
Counties/Parishes	27.6	6
Colleges/Universities	10.1	2
Direct Issuers	7.2	2

Source: Thomson Reuters

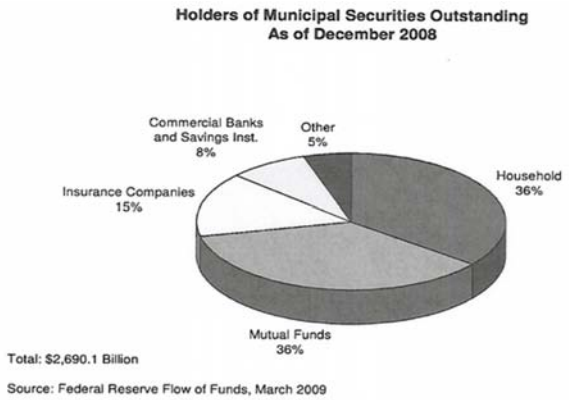
The market is unique among the world's major capital markets because the number of issuers is so large—no other direct capital market encompasses so many borrowers. The issues range from multi-billion dollar financings of large state and city governments to issues less than $100,000 in size, issued by localities, school districts, fire districts, and various other issuing authorities. The purposes for which these securities are issued include not only financing for basic government functions, but also a variety of public needs such as transportation, utilities, health care, higher education, and housing as well as some essentially private functions to enhance industrial development. In the last two decades debt issuance has become an important management tool for many municipalities, allowing flexibility in arranging finances and meeting annual budget considerations according to local needs and local priorities. The terms and features of some municipal securities have evolved over time into highly complex structures to meet a multitude of issuer borrowing and investment needs. Differences in laws among the 50 states, as well in local ordinances and codes among the tens of thousands of localities, that affect borrowing authority, lending of credit, powers to impose taxes and special assessments, contracting powers, budgeting restrictions, and many other matters result in an enormous variety of financing structures across the country that defies commoditization of the municipal securities market.

By contrast, there are only approximately 5,500 issuers of corporate debt and less than 50,000 corporate debt securities,[15] even though the amount of corporate debt outstanding is $6.3 trillion.[16]

C. Investors

The municipal securities market has one of the highest levels of participation by individual investors, either through direct investments or through mutual funds, together representing the majority of total municipal securities holdings. The other major categories of investors in municipal securities include property and casualty insurers and commercial banks. Figure 2 shows the percentages of direct investments in municipal securities in categories tracked by the Federal Reserve Board.

[14] Source: Thomson Reuters (includes issuance of both long-term and short-term securities).
[15] Source: FINRA. Includes all TRACE-eligible securities.
[16] December 2008 estimates. See Federal Reserve Flow of Funds (March 2009), available at *www.federalreserve.gov*. Corporate debt outstanding excludes asset-backed securities and foreign issues held by U.S. residents.



The "household" category in Figure 2 includes both direct investments by individual investors as well as trusts and other accounts (*e.g.,* some types of hedge fund accounts that do not fall into other tracked categories). The "mutual funds" category includes both municipal bond funds and money market funds.[17]

D. Municipal Securities Dealers

The municipal securities market is an over-the-counter, dealer market. There are no central exchanges, specialists, or formal market maker designations. At the end of 2008, approximately 2,040 securities firms and banks were authorized to act as brokers and dealers in municipal securities (collectively, "dealers"). During a given year, approximately 1,430 dealers report transactions in municipal securities to the MSRB under its price transparency program. About 185 of these dealers serve as managing underwriters of new issues.

E. Market Activity

In general, municipal securities investors tend to be "buy and hold" investors. Trading patterns for municipal securities with fixed interest rates typically involve relatively frequent trading during the initial weeks after issuance, followed by infrequent or sporadic trading activity during the remaining life of the security. Issues with variable interest rates tend to trade more frequently. Of the approximately 1.23 million outstanding municipal securities, the likelihood of any specific security trading on a given day is about one percent. Less than 10 percent of outstanding municipal securities are likely to trade in any given month.[18]

Notwithstanding the thin secondary market trading in individual municipal securities, aggregate daily trading activity in the market is substantial. During the period 2005–2008, an average of approximately 36,000 transactions in municipal securities was reported to the MSRB each business day, resulting in par values averaging about $23.2 billion per day. For the same period, nearly two-thirds of par value traded was variable rate securities, while fixed-rate securities accounted for almost 30 percent. Figure 3 shows the 30-day trailing average of daily transaction activity and volume in par (principal) amount traded for all types of municipal securities.[19]

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[17] Data collected by the Investment Company Institute ("ICI") indicate that, as of September 24, 2008, the total net assets in tax-exempt money market accounts were approximately $482 billion, which would account for more than half of the Federal Reserve estimates of mutual fund holdings of municipal securities at this time. Of the $482 billion in tax-exempt money market funds tracked by the ICI in September, approximately $295 billion was held in retail money market funds and $187 billion was held in institutional money market funds. Source: ICI, "Weekly Total Net Assets (TNA) and Number of Money Market Funds," available at *www.ici.org.*

[18] Source: MSRB transaction data.

[19] The MSRB provides statistical data on market activity on its Web site at *www.msrb.org* and through EMMA.

Figure 3

III. MSRB Actions To Promote Transparency in the Municipal Market

A. Primary Market Disclosure

As noted above, since 1990, the MSRB has sought to improve the availability of municipal securities issuer disclosure documents to investors through its MSIL system. At that time, the SEC adopted its Rule 15c2-12 to, among other things, require the underwriter for most offerings of municipal securities to receive and review the issuer's official statement before underwriting the issue. In turn, MSRB Rule G-36 requires underwriters to submit such official statements to the MSIL system. The MSIL system was the first comprehensive library of primary market disclosure documents in the municipal securities market. The MSRB developed the MSIL system to serve as a repository of disclosure documents and a "wholesaler" of these documents to market participants and information vendors. Since most disclosure documents in 1990 were made available in paper form, the MSIL system received such documents, scanned them, and provided electronic versions to subscribers for a minimal fee for use in information products provided to the market. More recently, many primary market disclosure documents are available in electronic form and the MSRB receives such documents and provides them directly to subscribers.

In March 2008, the MSRB launched its Electronic Municipal Market Access ("EMMA") pilot. EMMA is an Internet-based disclosure portal that provides free public access to primary market disclosure documents and real-time municipal securities trade price data for the municipal securities market, in a manner specifically tailored to retail investors. The EMMA Web site is accessible at *www.emma.msrb.org.* EMMA currently provides an easily navigable integrated display of primary market disclosures and transaction pricing data for a specific security, incorporating detailed user help and investor education information designed to make the information easily understood by retail investors. EMMA currently provides free access to the MSRB's full collection of issuer disclosure documents dating back to 1990, as well as to trade price information since January 2005.

On Monday of this week, the MSRB filed with the SEC a proposal to continue operation of EMMA on a permanent basis and to provide for more rapid dissemination of primary market disclosures through a centralized electronic submission and public access service. The MSRB expects that this new phase of EMMA will be fully operational by the end of May of this year. At that time, all underwriters will be required to submit official statements and related documents and information to EMMA electronically for immediate free public access through the EMMA Web site portal. Users of the Web site will be able to sign up for free optional e-mail alerts to be notified of new and updated postings of disclosure documents and other information offered on EMMA. These documents will continue to be displayed in conjunction with real-time trade price information so that users viewing trading data for a specific municipal security will have immediate access to key disclosure information about that security. EMMA's search engine is designed to assist retail investors in quickly finding the right document and information for a particular security.

EMMA is the central force in moving the municipal securities market from the old paradigm where only the buyer of a specific new issue municipal security could be assured of receiving a copy of the disclosure document for that security when the trade is completed to a new marketplace where the general public will have free ongoing immediate access to disclosure documents for all issues as soon as the docu-

ments become available. To further ensure broad access to the disclosures provided in official statements and advance refunding documents, the MSRB will make these documents available by subscription to information vendors and other bulk data users on terms that will promote the development of value-added services by subscribers for use by market participants.

B. Continuing Disclosure

The SEC revised its Rule 15c2-12 in 1995 to require underwriters to ensure that issuers have contracted to provide certain continuing disclosure information, including annual financial and operating data and material events notices, to certain private-sector information services designated as Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs"). In these amendments, the MSRB was included as an alternative recipient of material event notices only.

During the last few years, however, the MSRB grew concerned about investor access to continuing disclosure documents through the current NRMSIR system. As a result, after consultation with the SEC and review of the SEC's White Paper to Congress on the municipal securities market,[20] the MSRB began to plan for a continuing disclosure component of EMMA. This enhancement will combine continuing disclosure information with the primary market disclosure and trade information currently available to provide a central location for all such municipal securities market information.

On December 5, 2008, the SEC approved amendments to its Rule 15c2-12 to make the MSRB the central location for issuer continuing disclosure documents, effective July 1, 2009. EMMA's continuing disclosure service will provide a user-friendly interface for free electronic submission of continuing disclosure documents by issuers, other obligated parties and their agents. As with official statements, these continuing disclosure documents will become immediately available for free to the general public through the EMMA Web site portal. Free optional e-mail alerts relating to new postings will also be made available in connection with continuing disclosure documents. In addition, the continuing disclosure documents will be integrated into the existing official statement and trade data display to produce an all-encompassing view of the relevant primary market, secondary market, and trade price information for each security in the marketplace easily accessible through EMMA's powerful search engine.

The MSRB expects to file with the SEC next week a proposed rule that would permit EMMA to accept voluntary filings of continuing disclosure by issuers and obligors. We hope that this will encourage disclosure beyond that which is currently required by SEC Rule 15c2-12, such as quarterly financial information and information about related municipal derivative transactions.

C. Auction Rate Securities/Variable Rate Demand Obligation Transparency

In 2009, the MSRB implemented its Short-term Rate Transparency ("SHORT") System to increase transparency of municipal ARS and VRDOs. The SHORT System is the first centralized system for collection and dissemination of critical market information about ARS and VRDOs. Information collected by the SHORT System is made available to the public, free of charge, on EMMA.

The SHORT System will be implemented in phases. The first phase, which became operational on January 30, 2009, collects and disseminates interest rate and related information about municipal ARS, including information about the success or failure of each auction. The SHORT System is scheduled to become operational for VRDOs on April 1, 2009. This interest rate information allows market participants to compare ARS and VRDOs across issues and track current interest rates. Included in this information is the current interest rate, the length of the interest rate reset period as well as characteristics of the security, such as the identities of broker-dealers associated with the operation of the securities.

Later phases of this initiative to increase transparency of ARS and VRDOs include the collection and dissemination of ARS bidding information. This information will allow market participants to obtain important information about the liquidity of ARS and greater granularity into the results of the auction process. In addition, the MSRB plans to collect ARS documents that describe auction procedures and interest rate setting mechanisms as well as VRDO documents that describe the provisions of liquidity facilities, such as letters of credit and standby bond purchase agreements.

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[20] July 26, 2007, available at *http://www.sec.gov/news/press/2007/2007-148wp.pdf.*

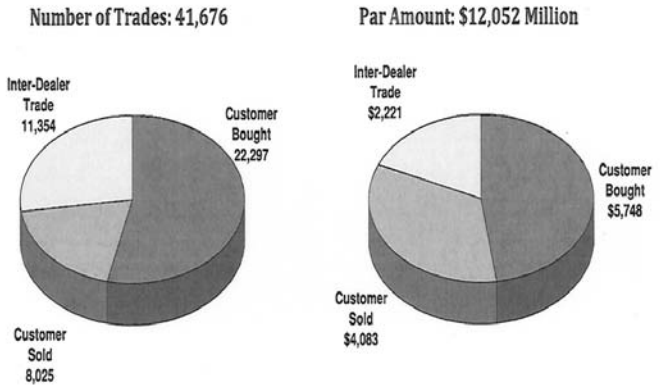
D. Market Statistics and Data

EMMA provides market activity information, including transaction price data for the most recent daily trades and a daily summary of trading activity throughout the municipal securities market. EMMA's daily trade summary provides the type of trade (*i.e.,* customer bought, customer sold or inter-dealer trades), the number of securities and the number of trades for each trade type and the par amount of the trades for all published trades disseminated by the MSRB for every trading day since May 2006. This information is provided on EMMA's market statistics pages and provides municipal securities investors with a market-wide view of the municipal securities market. An example of such information follows:

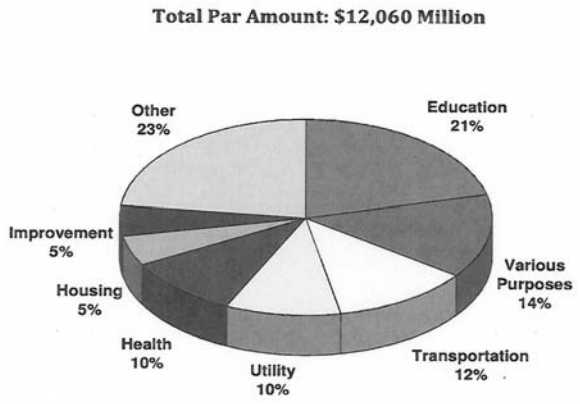
Daily Trade Summary By Trade Type – February 20, 2009

Trade Type	Number of Securities	Number of Trades	Par Amount ($ Millions)
Customer Bought	9,623	22,514	$6,077
Customer Sold	6,268	7,425	$3,661
Inter-Dealer Trade	4,941	10,333	$2,322
All Trades	13,587	40,272	$12,060

30-Day Average Trade By Trade Type – January 08, 2009 to February 20, 2009



Market statistics on EMMA also include the par amount traded for the most active sectors of the municipal securities market and trading volume by trade size, maturity, and source of repayment.



E. Investor Outreach and Education

The MSRB is conducting an aggressive campaign to reach out to investors about all the information that is easily available to them through EMMA. We have also added important educational materials to the EMMA site to assist investors in their understanding of the municipal securities market. The MSRB is gratified that we have had over 53,000 visitors to EMMA in its 12 months of pilot operation who have downloaded almost 4.0 terabytes of files and data. Messages we have received through the EMMA feedback and contact pages indicate a very positive response from users, which include retail and institutional investors, brokers, investment advisors, issuers, information services, researchers, media, and others. We plan to continue diligently to improve EMMA's service to both investors and issuers.

The MSRB has long sought to improve investor access to municipal securities disclosure as well as to require, through its dealer regulation, that the municipal securities market continue to be fair to investors and efficient for all market participants. Once fully operational, EMMA will allow for more timely and accurate disclosures, valuations, and information regarding municipal securities, which will benefit all market participants. EMMA's free public access to real-time trade price information and to the key disclosure documents has already provided unprecedented transparency to this market. As we complete each new phase of EMMA, the MSRB will provide increasing levels of transparency that will greatly benefit both investors and issuers alike and which is unparalleled in other markets.

IV. An Expanded Role for the MSRB To Enhance Investor Protection and Regulation of the Securities Markets

A. Unregulated Parties in the Municipal Securities Market.

The current financial crisis has exposed gaps in the regulatory structure that governs U.S. financial institutions and the products they offer. It is clear that regulatory reform is necessary to address changes in the capital markets, such as the creation of new financial products and the emergence of firms providing advice regarding these products. The municipal securities marketplace has evolved from one in which states and municipalities offered traditional, fixed rate bonds to finance specific projects into a market that involves the use of complex derivative products and intricate investment strategies.

Current federal law does not permit the MSRB to regulate the swap firms that assist in the creation of these derivative products for municipal issuers. The law also does not permit the MSRB to regulate other nondealer municipal market participants, such "independent" financial advisors that provide advice to issuers regarding bond offerings or investment brokers that assist issuers with investing bond proceeds. The MSRB believes regulation of these entities and other municipal advisors is essential to protect investors and ensure market integrity, and that the MSRB is in the best position to provide this regulation and therefore should be given such authority. The MSRB believes that its current regulatory structure for municipal securities dealers provides a ready model for oversight of municipal advisors, including financial advisors and investment brokers. The MSRB also believes that expanded oversight would be most effective in a dual regulatory structure with the SEC. Under this approach, firms would be required to register with the SEC, and the MSRB would provide more prescriptive rules applicable to these firms and

their activities. With the expansion of its jurisdiction, the MSRB's composition should be reviewed to provide for appropriate representation of all types of regulated parties as well as to ensure expanded public representation.

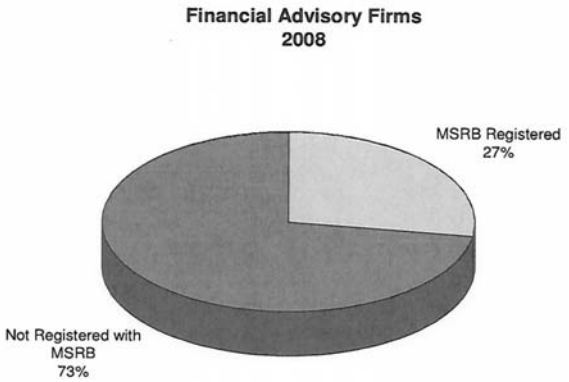
1. Financial Advisors and Investment Brokers and Other Municipal Market Participants. As federal lawmakers and policymakers are looking into unregulated participants throughout the financial markets such as mortgage brokers, so too should attention be paid to these participants in the municipal market. As municipal finance transactions have evolved and become more complex, there are many more advisors who work with municipal issuers, and brokers who act as intermediaries between issuers and others who provide necessary investment and other services. These participants have significant influence with issuers, earn significant fees, and many times, are not subject to any constraints on pay-to-play, as dealers have been since 1994. Unfortunately, the regulatory structure over the municipal market has not kept up with the evolving marketplace and nearly all of these participants are unregulated. At a minimum, municipal advisors such as financial advisors and investment brokers should be held to standards of conduct that protect municipal issuers, taxpayers, and investors in this market. The existing MSRB rulebook provides a ready model for the types of rules that could be developed for these market participants—particularly in light of the fiduciary nature of many of the advisory services they provide. Preventing pay-to-play throughout the municipal market is even more important now as the Congress has recognized the importance of rebuilding the Nation's infrastructure and has supported that goal through the stimulus bill. Also, as Treasury seeks to find solutions to assist the municipal bond market through the financial crisis, ensuring that all market participants adhere to the highest professional standards is essential.

Investors in the municipal securities market would be best served by subjecting unregulated market professionals to a comprehensive body of rules that (i) prohibit fraudulent and manipulative practices, (ii) require the fair treatment of investors, issuers, and other market participants, (iii) mandate full transparency, (iv) restrict real and perceived conflicts of interests, (v) ensure rigorous standards of professional qualifications, and(vi) promote market efficiencies. The municipal securities dealer community undertook the transition from being unregulated to becoming subject to such a body of rules and standards beginning in 1975 with the creation of the MSRB. The MSRB believes it is now time for the unregulated professionals in this market to undertake this same transition, and that the MSRB is the most appropriate regulatory body to provide this regulation.

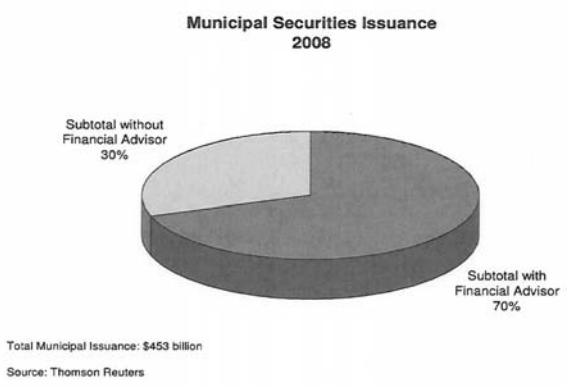
2. Current Regulation of Financial Advisors. It should be noted that many financial advisory firms are registered as broker-dealers or municipal securities dealers and are, therefore, subject to MSRB rules, including Rules G-23 and G-37. Rule G-23 is a disclosure rule designed to minimize the apparent conflict of interest that exists when a municipal securities professional acts as both financial advisor and underwriter with respect to the same issue. With respect to financial advisors that are not dealers (known as "independent" financial advisors), approximately fifteen states have some form of pay-to-play prohibition. Some states have very broad pay-to-play rules that cover most state and local contracts, including those for financial advisory services. Other states have very narrow rules that apply only to specific situations. Some municipalities also have enacted such rules. Additionally, certain states and municipalities and agencies have disclosure obligations. While some states and localities have such pay-to-play laws, in many cases based on MSRB Rule G-37, the limited and patchwork nature of these state and local laws has not been effective in addressing in a comprehensive way the possibility and appearance of pay-to-play activities in the unregulated portions of the national municipal securities market. It is time for a coordinated and comprehensive approach to regulating municipal advisors, including "independent" financial advisors.

3. Number of Financial Advisors Active in the Marketplace. Given the unregulated nature of this market, it is difficult to identify with precision the number of financial advisors, the number of offerings in which they participated, or the nature and scope of their advice. Nevertheless, the MSRB has reached out to market participants and has reviewed data on financial advisors supplied by Thomson Reuters. The MSRB believes that this information provides a reasonable estimate of the size of the market, but does not capture the entirety of it.

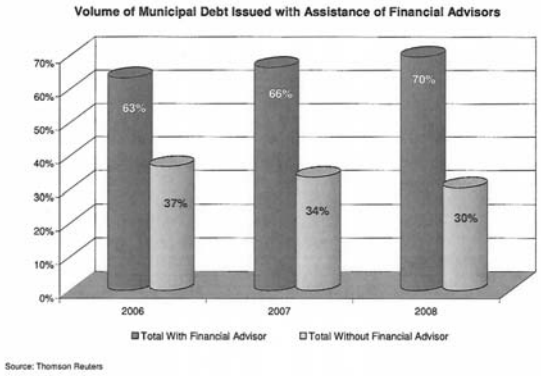
Based on the MSRB's review, of the 358 financial advisory firms that participated in at least one primary market transaction in 2008, only 98 were registered with the MSRB as dealers. It appears that the vast majority of active financial advisory firms currently are not regulated by the MSRB or, in general, anyone else.



4. Volume of Municipal Debt Issued With the Assistance of Financial Advisors. According to data obtained by the MSRB, approximately 70 percent of the total volume of municipal debt (by par amount) issued in 2008 was issued with the assistance of financial advisors. The total amount of municipal debt issued in 2008 was $453 billion, and financial advisors provided advice in offerings that accounted for $315 billion of this total.

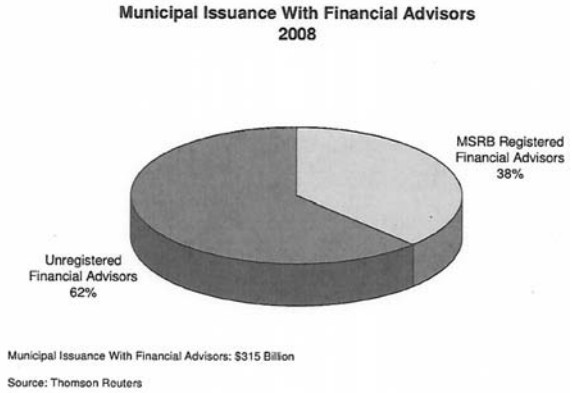


This percentage has increased over the last 2 years. In 2007, financial advisors participated in 66 percent of the total volume of offerings and, in 2006, financial advisors participated in 63 percent of the total volume of offerings.



The length of maturity of the offerings did not change the percentages significantly. In short-term offerings (maturities of less than 13 months) in 2008, financial advisors participated in 69.3 percent of the offerings, and in long term offerings, financial advisors participated in 69.7 percent of the offerings. Hence, an overwhelming percentage of short and long term offerings were issued with the assistance of financial advisors.

5. Percentage of Unregistered Firms That Participated in Offerings. Dealers participated as financial advisors in 38 percent of the total volume of offerings in which financial advisors provided assistance. Correspondingly, unregistered financial advisors participated in 62 percent of those offerings, which represented $196 billion of the $315 billion total.



6. The Role of Swap Advisors. The municipal securities derivatives market emerged in the 1980s and is still evolving. This market is very complex, with a variety of derivative products such as floating-to-fixed rate swaps, fixed-to-floating rate swaps, basis swaps, and swaptions. According to market participants, the vast majority of transactions are floating-to-fixed swaps, which are used to create synthetic fixed rate structures. These derivative products carry numerous embedded risks that may not be easily understood by less financially sophisticated issuers. Some such risks are interest rate risk, basis risk, tax risk, termination risk, and counterparty risk. Recent market conditions highlight this concern. Many sophisticated issuers face large swap termination fees due to changes in short-term interest rates. The extent to which many of these issuers may have underestimated the potential termination fees is of great concern to the MSRB.

To assist issuers in understanding the characteristics, risks, and potential benefits of these products, many firms developed expertise as swap advisors. These firms, of which there are approximately four dozen, according to the Bond Buyer's Municipal Marketplace Directory 2008, provide financial advice to issuers regarding swap policy development, transaction structuring, documentation, and pricing. Swap advisors now include boutique firms, registered broker-dealers, and banks. While many firms adhere to their own standards of professional conduct, their swap advisory services are, for the most part, unregulated.

Also problematic is the lack of available public information regarding the size of the municipal securities derivative market. Market participants have suggested that the market is between $100 billion and $300 billion, annually, in notional principal amount, but until these derivative transactions are formally tracked, the figures will be unreliable. Given the complexity of municipal derivative transactions, the variety of risks, the growth of the market, and the reliance by issuers on the expertise of swap advisors, the MSRB believes these municipal market professionals should also be regulated. Moreover, the MSRB believes that its rules provide an appropriate framework for such regulation.

7. The Role of Investment Brokers. A small group of advisory firms also provide investment advice to issuers concerning funds that are available to invest. These funds are typically bond funds, construction funds, escrow funds, debt service reserve funds, or capitalized interest funds. Advisory firms may recommend a variety of investments to the issuer, including bank investment agreements, guaranteed investment contracts, repurchase agreements, or forward delivery agreements. These investments may be offered by banks, insurance companies, or broker-dealers, and are bid competitively. Firms that offer such investment advice to issuers are not,

for the most part, regulated. Given the complexity of these investments, their integral relationship to the municipal securities transactions, and the investment advice provided by these firms, MSRB believes that these municipal market professionals should be regulated as well. At a minimum, given the investment advice they provide to clients, these firms should be registered as investment advisors with the SEC. Additionally, MSRB believes that its rules, which go significantly beyond the antifraud provisions of the federal securities laws, provide an appropriate model for regulation of these market professionals.

8. Municipal Issuers. When considering a new regulatory structure for the municipal securities market, it is important to recognize that the municipal market is distinct from other securities markets due to the role of sovereign municipal issuers, the diversity of issuer types, federal tax law and state law requirements and restrictions that relate to the issuance and sale of municipal securities. As the regulator of municipal securities dealers, the MSRB is keenly attuned to its role at the boundary between the federal government (establishing an efficient national marketplace and uniform investor protections) and states and municipalities exercising their public trust to meet the unique needs of their citizens. In the service of these goals, the MSRB has sought to provide rulemaking that is based on an understanding of the products that are being created and sold, and the dynamics driving decisions and market practices of the issuers, investors, and dealers. This requires careful tailoring of basic securities regulation principles to achieve key investor protection objectives without unduly imposing direct or indirect restraints on municipal issuers.

The SEC 's current jurisdiction includes authority to enforce antifraud laws with respect to issuers of municipal securities, and the SEC has brought enforcement actions in a number of high profile cases in the past few years. In addition, the associations representing state and local municipal issuers (Government Finance Officers Association and National Association of State Treasurers, in particular) also have an extensive body of recommended practices and an impressive educational outreach effort to help municipal issuers adhere to the highest standards of conduct. The MSRB is not suggesting the need for any additional federal regulation governing municipal issuers.

We believe that the MSRB's new EMMA system is a key turning point in moving forward with considerably improved disclosure practices in the municipal securities market, and the issuer community wholeheartedly supports this evolution. The current system of continuing disclosure based on a limited number of private enterprises, through which disclosures are available for a fee and in most cases only through a laborious process that does not promote public access, fails to provide the sunshine on disclosure practices that EMMA soon will. Good and bad disclosure practices alike are largely obscured in the current restrictive continuing disclosure scheme. This will no longer be the case with the advent of the MSRB's continuing disclosure service through EMMA. The EMMA system will serve as a red flag for poor disclosure by issuers, while revealing good disclosure practices. It also will remove existing impediments to ensuring that investors buy and sell in securities based on the most up-to-date disclosures. The EMMA Web site will make it abundantly clear to investors when disclosures are less than satisfactory, as opposed to the current restrictive system. If investors are not satisfied with an issuer's disclosure standards, or if they are alerted to information of concern through disclosures, they will extract a penalty, and the issuer eventually will pay the price through higher borrowing costs. In partnership with the state and local government issuer community, the MSRB believes that recent improvements in the quality and timeliness of disclosures in the municipal securities market will accelerate.

B. Financial Markets Regulatory Structure

The MSRB supports the concept of a multi-layered regulatory framework as a starting point for consideration of a new regulatory structure for the financial markets, as has been proposed by a number of governmental and nongovernmental bodies in recent months.[21]

Such a multi-layered regulatory framework would consist of (1) a market stability regulator to address overall conditions of financial market stability that could impact the general economy; (2) a prudential financial regulator; and (3) a business conduct regulator (linked to consumer protection regulation) to address standards

[21] See, *e.g.,* U.S. Government Accountability Office, "Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (GAO-09-216)," January 8, 2009, available at *http://www.gao.gov/new.items/d09216.pdf;* Group of Thirty, "Financial Reform: A Framework for Financial Stability," January 15, 2009, available at *http://www.group30.org/pubs/pub_1460.htm*; U.S. Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure," available at *http://www.treas.gov/press/releases/reports/Blueprint.pdf.*

for business practices. The MSRB stands ready to work closely with any systemic regulator to gather and analyze data about the municipal market as it relates to systemic risk in the financial markets. As well as a repository for municipal market data, the MSRB can be even better equipped to proactively monitor market activity and assist aggressively in enforcement activities.

A multi-layered regulatory approach, or in fact any scenario, requires that the regulatory entities have deep and extensive knowledge of all financial markets. The lack of municipal finance expertise at the federal level became apparent during the past year and resulted in a very late and limited recognition of the impact of the credit crisis on state and local municipal finances, and the failure of federal programs intended to alleviate the economic impact of the credit crisis to address the needs of state and local governments.

To this end, the MSRB strongly recommends the creation of a Treasury Department office or other significant federal position charged with representing the unique needs of the municipal securities market. We have proposed to President Obama's Administration, as an alternative to such a federal position, the development of a senior level group to coordinate municipal finance issues among the White House, Department of the Treasury, Federal Reserve, SEC, MSRB, and other federal agencies and stakeholders.

C. Self-Regulatory Organizations

The MSRB also believes that there is an important role for market-specific, self-regulatory organizations in any comprehensive regulatory framework. These SROs would continue to adopt rules and standards, establish market mechanisms and systems and standards of operations, and adopt market-specific rules and standards for investor protection. These SRO activities can far exceed the antifraud standards of the federal securities laws and can extend to the regulation of the behavior of market intermediaries, thereby ensuring the goals of investor protection and integrity of the securities markets. SROs are also uniquely situated to work with the industry to develop effective rules and information systems, and can be vital links between the industry and the broader regulatory community. SRO jurisdiction must be flexible and broad enough to encompass new products, market developments, new market entrants, market movements, and other changes.

D. Enforcement

Enforcement is key to an effective system of municipal regulation. Traditionally, enforcement activities have been spread across numerous federal and state governmental entities and self-regulatory organizations, consisting of the SEC, FINRA, various bank regulatory agencies, and state attorneys general, creating a patchwork of overlapping jurisdiction and inconsistent and uncoordinated enforcement activities. The SEC can be more effective if given additional resources for municipal enforcement. Further, while some coordination of enforcement activities currently exists, the MSRB strongly recommends that each of the entities that are charged with the enforcement of securities laws—regardless of the genesis of those laws—develop a more formal process to coordinate their regulatory and enforcement activities. Coordinated actions could avoid regulatory gaps, provide clearer statutory authority and promote an efficient and consistent enforcement mechanism for the industry.

Finally, we recommend that Congress modify the MSRB's regulatory authority to include an enforcement and examination support function that would further strengthen enforcement in the municipal securities market. With an increased statutory mandate, the MSRB could better analyze the large amount of data that we collect to assist in surveillance of the market. The MSRB and its staff have a depth of expertise in all aspects of the municipal market that is found nowhere else in the federal government, and we stand ready to further assist, if given the congressional mandate.

E. Derivative Products

While derivatives can be an important risk management tool, they can be dangerous if the state and local government issuers who purchase them do not understand the risks they may create. The current state of the law as articulated in the Commodities Futures Modernization Act of 2000 prohibits regulation of swap agreements (which are broadly defined) with the exception of antifraud, and the issue of whether and how to regulate credit default swaps ("CDS") and other derivative instruments remains controversial. While municipal derivatives play an important risk management role in the overall municipal securities market, municipal derivatives are only a fraction of the overall derivatives markets. The MSRB recognizes that the question of whether to regulate municipal derivative instruments should be answered by Congress in the context of the broader derivatives market and that,

should Congress choose to place such derivative products under new regulations, the regulatory structure should encompass municipal derivatives as well.

In particular, consideration should be given to the inclusion of municipal CDS in the types of CDS covered by central counterparties and clearinghouses. The application of central counterparties and clearinghouses to municipal CDS would address concerns about the problems of lack of minimum capitalization of CDS protection sellers. It would also address the lack of transparency in CDS pricing, which currently may disadvantage certain investors and dealers. Furthermore, it would provide municipal issuers with information about whether dealers who underwrite their securities are also selling CDS on their debt. Issuers who considered such a dual role to pose a conflict of interest could then take whatever actions they deemed appropriate. Should enhanced disclosures in derivative instruments be a part of any regulatory scheme, the MSRB is well poised with its EMMA system to provide disclosures of municipal derivative contracts and provide the necessary transparency for our market.

V. Executive Summary

Since its creation in 1975, the MSRB has worked diligently to foster and preserve a fair and efficient municipal securities market that serves the public interest. The dual goals of investor protection and market integrity have guided this mission. However, the increased sophistication of our market, changing financial markets generally, and the importance of investor protection in the market require a review of the regulatory structure of this market.

To that end, we make the following recommendations:

- We believe that financial advisors, investment brokers, and other intermediaries in the municipal market should be brought under a comprehensive regulatory scheme. Further, we believe that the MSRB is the appropriate regulatory body to regulate these unregulated municipal market participants, as part of a dual regulatory structure with the SEC.
- We support a multi-layered overall regulatory framework for the financial markets consisting of a market stability regulator, a prudential financial regulator, and a business conduct regulator.
- We believe that there is an important role for market-specific SROs that are charged with adopting rules and standards, market mechanisms, information systems, and standards of operations that embody and expand upon the basic antifraud standards of the federal securities laws.
- We recommend the creation of a Treasury Department office or other significant federal position charged with representing the unique needs of the municipal securities market, or alternatively, a senior-level multiple-agency group to coordinate municipal finance issues among all market stakeholders.
- We strongly recommend that federal and state entities charged with the enforcement of securities laws develop a more formal process to coordinate their regulatory and enforcement activities.
- We believe that derivative instruments based on municipal securities should be subject to the same comprehensive regulatory framework that may be developed for swaps and other types of derivative financial products in other markets. The rules governing dealer activity developed by the MSRB over its history provide an appropriate model for the comprehensive regulation that should apply to all financial intermediaries active in the municipal market.

We stand ready to assist in this important work and are certain that investor protection will be served by increasing our mandate.

PREPARED STATEMENT OF RICHARD BAKER

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
MANAGED FUNDS ASSOCIATION

MARCH 26, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the Senate Committee on Banking, Housing, & Urban Affairs hearing, "Enhancing Investor Protection and the Regulation of Securities Markets—Part II" held on March 26, 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 the important subjects of investor protection and the regulation of securities markets. In considering theses issues, it is important to remember that vibrant, liquid markets are important to investors and that for these markets to work, financial institutions need to be able to perform their important market functions.

Hedge funds play an important role in our financial system, as 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. 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 allowed investors means to diversify their investments, thereby reducing their 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.

In order 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 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 in excess of $1.9 trillion. 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 percent 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. The value of hedge funds (and other private pools of capital) as private investors has been recognized by Treasury Secretary Geithner in his proposals for the recently announced Public Private Partnership Investment Program (the "PPIP") and implementation of the Term Asset-Backed Securities Loan Facility, each of which is dependent on private investor participation to be successful. In addition to providing liquidity, managers of private pools of capital have significant trading and investing experience and knowledge that can assist policy makers as they continue to contemplate the best way to implement the Administration's Financial Stability Plan.

MFA is supportive of the new PPIP. We share Secretary Geithner's commitment to promote efforts that will stabilize our financial markets and strengthen our Nation's economy. MFA and its members look forward to working with Secretary Geithner, Congressional leaders, and members of President Obama's economic team

on this and other important issues in order to achieve the shared objective of restoring stability and investor confidence in our financial markets.

Regulatory reform also will be an important part of stabilizing markets and restoring investor confidence, but it will not, in and of itself, be sufficient to do so. The lack of certainty regarding major financial institutions (*e.g.,* banks, broker dealers, insurance companies) and their financial condition has limited the effectiveness of government intervention efforts to date. Investors' lack of confidence in the financial health of these institutions is an impediment to those 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 Treasury Department's plan to conduct comprehensive stress tests on the 19 largest bank holding companies is designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. Treasury's announcement that it plans to involve private asset managers in helping to value illiquid assets held by banks as part of the PPIP recognizes the beneficial role that private asset managers can play in helping provide that certainty. We believe that, to achieve this certainty, 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 "smart" regulation cannot, in and of itself, restore financial stability and properly functioning markets, it is a necessary component of any plan to achieve those ends. "Smart" regulation would include appropriate, effective, and efficient regulation and industry best practices that better monitor and reduce systemic risk and promote efficient capital markets, market integrity, and investor protection. Regulation that addresses these key issues 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 has been the leader in developing, enhancing and promoting standards of excellence through its document, Sound Practices for Hedge Fund Managers ("Sound Practices"). 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.

Because of the complexity of our financial system, an ongoing dialogue between 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.

I. Systemic Risk Regulation

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 of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants.

As an Association, we are currently engaged in an active dialogue with our members to better understand how these factors, among others, may relate to the systemic relevance of all financial market participants—including our industry and its members. 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. We are committed to being constructive participants in the dialogue regarding the creation of that framework.

A. Central Systemic Risk Regulator

Under our current regulatory structure, systemic risk oversight is the responsibility of multiple regulatory entities, or worse, no one's responsibility. For systemic risk oversight to be effective, there must be oversight over 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. We believe that a single central systemic risk regulator should be considered to accomplish this goal. This central regulator should be responsible for oversight of the structure,

classes of institutions and products of all financial system participants. MFA is engaged in discussions with its members with respect to which regulatory entity, whether new or existing, would be best suited for this role.

We believe that having multiple regulators with responsibility for overseeing systemic risk likely would not be an effective framework. Jurisdictional conflicts, unintended gaps in regulatory authority, and inefficient and costly overlapping authorities likely would inhibit the effectiveness of such a regulatory framework. Moreover, in a framework with multiple systemic risk regulators, no one regulator would be able to assess potential systemic risks from a holistic perspective, as no regulator would oversee the entire system.

B. Confidential Reporting to Regulator

MFA and its members recognize that for a systemic risk regulator to be able to adequately assess potential risks to our financial system, that regulator needs access to information. We support a systemic risk regulator having the authority to request and receive, on a confidential basis, from those entities that it determines (at any point in time) to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system.

In considering the appropriate scope of this authority, we believe that it is important for the systemic risk regulator to have sufficient authority and flexibility to adapt to changing conditions and take a forward-looking view toward risk regulation. Attempting to pre-determine what information a regulator would need would not provide sufficient flexibility and likely would be ineffective as a tool to address potential future risks. We believe that granting the systemic risk regulator broad authority with respect to information gathering, along with ensuring that it has the appropriate resources and capabilities to effectively analyze that information, would be a more effective framework.

While we support a systemic risk regulator having access to whatever information it deems necessary or advisable to assess potential systemic risks, we believe that it is critical for such information to be kept confidentially and granted full protection from public disclosure. We recognize the benefit of a regulator having access to all important data, even potentially sensitive or proprietary information from systemically relevant entities. A systemic risk regulator can fulfill its mandate to protect the financial system without publicly disclosing all the proprietary information of financial institutions. We do not believe that there is a public benefit to such information being publicly disclosed.

Moreover, public disclosure of such information could be misleading, as it would likely be incomplete data that would be viewed by the public outside of the proper context. Public investors may be inclined to take action based on this data without fully understanding the information, which could lead to adverse consequences for those investors, for the investors in systemically relevant entities, and for the stability of the financial system as a whole. Public disclosure of proprietary information also harms the ability of market participants to establish and exit from investment positions in an economically viable manner. Such disclosure also could lead to systemically relevant entities being placed at an unfair competitive disadvantage compared to nonsystemically relevant entities, as sensitive and proprietary information of only the systemically relevant entities would be publicly available.

C. Mandate To Protect the Financial System

Setting a clear and specific mandate is important for any regulator to be effective. This is particularly true in a regulatory framework that has multiple regulatory entities, as a lack of clarity in the mandates of regulators can lead to gaps in oversight, or costly and inefficient overlapping regulation. We believe that the systemic risk regulator's mandate should be the protection of the financial system. Investor protection and market integrity should not be part of its mandate, but should instead be addressed by other regulatory entities. Congress should be clear in stating that the risk regulator should collect information only for its mandate to protect the financial system, and should not use that authority for other purposes.

To fulfill its mandate to protect the financial system, we recognize that the regulator would need to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. Absent such a concern about broad systemic consequences, however, the systemic risk regulator should not focus on preventing the failure of systemically relevant entities. Systemically relevant market participants do not necessarily pose the same risks or concerns as each other. There likely are entities that would be deemed systemically relevant for purposes of reporting information, but whose failure would not threaten the broader financial system. For this reason, we believe that the systemic risk regulator should focus on

preventing failures of market participants only when there is concern about the consequences to the broader financial system, and should not focus on preventing the failure of all systemically relevant entities.

Consistent with this mandate, the systemic risk regulator should not equate systemically relevant entities with entities that are too big, or too interconnected, to fail. An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against its failure.

D. Scope of Regulatory Authority

The last part of systemic risk regulation that I would like to address in my testimony is the scope of authority that a systemic risk regulator should have to fulfill its mandate to protect our financial system. There are a number of suggestions that various people have made as to the type of authority a systemic risk regulator should have. We continue to discuss with our members what the appropriate scope of authority should be for such a regulator.

We believe that whatever authority the regulator has should ensure that the regulator has the ability to be forward-looking to prevent potential systemic risk problems, as well as the authority to address systemic problems once they have arisen. The systemic risk regulator's authority must be sufficiently flexible to permit it to adapt to changing circumstances and address currently unknown issues. An attempt to specifically define the regulator's authority must avoid unintentionally creating gaps in authority that would prevent the systemic risk regulator from being able to fulfill its mandate to protect the financial system in the future.

We do believe that the systemic risk regulator needs the authority to ensure that a failing market participant does not pose a risk to the entire financial system. In the event that a failing market participant could pose such a risk, the systemic risk regulator should have the authority to directly intervene to ensure an orderly dissolution or liquidation of the market participant. The significant adverse consequences that resulted from the failure of Lehman Brothers, Inc. this past fall is an example of what can happen when there is not an intervention to prevent a disorderly dissolution of such a market participant. The continuing market disruption caused by the failure of Lehman Brothers also demonstrates the importance of ensuring that there is a coordinated global effort with respect to such interventions.

Whatever the scope of authority that a systemic risk regulator has, its implementation of that authority will be critical to the effectiveness of any regulatory regime. We believe that the systemic risk regulator should implement its authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products. Because systemic risk concerns may arise from a combination of factors, rather than from the presence of any particular factor, a holistic approach is more likely to successfully identify and assess potential systemic risks.

Recent coordinated efforts between the Federal Reserve Bank of New York (the "New York Fed") and industry participants provide a good example of how a systemic risk regulator could address systemic risk concerns posed by structural issues in our markets. In recent years, the New York Fed, working with MFA and other industry participants through the Operations Management Group ("OMG") and other industry-led initiatives has made notable progress in addressing concerns related to the over-the-counter ("OTC") derivatives market. Some of the more recent market improvements and systemic risk mitigants have included: (1) the reduction by 80 percent of backlogs of outstanding credit default swap ("CDS") confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) the establishment of a trade information repository to document and record confirmed CDS trades; (4) the establishment of a successful auction-based mechanism actively employed in 14 credit events including Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (5) the reduction of 74 percent of backlogs of outstanding equity derivative confirmations since 2006 and 53 percent of backlogs in interest rate derivative confirmations since 2006.

In addition to these efforts, MFA, its members and other industry participants have been working with the New York Fed to expedite the establishment of central clearing platforms covering a broad range of OTC derivative instruments. We believe a central clearing platform, if properly established, could provide a number of market benefits, including: (1) the mitigation of systemic risk; (2) the mitigation of counterparty risk and protection of customer collateral; (3) market transparency and operational efficiency; (4) greater liquidity; and (5) clear processes for the determination of a credit event (for CDS).

II. Prudential Regulation

We recognize that, in addition to systemic risk regulation, some policy makers, regulators and authors of various reports (*e.g.,* the Group of 30, Government Accountability Office and Congressional Oversight Panel) have contemplated the notion of a prudential regulatory framework, including mandatory registration for private pools of capital. There are a great many issues that should be considered in determining what, if any, such a framework should look like. As an Association, we are currently engaged in an active dialogue with our members on these critical issues and we are committed to being constructive participants as discussions on these issues progress.

While many of the details regarding reform initiatives have yet to be proposed, we would like to share some initial thoughts with you on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider prudential regulatory reform. Those principles are:

- The goal of regulatory reform should be to develop intelligent regulation, which makes our system stronger for the benefit of businesses and investors.
- Prudential regulation should address identified risks or potential risks, and should be appropriately tailored to those risks.
- 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 the right information to 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. I would add that it is critical that any reporting of sensitive, proprietary information by market participants be kept confidential. As discussed in the section above on reporting to a systemic risk regulator, 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.
- We believe that any prudential 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 should not be limited only to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored approach.
- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and viewed as an important complement to prudential regulation. Strong business practices and robust diligence are critical to addressing investor protection concerns.

III. Short Selling

One issue in particular 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 Securities and Exchange Commission (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."[1] 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.[2] We strongly agree with the SEC and the FSA that short selling, along with derivatives trading, provides capital markets with nec-

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

[2] Temporary Short Selling Measures, FSA Consultation Paper 09/1 (Jan. 2009), at page 4.

essary 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.

We are concerned 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. The risk of public disclosure could cause investors, including pension plans and endowments, with billions of dollars of assets to withdraw capital and further disrupt already stressed capital markets. In the long-term, pension, endowment and foundation investors would forego diversification and risk management benefits provided by alternative investment vehicles.

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.

Conclusion

Hedge funds 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.

PREPARED STATEMENT OF JAMES CHANOS

CHAIRMAN,

COALITION OF PRIVATE INVESTMENT COMPANIES

MARCH 26, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is James Chanos, and I am President of Kynikos Associates LP, a New York private investment management company that I founded in 1985.[1] I am appearing today on behalf of the Coalition of Private Investment Companies (CPIC), a group of about twenty private investment companies with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.

I want to thank the Senators of this Committee for your efforts to develop and implement an approach to modernize financial regulation which would address the failures and inadequacies that contributed to the financial crisis confronting our country and our global economy. I am honored to have this opportunity to testify on behalf of CPIC and look forward to working with you and your staff in the months ahead.

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[1] Prior to founding Kynikos Associates LP, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science.

I. Executive Summary

This is a difficult time for our Nation. Overhauling our regulatory structure is necessary to regain investor confidence. Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud.

In recent years, prior to the current economic downturn, many observers of the financial system believed that hedge funds and other private pools of capital would be the source of the next financial crisis. Of course, as we have all painfully learned, in fact, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from institutions such as banks, insurance companies, broker-dealers, and government-sponsored enterprises operating with charters and licenses granted by state and federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC—which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation—to perpetrate his Ponzi scheme.

Nonetheless, hedge funds and other private investment companies are important market players, and we recognize that a modernized financial regulatory system—one that addresses overall risk to the financial system and that regulates market participants performing the same functions in a consistent manner—will include regulation of hedge funds and other private pools of capital. We are ready to work with you as you seek to craft appropriate regulation for our industry.

With respect to the new regime for monitoring systemic risk, CPIC would like to offer the following principles upon which to base legislative and regulatory action:

- First, regulation must be based upon activities, not actors, and it should be scaled to size and complexity.
- Second, all companies that perform systemically significant functions should be regulated.
- Third, regulators should have the authority to follow the activities of systemically important entities regardless of where in the entity that activity takes place.
- Fourth, as complexity of corporate structures and financial products intensifies, so, too should regulatory scrutiny.
- Fifth, there should be greater scrutiny based upon the "Triple Play"—being an originator, underwriter/securitizer and investor in the same asset.
- Sixth, and above all, the systemic risk regulator must enforce transparency and practice it.

With respect to increasing the functional regulation of hedge funds, CPIC offers the following for your consideration:

- Simply removing exemptions from the Investment Company Act and the Investment Advisers Act upon which private investment funds rely will prove unsatisfactory.
- Any new regulation should provide for targeted controls and safeguards to provide appropriate oversight of private investment companies, but should also preserve the flexibility of their operations.
- More detailed requirements for large private investment companies would address the greater potential for systemic risk posed by such funds, depending on their use of leverage and their trading strategies.
- Regulation should address basic common-sense protections for investors in private investment companies, particularly with respect to disclosure, custody of fund assets, and periodic audits.
- Areas such as counterparty risk, lender risk, and systemic risk should be addressed through disclosures to regulators and counterparties.

With respect to hedge funds as significant investors in the capital markets, CPIC believes that maximum attention should be paid to maintaining and increasing the transparency and accuracy of financial reporting to shareholders, counterparties, and the market as a whole.

II. The State of the Hedge Fund Sector

Since I last testified before the Senate Banking Committee on May 16, 2006,[2] the hedge fund industry has undergone profound change in the face of unprecedented challenges. In 2006, the industry was continuing its rapid growth and evolution into new strategies and products, to offer qualified investors greater flexibility and opportunities for managing risks and achieving returns that exceeded equity and bond markets' performance. In 2006, the industry had an estimated $1.47 trillion in assets under management and there were an estimated 9,462 funds. A year later, total assets under management for an estimated 10,096 funds rose to about $1.87 trillion, culminating 18 years of growth since 1990 at a cumulated average annual growth rate (CAGR) of 25 percent. In several markets, hedge funds became the main players, accounting for more than 50 percent of trading in U.S. convertible bonds, distressed debt, and credit derivatives.[3] We experienced a host of new strategies to address investors' increasingly complex risk-management and asset growth demands, as the variety and complexity of financial instruments—and the global nature of those products—grew exponentially. The sheer variety of investment strategies that hedge funds employed strengthened capital markets, improved opportunities for price discovery, and facilitated the efficient allocation of capital.[4]

The attraction of hedge funds was a function, too, of their performance. According to Hedge Fund Research, Inc., hedge funds have returned an average of 11.8 percent annually during the period 1990 through 2008, and an average 15.9 percent in the 12 months following the five largest historical declines.[5]

As Andrew W. Lo, a professor at the MIT Sloan School of Management, testified on November 13, 2008, "[t]he increased risk-sharing capacity and liquidity provided by hedge funds over the last decade has contributed significantly to the growth and prosperity that the global economy has enjoyed."[6] It is a point that Treasury Secretary Timothy F. Geithner made as Federal Reserve Bank President and CEO in speeches in 2004 and 2005.[7]

Despite the rapid growth and size of hedge funds ($1.41 trillion), their relative size with the financial sector is small, accounting for 0.7 percent of the $196 trillion invested in equities, tradable government and private debt, and bank deposits, according to McKinsey Global Institute.[8]

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[2] Testimony of James Chanos, Chairman, Coalition of Private Investment Companies. U.S. Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities and Investment. Hearing on the Hedge Fund Industry. May 16, 2006. Available at: *http://banking.senate.gov/public/__files/ACF82BA.pdf.*

[3] Kambhu, John, Schuermann, Til and Stiroh, Kevin J., Hedge Funds, Financial Intermediation, and Systemic Risk. Economic Policy Review, Vol. 13, No. 3, December 2007 (available at SSRN: *http://ssrn.com/abstract=1012348*).

[4] Knowledge@Wharton, "Hedge Funds Are Growing: Is This Good or Bad?" June 29, 2005. Available at: *http://knowledge.wharton.upenn.edu/article.cfm?articleid=1225&CFID=4349082&CFTOKEN=6202640.* Jeremy Siegel, Professor of Finance at the Wharton School of the University of Pennsylvania, observes that short selling contributes to the market's process of finding correct prices, and it's valuable to have hedge funds doing this. Sebastian Mallaby, "Hands Off Hedge Funds," Foreign Affairs, January/February 2007. Available at: *http://www.foreignaffairs.org/20070101faessay86107/sebastian-mallaby/hands-off-hedge-funds.html.* The importance of hedge funds has been acknowledged by the President's Working Group on Financial Markets, the Commodities Futures Trading Commission, the Securities and Exchange Commission, two chairs of the Federal Reserve Board, and members of Congress.

[5] Hedge Fund Research, Inc. "Investors Withdraw Record Capital from Hedge Funds as Industry Concludes Worst Performance Year in History." Press Release. Available at: *https://www.hedgefundresearch.com/pdf/pr__01212009.pdf.*

[6] Written Testimony of Andrew W. Lo, Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008, Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform November 13, 2008 Hearing on Hedge Funds.

[7] Mr. Geithner stated: "Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an importance source of risk transfer and diversification." Available at: *http://www.ny.frb.org/newsevents/speeches/2004/gei041117.html.* Mr. Geithner also stated "Hedge funds, private equity funds and other kinds of investment vehicles help to disperse risk and add liquidity." See Keynote Address at the National Conference on the Securities Industry: Hedge Funds and Their Implications for the Financial System (November 17, 2004). Remarks at the Institute of International Bankers Luncheon in New York City (October 18,2005). Available at: *http://www.ny.frb.org/newsevents/speeches/2005/gei051018.html.*

[8] McKinsey Global Institute, Mapping Global Capital Markets: Fifth Annual Report. October 2008. Available at: *http://www.mckinsey.com/mgi/reports/pdfs/fifth__annual__report/fifth__annual__report.pdf.*

In the summer of 2007 and throughout 2008, financial markets began to unravel. Major regulated financial institutions collapsed or went bankrupt as the U.S. Treasury administered life support through both capital infusions and U.S.-backed guarantees to prevent the demise of banks, insurance companies, and others who were deemed "too big to fail," and thereby stave off an imminent global economic collapse comparable to that of the Great Depression. A chain of interlinked securities—including derivatives and off-balance sheet vehicles—sensitive to housing prices triggered a death spiral in financial markets worldwide, demonstrating the scale and intensity of interdependence in the global economy and the vulnerability it causes.[9] As the problems became more severe, the crisis mushroomed beyond subprime debt to threaten less risky assets. Credit markets dried up, and equity markets in 2008 posted one of their worst years since the 1930s. As a result, the value of financial assets held at banks, investment firms, and others collapsed, jeopardizing their survival as they sharply curtailed activities. Institutional investors rushed to the sidelines, seeking safe havens in cash investments. The downturn spread throughout our economy and worldwide, fueling job losses, prompting bankruptcies, and causing household wealth to erode. That is a greatly distilled and simplified recounting of the events in 2007–2009. And, as might be expected with those events, the hedge fund industry experienced a sharp reversal.[10]

As a consequence of the financial crisis, as was the case with other sectors of the financial services industry, the amount of money managed by hedge funds plummeted, reflecting an amalgam of sharp declines in asset values, the rise in client redemptions, and regulatory closures of margin accounts. Last year was easily among the worst in the industry's history, with total assets under management falling to $1.41 trillion—a decline of $525 billion from the all-time peak of $1.93 trillion reached mid-year 2008, with more than 1,471 funds—a record in 1 year—liquidating. Investors withdrew a record $155 billion.

Hedge funds on average in 2008 posted their worst performance since 1990. The HFRI Fund Weighted Composite Index dropped 18.3 percent for all of last year, which was only the second calendar year decline since 1990.[11] That said, though, hedge fund losses on average were less than those of the S&P500, with 24 different hedge fund strategies performing better than the S&P 500 benchmark.

III. Mitigation of Systemic Risk

The financial crisis of the past 2 years has raised many questions about the extent to which systemic risks are effectively contained and ameliorated within the U.S. and global economies. As globalization has led to better risk sharing and increased market liquidity, shocks originating in one market are more quickly transmitted to other markets. Regulators and central banks say they need more information to understand the sources of risks and potential impact on markets and economies. Consensus is emerging among U.S. policy makers and in other countries for the need to strengthen systemic risk regulation. Towards that end, allow me to outline some basic principles to guide the thinking about establishing a regulator with responsibility for addressing systemic risks and the attendant laws and regulations to accomplish that objective.

First, regulation must be based upon activities, not actors, and it should be scaled to size and complexity. Regulatory scrutiny should be triggered based upon any of the following: the overall scale of market participants, relative importance in a given market or markets, complexity of corporate structure, and complexity of financial instruments used for investment or dealer purposes. All participants undertaking a similar activity should be treated equally; for example, proprietary trading by financial institutions should not be treated in a different manner than trading by any other kind of entity. While the regulator should have broad and flexible authority to determine the basis upon which it wants to include systemically significant enti-

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[9] There are many research papers and studies that examine the source of the financial crisis. One example: Gary B. Gorton, "The Panic of 2007." August 25, 2008. Yale ICF Working Paper No. 08-24. Available at: *http://ssrn.com/abstract=1255362.*

[10] I would encourage you to read the trenchant analysis by Lord Adair Turner, Chairman of the U.K. Financial Services Authority ("FSA"), in which he eloquently recounts how developments in the banking and the near-bank system caused serious harm to the real economy. Lord Adair Turner, Chairman, FSA. "The financial crisis and the future of regulation." January 21, 2009. The Economist's Inaugural City Lecture (available at *http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml.* A more extensive discussion is provided in: The Turner Review: A Regulatory Response to the Global Banking Crisis. March 18, 2009 (available at *http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/037.shtml*).

[11] According to Hedge Fund Research, Inc. "during 2008, the industry experienced a period of six consecutive months of declines between June and November, interrupted only by December's 0.41 percent gain, including a concentrated, volatile two-month period in September and October in which the cumulative decline approached 13 percent." See *supra* n. 5.

ties, it should be clear and transparent in disclosing the criteria upon which it seeks to include a specific market participant.

Second, all companies that perform systemically significant functions should be regulated. The regulator should have the authority to examine and discipline market players such as credit rating agencies and financial guarantors, based on the importance of the integrity of their functions to the entire financial system.

Third, the regulator should have the authority to follow the activities of systemically important entities regardless of where in the entity that activity takes place. No matter where the activity takes place in a corporation, regulators should be allowed to look into those activities. This point speaks against assigning regulators specific discrete parts of entities to cover and for an evolution of functional regulation.

Fourth, as complexity of corporate structures and financial products intensifies, so, too should regulatory scrutiny. Greater regulatory scrutiny should be borne by complex enterprises—not just in the sense of adding additional functional regulation for each new piece of a diversified company but also in the sense of materially increasing the federal regulatory oversight exercised by any new systemic regulator. Entities should come under the ambit of a systemic regulator based upon the complexity, opacity, and system-wide interdependent nature of the instruments that they underwrite, produce, deal in or invest.

Fifth, there should be greater scrutiny based upon the "Triple Play"—being an originator, underwriter/securitizer, investor in the same asset. Greater regulatory scrutiny should be borne by those entities that endeavor to achieve the trifecta: that is, to own the "means of production" of an asset, to act as a dealer in financial instruments created from those assets, and to be a direct investor in those instruments or assets. In other words, if a company were a mortgage originator, a dealer in mortgage-backed securities, and an investor for its own account in mortgage-backed securities, that "triple play" would trigger oversight by the systemic regulator not only of the individual activities but also the management of the inherent conflicts of interest between those vertically integrated pieces.

Sixth, and above all, a systemic risk regulator must enforce transparency and practice it. The regulatory structure should include reviews of how accurately entities make required disclosures of their true financial condition to their shareholders and/or counterparties and investors. The regulator, too, must be transparent; it should annually disclose the entities under its regulatory umbrella and the reason for their inclusion. The regulator should be accountable to Congress and the public. Although the markets alone are not up to the task of identifying and containing systemic risk, it is also the case that the government alone is not up to the task. The combined efforts of government regulators and market discipline brought about by transparent disclosure of risks are needed in any plan for future operation of our financial markets. Further, consideration should be given to modeling disclosure of regulatory or enforcement activity on those of the SEC or CFTC, rather than some of the other, more opaque, federal regulatory agencies.

IV. Hedge Funds and Functional Regulation

Private investment companies of all types play significant, diverse roles in the financial markets and in the economy as a whole. Venture capital funds, for instance, are an important source of funding for start-up companies or turnaround ventures. Other private equity funds provide growth capital to established small-sized companies, while still others pursue "buyout" strategies by investing in underperforming companies and providing them with capital and/or making organizational changes to improve results. These types of funds may focus on providing capital in the energy, real estate, and infrastructure sectors. Hedge funds trade stocks, bonds, futures, commodities, currencies, and a myriad of other financial instruments on a global level. These flexibly structured pools of capital provide substantial benefits to their investors and to the markets more broadly in terms of liquidity, efficiency, and price discovery. In addition, they are a potential source of private investment to participate with the government in addressing the current financial crisis.[12] It, therefore, is in all of our interests that private investment funds continue to participate in our financial markets.

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[12] United States Department of the Treasury, Fact Sheet: Public–Private Investment Program (Mar. 23, 2009) (available at *http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf).*

While it often is said that private investment companies are "unregulated," they are, in fact, subject to a range of securities antifraud, antimanipulation,[13] margin,[14] and other trading laws and regulations that apply to other securities market participants.[15] They also are subject to SEC enforcement investigations and subpoenas, as well as civil enforcement action and criminal prosecution if they violate the federal securities laws. However, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of certain exemptions from registration under the Investment Company Act of 1940 (the "Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act").[16] Congress created exemptions under these laws because it determined that highly restrictive requirements of laws designed to regulate publicly offered mutual funds and investment advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

To date, legislative proposals to regulate private investment companies have been directed at removing the exemptions from regulation of private investment companies under the Investment Company Act and Advisers Act and thus subjecting private investment companies to the requirements of those Acts. But, for policy makers who believe private investment companies and their managers should be subject to greater federal oversight, I would argue that simply eliminating the exemptions in either or both of these statutes will prove unsatisfactory.[17]

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[13] See Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. §78j) and Rule 10b-5 thereunder (17 C.F.R. § 240.10b-5).

[14] 12 C.F.R. §§220, 221, 224.

[15] See, *e.g.,* Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f) (15 U.S.C. §§78m(d), 78m(e), 78n(d), 78n(e) and §78n(f)) and related rules (which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests).

[16] Section 3(c)(1) of the Investment Company Act excludes a company from the definition of an "investment company" if it has 100 or fewer beneficial owners of its securities and does not offer its securities to the public. Under the Securities Act of 1933 and SEC rules, an offering is not "public" if it is not made through any general solicitation or advertising to retail investors, but is made only to certain high-net-worth individuals and institutions known as "accredited investors." "Accredited investors" include banks, broker-dealers, and insurance companies. The term also includes natural persons whose individual net worth or joint net worth with a spouse exceeds $1 million, and natural persons whose individual income in each of the past 2 years exceeds $200,0000, or whose joint income with a spouse in each of the past 3 years exceeds $300,000, and who reasonably expect to reach the same income level in the current year.

Section 3(c)(7) of the Investment Company Act excludes a company from the definition of an "investment company" if all of its securities are owned by persons who are "qualified purchasers" at the time of acquisition and if the Company does not offer its securities to the public. Congress added this section to the Investment Company Act in 1996 after determining that there should be no limit on the number of investors in a private investment fund, provided that all of such investors are "qualified purchasers." In brief, "qualified purchasers" must have even greater financial assets than accredited investors. Generally, individuals that own not less than $5 million in investments and entities that own not less than $25 million in investments are qualified purchasers.

Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser that, during the course of the preceding twelve months has had fewer than fifteen clients and that does not hold itself out as an investment adviser nor act as an investment adviser to any investment company. Advisers to hedge funds and other private investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

In some cases, where these companies and their advisers engage in trading commodity futures, they also comply with exemptions from registration under the "commodity pool operator" and "commodity trading advisor" provisions of the Commodity Exchange Act ("CEA"). These exemptions generally parallel the exemptions from registration under the securities laws.

[17] In my testimony before the SEC's public roundtable on hedge funds in 2003, I recommended that, as a further condition to exemption under the Advisers Act, hedge funds should be subject to specific standards relating to investor qualifications, custody of fund assets (an issue on which there now is significant focus as a result of the Madoff scandal), annual audits and quarterly unaudited reports to investors, clear disclosure of financial arrangements with interested parties (such as the investment manager, custodian, prime broker, and others—in order to address conflicts issues), clear disclosure of investment allocation policies, and objective and transparent standards for valuation of fund assets that are clearly disclosed, not stale, and subject to audit. Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (available at *http://sec.gov/spotlight/hedgefunds/hedgechanos.htm*).

When I testified before this Committee in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they met the standards outlined above. Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (available at *http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-*

The first lesson we all learned in shop class is you need to use the right tool for the job. Although you can use a pipe wrench to pound in a nail, or a claw hammer to loosen up a pipe, it is not a good idea to do so. Neither the Investment Company Act nor the Advisers Act is the right tool for the job of regulating hedge funds and other private investment companies. They do not contain the provisions needed to address the potential risks posed by the largest large private investment companies, the types of investments they hold, and the contracts into which they enter. At the same time, those laws each contain provisions designed for the types of businesses they are intended to regulate—laws that would either be irrelevant to oversight of private investment companies or would unduly restrict their operation. If Congress determines that legislation is needed, I believe a more tailored and targeted law should be drafted in order to address current public policy concerns about investor protection and systemic risks. Yet, Congress should avoid trying to shoehorn private investment companies into laws designed for retail investors.

For example, the Investment Company Act and Advisers Act are designed purely for investor protection, and have no provisions designed to protect counterparties or to control systemic risk. Similarly, these acts are generally silent on methods for winding down an investment fund or client account, an area which the law should address in some detail for large private investment companies. Further, the Advisers Act custody provisions exclude certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custody requirement provides.

At the same time, many requirements of the Investment Company Act and the Advisers Act are irrelevant, or would be counterproductive, if applied to private investment companies. For example, current restrictions on mutual funds from engaging in certain types of transactions, such as trading on margin and short selling, would severely inhibit or foreclose a number of hedge fund trading strategies that are fundamental to their businesses and the markets.[18] As another example, requirements for boards of directors imposed by the Investment Company Act and compensation restrictions imposed by the Advisers Act are not particularly well suited to the regulation of managers of investment pools with high net worth and institutional investors. Such investors are fully capable of understanding the implications of performance-based fees, and do not need regulatory attention to protect themselves. Likewise, client-trading restrictions under the Advisers Act that require client consent on a transaction-by-transaction basis are unduly burdensome for private fund management. In sum, the Investment Company Act and Advisers Act, which were adopted in largely their current forms in 1940, are not well suited to being adapted for a new use in regulating investment structures and strategies developed primarily over the last 20 years.

Congress should think carefully as it considers the right tool for the task of regulating private investment companies. In my view, whatever legislation is developed should contain targeted controls and safeguards needed to provide appropriate oversight for the regulation of such entities, yet retain the flexibility of their operations. Congress may wish to consider more detailed requirements on large private investment companies (or families of private investment companies) in order to address the greater potential for systemic risk posed by such funds, depending upon their use of leverage and their trading strategies.

Congress also may wish to consider giving legal effect to certain measures that were identified as "best practices" for fund managers in a report issued earlier this

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9855-47d4-a514-840725ad912c). See also Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (available at *http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf*). This would have provided the SEC with hedge fund "census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).

As this Committee knows, the SEC's hedge fund adviser registration rule was struck down in 2006, (*id.*) and the SEC decided not to appeal. Some hedge fund managers that had registered with the SEC under the rule withdrew their registrations. I decided that my firm should remain registered as an investment adviser (which we are still today), but, as I testified in 2006 before this Committee, the Advisers Act is "an awkward statute for providing the SEC with the information it seeks . . . and for dealing with the broader issues that are outside the Act's purposes." Testimony of James Chanos, CPIC, before the Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities and Investment; Hearing on the Hedge Fund Industry, at 7 (available at *http://banking.senate.gov/public/—files/ACF82BA.pdf*).

[18] For example, convertible bond arbitrage relies on selling short the underlying equity security while buying the bond. This strategy provides an essential support for the convertible bond market, upon which many corporations rely for capital.

year by the Asset Managers' Committee ("AMC Best Practices")—a group on which I served at the request of the President's Working Group on Financial Markets.[19] For example, one of the most important of these recommendations is that managers should disclose more details—going beyond Generally Accepted Accounting Standards—regarding the portion of income and losses that the fund derives from Financial Accounting Standard (FAS) 157 Level 1, 2, and 3 assets.[20] Another recommendation is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This type of information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations.

Congress also should require safeguards that I have advocated for many years—simple, common-sense protections relating to custody of fund assets and periodic audits.

As I mentioned earlier, there are areas of importance to the financial system that the Investment Company Act and Advisers Act do not address, including counterparty risk, lender risk, and systemic risk. These types of issues can be addressed through required disclosures to regulators and to counterparties. Of course, Congress also will need to choose a regulator, and since the SEC already has regulatory responsibility over publicly-offered funds, the SEC is the logical choice. If Congress decides to establish an overall systemic risk regulator, that regulator also may have a role in overseeing the largest, systemically important funds.

V. Hedge Funds as Financial Investors

One of the most important roles that hedge funds play in our economy is that of investor. Perhaps no other role played by hedge funds and other private investment vehicles, like venture capital funds, is more important to a return to economic growth than this one. From the point of view of an investor that provides capital to corporations by buying equity or debt, or of a potential purchaser of asset-backed securities in the secondary market, certain principles will be essential to encouraging investment in products that do not carry an explicit government and taxpayer guarantee against loss. One key principle is a generally accepted and respected valuation of assets.

Mark-to-market ("MTM") accounting is not perfect, but it does provide a compass for investors to figure out what an asset would be worth in today's market if it were sold in an orderly fashion to a willing buyer. Before mark-to-market accounting took effect, the Financial Accounting Standards Board (FASB) produced much evidence to show that valuing financial instruments and other difficult-to-price assets by "historical" costs, or "mark to management," was folly.

The rules now under attack are neither as significant nor as inflexible as critics charge. Mark-to-market accounting is generally limited to investments held for trading purposes, and to certain derivatives. For many financial institutions, these investments represent a minority of their total investment portfolio. For example, Bloomberg columnist David Reilly reports that of the 12 largest banks in the KBW Bank Index, only 29 percent of the $8.46 trillion in assets are at MTM prices.[21]

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[19] Report of the Asset Managers' Committee: Best Practices for the Hedge Fund Industry (January 15, 2009) (available at *http://www.amaicmte.org/Asset.aspx*).

[20] In brief, under FAS 157, Level 1 assets are those that have independently derived and observable market prices. Level 2 assets have prices that are derived from those of Level 1 assets. Level 3 assets are the most difficult to price—theirs are derived in part by reference to other sources and rely on management estimates. Disclosure of profits and losses from these categories will allow investors to better assess the diversification and risk profile of a given investment, and to determine the extent to which fund valuations are based on the "best guess" of fund management.

[21] David Reilly, Elvis Lives and Mark to Market Rules Fuel Crisis (Mar. 11, 2009), Bloomberg (available at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aD11FOjLK1y4*). "Of the $8.46 trillion in assets held by the 12 largest banks in the KBW Bank Index, only 29 percent is marked to market prices, according to my analysis of company data. General Electric Co., meanwhile, said last week that just 2 percent of assets were marked to market at its General Electric Capital Corp. subsidiary, which is similar in size to the sixth-biggest U.S. bank. What are all those other assets that aren't marked to market prices? Mostly loans—to homeowners, businesses and consumers. Loans are held at their original cost, minus a reserve that banks create for potential future losses. Their value doesn't fall in lockstep with drops in market

Why is that so? Most bank assets are in loans, which are held at their original cost using amortization rules, minus a reserve that banks must set aside as a safety cushion for potential future losses.

MTM rules also give banks a choice. MTM accounting is not required for securities held to maturity, but you need to demonstrate a "positive intent and ability" that you will do so. Further, an SEC 2008 report found that "over 90 percent of investments mark-to-market are valued based on observable inputs."[22]

Obfuscating sound accounting rules by gutting MTM rules will only further reduce investors' trust in the financial statements of all companies, causing private capital—desperately needed in securities markets—to become even scarcer. Worse, decreased clarity will further erode confidence in the American economy, with dire consequences for many of the financial institutions who are calling for MTM changes.

Greater transparency is also necessary in the over-the-counter derivatives markets. These markets play a critical role in the establishment of prices in almost every public or regulated market, from determining interest rates to share prices. Reducing the need for reliance on a few opaque counterparties, increasing regulatory access to price and volume and other transactional information, and fostering integrity in the price discovery function for OTC products that affect the borrowing costs of individual companies, are all objectives that should be aggressively pursued as part of this Committee's modernization of our financial regulatory structure.

VI. Conclusion

Honesty and fair dealing are at the foundation of the investor confidence our markets enjoyed for so many years. A sustainable economic recovery will not occur until investors can again feel certain that their interests come first and foremost with the companies, asset managers, and others with whom they invest their money, and until they believe that regulators are effectively safeguarding them against fraud. CPIC is committed to working diligently with this Committee and other policy makers to achieve that difficult but necessary goal.

PREPARED STATEMENT OF BARBARA ROPER

DIRECTOR OF INVESTOR PROTECTION,
CONSUMER FEDERATION OF AMERICA

MARCH 26, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: My name is Barbara Roper. I am Director of Investor Protection of the Consumer Federation of America (CFA). CFA is a nonprofit association of approximately 280 organizations. It was founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the opportunity to appear before you today to discuss needed steps to strengthen investor protection.

The topic we have been asked to address today, "Enhancing Investor Protection and the Regulation of Securities Markets," is broad. It is appropriate that you begin your regulatory reform efforts by casting a wide net, identifying the many issues that should be addressed as we seek to restore the integrity of our financial system. In response, my testimony will also be broader than it is deep. In it, I will attempt to identify and briefly describe, but not comprehensively detail, solutions to a number of problems in three general categories: responding to the current financial crisis, reversing harmful policies, and adopting pro-investor reforms. I look forward to working with this Committee and its members on its legislative response.

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prices. Yet these loans still produce losses, thanks to the housing meltdown and recession. In fact, bank losses on unmarked loans are typically bigger than mark-to-market losses on securities like bonds backed by mortgages."

[22] SEC, Office of the Chief Accountant, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting (available at: *http://www.sec.gov/news/studies/2008/marktomarket123008.pdf*). The report concludes: "The Staff observes that fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008. Rather, bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed." *At* 4.

Introduction

Before I turn to specific issues, however, I would like to take a few moments to discuss the environment in which this reform effort is being undertaken. I'm sure I don't need to tell the members of this Committee that the public is angry, or that investor confidence—not just in the safety of the financial markets but in their integrity—is at an all-time low. Perhaps you've seen the recent Harris poll, taken before the news hit about AIG's million-dollar bonuses, which found that 71 percent of respondents agreed with the statement that, "Most people on Wall Street would be willing to break the law if they believed they could make a lot of money and get away with it." If not, you've surely heard a variant on this message when you've visited your districts or turned on the evening news.

Right now, the public rage is unfocused, or rather it is focused on shifting targets in response to the latest headlines: Bernie Madoff's Ponzi scheme one day, bailout company conferences at spa resorts the next, AIG bonuses today. Imagine what will happen if the public ever really wakes up to the fact that all of the problems that have brought down our financial system and sent the global economy into deep recession—unsound and unsustainable mortgage lending, unregulated over-the-counter derivatives, and an explosive combination of high leverage and risky assets on financial institution balance sheets—were diagnosed years ago but left unaddressed by legislators and regulators from both political parties who bought into the idea that market discipline and industry self-interest were all that was needed to rein in Wall Street excesses and that preserving industry's ability to innovate was more important than protecting consumers and investors when those innovations turned toxic.

Now, this Committee and others in Congress have begun the Herculean task of rewriting the regulatory rulebook and restructuring the regulatory system. That is an effort that CFA strongly supports. But, as the Securities Subcommittee hearing last week on risk management regulation made all too clear, those efforts are likely to have little effect if regulators remain reluctant to act in the face of obvious industry shortcomings and clear signs of abuse. After all, we might not be here today if regulators had done just that—if the Fed had used its authority under the Home Ownership and Equity Protection Act to rein in the predatory subprime lending that is at the root of this problem, or if SEC and federal banking regulators had required the institutions under their jurisdiction to adopt appropriate risk management practices that could have made them less vulnerable to the current financial storm.

Before we heap too much scorn on the regulators, however, we would do well to remember that, in recent years at least, global competitiveness was the watchword, and regulators who took too tough a line with industry were more likely to be called on the carpet than those who were too lax. Even now, it is not clear how much that has changed. After all, just two weeks ago, the House Capital Markets Subcommittee subjected the Financial Accounting Standards Board (FASB) to a thorough grilling for doing too little to accommodate financial institutions seeking changes to fair value accounting, changes, by the way, that would make it easier for those institutions to hide bad news about the deteriorating condition of their balance sheets from investors and regulators alike. Unless something fundamental changes in the way we approach these issues, it is all too easy to imagine a new systemic risk regulator sitting in that same hot seat in a couple of years, asked to defend regulations industry groups complain are stifling innovation and undermining their global competitiveness. More than any single policy or practice, that antiregulatory bias among regulators and legislators is what needs to change if the goal is to better protect investors and restore the health and integrity of our securities markets.

I. Respond to the Current Financial Crisis

It doesn't take a rocket scientist to recognize that, in the midst of a financial crisis of global proportions, the top investor protection priority today must be fixing the problems that caused the financial meltdown. Largely as the result of a coincidence in the timing of Bear Stearns' failure and the release of the Treasury Department's Blueprint for Financial Regulatory Reform, many people have sought solutions to our financial woes in a restructuring of the financial regulatory system. CFA certainly agrees that our regulatory structure can, and probably should, be improved. We remain convinced, however, that structural weaknesses were not a primary cause of the current crisis, and structural changes alone will not prevent a recurrence. We appreciate the fact that this Committee has recognized the importance of treating these issues holistically and has pledged to take an inclusive approach. As the Committee moves forward with that process, the following are among the key investor protection issues CFA believes must be addressed as part of a comprehensive response to the financial meltdown.

1. Shut down the "shadow" banking system

The single most important step Congress can and should take immediately to reduce excessive risks in the financial system is to close down the shadow banking system completely and permanently. While progress is apparently being made (however slowly) in moving over-the-counter credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, Infectious Greed, a primary use of the "shadow" banking system—and indeed the main reason for its existence—is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So, when Japanese insurers in the 1980s wanted to evade restrictions that prevented them from investing in the Japanese stock market, Bankers Trust designed a complex three-way derivative transaction between Japanese insurers, Canadian bankers, and European investors that allowed them to do just that. Institutional investors that were not permitted to speculate in foreign currencies could do so indirectly using structured notes designed by Credit Suisse Financial Products that, incidentally, magnified the risks inherent in currency speculation. And banks could do these derivatives deals through special purpose entities (SPEs) domiciled in business-friendly jurisdictions like the Cayman Islands in order to avoid taxes, keep details of the deal hidden, and insulate the bank from accountability.

These same practices, which led to a series of mini-financial crises throughout the 1990s, are evident in today's crisis, but on a larger scale. Banks such as Citigroup were still using unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks such as Merrill Lynch sold subprime-related CDOs to pension funds and other institutional investors in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter derivatives market, often by AIG, without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

To be credible, any proposal to respond to the current crisis must confront the "shadow banking system" issue head-on. This does not mean that all investors must be treated identically or that all financial activities must be subject to identical regulations, but it does mean that all aspects of the financial system must be subject to regulatory scrutiny based on appropriate standards. One focus of that regulation should be on protecting against risks that could spill over into the broader economy. But regulation should also apply basic principles of transparency, fair dealing, and accountability to these activities in recognition of the two basic lessons from the current crisis: 1) protecting consumers and investors contributes to the safety and stability of the financial system; and 2) the sheer complexity of modern financial products has made former measures of investor "sophistication" obsolete.

The basic justification for allowing two systems to grow up side-by-side—one regulated and one not—is that sophisticated investors do not require the protections of the regulated market. According to this line of reasoning, these investors are capable both of protecting their own interests and of absorbing any losses. That myth should have been dispelled back in the early 1990s, when Bankers Trust took "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. Or when Orange County, California lost $1.7 billion, and ultimately went bankrupt, buying structured notes with borrowed money in what essentially amounted to a $20 billion bet that interest rates would remain low indefinitely. Or when a once-respected conservative government bond fund, Piper Jaffray Institutional Government Income Portfolio, lost 28 percent of its value in less than a year betting on collateralized mortgage obligations that involved "risks that required advanced mathematical training to understand."[1]

All of these deals, and many others like them, had several characteristics in common. In each case, the brokers and bankers who structured and sold the deal made millions while the customers lost fortunes. The deals were all carried out outside the regulated securities markets, where brokers, despite their best lobbying efforts

[1] Frank Partnoy, Infectious Greed, How Deceit and Risk Corrupted the Financial Markets, Henry Holt and Company (New York), 2003, p. 123.

throughout much of the 1990s, still faced a suitability obligation in their dealings with institutional clients. Once the deals blew up, efforts to recover losses were almost entirely unsuccessful. And, in many cases, strong evidence suggests that the brokers and bankers knowingly played on these "sophisticated" investors' lack of sophistication. Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[2]

More recent accounts suggest that little has changed in the intervening decades. As *Washington Post* reporter Jill Drew described in a story detailing the sale of subprime CDOs:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.
>
> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[3]

The sophisticated investor myth survived earlier scandals thanks to Wall Street lobbying and the fact that the damage from these earlier scandals was largely self-contained. What's different this time around is the harm that victimization of "sophisticated" investors has done to the broader economy. Much as they had in the past, "sophisticated" institutional investors have once again loaded up on toxic assets—in this case primarily mortgage-backed securities and collateralized debt obligations—without understanding the risks of those investments. In an added twist this time around, many financial institutions also remained exposed to the risk of these assets, either because they made a conscious decision to retain a portion of the investments or because they couldn't sell off their inventory after the market collapsed. As events of the last year have shown, the damage this time is not self-contained; it has led to a 50 percent drop in the stock market, a freezing of credit markets, and a severe global recession. Meanwhile, the administration is still struggling to find a way to clear toxic assets from financial institutions' balance sheets.

Once it has closed existing gaps in the regulatory system, Congress will still need to give authority to some entity—presumably whatever entity is designated as systemic risk regulator—to prevent financial institutions from opening up new regulatory loopholes as soon as the old ones are closed. That regulator must have the ability to determine where newly emerging activities will be covered within the regulatory structure. In making those decisions, the governing principle should be that activities and products are regulated according to their function. For example, where credit default swaps are used as a form of insurance, they should be regulated according to standards that are appropriate to insurance, with a focus on ensuring that the writer of the swaps will be able to make good on any claims. The other governing principle should be that financial institutions are not permitted to engage in activities indirectly that they would be prohibited from engaging in directly. Until that happens, anything else Congress does to reduce the potential for systemic risks is likely to have little effect.

2. Strengthen regulation of credit rating agencies

Complex derivatives and mortgage-backed securities were the poison that contaminated the financial system, but it was their ability to attract high credit ratings that allowed them to penetrate every corner of the market. Over the years, the number of financial regulations and other practices tied to credit ratings has grown rapidly. For example, money market mutual funds, bank capital standards, and pension fund investment policies all rely on credit ratings to one degree or another. As Jerome S. Fons and Frank Partnoy wrote in a recent *New York Times* op ed: "Over time, ratings became valuable . . . because they "unlock" markets; that is, they are a sort of regulatory license that allows money to flow."[4] This growing reli-

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[2] Partnoy, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now . . . $20 Million: How Bankers Trust Sold Gibson Greetings a Disaster," *Washington Post,* June 11, 1995, p. A1.

[3] Jill Drew, "Frenzy," *Washington Post,* December 16, 2008, p. A1.

[4] Jerome S. Fons and Frank Partnoy, "Rated F for Failure," *New York Times,* March 16, 2009.

ance on credit ratings has come about despite their abysmal record of under-estimating risks, particularly the risks of arcane derivatives and structured finance deals. Although there is ample historical precedent, never was that more evident than in the current crisis, when thousands of ultimately toxic subprime-related mortgage-backed securities and CDOs were awarded the AAA ratings that made them eligible for purchase by even the most conservative of investors.

Looking back, many have asked what would possess a ratings agency to slap a AAA rating on, for example, a CDO composed of the lowest-rated tranches of a subprime mortgage-backed security. (Some, like economists Joshua Rosner and Joseph Mason, pointed out the flaws in these ratings much earlier, at a time when, if regulators had heeded their warning, they might have acted to address the risks that were lurking on financial institutions' balance sheets.)[5] Money is the obvious answer. Rating structured finance deals pays generous fees, and ratings agencies' profitability has grown increasingly dependent in recent years on their ability to win market share in this line of business. Within a business model where rating agencies are paid by issuers, the perception at least is that they too often win business by showing flexibility in their ratings. Another possibility, no more attractive, is that the agencies simply weren't competent to rate the highly complex deals being thrown together by Wall Street at a breakneck pace. One Moody's managing director reportedly summed up the dilemma this way in an anonymous response to an internal survey: "These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both."[6]

The Securities and Exchange Commission found support for both explanations in its July 2008 study of the major ratings agencies.[7] It documented both lapses in controls over conflicts of interest and evidence of under-staffing and shoddy practices: assigning ratings despite unresolved issues, deviating from models in assigning ratings, a lack of due diligence regarding information on which ratings are based, inadequate internal audit functions, and poor surveillance of ratings for continued accuracy once issued. Moreover, in addition to the basic conflict inherent in the issuer-paid model, credit rating agencies can be under extreme pressure from issuers and investors alike to avoid downgrading a company or its debt. With credit rating triggers embedded in AIG's credit default swaps agreements, for example, a small reduction in rating exposed the company to billions in obligations and threatened to disrupt the CDS market.

It is tempting to conclude, as many have done, that the answer to this problem is simply to remove all references to credit ratings from our financial regulations. This is the recommendation that Fons and Partnoy arrive at in their Times op ed. "Regulators and investors should return to the tool they used to assess credit risk before they began delegating responsibility to the credit rating agencies," they conclude. "That tool is called judgment." Unfortunately, Fons and Partnoy may have identified the only thing less reliable than credit ratings on which to base our investor protections.

The other frequently suggested solution is to abandon the issuer-paid business model. Simply moving to an investor-paid model suffers from two serious shortcomings, however. First, it is not as free from conflicts as it may on the surface appear. While investors generally have an interest in receiving objective information before they purchase a security—unless they are seeking to evade standards they view as excessively restrictive—they may be no more interested than issuers in seeing a security downgraded once they hold it in their portfolio. Moreover, we stand to lose ratings transparency under a traditional investor-paid model, since investors who purchase the rating are unlikely to want to share that information with the rest of the world on a timely basis. SEC Chairman Mary Schapiro indicated in her confirmation hearing before this Committee that she was exploring other payment models designed to get around these problems. We look forward to reviewing concrete suggestions that could form an important part of any comprehensive solution to the credit rating problem.

While it is easier to diagnose the problems with credit ratings than it is to prescribe a solution, we believe the best approach is found in simultaneously reducing reliance on ratings, increasing accountability of ratings agencies, and improving regulatory oversight. Without removing references to ratings from our legal require-

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[5] Joseph R. Mason and Joshua Rosner, How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (preliminary paper presented at Hudson Institute) February 15, 2007.

[6] Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times,* December 7, 2008.

[7] U.S. Securities and Exchange Commission, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies, July 2008.

ments entirely, Congress could reduce reliance on ratings by clarifying, in each place where ratings are referenced, that reliance on ratings does not substitute for due diligence. So, for example, a money market fund would still be restricted to investing in bonds rated in the top two categories, but they would also be accountable for conducting meaningful due diligence to determine that the investment in question met appropriate risk standards.

At the same time, credit rating agencies must lose the First Amendment protection that shields them from accountability. Although we cannot be certain, we believe ratings agencies would have been less tolerant of the shoddy practices uncovered in the SEC study and congressional hearings if they had known that investors who relied on those ratings could hold them accountable in court. First Amendment protections based on the notion that ratings are nothing more than opinions are inconsistent with the ratings agencies' legally recognized status and their legally sanctioned gatekeeper function in our markets. Either their legal status or their protected status must go. As noted above, we believe the best approach is to retain their legal function but to add the accountability that is appropriate to that function.

Finally, while we appreciate the steps Congress, and this Committee in particular, took in 2006 to enhance SEC oversight of ratings agencies, we believe this legislation stopped short of the comprehensive reform that is needed. New legislation should specifically address issues raised by the SEC study (a study made possible by the earlier legislation), such as lack of due diligence regarding information on which ratings are based, weaknesses in post-rating surveillance to ensure continued accuracy, and inadequacy of internal audits. In addition, it should give the SEC express authority to oversee ratings agencies comparable to the authority the Sarbanes-Oxley Act granted the PCAOB to oversee auditors. In particular, the agency should have authority to examine individual ratings engagements to determine not only that analysts are following company practices and procedures but that those practices and procedures are adequate to develop an accurate rating. Congress would need to ensure that any such oversight function was adequately funded and staffed.

3. Address risks created by securitization

Few practices illustrate better than securitization the capacity for market innovations to both bring tremendous benefits and do enormous harm. On the one hand, securitization makes it possible to expand consumer and business access to capital for a variety of beneficial purposes. It was already evident by the late 1990s, however, that securitization had fundamentally altered underwriting practices in the mortgage lending market. By the middle of this decade, it was glaringly obvious to anyone capable of questioning the wisdom of the market that lenders were responding to those changes by writing huge numbers of unsustainable mortgages. Unfortunately, the Fed, which had the power to rein in unsound lending practices, was among the last to wake up to the systemic risks that they posed.

In belated recognition that incentives had gotten out of whack, many are now advocating that participants in securitization deals be required to have "skin in the game," in the form of some retained exposure to the risks of the deal. This is an approach that CFA supports, although we admit it is easier to describe in theory than to design in practice. We look forward to working with the Committee as it seeks to do just that. However, we also caution against putting exclusive faith in this approach. Given the massive fees that lenders and underwriters have earned, it will be difficult to design an incentive strong enough to counter the lure of high fees. Financial regulators will need to continue to monitor for signs that lenders are once again abandoning sound lending practices and use their authority to rein in those practices wherever they find them.

Another risk associated with securitization has gotten less attention, though it is at the heart of the difficulties the administration now faces in restoring the financial system. Their sheer complexity makes it extremely difficult, if not impossible to unwind these deals. As a result, that very complexity becomes a source of systemic risk. New standards to counteract this design flaw should be included in any measure to reduce securitization risks.

4. Improve systemic risk regulation

Contrary to conventional wisdom, the current crisis did not stem from the lack of a regulator with sufficient information and the tools necessary to protect the financial system as a whole against systemic risks. In the key areas that contributed to the current crisis—unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system—regulators had all the informa-

tion they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in the case of former CFTC Chair Brooksley Born, were denied the authority they requested to rein in those risks. Unless that reluctance to regulate changes, simply designating and empowering a systemic risk regulator is unlikely to have much effect.

Nonetheless, CFA agrees that, if accompanied by a change in regulatory approach and adoption of additional concrete steps to reduce existing systemic threats, designating some entity to oversee systemic risk regulation could enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of nonbank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain in some areas regarding the best way to accomplish that goal. Certain issues we believe are clear: (1) systemic risk regulation should not be focused exclusively on a few "systemically significant" institutions; (2) the systemic risk regulator should have broad authority to survey the entire financial system; (3) regulatory oversight should be an on-going responsibility, not emergency authority that kicks in when we find ourselves on the brink of a crisis; (4) it should include authority to require corrective actions, not just survey for risks; (5) it should, to the degree possible, build incentives into the system to discourage private parties from taking on excessive risks and becoming too big or too inter-connected to fail; and (6) it should include a mechanism for allowing the orderly unwinding of troubled or failing nonbank financial institutions.

CFA has not yet taken a position on the controversial question of who should be the systemic risk regulator. Each of the approaches suggested to date—assigning this responsibility to the Federal Reserve, creating a new agency to perform this function, or relying on a panel of financial regulators to coordinate systemic risk regulation—has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation. Problems that have been identified with assigning this role to the Fed strike us as particularly difficult to overcome. Regardless of the approach Congress chooses to adopt, it will need to take steps to address the weaknesses of that particular approach. One step we urge Congress to take, regardless of which approach it chooses, is to appoint a high-level advisory panel of independent experts to consult on issues related to systemic risk.

Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such an assignment. The panel would be charged with conducting an ongoing and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency.

The above discussion merely skims the surface of issues related to systemic risk regulation. Included at the back of this document is testimony CFA presented last week in the House Financial Services Committee that goes into greater detail on the various strengths and weaknesses of the different approaches that have been suggested to enhance systemic risk regulation and, in particular, the issue of who should regulate.

5. Reform executive compensation practices

Executive pay practices appear to have contributed to excessive risk-taking at financial institutions. Those who have analyzed the issues have typically identified two factors that contributed to the problem: (1) a short-term time horizon for incentive pay that allows executives to cash out before the consequences of their actions are apparent; and (2) compensation practices, such as through stock options, that provide unlimited up-side potential while effectively capping down-side exposure. While the first encourages executives to focus on short-term results rather than long-term growth, the latter may make them relatively indifferent to the possibility that things could go wrong. As AFL–CIO General Counsel Damon Silvers noted in recent testimony before the House Financial Services Committee, this is "a terrible way to incentivize the manager of a major financial institution, and a particularly terrible way to incentivize the manager of an institution the Federal government might have to rescue." Silvers further noted that adding large severance packages to the mix further distorts executive incentives: "If success leads to big payouts, and failure leads to big payouts, but modest achievements either way do not, then there is once again a big incentive to shoot for the moon without regard to downside risk."

In keeping with this analysis, we believe executive compensation practices at financial institutions should be examined for their potential to create systemic risk. Practices such as tying incentive pay to longer time horizons, encouraging payment in stock rather than options, and including claw-back provisions should be encouraged. As with other practices that contribute to systemic risk, compensation practices that do so could trigger higher capital requirements or larger insurance premiums as a way to make risk-prone compensation practices financially unattractive. At the same time, reforms that go beyond the financial sector are needed to give shareholders greater say in the operation of the companies they own, including through mandatory majority voting for directors, annual shareholder votes on company compensation practices, and improved proxy access for shareholders. This is the great unfinished business of the post-Enron era. Adoption of crucial reforms in this area should not be further delayed.

6. Bring enforcement actions for law violations that contributed to the crisis

CFA is encouraged by the changes we see new SEC Chairman Mary Schapiro making to reinvigorate the agency's enforcement program. Mounting a tough and effective enforcement effort is essential both to deterring future abuses and to reassuring investors that the markets are fair and honest. While we recognize that many of the activities that led to the current crisis were legal, evidence suggests that certain areas deserve further investigation. Did investment banks fulfill their obligation to perform due diligence on the deals they underwrote? Did they provide accurate information to credit rating agencies rating those deals? Did brokers fulfill their obligation to make suitable recommendations? In many cases, violations of these standards may be out of reach of regulators, either because the sales were conducted through private placements or the products sold were outside the reach of securities laws. Nonetheless, we urge the agency to determine whether at least some of what appear to have been rampant abuses were conducted in ways that make them vulnerable to SEC enforcement authority. Such an investigation would not only be crucial to restoring investor confidence that the agency is committed to representing their interests, it could also provide regulators with a roadmap to use in identifying regulatory gaps that increase the potential for systemic risks.

II. Reverse Harmful Policies

Instead of identifying and addressing emerging risks that contributed to the current crisis, the SEC has devoted its energies in recent years to advancing a series of policy proposals that would reduce regulatory oversight, weaken investor protections, and limit industry accountability. In all but one case, these are issues that can be dealt with through a reversal in policy at the agency, and new SEC Chair Mary Schapiro's statements at her confirmation hearing suggested that she is both aware of the problems and prepared to take a different course. The role of the Committee in these cases is simply to provide appropriate support and oversight to ensure that those efforts remain on track. The other issue, where this Committee can play a more direct role, is in ensuring that the SEC receives the resources it needs to mount an effective regulatory and enforcement program.

1. Increase funding for the SEC

The new SEC chairman inherited a broken and demoralized agency. By all accounts, she has begun to undertake the thorough overhaul that the situation demands. Some, but not all, of the needed changes can be accomplished within the agency's existing budget, but others (such as upgrading agency technology) will re-

quire an infusion of funds. Moreover, while we recognize this Committee played an important role in securing additional funds for the agency in the wake of the accounting scandals earlier in this decade, we are convinced that the agency remains under-funded and under-staffed to fulfill its assigned responsibilities.

Perhaps you recall a study Chairman Dodd commissioned in 1988 to explore the possibility of self-funding for the SEC. It documented the degree to which the agency had been starved for resources during the preceding decade, a period in which its workload had undergone rapid growth. Although agency resources experienced more volatility in the 1990s—with years that saw both significant increases and substantial cuts—the overall picture was roughly the same: a funding level that did not keep pace with either the market's overall growth or, of even greater concern, the dramatic increase in market participation by average, unsophisticated retail investors.

After the Enron and Worldcom scandals, Congress provided a welcome and dramatic increase in funding. Certainly, the approximate doubling of the agency's budget was as much as the SEC could be expected to absorb in a single year. Operating under the compressed timeline that the emergency demanded, however, no effort was made at that time to thoroughly assess what funding level was needed to allow the agency to fulfill its regulatory mandate. The previous Chairman proved reluctant to request additional resources once the original infusion of cash was absorbed. We believe that the time has come to conduct an assessment, comparable to the review provided by this Committee in 1988, of the agency's resource needs. Once conducted, that review could provide the basis for a careful, staged increase in funding targeted at specific shortcomings in agency operations.

2. Halt mutual recognition negotiations

Last August, the SEC announced that it had entered a mutual recognition agreement with Australia that would allow eligible Australian stock exchanges and broker-dealers to offer their services to certain types of U.S. investors and firms without being subject to most SEC regulation. At the same time, the agency announced that it was negotiating similar agreements with other jurisdictions. The agency adopted this radical departure in regulatory approach without first assessing its potential costs, risks and unintended consequences, without setting clear standards to be used in determining whether a country qualifies for mutual recognition and submitting them for public comment, and without offering any evidence that this regulatory approach is in the public interest.

It is our understanding that, thanks in part to the intervention of members of this Committee, this agreement has not yet been implemented. We urge members of this Committee to continue to work with the new SEC Chair to ensure that no further actions are taken to implement a mutual recognition policy at least until the current financial crisis is past. At a bare minimum, we believe any decision to give further consideration to mutual recognition must be founded on a careful assessment of the potential risks of such an approach, clear delineation of standards that would be used to assess whether another jurisdiction would qualify for such treatment, and transparency regarding the basis on which the agency made that determination. CFA believes, however, that this policy is ill-advised even under the best of circumstances, since no other jurisdiction is likely to place as high a priority on protecting U.S. investors as our own regulators. As such, we believe the best approach is simply to abandon this policy entirely and to focus instead on promoting cooperation with foreign regulators on terms that increase, rather than decrease, investor protections.

At the same time, we urge Congress and the SEC to work with the Public Company Accounting Oversight Board (PCAOB) to ensure that it does not proceed with its similarly ill-conceived proposal to rely on foreign audit oversight boards to conduct inspections of foreign audit firms that play a significant role in the audits of U.S. public companies. This proposal is, in some ways, even more troubling than the SEC's mutual recognition proposal, since the oversight bodies to be relied are, many of them, still in their infancy, lack adequate resources, and do not meet the Sarbanes-Oxley Act's standards for independence. Prior to issuing this proposal, the PCAOB had focused its efforts on developing a program of joint inspections that is clearly in the best interests of U.S. and foreign investors alike. This proposed change in policy at the PCAOB has thrown that program into jeopardy, and it is important that it be gotten back on track.

3. Do not approve the IFRS Roadmap

In a similar vein, the SEC has recently proposed to abandon a long and fruitful policy of encouraging convergence between U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. In its place, the agency

has proposed to move rapidly toward U.S. use of international standards. Once again, the agency has proposed this change in policy without adequate regard to the potentially enormous costs of the transition, the loss of transparency that could result, or the strong opposition of retail and institutional investors to the proposal. We urge the Committee to work with the SEC to ensure that we return to a path of encouraging convergence of the two sets of standards so that, eventually, as that convergence is achieved, financial statements prepared under the two sets of standards would be comparable.

4. Enhance investor representation on FASB

In arguing against adoption of the IFRS roadmap, CFA has in the past cited IASB's lack of adequate due process and susceptibility to industry and political influence. Unfortunately, FASB's recent proposal to bow to industry pressure and weaken fair value accounting standards—and to do so after a mere two-week comment period and with no meaningful time for consideration of comments before a vote is taken—suggests that FASB's vaunted independence and due process are more theoretical than real. We recognize and appreciate that leaders of this Committee have long shown a respect for the independence of the accounting standard-setting process. Moreover, we appreciate the steps that this Committee took, as part of the Sarbanes-Oxley Act, to try to enhance FASB's independence. However, in light of recent events, CFA believes more needs to be done to shore up those reforms. Specifically, we urge you to strengthen the standards laid out in SOX for recognition of a standard-setting body by requiring that a majority of both the board itself and its board of trustees be investor representatives with the requisite accounting expertise.

5. Ignore calls to weaken materiality standards and lessen issuer and auditor accountability for financial misstatements

The SEC Advisory Committee on Improvements of Financial Reporting (CIFiR) released its final report last August detailing recommendations to "increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors." While the report includes positive suggestions—including a suggestion to increase investor involvement in the development of accounting standards—it also includes anti-investor proposals to: (1) revise the guidance on materiality in order to make it easier to dismiss large errors as immaterial; (2) revise the guidance on when errors have to be restated to permit more material errors to avoid restatements; and (3) offer some form of legal protection to faulty professional judgments made according to a recommended judgment framework. Weakening investor protections in this way is ill-advised at any time, but it is particularly so when we find ourselves in the midst of a financial crisis of global proportions. While we are confident that the new SEC Chair understands the need to strengthen, not weaken, financial reporting transparency, reliability, and accountability, we urge this Committee to continue to provide oversight in this area to ensure that these efforts remain on track.

III. Adopt Additional Pro-Investor Reforms

In addition to responding directly to the financial crisis and preventing a further deterioration of investor protections, there are important steps that Congress and the SEC can take to strengthen our markets by strengthening the protections we offer to investors. These include issues—such as regulation of financial professionals and restoring private remedies—that have already been raised in the context of financial regulatory reform. We look forward to a time, once the crisis is past, when we have the luxury of also returning our attention to additional issues, such as disclosure, mutual fund, and broker compensation reform, where a pro-investor agenda has languished and is in need of revival. For now, however, we will focus in this testimony only on the first set of issues.

1. Adopt a rational, pro-investor policy for the regulation of financial professionals

Reforming regulation of financial professionals has been a CFA priority for more than two decades, with precious little to show for it. Today, investment service providers who use titles and offer services that appear indistinguishable to the average investor are still regulated under two very different standards. In particular, brokers have been given virtually free rein to label their salespeople as financial advisers and financial consultants and to offer extensive personalized investment advice without triggering regulation under the Investment Advisers Act.

As a result, customers of these brokers are encouraged to believe they are in an advisory relationship but are denied the protections afforded by the Advisers Act's fiduciary duty and obligation to disclose conflicts of interest. Moreover, customers still don't receive useful information to allow them to make an educated choice

among different types of investment service providers. This inconsistent regulatory treatment and lack of effective pre-engagement disclosure are of particular concern given research that shows that the selection of an investment service provider is the last real investment decision many investors will ever make. Once they have made that choice, most are likely to rely on the recommendations they receive from that individual with little or no additional research to determine the costs or appropriateness of the investments recommended.

Some now suggest that the efforts being undertaken by Congress to reform our regulatory system offer an opportunity to "harmonize" regulation of brokers, investment advisers, and financial planners. CFA agrees, but only so long as any "harmonization" strengthens investor protections. It is not clear that most proposals put forward to date meet that standard. Instead, the broker-dealer community appears to be trying to use this occasion to distract from the central issue—that brokers have over the years been allowed to transform themselves into advisers without being regulated as advisers—and to push an investment adviser SRO and a watered down "universal standard of care." Unfortunately, this is one area where the new SEC Chairman's Finra background appears to have influenced her thinking, and she echoed these sentiments during her confirmation hearing. It will therefore be incumbent on members of this Committee to ensure that investor interests predominate in any reforms that may be adopted to "harmonize" our system of regulating investment professionals.

As a first principle, CFA believes that investment service providers should be regulated according to what they do rather than what type of firm they work for. Had the SEC implemented the Investment Advisers Act consistent with the clear intent of Congress, this would be the situation we find ourselves in today. That is water under the bridge, however, and we are long past the point where we can recreate the clear divisions that once was envisioned between advisory services and brokers' transaction-based services. Instead, we believe the best approach is to clarify the responsibilities that go with different functions and to apply them consistently across the different types of firms.[8]

- *A Fiduciary Duty for Advice:* All those who offer investment advice should be required to place their clients' interests ahead of their own, to disclose material conflicts of interest, and to take steps to minimize those potential conflicts. That fiduciary duty should govern the entire relationship; it must not be something the provider adopts when giving advice but drops when selling the investments to implement recommendations.
- *A Suitability Obligation for Sales:* Those who are engaged exclusively in a sales relationship should be subject to the know-your-customer and suitability obligations that govern brokers now.
- *No Misleading Titles:* Those who choose to offer solely sales-based services should not be permitted to adopt titles that imply that they are advisers. Either they should be prohibited from using titles, such as financial adviser or financial consultant, designed to mislead the investor into thinking they are in an advisory relationship, or use of such titles should automatically carry with it a fiduciary duty to act in clients' best interests.

Because of the obvious abuses in this area that have grown up over the years, we have focused on the inconsistent regulatory treatment of advice offered by brokers, investment advisers, and financial planners. If, however, there are other services that investment advisers or financial planners are being permitted to offer outside the appropriate broker-dealer protections, we would apply the same principle to them. They should be regulated according to what they do, subject to the highest existing level of investor protections.

One issue that has come up in this regard is whether investment advisers should be subject to oversight by a self-regulatory organization. The underlying argument here is that, while the Investment Advisers Act imposes a higher standard for advice, it is not backed by as robust a regulatory regime as that which governs broker-dealers. Finra has made no secret of its ambition to expand its authority in this area, at least with regard to the investment advisory activities of its broker-dealer member firms. There is at least a surface logic to this proposal. As Finra is quick to note, it brings significant resources to the oversight function and has rule-making authority that in some areas appears to go beyond that available to the SEC.

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[8] While we have discussed this approach here in the context of investment service providers, CFA believes this is an appropriate approach throughout the financial services industries: a suitability obligation for sales—whether of securities, insurance, mortgages or whatever—and an overriding fiduciary duty that applies in an advisory relationship.

Despite that surface logic, there are several hurdles that Finra must overcome in making its case. The first is that Finra's record of using its rule-making authority to benefit investors is mixed at best. Nowhere is that more evident than on this central question of the obligation brokers owe investors when they offer advice or portray themselves as advisers. For the two decades that this debate has raged, Finra and its predecessor, NASD regulation, have consistently argued this issue from the broker-dealer industry point of view. This is not an isolated instance. Finra has shown a similar deference to industry concerns on issues related to disclosure and arbitration. This is not to say that Finra never deviates from the industry viewpoint, but it does mean that investors must swim against a strong tide of industry opposition in pushing reforms and that those reforms, when adopted, tend to be timid and incremental in nature.

This is, in our view, a problem inherent to self-regulation. Should Congress choose to place further reliance on bodies other than the SEC to supplement the agency's oversight and rulemaking functions, it should at least examine what reforms are needed to ensure that those authorities are not captured by the industries they regulate and operate in a fully transparent and open fashion. We believe the governance model at the PCAOB offers a better model to ensure the independence of any body on which we rely to perform a regulatory function.

The second issue regarding expanded Finra authority relates to its oversight record. It is ironic at best, cynical at worst, that Finra has tried to capitalize on its oversight failure in the Madoff case to expand its responsibilities to cover investment adviser activities. There may be good reasons why Finra's predecessor, NASD Regulation, missed a fraud that operated under its nose for several decades. NASD Regulation was not, as we understand it, privy to the whistleblower reports that the SEC received. One factor that clearly was not responsible for NASD Regulation's oversight failure, however, was its lack of authority over Madoff's investment adviser operations. This should be patently obvious from the fact that there was no Madoff investment adviser for the first few decades in which the fraud was apparently being conducted. During that time, Madoff's regulatory reports apparently indicated that he was engaged exclusively in proprietary trading and market making and did not have clients. NASD Regulation apparently did not take adequate steps to verify this information, despite general industry knowledge and extensive press reports to the contrary.

What concerns us most about this situation is not that Finra missed the Madoff fraud. Individuals and institutions make mistakes, and the problems that lead to those mistakes can be corrected. We are far more concerned by what we view as Finra's lack of honesty in accounting for this failure. That suggests a problem with the culture of the organization that is not as easily corrected. We have nothing but respect for new Finra President and CEO Rick Ketchum. However, the above analysis suggests he faces a significant task in overhauling Finra to make it more responsive to investor concerns, more effective in providing industry oversight, and more transparent in its dealings. Until that has been accomplished, we would caution against any expansion of Finra's authority or any increased reliance on self-regulatory bodies generally.

2. Restore private remedies

In an era in which investors have been exposed to constantly expanding risks and repeated frauds, they have also experienced a continual erosion of their right to redress. This has occurred largely through unfavorable court decisions that have undermined investors' ability to recover losses from those who aided the fraud and, with recent decisions on loss causation, even from those primarily responsible for perpetrating it. To restore balance and fairness to the system, CFA supports legislation to restore aiding and abetting liability, to eliminate the ability of responsible parties to avoid liability by manipulating disclosures, and to protect the ability of plaintiffs to aggregate small claims and access federal courts.

CFA also supports the elimination of pre-dispute binding arbitration clauses in all consumer contracts, including those with securities firms. For many, even most investors, arbitration will remain the most attractive means for resolving disputes. However, not all cases are suitable for resolution in a forum that lacks a formal discovery process or other basic procedural protections. By forcing all cases into an industry-run arbitration process, regardless of suitability, binding arbitration clauses undermine investor confidence in the fairness of the system while making the system more costly and slower for all. While Finra has taken steps to address some of the worst problems, these reforms have been slow to come and have been incremental at best. We believe investors are best served by having a choice of resolution mechanisms that they are currently denied because of the nearly universal use of pre-dispute binding arbitration clauses.

Conclusion

For roughly the past three decades, regulatory policy has been driven by an irrational faith that market discipline and industry self-interest could be relied on to rein in Wall Street excesses. Regulation was seen as, at best, a weak supplement to these market forces and, at worst, a burdensome impediment to innovation. The recent financial meltdown has proven the basic fallacy of that assumption. In October testimony before the House Oversight and Government Reform Committee, former Federal Reserve Chairman Alan Greenspan acknowledged, in clearer language than has been his wont, the basic failure of this regulatory approach:

> Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance . . . If it fails, as occurred this year, market stability is undermined . . .
>
> I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms.

Former Chairman Greenspan deserves credit for this forthright acknowledgement of error.

What remains to be seen is whether Congress and the Administration will together devise a regulatory reform plan that reflects this fundamental shift. A bold and comprehensive plan is needed that restores basic New Deal regulatory principles and recognizes the role of regulation in preventing crises, not simply cleaning up in their wake. This approach, adopted in response to the Great Depression, brought us decades of economic growth, free from the recurring financial crises that have characterized the last several decades. If, on the other hand, policymakers do not acknowledge the pervasive and deep-seated flaws in financial markets, they will inevitably fail in their efforts to reform regulation, setting the stage for repeated crises and prompting investors to question not just the integrity and safety of our markets, but the ability of our policymakers to act in their interest.

Even as we testify here today, Treasury Secretary Geithner is reportedly scheduled to present the Administration's regulatory reform plan before another congressional committee. We will be subjecting that proposal and others that are developed as this process moves forward to a thorough analysis to determine whether it meets this standard: does the boldness and scope of the plan match the severity of the current crisis? We look forward to working with members of this Committee in the days and months ahead to craft a regulatory reform plan that meets this test and restores investors' faith in the integrity of our markets and the effectiveness of our government.

Appendix

Testimony of Travis Plunkett, Legislative Director, Consumer Federation of America

MARCH 17, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a nonprofit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our Nation's failed financial regulatory system—how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regu-

lators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.
- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.
- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis—unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system—regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis—either by preventing the unsound mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial

regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, Infectious Greed, a primary use of the "shadow" banking system—and indeed the main reason for its existence—is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side—one regulated and one not—is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory

system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: (1) to ensure that risks that could threaten the broader financial system are identified and addressed; (2) to reduce the likelihood that a "systemically significant" institution will fail; (3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and (4) to provide for the orderly failure of nonbank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should There Be a Central Systemic Risk Regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who Should It Be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: (1) assign responsibility for systemic risk regulation to the Fed; (2) create a new market stability regulator; and (3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

The Federal Reserve Board—Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (*e.g.,* the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system . . . If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure.

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: (1) its ability to obtain adequate resources without relying on the congressional budget process and (2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis—its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system—but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> If the Federal Reserve is also . . . to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability . . . all backed by a stronger, larger, highly experienced and reasonably compensated professional staff.

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to (1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and (2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency—Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only

if it is part of a more radical regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group—The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its shortcomings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC—A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of nonbank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include nonbank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel—One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini,

Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who Should Be Regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (*e.g.,* transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk.

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more

broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant . . . whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex—going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How Should They Regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?
- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?
- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil—in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30 noted in its report on regulatory reform: " . . . a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;
- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;
- Directly supervise at least certain institutions;
- Act as lender of last resort with regard to institutions at risk of failure;
- Act as a receiver or conservator of a failed nondepository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;
- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;
- Make regular reports to Congress; and
- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority—such as demanding corrective actions to reduce risks—directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for nonbank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House Subcommittee testimony:

> An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure.

Unfortunately, the recent actions the government was called on to take to rescue a series of nonbank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee, which could . . . force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take.

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.

PREPARED STATEMENT OF DAVID G. TITTSWORTH

EXECUTIVE DIRECTOR AND EXECUTIVE VICE PRESIDENT,
INVESTMENT ADVISER ASSOCIATION

MARCH 26, 2009

EXECUTIVE SUMMARY

Profile of Investment Advisory Profession. There are about 11,000 SEC-registered investment advisers. These firms collectively provide investment management and other advisory services to a wide range of clients, including individuals, trusts, and families, as well as institutional clients, such as endowments, foundations, charitable institutions, state and local governments, pension funds, corporations, mutual funds, and hedge funds. There are relatively few large firms in the investment advisory profession, but they manage the lion's share of total assets. Most investment advisers are small businesses. About 7,500 employ 10 or fewer employees and 90 percent employ fewer than 50 people.

Principles for Regulatory Reform. Restoring the vitality of the U.S. economy, renewing investor confidence, and addressing failures of and weaknesses in the current regulatory framework are clearly the highest priority for this Committee. To that end, the IAA offers the following principles for the Committee's consideration:

- First, the IAA supports the efforts of the Congress, the Administration, regulators, and others to address the root causes of the economic crisis, including subprime mortgages, securitization of mortgage-related instruments, and the degree to which leverage contributed to the crisis.
- Second, systemic risk oversight must be strengthened. Such oversight should complement but not replace robust functional regulation of financial institutions. In that vein, Congress must preserve and adequately fund the Securities and Exchange Commission's core missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation.

- Third, we believe Congress and regulators must address the true regulatory gaps that exist in our current system. Any systemic risk initiatives are destined for failure until and unless these gaps are addressed.
  - The IAA continues to support centralized registration and regulation of hedge fund managers by the SEC. Investors, the marketplace, and regulators will benefit from the disclosure, compliance protocols, recordkeeping, exams, and other requirements that accompany SEC registration and regulation of hedge fund managers.
  - We also support stronger oversight and transparency of credit default swaps and other complex financial derivatives. The role of these products in the economic crisis has been demonstrated all too clearly. Action must be taken to ensure that these products can no longer be traded outside of a regulatory system that promotes transparency and accountability.
  - The IAA supports efforts to provide greater regulatory oversight of credit rating agencies. Congress should address conflicts of interest inherent in the rating agencies' compensation structures and bring greater transparency to the process.
- Congress should consider enhancing investor protection by applying the core principles of the Investment Advisers Act of l940 as integral elements of a regulatory framework for other financial service providers.

Investment Adviser Issues. In the current debate, two issues have been raised that directly implicate the Investment Advisers Act, the law governing investment advisory firms.

- Testimony before this Committee has raised the concept of "harmonizing" laws and regulations governing brokers and investment advisers, including proposals to replace an investment adviser's fiduciary duty with some other standard. The IAA agrees that market and regulatory developments—primarily the migration of brokers toward more traditional advisory services—has created investor confusion about the respective roles and obligations of brokers, advisers, and others who provide investment advice. But we disagree that extending the sale-of-products structure governing brokers would be appropriate for investment advisers providing professional services. Instead, we believe any "harmonization" of laws and regulations governing brokers and investment advisers should extend the investor protection benefits of investment adviser fiduciary standards to anyone who offers investment advice. Fiduciary duty requires firms to act in the best interest of their clients and to place client interests ahead of their own. Other standards may require only a commercial duty of fair dealing in arm's-length transactions. Such standards are not commensurate with the trust and confidence placed by investors in their financial services professional. Earlier this week, our organization joined the North American Securities Administrators Association and the Consumer Federation of America in a joint letter to this Committee that underscores the need to apply fiduciary standards to all who provide investment advice.
- The idea of establishing a self-regulatory organization (SRO) for investment advisers has been raised and rejected a number of times over the years. We continue to oppose the creation of an SRO for the advisory profession. The drawbacks to an SRO—including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs and bureaucracy—continue to outweigh any alleged benefits. We particularly oppose the idea of FINRA as the SRO for investment advisers, given its governance structure, costs, track record, and advocacy of the broker-dealer model of regulation.
- We believe the SEC has the necessary expertise and experience to govern the activities of the investment advisory profession. However, the adequacy of the SEC's resources to exercise proper oversight of investment advisers is a legitimate question that deserves serious attention by policy makers. Instead of focusing on an SRO as the response to this question, Congress and the SEC should take steps to bolster the SEC's resources:
  - There must be full funding for the SEC's regulatory, inspection, and enforcement efforts. We believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding, including self-funding mechanisms.
  - The SEC should increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the threshold would reduce the number of SEC-registered advisers and permit the SEC to focus

on the appropriate universe of advisers on a risk-adjusted basis in its examination program.

- The SEC can and should improve its inspection program for investment advisers. There are a number of steps the SEC can take to better leverage its resources with respect to examinations. For example, the SEC should consider revamping its inspection program to focus more on finding fraud as opposed to technical rules violations. Better technology, enhanced training, and additional data could assist in these efforts as well. We would be pleased to work with the Committee and the SEC to explore additional ways to ensure that investment advisers are subject to appropriate and timely examinations.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to address significant issues and developments relating to enhancing investor protection and the regulation of securities markets.

The IAA's members bring important perspectives to the regulatory reform discussion both as entities subject to regulation and as investors in the securities markets on behalf of their clients. The continuing economic crisis, as well as recent events such as the Madoff scandal, have focused attention on issues relating to how the financial services industry is regulated. These developments have prompted a reevaluation of whether current oversight structures should be strengthened and modernized. The crisis provides both regulators and the industry with an opportunity to enhance investor protection and establish more effective regulatory oversight.

The IAA stands ready to assist the Committee in undertaking the critical tasks of restoring the vitality of the U.S. economy, renewing investor confidence, and addressing failures of, and weaknesses in, the current regulatory framework.

I. Regulatory Reform

Before discussing our views on matters that specifically relate to investment adviser regulation, we wish to emphasize our views regarding broader issues of regulatory reform.

- The Congress, Administration, regulators, and other policy makers should focus their collective attention on the root causes of the economic crisis: subprime mortgages, securitization of mortgage-related instruments, and the degree to which leverage contributed to the crisis. These issues clearly represent the highest priority for legislative and regulatory action. Indeed, the issues discussed below relating to potential changes in investment adviser regulation, while important to investor protection, do not address the underlying causes and related regulatory and structural changes that need to be put in place to respond to the economic crisis.
- Systemic risk oversight is long overdue. The present fragmented financial regulatory system does not enable adequate coordination and cooperation among a complex network of market participants and regulators and no one regulatory body is responsible for monitoring and assessing system-wide risk. While systemic risk oversight must be strengthened, such oversight should not replace robust functional regulation of financial institutions.
  - As part of the review of financial regulatory systems, restructuring certain government agencies (such as merging the Commodity Futures Trading Commission into the Securities and Exchange Commission) should be considered to ensure more effective regulation, efficiency, and accountability. The SEC is the primary regulator charged with the mission of protecting investors. In reforming the current regulatory structure, Congress must preserve and adequately fund the SEC's core missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation.
- Congress and regulators should close regulatory gaps and appropriately regulate relatively new services and products that have expanded exponentially over the last decade, significantly impacting the financial system. Any systemic risk initiatives are destined for failure until and unless these gaps are addressed:

[1] The Investment Adviser Association (IAA) is a not-for-profit trade association that exclusively represents the interests of federally registered investment advisory firms. Founded in 1937 as the Investment Counsel Association of America (ICAA), the IAA's membership consists of investment advisory firms that provide investment advice to a wide variety of clients, including individuals, trusts, endowments, foundations, corporations, pension funds, mutual funds, state and local governments, and hedge funds. For more information, please see *www.investmentadviser.org.*

- *Hedge Funds.* The IAA continues to support centralized registration and regulation of hedge fund managers by the SEC. The SEC is the appropriate functional regulator for investment advisers to hedge funds and other unregulated pooled investment vehicles. We do not agree with suggestions by some that hedge funds simply be required to provide information periodically to a systemic risk regulator. Investors and the marketplace will benefit from the disclosure, compliance protocols, recordkeeping, examinations, and other requirements that will accompany SEC registration and regulation of hedge fund managers.
- *Derivatives.* The IAA supports far stronger oversight and transparency of credit default swaps and other complex financial derivatives. These products played a significant role in the recent market disruptions. Congress should consider ways to regulate securities and economic substitutes for securities in a similar fashion. Current efforts to establish central counterparties to clear credit default swaps, while laudable, are not sufficient, particularly because participation is voluntary.
- *Credit Rating Agencies.* The IAA supports efforts to provide greater regulatory oversight of credit rating agencies, which have increasingly played an important role in the markets. Congress should address conflicts of interest inherent in the rating agencies' compensation structures and bring greater transparency to the process.

- Congress should consider enhancing investor protection by applying the core principles of the Investment Advisers Act of l940 as integral elements of a regulatory framework for other financial service providers.
  - The core principles of the Advisers Act are fiduciary duty, which includes the duty to place the interests of your client above your own interests at all times, coupled with broad antifraud authority and full and fair disclosure obligations overseen by a single direct regulator (SEC). Congress should extend the investor protection benefits of investment adviser fiduciary standards to all entities that offer investment advice.

In effecting regulatory reform of the financial services industry, policy makers should be mindful of three maxims. First, shuffling boxes (*i.e.,* creating new regulatory authorities or merging or eliminating existing regulators) does not necessarily constitute regulatory reform. Effective regulation requires direct and appropriate statutory authority, clear and reasonable regulations, and intelligent enforcement.

Second, policy makers should "do no harm" in addressing regulatory reform. Some financial service providers already are appropriately regulated and did not contribute to the current crisis. Where such situations exist, policy makers should not attempt to reinvent the wheel or create new and additional regulatory requirements.

Third, the changes under consideration by this Congress are significant and have the potential to dramatically reshape the regulatory landscape for decades. Even in this environment, getting it right is much more important than acting in haste.

II. Investment Advisers Act Issues

In addition to the regulatory reforms under consideration that directly pertain to the ongoing financial crisis, two primary issues have been raised that relate to the Investment Advisers Act:

- The concept of "harmonizing" laws and regulations governing broker-dealers and investment advisers, including a brokerage industry proposal to replace an investment adviser's fiduciary duty with a universal "fair dealing" standard.
- Establishment of a self-regulatory organization (SRO) for investment advisers.

As we discuss in greater detail below, we believe that any "harmonization" of laws and regulations governing broker-dealers and investment advisers should extend the investor protection benefits of investment adviser fiduciary standards to anyone who offers investment advice. In particular, pursuant to fiduciary duty standards, the obligation to disclose conflicts of interest should apply to all those who provide investment advice. In addition, any "harmonization" should not result in subjecting investment advisers to inappropriate broker-dealer rules, including those of a self-regulatory organization.

In considering these issues, it is critical to understand the investment advisory profession.

A. Profile of the Investment Adviser Profession

There are about 11,000 SEC-registered investment advisers, representing a broad spectrum of firms. There are a few relatively large firms that oversee the lion's share of assets under management. According to information filed with the SEC, as

of April 2008, 82 investment advisory firms (less than .7 percent) had investment management authority with respect to more than half of the $38.67 trillion in discretionary assets managed by all SEC-registered advisers. Some of these larger firms are affiliated with other investment advisers, banks, broker-dealers, and insurance companies. However, the vast majority of investment advisory firms are small, unaffiliated businesses.[2] According to information filed with the SEC, 90 percent of all federally registered investment adviser firms have fewer than 50 employees and 68 percent (more than 7,500 firms) have ten or fewer employees.[3] Firms with five or fewer employees make up nearly half (49 percent) of all advisers.

Investment advisers manage assets for a wide array of individual and institutional investors, including high net worth individuals, educational institutions, endowments, foundations, corporations, pension plans, mutual funds, hedge funds, private equity funds, bank collective trusts, insurance companies, and state and local governments. The overwhelming majority of SEC-registered investment advisers have discretionary authority to make investment decisions on behalf of their clients, consistent with the terms of the advisory contract and any client guidelines. Advisory firms employ a variety of investment strategies on behalf of their clients. Given the enormous diversity and complexity among different types of investment adviser firms, it is notable that 67 percent of the more than 11,000 investment advisers that were federally registered as of April 2008 were not engaged in any business activity other than giving investment advice. Only 644 investment advisers (5.8 percent) were dually registered as broker-dealers.

The diverse and small business nature of the investment advisory profession benefits the wide range of investors—both individuals and institutions—seeking investment advice and should be preserved.

B. "Harmonization" of Investment Adviser and Broker-Dealer Laws and Regulations

Background. Although the concept of "harmonization" of broker-dealer and investment adviser regulation has been advanced recently, few details have emerged describing what harmonization actually means.[4] The term surfaced last year in the Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure." Among its "intermediate-term" findings, the Blueprint contains a discussion of the "ongoing debate regarding broker-dealer regulation and investment adviser regulation," and states:

> Treasury notes the rapid and continued convergence of the services provided by broker-dealers and investment advisers and the resulting regulatory confusion due to a statutory regime reflecting the brokerage and investment advisory businesses of decades ago. An objective of this report is to identify regulatory coverage gaps and inefficiencies. This is one situation in which the U.S. regulatory system has failed to adjust to market developments, leading to investor confusion. Accordingly, Treasury recommends statutory changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors.[5]

Despite suggesting statutory harmonization, the Treasury Blueprint did not include any specific recommendations about what this might entail.

The Blueprint followed on the heels of a report commissioned by the SEC that examined marketing practices and financial products and services provided to individual investors by broker-dealers and investment advisers and evaluated investor

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[2] More than 91 percent of SEC-registered advisory firms manage less than $1 billion in assets. See IAA/NRS, Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession (2008), available on our Web site, at 3. Further, approximately 43.7 percent (4,820) of all investment advisers are not affiliated with any other financial industry entity. Id. at 11.

[3] *Id.* at 8.

[4] The IAA has been actively involved in discussions and proceedings relating to the potential "harmonization" of broker and adviser rules for many years. We filed numerous comment letters responding to the SEC's rulemakings (first proposed in 1999) relating to the circumstances under which the provision of investment advice by brokers subjects their activities to the Advisers Act. See, *e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Jan. 12, 2000); Letter from David G. Tittsworth, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 7, 2005). In those rulemakings, the IAA supported applying a consistent, functional regulatory approach so that the same rules apply to the same activities. We also supported functional regulation with respect to other market participants. See, *e.g.,* Letter from David G. Tittsworth, Investment Counsel Association of America,, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, re: Exemption for Thrifts Under the Investment Advisers Act (Dec. 27, 2001).

[5] The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008), at 125–126.

understanding of the differences between investment adviser and broker-dealer products, services, duties, and obligations.[6] The so-called RAND report found that "trends in the financial service market since the early 1990s have blurred the boundaries" between broker-dealers and investment advisers and that "the typical retail investor finds it difficult to understand the nature of the business from which he or she receives investment advisory or brokerage services." The RAND report did not set forth any specific policy recommendations relating to its findings.

Fiduciary Duty. Consistent with our long-standing support for a functional approach, we believe that brokers, advisers and others should be held to the same high standards depending not on the statute under which they are registered, but upon the role they are playing. If the service being offered bears the core characteristics of investment advisory services from the investor's perspective, it should be subject to the same high standards and duties. That high standard is fiduciary duty.

Investment advisers are subject to a strict fiduciary duty. This duty has been upheld by the U.S. Supreme Court[7] and espoused by the SEC for over half a century.[8] Fiduciary duty is the highest standard of care recognized under the law and serves as a bedrock principle of investor protection. This duty is one of the primary distinctions between investment advisers and others in the financial services industry. As a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[9] Fiduciary duty is not susceptible to strict definition or formulaic application but rather is dependent upon facts and circumstances. However, certain core principles of an adviser's fiduciary duty have been well-established, as reflected in our organization's *Standards of Practice.*[10]

There has been some dissent from the view that the highest standard should be applied to all those who give investment advice. At a recent hearing before the Senate Banking Committee, the Securities Industry and Financial Markets Association (SIFMA), in echoing calls for "harmonization" of investment adviser and broker-dealer regulation, concluded that a different legal standard should be applied:[11]

> SIFMA recommends the adoption of a "universal standard of care" that avoids the use of labels that tend to confuse the investing public, and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers. Such a standard could provide a uniform code of conduct applicable to all financial professionals.

We urge the Committee to consider ways to extend an investment adviser's fiduciary duty to other financial services professionals who offer investment advice—not to eliminate it or water it down with some new "fair dealing" standard. Investors deserve nothing less than the fiduciary duty owed to them under the Investment Advisers Act. Our views on this important subject are shared by others. Earlier this week, the IAA joined the North American Securities Administrators Association and the Consumer Federation of America in a joint letter to this Committee that supports the extension of an investment adviser's fiduciary standard to others that provide advisory services:

> Surely we can all agree that, in the current climate, there must be no weakening of investor protections. We therefore urge you to resist the call to water down the standards applicable to advisory activities and instead to extend application of the fiduciary duty to all those engaged in advisory services.

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[6] Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, LRN-RAND Center for Corporate Ethics, Law, and Governance (pre-publication copy Dec. 2007).

[7] *SEC v. Capital Gains Research Bureau,* 375 U.S. 180 (1963).

[8] See, *e.g.,* In re: Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948).

[9] Lemke & Lins, Regulation of Investment Advisers, at 2:33 (2008).

[10] The first article of the IAA Standards of Practice, entitled "Fiduciary Duty and Professional Responsibility," provides as follows: "An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients." The Standards describe some of the parameters of fiduciary duty, available at: *http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=StandardsPractice.*

[11] Testimony of T. Timothy Ryan, Jr., President and Chief Executive Officer, Securities Industry and Financial Markets Association, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Enhancing Investor Protection and the Regulation of the Securities Markets" (Mar. 10, 2009) ("March 10 Banking Committee Hearing").

A number of witnesses made similar statements at the Committee's first hearing on this subject.[12]

Other Harmonization Issues. Other than extending fiduciary duty to other financial services providers, the Committee should scrutinize carefully any further specific "harmonization" proposals. We believe that the basic structure of the Investment Advisers Act—including an overarching fiduciary duty, broad antifraud provisions, and single regulator—provides an appropriate structure best designed to promote investor protection. The duties of a fiduciary are significantly different from those involved in commercial transactions, including brokers that sell financial products.

Many of the differences in the regulations governing brokers and advisers appropriately reflect the different business models and services of brokers and advisers. Those calling for harmonization do not appear to recognize these differences. For example, at a recent hearing before the Senate Banking Committee, FINRA testimony regarding harmonization focused on products and transactions, rather than professional fiduciary services.[13] Broker-dealer rules have derived from the historic role of brokers executing transactions and selling financial products to consumers (thus, the brokerage industry is commonly referred to as the "sell side"). Investment adviser rules have derived from the historic role of advisers in providing investment advisory services to clients, including managing client portfolios (thus, the advisory profession is commonly referred to as the "buy side").

Traditionally, brokers have been compensated by commissions derived from sales of securities, and any related financial advice provided was nondiscretionary (*i.e.,* requiring customer consent). In contrast, advisers traditionally have been compensated by fees (typically based on assets under management) and have provided discretionary advice to clients. In a typical contract for discretionary investment management services, the client grants the adviser authority to decide which securities to purchase or sell on its behalf. The client also typically grants the adviser authority to select brokers as appropriate to execute trades for the client's account. The investment adviser is then responsible for determining the overall investment strategy for the client or the portion of client assets it is retained to manage, consistent with its fiduciary duty to make decisions in the best interest of the client and with any written investment guidelines established by the client. Brokers typically have custody of customer funds and securities, whereas most investment advisers use the services of independent third-party custodians to hold client assets.

We agree that, in some situations, the lines between traditional brokerage and investment advisory services have been blurred in recent years, primarily as a result of the migration of brokers toward more traditional advisory services. Accordingly, in adopting business models that include investment advisory services, brokers should be subject to the fiduciary advice regulatory structure of the Advisers Act, rather than attempting to subject advisers to the inapt product-sales approach of the Exchange Act.

We also agree with the RAND report that the migration of brokers toward more traditional advisory services—in combination with their use of misleading titles (*e.g.,* financial advisor and financial consultant) and a lack of meaningful enforcement of current rules governing the broker-dealer exemption from the Advisers Act—has created investor confusion about the respective roles and obligations of brokers, advisers, and others who provide investment advice. It would be a perverse result, however, if this confusion leads to a diminution in the duties of financial professionals to their clients. Instead, all financial services firms and their personnel should be required to provide clear information at the inception of the relationship about the services they provide, the fees they charge, and any conflicts of interest. Registered investment advisers already are required to provide such information to their clients at or before the time they enter into the advisory relationship.

Investor Education. Strengthening investor protection by imposing the highest standards is only a part of the solution. Educated and informed investors will not only reduce confusion regarding types of service providers but can also serve as an effective guard against fraudsters seeking to take advantage of their clients. At a

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[12] See Testimony of Paul Schott Stevens, Investment Company Institute, at p. 13; Testimony of Damon A. Silvers, AFL–CIO, at p. 8; Testimony of Mercer E. Bullard, Fund Democracy, at p. 38; March 10, Banking Committee Hearing.

[13] Testimony of Stephen Luparello, Interim Chief Executive Officer, FINRA, before the Senate Committee on Banking, Housing, and Urban Affairs, at p. 6–7 (Jan. 27, 2009) ("Luparello Testimony") (the solution is "greater regulatory harmonization—creating a regulatory system that gives retail investors the same protections and rights no matter what product they buy," including that for every "transaction," there be consistent: (1) licensing requirements; (2) advertising requirements; (3) "appropriateness" standards for products, and (4) full disclosure for the "*products being sold.*") (emphasis added).

minimum, we believe the SEC and FINRA, as well as financial services firms, should do more to assist investors in understanding and assessing differences between various investment services professionals. In 2006, we participated with the North American Securities Administrators Association (NASAA), Consumer Federation of America (CFA), and others in publishing a brochure that is designed to help educate investors about the differences between investment advisers, brokers, and financial planners, the legal duties and standards applicable to each, and questions that investors should ask in seeking an investment services professional. Entitled, "Cutting Through the Confusion: Where to Turn for Help with Your Investments," the brochure is an example of the type of investor education that is necessary to assist individuals who seek investment assistance.[14]

C. Self-Regulatory Organizations and the Advisory Profession

Background. The idea of establishing a self-regulatory organization (SRO) for investment advisers is not new; it has been raised and rejected a number of times over the years. For example, in 1989,[15] the SEC transmitted a legislative proposal to Congress to provide for the establishment of one or more self-regulatory organizations for registered investment advisers.[16] The impetus for the 1989 proposal was the growth of registered investment advisers—and corresponding increases in the number of advisory clients and assets under management—and the lack of adequate SEC resources to conduct effective oversight of the profession.[17] In responding to the proposed legislation, our organization supported the goal of more effective oversight of the advisory profession, but strongly opposed the establishment of a self-regulatory organization for investment advisers. As is the case today, we commented that the problem is not one of structure, but rather how to better fund inspections, and noted that the same increased fees that would fund self-regulations would fund needed enhancements to the SEC's inspection program.[18]

The 1989 SRO proposal was not pursued. However, a few years later, Congress took action to strengthen oversight of the investment advisory profession. The Investment Advisers Supervision Coordination Act was enacted in 1996.[19] The Coordination Act was the most significant revision of the Investment Advisers Act since 1940. The law allocated responsibility for investment advisers between the SEC and the states, with the SEC regulating larger advisers and the states regulating smaller advisers.

The IAA strongly supported enactment of the Coordination Act, which prohibits an investment adviser from registering with the SEC unless it has more than $25 million in assets under management (AUM)[20] or is an adviser to a registered investment company or fits within another exemption. The Coordination Act's allocation of regulatory responsibility between the SEC and the states enhances investor protection, provides for more efficient use of limited regulatory resources, and reduces burdensome, inconsistent, and unnecessary regulatory costs.

The 2008 Treasury Blueprint also raised the SRO issue by recommending that Congress should subject investment advisers to a "self-regulatory regime similar to that of broker-dealers." The Blueprint asserted that "self-regulation of the invest-

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[14] *Cutting Through the Confusion: Where To Turn for Help with Your Investments,* published by the Coalition for Investor Education (IAA, CFA, NASAA, Financial Planning Association, and CFA Institute), available at: *http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=Confused.*

[15] Questions relating to the establishment of a self-regulatory organization for the investment advisory profession were raised well before 1989. For example, on June 11, 1962, our organization responded to a series of questions from Milton H. Cohen, Director of the SEC's Special Study of the Securities Markets, which included a question as to whether we would consider it desirable in the public interest for our organization to "obtain official status as an industry self-governing body."

[16] See Letter from David S. Ruder, Chairman, U.S. Securities and Exchange Commission to The Honorable Dan Quayle, President of the U.S. Senate. (June 19, 1989).

[17] In 1980, there were 5,600 SEC-registered investment advisers. By 1990, the number had grown to more than 17,000. When the Investment Advisers Supervision Coordination Act was enacted in 1996 (Title III of the National Securities Markets Improvement Act), the number of SEC-registered investment advisers was more than 22,500.

[18] Letter from Charles E. Haldeman, Jr., President, Investment Counsel Association of America, Inc., to Senators Christopher J. Dodd and John Heinz (Sept. 22, 1989).

[19] Title III, National Securities Markets Improvement Act, Pub. Law No. 104-290.

[20] The $25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the Commission "may also use its exemptive authority under the bill to raise the $25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act." S. Rpt. 104-293, p. 5 (June 26, 1996).

ment advisory industry should enhance investor protection and be more cost-effective than direct SEC regulation."[21] This recommendation presumably was prompted by FINRA—the only commenter on the Blueprint to recommend an SRO for advisers.[22] More recently, FINRA has cited the Madoff scandal as further justification for its longstanding desire to extend its jurisdiction to investment advisers.[23] This argument is misplaced.

The Madoff Scandal. We share the outrage of the Committee and all investors about the Madoff scandal. The Madoff case has raised justifiable concerns about the ability of regulators to uncover and prevent fraudulent activities. Such fraudulent activities cast a shadow over legitimate enterprises and thus underscore our continued support for effective regulatory, inspection, and enforcement activities to ensure investor confidence and protection.

We believe the Madoff scandal represents a failure of enforcement, not of investment adviser regulation. Bernard Madoff operated his Ponzi scheme for decades through Bernard Madoff Investment Securities LLC, a brokerage firm. He only became subject to investment adviser regulation in September 2006 when his firm dually registered with the SEC as an investment adviser.[24] Neither before nor after September 2006 were his investment advisory activities ever operated though a subsidiary or any other legal entity separate from his brokerage firm.

According to information that has been made available thus far, both the SEC and FINRA conducted numerous inspections of the Madoff firm over a period of many years. This fact alone negates any argument that the failure to uncover Madoff's fraudulent activities was the result of insufficient resources or lack of oversight since both the SEC and FINRA (and its predecessor organization NASD) had clear authority to inspect all aspects of the Madoff enterprise and used their resources to inspect the firm on numerous occasions. Unfortunately, these examinations failed to uncover the fraudulent activities of the firm.

Despite FINRA's claims to the contrary, FINRA had ample authority to examine all aspects of the Madoff firm. Professor John C. Coffee, Jr., a witness at the Committee's January 27 hearing and a widely acknowledged authority on securities law, specifically addressed whether FINRA had jurisdiction to examine all accounts of the Madoff firm and definitively concluded that FINRA/NASD had clear and unequivocal authority to do so.[25]

We thus find it troublesome that FINRA is using the Madoff scandal as an example of why investment advisers should be subjected to its jurisdiction as a self-regulatory organization.[26] Rather than using Madoff as a pretext to expand its jurisdiction, we urge FINRA to instead take steps—similar to those the SEC is taking—to seriously examine why its inspections of Madoff failed to uncover the Ponzi scheme and how it can avoid such failures in the future.

The "solution" to Madoff—solely a broker-dealer for most of its existence—is not to create a new regulatory structure for advisers, but to enhance the SEC's tools to prevent and detect fraud. For example, sharing of information between FINRA and the SEC—especially with regard to dually registered broker-dealers like

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[21] The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008) at 125–126.

[22] Letter from Mary L. Schapiro, CEO, FINRA, to the Department of the Treasury re: Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions (Dec. 19, 2007), at 5.

[23] Luparello Testimony, supra note 13 at p. 5.

[24] Until September 2006, Madoff was registered only as a broker-dealer. Because his firm received no separate fees for his advisory services, Madoff apparently availed himself of the broad exemption under the Advisers Act for broker-dealers whose advisory services are "solely incidental" to their brokerage activities and who do not charge "special compensation" for advice. However, on January 31, 2006, full compliance with the new SEC "Broker-Dealer Rule" was required. Among other things, the new Rule (vacated by court decision on March 30, 2007) clarified that discretionary management of clients' accounts—as provided by Madoff—could not be considered "solely incidental" to brokerage activities. Accordingly, Madoff could no longer claim an exemption from the Advisers Act on this basis and, reportedly at the direction of the SEC, registered as an investment adviser. Even after Madoff dually-registered in September 2006, his investment advisory function was not operated though a separate entity.

[25] Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the Senate Committee on Banking, Housing and Urban Affairs (Jan. 27, 2009).

[26] Instead, the Madoff scandal "demonstrates the problem of leaving solely to broker regulation the kinds of advisory activities that are clearly in need of investment adviser oversight. The SEC has corrected the regulatory gap that allowed brokers who provided discretionary advice to avoid advisory regulation. As discussed below, the Commission should take steps to ensure that all individualized investment advice is subject to advisory regulation." Testimony of Mercer Bullard, President and Founder of Fund Democracy, Inc. and Associate Professor of Law at University of Mississippi School of Law, March 10 Banking Committee Hearing.

Madoff—should be formalized. Further, in recent testimony SEC staff noted that it is considering ways to "strengthen the custody and audit requirements for regulated firms." We recently submitted a letter to SEC Chairman Schapiro that sets forth a number of recommendations for the Commission to consider in issuing an expected proposed rulemaking addressing self-custody issues.[27] The SEC's Office of Inspector General is conducting an investigation relating to the agency's handling of the Madoff case (including issuing a request for proposal to review the SEC's inspection program)[28] and the results of that investigation may provide additional recommendations the agency should consider to detect similar frauds in the future.

The SEC Is the Appropriate Direct Regulator of Investment Advisers. The IAA strongly supports robust and appropriate oversight and regulation of the investment advisory profession. We believe the SEC has the necessary expertise and experience to govern the activities of the investment advisory profession. Given the great diversity among advisory firms—including a relatively small number of large firms and thousands of small businesses—this expertise and experience is critical in regulating and overseeing the profession.

The SEC has been an effective regulator with a strong enforcement arm in the areas of disclosure and fiduciary duty, the bedrock principles underlying investment adviser regulation. While the current system of regulation and oversight of investment advisers can and should be improved, adding a new and additional layer of bureaucracy and cost on the profession via an SRO will not significantly enhance investor protection.

We therefore continue to oppose the creation of an SRO for the advisory profession. Ultimately, the drawbacks to an SRO continue to outweigh any alleged benefits. These drawbacks include inherent conflicts of interest based on industry funding and influence, questions regarding transparency, accountability and oversight, due process issues in disciplinary proceedings, and added cost and bureaucracy.

While self-regulation may appeal to those who wish to shift taxpayer-funded regulation costs to industry, we also note that appropriate government oversight is required in any SRO structure and thus requires expanded dedication of government resources. Further, most investment advisory firms are small businesses with limited resources. The costs of any SRO are borne by the regulated entities and will obviously impact all investment advisers, including thousands of small advisory firms. Ultimately, those costs may be passed on to investors. It would be more cost effective to use the industry's funds that would be spent on an SRO to bolster the SEC's oversight efforts, for example through a self-funding structure as discussed below.

Further, the reasons that persuaded Congress to authorize the creation of an SRO for broker-dealers in 1939—including the high level of interconnectivity between broker-dealers as well as highly technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions—simply do not exist in the investment advisory profession.

Finally, the diversity of the investment adviser industry makes a rules-based SRO model unworkable. There is not sufficient commonality among the various types of adviser business models—traditional asset management firms, financial planners, wealth managers, advisers that are part of global financial institutions, small advisers with a limited number of high net worth clients, advisers that sell products, asset allocators, hedge fund managers, mutual fund managers, pension consultants, and others—to achieve fair and flexible self-regulation. Command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues do not lend themselves to this widely divergent community of advisers. We thus believe that continued oversight of the advisory profession by the SEC under the current structure of the Advisers Act—and its reliance on disclosure and broad antifraud authority rather than specific and rigid regulatory requirements—is both appropriate and effective.

FINRA as Adviser SRO. Putting aside the merits of the SRO model as such, we strongly believe that FINRA would be an inappropriate SRO for investment advisers. As noted above, FINRA has been pursuing a role in supervising investment ad-

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[27] Letter from Karen L. Barr, General Counsel, Investment Adviser Association to The Hon. Mary L. Schapiro, Chairman, SEC (Mar. 6, 2009) ("IAA Letter"). The letter is available on our web site under "Publications/News" and "Comments & Statements."

[28] See SEC's Request for Quotation for Examination Inspection Review (Feb. 12, 2009), available at: *https://www.fbo.gov/download/300/300792fafb8a21b909f4b5e1b9d4c0f4/Amend_3_SECHQ1-09-Q-0125_Examination_Inspection_Review.pdf.*

visers for some time. We have serious concerns about FINRA, its governance structure, costs imposed on its members,[29] areas of expertise, and track record.

Perhaps most important, FINRA has demonstrated an agenda favoring the extension of its broker-dealer rules and requirements to investment advisers. As a result of this bias, we are extremely concerned that establishing FINRA as the SRO for investment advisers would result in a complete overhaul of investor protections set forth in the Investment Advisers Act, including fiduciary duty, requirements to disclose conflicts of interest, and restrictions on principal trading.[30]

Given its clear preference for broker-dealer rules, we believe it would be inappropriate and counterproductive to establish FINRA as the SRO for investment advisers. Any regulator for investment advisers should, at a minimum, acknowledge and reflect the practices, culture, regulation, and oversight of the advisory profession. In light of its explicit statements favoring the broker-dealer regulatory model, FINRA clearly cannot serve in this capacity. Establishing FINRA as the SRO for investment advisers would eviscerate the "self" in self-regulation. Instead, it would lead to an extension of the broker-dealer regulatory model to the advisory profession.

In any case, it is far too premature to consider the possibility of an SRO for investment advisers. Instead, as discussed below, there are several other steps that should be taken to bolster the resources of the SEC, which is in a much better position to regulate and oversee the advisory profession consistent with its mission of investor protection.

The SEC's Resources Should Be Bolstered. The adequacy of the SEC's resources to appropriately oversee and examine investment advisers is a legitimate and compelling concern that deserves serious consideration and action by policy makers. We believe there are steps—other than the establishment of an adviser SRO—that should be taken to address the SEC's resources and to ensure a robust and appropriate oversight program of the investment advisory profession.

First, as long supported by the IAA, there must be full funding for the SEC's regulatory and enforcement efforts. While we applaud the Administration's recommended budget increase for the SEC, more resources are still needed. We believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding. SEC Commissioner Luis Aguilar, for example, has spoken in favor of a self-funding mechanism for the SEC, stating that self-funding "would greatly enhance the SEC's ability to advance its mission."[31] As he noted in a recent speech:

> Being self-funded is not a novel idea. In addition to the Federal Deposit Insurance Corporation, other regulators that are independently funded include the Office of Thrift Supervision, Office of the Comptroller of the Currency, and the Federal Reserve, to name a few. There is no logical reason to treat the SEC differently, and many reasons to similarly empower the Commission.[32]

Congress should consider providing the SEC with the ability to budget and self-fund its operations. In this challenging environment, the SEC should be able to set

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[29] For example, FINRA collected more than $680 million in members fees alone in 2007. It charges a variety of other fees as well. See data from FINRA 2007 Annual Financial Report, available at *http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p038602.pdf* ; see also By-Laws of FINRA, Inc., available at: *http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4598&record_id=5998*.

[30] In written testimony before this Committee, FINRA specifically referenced its belief that broker-dealer rules should be extended to the investment advisory profession: "The absence of FINRA-type oversight of the investment adviser industry leaves their customers without an important layer of protection inherent in a vigorous examination and enforcement program and the imposition of specific rules and requirements. It simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive." Luparello Testimony, supra note 13 at p. 5. FINRA's recent testimony echoes arguments made by NASD in written comments submitted to the SEC in 2005 relating to the broker-dealer exclusion under the Investment Advisers Act. See Letter of Mary L. Schapiro and Elisse B. Walter, NASD to Annette Nazareth and Meyer Eisenberg, SEC (Apr. 4, 2005): "[A] careful analysis of the relative regulatory standards shows that the substantive protections afforded broker-dealer customers are equivalent to, and in many cases exceed, those afforded to adviser customers."

[31] "Empowering the Markets Watchdog To Effect Real Results" by Commissioner Luis A. Aguilar, SEC, at North American Securities Administrators Association's Winter Enforcement Conference (Jan. 10, 2009). He also noted in that speech that "the return on investment in the SEC is extremely high."

[32] Reinvigorating the Enforcement Program to Restore Investor Confidence, Speech by SEC Commissioner Luis A. Aguilar before the District of Columbia Bar (Mar. 18, 2009).

long-term budgets, be able to react to changing markets and new products and services, and be able to adjust its staffing as appropriate.[33]

Second, we recommend that the SEC increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the $25 million level would reduce the number of SEC-registered advisers (such advisers would be subject to regulation and oversight of state securities regulators).[34] The allocation of responsibility between the states and the SEC set forth in the Coordination Act has worked well, and the Act explicitly contemplated that the threshold would be regularly re-evaluated and adjusted.[35] Although the SEC has authority to do so, in more than 12 years since enactment of the law, the SEC has never, to our knowledge, initiated any formal review or proceeding to determine whether the threshold should be increased. In considering such action, the SEC obviously needs to coordinate closely with the North American Securities Administrators Association (NASAA) to ensure that state securities regulators are comfortable with any increased AUM level.

Third, we believe the SEC can and should improve its inspection program for investment advisers. We recognize that the number of investment advisers has outgrown the SEC's ability to conduct frequent examinations of the adviser population. In addition to the funding and threshold recommendations discussed above, there are steps the SEC can take to make more effective use of its resources with respect to examinations. For example, the SEC should consider revamping its inspection program to focus more on finding fraud and misappropriation of client funds as opposed to technical rules violations. In this vein, the SEC's inspection office has recently begun a series of focused examinations related to custody-related issues. SEC staff testified recently that it is considering a number of potential changes and improvements to its oversight program, including the "examination frequencies for investment advisers."[36]

These and other measures should be fully explored to implement meaningful reforms designed to effectuate an inspection program that focuses on activities that harm investors and pose the greatest risks. Chairman Schapiro recently testified that the Commission plans to "use additional technology funding to improve our ability to identify emerging risks to investors." She noted that the SEC needs better mechanisms to gather, link, and analyze data "to determine which firms or practices deserve a closer look."[37] In our recent letter to Chairman Schapiro on self-custody issues,[38] we recommended enhanced disclosures by investment advisers regarding custody arrangements, indicating, among other things, that the SEC could use this more specific data in its risk assessment process. In that letter, we also recommended that the SEC consider joint examinations of dually registered firms. Steps such as enhanced training, better technology, and more specific, focused data could assist the SEC in better leveraging its inspection resources.

We would be pleased to work with the Committee and the SEC to explore additional ways to ensure that all investment advisers are subject to appropriate and timely inspections.

The IAA appreciates the opportunity to discuss our views on regulatory reform and specific issues that have been raised with respect to the Investment Advisers Act. We look forward to working with the Committee in the coming weeks and months in efforts to enhance and improve the effective and appropriate regulation of the financial services industry, to restore the vitality of the U.S. economy, and to renew investor confidence in our markets.

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[33] See Testimony of Lynn Turner, March 10 Banking Committee Hearing, at p.16 ("The SEC has been chronically underfunded. A dedicated, independent financing arrangement, such as that enjoyed by the Federal Reserve, would be useful and is long overdue").

[34] To illustrate the effect of such a change, as of April 2008, there were more than 3,700 SEC-registered advisers that reported assets under management (AUM) between $25–100 million.

[35] See S. Rpt. 104-209, *supra* note 20.

[36] Testimony of Andrew J. Donohue, Lori Richards, Erik Sirri, Linda Chatman Thomsen, Andrew Vollmer, U.S. Securities and Exchange Commission, before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Concerning Investor Protection and Securities Fraud (Feb. 4, 2009).

[37] Testimony of March L. Schapiro, before the Subcommittee on Financial Services and General Government, House Committee on Appropriations, (Mar. 11, 2009).

[38] See IAA Letter, *supra* note. 27.

PREPARED STATEMENT OF RITA M. BOLGER

SENIOR VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL,
GLOBAL REGULATORY AFFAIRS, STANDARD & POOR'S

MARCH 26, 2009

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. My name is Rita Bolger. I head the Global Regulatory Affairs department at Standard & Poor's and I am pleased to appear before you today. These are unprecedented times and we at S&P appreciate the opportunity to work with Congress to address them. My testimony today covers four broad topics:

- The current regulatory regime for credit rating agencies, including S&P Ratings Services, our nationally recognized statistical ratings organization ("NRSRO");
- The SEC's exercise of its oversight authority under the current regime, including our implementation of recommendations made by the SEC following its recent examination;
- Initiatives we have undertaken to help restore market confidence; and
- Our views on potential changes to the current legislative and/or regulatory structure.

Before turning to these topics, I want to state at the outset that we at S&P appreciate the seriousness of the current dislocation in the capital markets and the challenges it poses for the American and global economies. For many decades, S&P has effectively served the global capital markets with high quality, independent, and transparent credit ratings. Today, there are approximately nine million current and historical ratings available on our Web sites and we have ratings outstanding on approximately $30 trillion worth of debt. S&P has a long tradition of—and a strong cultural commitment to—integrity and professionalism. We recognize, however, that a number of our recent ratings in the structured finance area have not performed in line with our historical standards. We have reflected on these events and have made, and are continuing to make, a number of changes to enhance our processes.

Restoring confidence in both ratings and the markets more broadly is critical. Workable solutions will involve both government action and private initiative. Toward that end, we have worked closely with lawmakers on potential measures and will continue to do so. We believe any legislative or regulatory action should reflect a systemic view and address all aspects of the capital markets that have contributed to the type of dislocation we have recently seen. Bringing together representatives from different areas of the capital markets, as the Committee has done in its two hearings on systemic risk, is in our view a productive way to work towards that goal.

As discussed later in my testimony, we have done a lot of thinking about the regulatory framework for rating agencies. Appropriate regulation can provide comfort to investors that the information available to them—including ratings—has integrity, and we support measures towards that end. Having said that, we would be concerned about legislation or regulation that purported to mandate particular analytical approaches, as analytical independence is the hallmark of ratings quality and, in our view, an essential factor in market confidence. As addressed later on, we also believe internationally consistent regulation is critical given the increasingly global nature of the capital markets.

The Current NRSRO Regulatory Regime

Recent calls for regulation of credit rating agencies have arisen in large part out of the poor performance of structured finance securities issued between the middle of 2005 and the middle of 2007, the years in which "subprime" lending reached its peak. It is true that, generally speaking, our ratings on these structured finance instruments have performed worse than we anticipated. Consistent with our commitment to constant improvement, we have taken a long, hard look at the situation and implemented a number of measures in response.

From a regulatory perspective, however, it is important to point out that the world in which virtually all of these structured finance ratings were issued is not the world we find ourselves in today. As the Committee is aware, the Credit Rating Agency Reform Act of 2006 ("CRARA"), passed in September of 2006, is the first comprehensive regulatory scheme for ratings agencies that choose to register as NRSROs. This regulatory regime was the product of several years of consideration and, in our view, reflects a judicious balance between oversight and analytical independence. The SEC's implementing rules took effect on June 26, 2007.

Today, NRSROs such as S&P are subject to a robust regulatory regime. That regime starts with the CRARA, the first comprehensive law focused on rating agencies. The regime has two primary goals:

- Promoting competition in the rating agency industry, thereby furthering ratings quality; and
- Providing for regulatory oversight to promote integrity in the ratings process.

We believe both goals have been significantly advanced in the short time since the CRARA became effective in the second half of 2007. On competition, the number of NRSROs has grown to ten, double what it was at the time the CRARA was enacted. Moreover, the SEC now requires NRSROs to disclose detailed performance data about their ratings, which facilitates comparisons and promotes competition. Going forward, we expect competition among NRSROs to continue to grow under the CRARA.

The current regime also includes a vigorous set of rules. As noted, the first set of SEC rules under the CRARA became effective in June 2007. Those rules addressed a number of topics, including the resources deployed by an NRSRO, potential conflicts of interest, the misuse of nonpublic information, and potentially abusive and unfair practices. Under these rules, certain practices are prohibited outright, such as issuing ratings for entities that provided the NRSRO with ten percent or more of its net revenue in the most recent fiscal year. Other practices must be disclosed and managed, including receiving compensation for ratings analysis (from either issuers or subscribers) and the provision of nonratings services to issuers. The rules also include extensive record-keeping requirements and require public disclosure of financial information, including revenues received from large issuers.

The SEC has continued its rule-making under the CRARA since 2007. Among other things, the SEC adopted additional rules earlier this year that:

- Require enhanced disclosure of ratings performance data;
- Require enhanced disclosures related to the rating methodologies employed by NRSROs;
- Require disclosure when ratings deviate from the output suggested by models used in the rating process;
- Prohibit an NRSRO from rating an issuer or security if the NRSRO provided recommendations to the issuer; and
- Prohibit an NRSRO from rating an issue or issuer if it receives gifts of more than *de minimus* value.

We have in place practices and procedures to comply with those rules that are in effect and are actively working to implement additional measures, as needed. We believe that, on the whole, the SEC's rules will further enhance the integrity of the ratings process and overall ratings quality to the benefit of the markets.

The SEC's Exercise of Its Oversight Authority Under the Current NRSRO Regime

Under the current framework, the SEC also has broad oversight and enforcement powers. Not only does the SEC have extensive examination and inspection authority, but it can also take disciplinary action against NRSROs—including censure, fines, or even revocation of their registration in certain circumstances—if it deems such action to be in the interest of investors. This provides a level of accountability that did not exist prior to the adoption of the CRARA.

Since the effective date of the CRARA, the SEC has been exercising its oversight authority over S&P. In the second half of 2007, the SEC began an examination of our practices and procedures, with a focus on our ratings of structured finance securities. The exam, which lasted several months, involved dozens of meetings and interviews and the production of a significant volume of documents.

The exam coincided with an exam by the SEC of two other NRSROs and resulted in a number of recommendations. These recommendations related to the following areas, among others:

- Staffing and resource levels dedicated to ratings analysis, including surveillance of existing ratings;
- Documentation of policies and procedures used to determine ratings on RMBS and CDOs;
- Potential conflicts of interest arising from the "issuer pays" model;
- Securities ownership by NRSRO employees; and
- Internal auditing of ratings practices and procedures.

At S&P, we have been active in implementing the SEC's recommendations:

- With respect to staffing and resource levels, S&P has reorganized the new issue and surveillance groups in its U.S. Structured Finance department, and, more broadly, has developed tools for resource planning and for strengthening the quality of analytical resources;
- It has long been S&P's practice and policy to disclose its ratings processes and methodologies, including its processes and methodologies for U.S. RMBS and CDOs. Nonetheless, consistent with the SEC's recommendation, S&P has initiated a review of its disclosures in those areas, including a review of its criteria administration process, a redesign of its Web site, among other things, to facilitate the publication of criteria, and a review and revision of its policies and procedures concerning the disclosure of ratings process and criteria changes;
- S&P is in the process of implementing new policies that will further insulate its analysts from commercial aspects of our business. In addition to our longstanding prohibition of analyst involvement in negotiating fees or commercial arrangements, analysts will not participate in the process of recording fees on forms, will not have responsibility for retaining engagement letters, and will not participate in business discussions about market share statistics or other financial information such as deal pipelines and financial performance. Commercial activities will be conducted outside of the analytical function by nonanalytical business management staff and a centralized group who will handle fee negotiations and contract discussions. In addition, consistent with current practice, no personnel engaged in commercial activities will be permitted to vote in a rating committee.
- S&P is also enhancing its existing personnel policies and procedures, including realigning performance goals for compensation and compensation pools for analytical staff to further diminish any potential commercial influences on analytical processes.

These are just some of the many steps that S&P has taken and is continuing to develop in response to the SEC's recommendations. The SEC has remained in regular communication with us regarding our progress and we have provided the SEC with copies of adopted policies and procedures related to its recommendations. The SEC has also continued to follow up on our progress on the remaining recommendations, including, for example, two telephonic updates in the last 10 days.

S&P's Initiatives To Enhance the Ratings Process and Promote Confidence

The restoration of investor confidence is critical to both the financial markets and global economy. We believe both appropriate government action and meaningful private initiatives are essential to accomplishing that goal. Therefore, it is imperative that all market participants take stock of what has happened and take whatever steps they can to promote market confidence.

At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. In 2008, we announced a series of initiatives aimed at promoting four broad objectives: (i) ensuring the integrity of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market; and (iv) more effectively educating the marketplace about ratings. To date, we have made significant implementation progress. For example, we have:

- Established an Office of the Ombudsman. The Ombudsman will address concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P's businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of McGraw-Hill and the Audit Committee of the Board of Directors;
- Implemented "look back" reviews to ensure the integrity of ratings, whenever an analyst leaves to work for an issuer;
- Instituted a rotation system for analysts;
- Established an enterprise wide independent Risk Assessment Oversight Committee. The committee will assess all risks that could impact the integrity and quality of the ratings process. This committee will also assess the feasibility of rating new types of securities;
- Increased our analyst training programs;
- Invested significantly in our compliance function;

- Created a separate Model Validation Group to independently analyze and validate all models, developed by S&P or provided by issuers, used in the ratings process;
- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- With respect to increased transparency, we have published a series of articles addressing certain "what if" scenarios; and
- With respect to investor education, we have published a "Guide to Credit Ratings Essentials" that provides important information about ratings and their role in the markets.

As these measures demonstrate, we believe in being proactive when it comes to taking steps to restore market confidence. S&P has always sought to study events and use the lessons learned to improve. That tradition has been a hallmark of our success over the years and you can expect the same commitment from us going forward.

Potential Regulatory Measures

We also believe legislation and/or regulation can play an important role in restoring investor confidence both in ratings and the markets as a whole. Appropriate regulation can provide a level of comfort to investors that policies are being disclosed and enforced and that there is consistency and integrity in the ratings process.

As noted earlier, we believe any regulatory approach should include "end-to-end" solutions. That is, legislation and/or regulation should cover all aspects of the capital markets that, taken together, contribute in a systemic way to their functioning, and we believe that international consistency, leading to increased transparency is a formula that should be workable for all market participants. With respect to ratings, we believe an appropriate combination of legislation and rule-making should cover not just rating agencies, but also those entities that can play a role in promoting the quality of ratings and their appropriate use. For example, an important factor in ratings quality is the reliability of information available to be analyzed. That information is not generated by rating agencies, but by others—*i.e.,* corporations, mortgage originators, underwriters, and others. Still other entities, such as professional audit firms in the corporate world and third-party due diligence firms in certain structured finance securities, are responsible for reviewing that information and verifying it. In our view, these entities and the roles they perform should be a part of any regulatory approach.

To that end, earlier this month, we published an article entitled "Toward a Global Regulatory Framework for Credit Ratings" that lays out how a regulatory framework for ratings agencies that takes account of their place in the broader markets might work. In it, we highlight those features we think would promote sound, global rating agency oversight. They include:

- *Registration.* One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This "passport" would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.
- *Performance Measurement.* Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.
- *Disclosure of Rating Methodologies.* Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.
- *Control Over Nonpublic Information and Disclosure of Underlying Data.* By having access to nonpublic information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies

should ensure that agencies have policies and procedures requiring their employees to treat nonpublic information confidentially.

- *Organizational Transparency.* Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis. This disclosure will allow regulators to assess the viability of agencies.
- *Development of Code of Ethics.* Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.
- *Elimination of Potential Conflicts of Interest.* A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.
- *Prohibitions on Anticompetitive Activity.* A regulatory regime should prohibit unfair, abusive, or coercive activity.
- *Transparency of Models.* A regulatory regime should require policies and procedures on the use and transparency of models, assumptions, and how agencies check their effectiveness, including through the use of third parties.
- *Accessibility.* A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.
- *Effective Oversight.* A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and refrain from second-guessing rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard risk in influencing a rating outcome.
- *Analytical Independence.* Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes, and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.
- *Accountability.* A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.
- *International Consistency.* Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information subject to confidentiality undertakings.
- *Meaning of Ratings.* Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.
- *Differentiate New and Complex Ratings.* A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

Each of these areas can play a meaningful role in restoring market confidence, but I want to highlight again two particularly important points here. The first is analytical independence. At its core, a rating is an analytical determination. It results from a group of experienced professionals analyzing a set of facts and forming a judgment as to what might happen in the future. For the markets to have confidence in those ratings, they must be made independently. That means, of course, that they must be free of undue commercial considerations—and we are fully committed to that principle—but it also means that they must truly reflect the substantive views of the analysts making them, not the dictates of a regulator or other external authority.

The second is the need for international consistency. Ratings are issued and used globally. This reflects one of their many benefits—their ability to provide a common language for analyzing risk. However, it also underscores the importance of a consistent approach to the regulation of ratings around the world. A rating produced under one set of regulations may not mean the same thing or address the same risks as one produced under another if those regulations are not compatible. Inconsistent ratings regulation could actually promote uncertainty in the markets, at a time when it can be least afforded.

Some have also asked whether ratings should be used in regulations and investment guidelines. S&P has never advocated for inclusion of its ratings in any regulation or guideline. However, we do believe that if legislators and regulators choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. For example, there may be additional appropriate benchmarks for market participants to choose from—whether in regulations, investment guidelines, or private agreements—that would protect against "credit cliffs" (*i.e.,* situations in which a deterioration in credit quality can occur quickly and without forewarning.) In short, because ratings speak to creditworthiness, and not other factors that may matter to investors, they have been designed to and should continue to be used only for the important but limited purposes for which they are intended and supplemented with other benchmarks, as appropriate.

Lastly, some have called for the prohibition of the "issuer pays" business model that S&P and most other NRSROs use. We believe that would be a mistake. The "issuer pays" model allows for a number of benefits to the market, particularly with respect to transparency, that are not available under other approaches. The question as we see it however is not whether one model is "good" while others are not, but whether potential conflicts of interest—which can exist in any business model—are appropriately managed so that the rating process employed has integrity. Critics sometimes ignore that any business model under which one entity is paid by another for a service poses the potential for a conflict of interest. The key question is whether the rating agency is capable of producing, and does produce, independent and robust analysis. Thus, the focus of any legislation or regulation should be on taking steps to protect the integrity of the ratings process from all potential conflicts of interest. Many of the steps outlined above and the measures we have undertaken are aimed at precisely that goal.

Conclusion

I thank you for the opportunity to participate in this hearing. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and governments, legislatures and policymakers worldwide as they explore the recent troubling developments and strive to develop solutions to restore stability in the global capital markets. I would be happy to answer any questions you may have.

STANDARD & POOR'S RATINGS SERVICES

Toward a Global Regulatory Framework for Credit Ratings

March 2009

STANDARD
&POOR'S

I. Overview and Summary

Our financial markets have changed radically in recent years, becoming more global, complex, and interdependent. Clearly, laws and regulations have to change as well, and world leaders are making good progress toward creating a new global financial architecture. The need for change includes the regulatory framework for credit rating agencies in the U.S., Europe, Asia, and the rest of the world. Rating agencies play an important role in the market's analysis of the creditworthiness of issuers and financial instruments. Investors also use rating opinions as a tool in making investment decisions—although it is important for investors to realize that ratings are only one tool, and they should not be used as a substitute for independent investment analysis.

For its part, Standard & Poor's Ratings Services (S&P) is reflecting on what more should be done in the future. It is clear that a number of the assumptions credit rating agencies used between 2005–2007 in rating structured finance bonds backed by subprime mortgages have not held up. One unforeseen development was the extreme nationwide collapse in the U.S. housing market. Rating agencies and others, including banks, insurance companies, regulators, and policymakers, did not anticipate the full extent of what has become a global recession, fuelled by the implosion of the unregulated derivatives market, loose monetary policy, excessive liquidity, and record levels of institutional and personal debt.

Going forward, it is important to the restoration of confidence in the markets that all market participants take stock of what has happened and adopt workable solutions. At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. We will continue to do so. We also believe regulation can play an important role in this process, and we welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of rating agencies' opinions and analytical processes. This White Paper is offered in a spirit of cooperation and openness to promote independent, credible ratings, and to foster investor confidence in the capital markets.

This paper provides S&P's recommendations for what regulations should accomplish generally, as well as specific recommendations that should be instituted globally for credit rating agencies, keeping in mind the necessity of restoring investor confidence and ensuring a fair playing field for investors. This paper also considers the current use of ratings in regulations and investment guidelines.

II. The Goals of Regulation Generally

The current financial crisis has prompted a number of questions about both the regulation of credit rating agencies and the financial regulatory system in general. In large part, the current regulatory structure reflects the fragmented state of the markets from nearly 70 years ago, when banks, securities firms, and insurance companies engaged in distinctly different activities. Today, many of the products and services offered by these financial firms have converged, yet the entities that regulate them and the rules under which they operate remain largely distinct. Regulators find that their jurisdiction does not match the activities of the entities they are regulating. At the same time, new, unregulated players have entered the scene, and products have been developed that fall outside the existing regulatory process. These developments suggest the need for reform of our financial regulatory architecture. Entities that have been

unregulated may require regulation, and some regulatory bodies may require their mandate to be widened to reflect changes in the activities of the entities they regulate. Recent U.S. Government Accountability Office and G-30 group reports call for clearly defined regulatory goals that are global, systemwide, and comprehensive, addressing all roles and processes and taking a flexible approach.

S&P believes any new regulatory architecture should focus on the following goals, both with regard to credit rating agencies and others:

- Safety and soundness of financial markets;
- Business conduct based on transparency and fair dealing;
- Efficiency and cost-effectiveness by aligning responsibilities among different participants across the marketplace;
- Consistency of regulation across similar businesses;
- Internationally consistent standards and coordinated enforcement;
- Adaptability to accommodate future innovations and changes in market structure;
- Flexibility to foster fair competition to benefit investors;
- Promote credit ratings that are analytically sound, independent, and unbiased; and
- Promote competition among rating agencies and differing views on creditworthiness.

III. The General Goals of Regulation of Credit Rating Agencies

S&P believes that well-crafted regulation of credit rating agencies can serve to meet the goals of regulation as described above. It can also serve to enhance the ratings process and restore investor confidence by facilitating consistent application of practical and flexible standards. While regulation should avoid dictating how a rating agency should go about performing its analysis, ultimately, a well-functioning ratings process offers benefits for the economy as a whole by contributing to greater investor confidence.

In order to address areas where investors and policymakers have identified gaps and key issues in the current regulatory regime for credit rating agencies, we have highlighted below the significant investor concerns and expectations we have heard and how regulation might enhance the process.

1. Independently derived, credible, and unconflicted credit ratings.

Appropriate regulation that addresses the effective management of potential conflicts of interest can only benefit the marketplace. This is an area where regulation can be particularly helpful by requiring policies and procedures to address potential conflicts of interest at the institutional and staff levels, including a code of ethics that requires disclosure of potential conflicts, how they are managed, with oversight of the code's effective application for all rating agency business models. Regulations could also prohibit activities that are clearly anticompetitive.

2. Transparency regarding issuer and rating agency communication.

Market participants want to know about the interaction between issuers and analysts during the rating process, particularly where issuers request a structured finance rating.

3. **The meaning and use of ratings should be clear, including the level of risk inherent in the rating.**
Rating agencies that are transparent about the meaning and limitations of their ratings—for example, clarifying that credit ratings do not address the suitability of a security for any individual investor—are of use to the market. Regulation that requires rating firms to provide publicly detailed explanations about the nature of their opinions and pertinent information used in the rating process would enhance investor knowledge as would regulation that encourages rating agencies to commit to ongoing investor education.

4. **Consistency and comparability of ratings across asset classes and geographies—accountability for ratings quality.**
Regulation that requires rating agencies to publicly disclose their ratings performance statistics would aid market participants in assessing ratings quality. Rating agencies can be subject to appropriate and proportionate penalties in cases of proven breaches of regulatory requirements.

5. **Transparency and soundness of credit rating analysis.**
Regulation that requires robust disclosure of the ratings process, including criteria and methodologies for assigning and updating ratings, would give investors critical information they need to make informed decisions, to compare ratings, and to form their own opinions on the soundness of an agency's analytics. A similar result could be achieved through regulation that requires identification of the models and underlying assumptions used in a rating agency's analysis. There is a particular need to identify such models and assumptions in structured finance. In addition, regulation that requires agencies to publicize their ratings performance statistics and allows for comparison across geographies, certain asset classes, and with competitors would inform independent investor analysis. Rating agencies could add to this informational process by making personnel available to explain their methodologies to users.

6. **Clear and consistent applications of policies to lessen "surprises" when and if ratings are changed.**
Rating agencies that use "warning signals" whenever possible, such as S&P's CreditWatch and Outlook signifiers—to signal to the marketplace potential future rating changes—are important to investors. However, rating users need to understand that ratings can change suddenly based on market or industry-specific events. This possibility is a reason that regulators might carefully reconsider using ratings exclusively in their regulations.

7. **Ratings on new and different securities should be differentiated.**
The current financial crisis has highlighted the need for markets to better understand the meaning of ratings on new and complex securities, including structured finance ratings, and how they differ from traditional ratings. Regulation could play a role in making those differences transparent.

8. **Availability of information, particularly for structured finance ratings.**
Rating agencies that utilize the issuer-pay model receive confidential information from issuers and others throughout the rating and surveillance process. Regulation that requires agencies to follow policies and procedures to avoid the disclosure and misuse of confidential information would be consistent with the spirit of current securities regulation. Where markets and regulators believe the confidential information should be made available to a rating agency's competitors or to others, regulation should require issuers and others responsible for the quality of that data to make this information widely available.

9. Confirm that rating agencies are following through on their commitments.

Regulation that provides for regulatory authorities to check agencies' compliance with their processes and policies through robust, periodic inspections would be beneficial to promoting ratings quality. However, regulators must protect analytical independence by avoiding rules and examination processes that impact the substance of rating opinions and an agency's analytics.

10. Competitive market for ratings with more and varying views on credit quality from qualified providers.

Ratings based on a high degree of integrity and intellectual rigor benefit the marketplace, and formal registration of credit rating agencies and promotion of increased industry competition should help in this area. A registration regime that follows globally consistent standards can serve as a model. Regulators that are transparent about the criteria they use in accepting applications, including the need for sufficient analytical and financial resources, would act as a uniting force in establishing a global regulatory framework. Regulation that requires disclosure about staffing, number of ratings issued, and training requirements would allow regulators to make more informed decisions regarding the adequacy of an agency's resources. Regulators could also increase their ability to evaluate agencies by analyzing financial information from agencies provided to regulators on a confidential basis. Regulators should be careful, however, not to attempt to supplant their own judgments about ratings analysis for that of independent rating agencies. Evaluations as to the quality of ratings and ratings processes should be left ultimately to the market.

IV. Specific Recommendations for an International Regulatory Framework for Credit Rating Agencies

Credit rating agencies conduct business in numerous countries across the globe. A regulatory framework that provides consistent standards across jurisdictions can promote the soundness of international, as well as domestic, business.

One potential model for an international regulatory approach is the IOSCO Code of Conduct, recently updated in May 2008. For example, in the U.S., credit rating agencies are subject to the Credit Rating Agency Reform Act of 2006, which sets standards that to a significant degree mirror those established under the IOSCO Code of Conduct.

Regulators in Europe, Japan, and Australia are actively reviewing formal oversight of rating agencies. Regulators in any country should take care before seeking to exceed existing standards given the effect such an approach could have on rating agencies operating in multiple jurisdictions. These agencies may face conflicting rules that could ultimately harm ratings consistency due to country- or region-specific requirements.

A sound regulatory framework for rating agencies globally should have the following components:

Registration. One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that

have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This "passport" would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.

Performance Measurement. Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.

Disclosure of Rating Methodologies. Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.

Control over Non-public Information and Disclosure of Underlying Data. By having access to non-public information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies should ensure that agencies have policies and procedures requiring their employees to treat non-public information confidentially. Regulators should understand that, if such information is disclosed to a rating agency, including to rate a structured finance product, the responsibility for the quality of the information provided and the disclosure to the marketplace in a broad and fair manner rests with the issuer and the underwriter. Regulators should consider if compulsory disclosure by issuers and underwriters of confidential information would be more efficient and beneficial to the marketplace. Such rules would allow competing agencies and sophisticated market participants to evaluate in greater detail the analysis and assumptions of the rating agency.

Organizational Transparency. Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis. This disclosure will allow regulators to assess the viability of agencies.

Development of Code of Ethics. Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.

Elimination of Potential Conflicts of Interest. A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings

process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.

Prohibitions on Anti-Competitive Activity. A regulatory regime should prohibit unfair, abusive, or coercive activity. Certain activities should be prohibited outright, such as threatening an issuer with an unfavorable rating or threatening to withdraw an existing rating unless the rating agency is paid to rate an issue.

Transparency of Models. A regulatory regime should require policies and procedures on the use and transparency of models, assumptions, and how agencies check their effectiveness, including through the use of third parties.

Accessibility. A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.

Effective Oversight. A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and without second-guessing rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard in influencing a rating outcome.

Analytical Independence. Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes, and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.

Accountability. A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.

International Consistency. Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information subject to confidentiality undertakings.

Meaning of Ratings. Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.

Differentiate New and Complex Ratings. A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

V. Use of Ratings in Regulations

The use of ratings in regulations and investment guidelines has been debated in global markets. We believe that if regulators and policymakers choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. There may be additional appropriate benchmarks for market participants to choose from—whether in regulations, investment guidelines, or private agreements—that would protect against "credit cliffs," namely situations when rating downgrades can occur quickly and without forewarning. Where regulations mandate minimum rating levels, credit cliffs can cause market disruption and significantly impair the liquidity of downgraded securities.

VI. Regulation of Other Market Participants

Ratings play only one role, among many, in the investment decision-making process. Others, such as auditors, play a unique role that rating agencies should not be expected to play because that would add unnecessary costs and inefficiencies to the system. Regulation should address the role of various market participants such as mortgage lenders and originators in addition to the role of rating agencies.

VII. Conclusion

This is a broad outline of a general approach to regulation of credit rating agencies and some specific suggestions for an international regulatory approach for credit rating agencies. It provides a framework for addressing the regulatory challenges of a global, fast-paced, rapidly changing market in which new financial instruments, products, markets, and participants are constantly emerging, the status quo is constantly changing, and market participants have little time to assess the impact of any change. An agreement in principle on this type of framework would open the path for further work aimed at developing more specific provisions.

But no aspect of the marketplace can be reviewed or regulated in isolation. Regulators and lawmakers should also review their regulatory regimes for all market participants. The current global financial crisis calls for a full and transparent review. No doubt the structure put in place in the coming months will set the foundation for oversight of a broad array of financial market participants for years to come. S&P looks forward to assisting regulators and policymakers in crafting fair, effective, and transparent regulation that will serve our global markets going forward.

For more information about Standard & Poor's actions to strengthen the ratings process, go to www.spnewactions.com.

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PREPARED STATEMENT OF DANIEL CURRY

PRESIDENT,
DBRS, INC.

MARCH 26, 2009

Introduction

The recent turmoil in the financial markets has shone a spotlight on the way in which various market participants are regulated and the effect of that regulation on investor protection. DBRS is pleased to have the opportunity to address these important issues as they relate to one segment of the financial markets, credit rating agencies. In particular, I would like to discuss four broad areas relating to credit rating agency regulation and investor protection:

1. The importance of competition in the credit rating agency industry to the safety and soundness of the capital markets;
2. The need for uniform rating agency regulation;
3. The need for regulatory stability; and
4. The need for regulatory recognition of the global nature of credit ratings.

In order to put this discussion in context, I would like to begin with an overview of our company.

Overview of DBRS

DBRS is a Toronto-based credit rating agency established in 1976 and still privately owned by its founders. With a U.S. affiliate located in New York and Chicago, DBRS analyzes and rates a wide variety of issuers and instruments, including financial institutions, insurance companies, corporate issuers, issuers of government and municipal securities and various structured transactions. The firm currently maintains ratings on more than 43,000 securities in approximately 35 countries around the globe. Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. DBRS operates on an "issuer-pay" model, which means that our ratings are available to the public free of charge.

DBRS is committed to ensuring the objectivity and integrity of its ratings and the transparency of its operations. To this end, the firm has adopted a wide range of internal controls designed to eliminate conflicts of interest wherever possible, and to disclose and manage those conflicts that cannot be eliminated. DBRS also has adopted a Business Code of Conduct in accordance with the Code of Conduct Fundamentals for Credit Rating Agencies developed by the International Organization of Securities Commissions (IOSCO). In addition to displaying its credit ratings, DBRS' public Web site also discloses the firm's ratings policies and methodologies as well as extensive information about how its ratings have performed over time. As a result of a recent SEC rule, DBRS will soon be making additional information about its ratings history available in a user-friendly, searchable format that will allow investors to compare DBRS' ratings to those of its competitors.

In 2003, DBRS was designated by the staff of the SEC as a full-service nationally recognized statistical rating organization (NRSRO)—the first non-U.S. based rating agency to attain that designation. Four years later, DBRS became registered as an NRSRO under the regulatory regime adopted pursuant to the Credit Rating Agency Reform Act of 2006 (Rating Agency Act). In addition to its NRSRO registration, DBRS has achieved broad recognition by regulators globally, including recognition as an External Credit Assessment Institution (ECAI) in the U.S., Canada, Switzerland, and the European Union.

With that background, I would like to turn my attention to what DBRS sees as an overarching principle that should inform all efforts at regulatory reform, namely, the development of a competitive market for credit ratings.

The Importance of Competition in the Credit Rating Industry

It is no secret that the credit rating industry in the United States is dominated by three players: Standard and Poor's, Moody's, and Fitch Ratings. This situation developed over the course of many years, and was no doubt perpetuated by a regulatory system that gave special treatment to NRSRO credit ratings, yet made the process of becoming an NRSRO opaque and hard to navigate. This concentrated structure benefitted neither issuers nor investors, as it left the large NRSROs with tremendous pricing power and provided limited diversity of rating opinions to the market.

Although great strides were made in opening the industry to the possibility of competition when Congress passed the Rating Agency Act in 2006, the actual competitive landscape has been very slow to change. DBRS submits that the continued

dominance of the largest rating agencies contributed to the recent turmoil in the structured finance market, when changes in the assumptions underlying their rating models led to rapid and dramatic ratings downgrades over a very short period of time. Concentrating ratings opinions in so few hands had a profound, destabilizing effect on the markets.

As the markets now struggle to regain their footing, more work needs to be done to open the credit rating industry to competition. Unfortunately, although the government can be a catalyst for change in this area, the opposite seems to be occurring.

Recognizing that the securitization markets have ceased to function and that such markets are crucial in providing diversified sources of liquidity to corporations and consumers, the Federal Reserve has created the Term Asset-Backed Securities Loan Facility, or "TALF." The Fed has announced that in order to be eligible for this program, an asset-backed security must receive a AAA-rating from a "major" NRSRO, which it defines as Standard and Poor's, Moody's and Fitch. No explanation has been given for the creation of this new sub-category of registered credit rating agency. The result of this approach is that DBRS—with over 30 years of experience as a rating agency and more than six, as an NRSRO—has been deemed unqualified to rate TALF-eligible securities, even though several issuers have asked it to do so. DBRS is consulting with the Fed about this issue and understands that the discriminatory policy is being reviewed. But while this review takes place, DBRS remains unable to participate in this important recovery effort.

The harmful effects of limiting rating agency competition under the TALF are profound, because for the foreseeable future, the TALF is likely to be the entire securitization market in the United States. Moreover, it is probable that the securitization market that emerges from this crisis will be different from the market that existed in the past. Therefore, by excluding all but the three largest rating agencies from the TALF, the government may be further entrenching the historic oligopoly for years to come. This not only will impede competition among existing NRSROs, but also will discourage the formation of new ones.

The long-term efficiency of the capital markets requires that NRSROs be allowed to compete on the quality of their work, not their size or their legacy. DBRS urges Congress to take whatever steps are necessary to make the promise of competition created by the Rating Agency Act a reality.

The Need for Uniform Regulation

Because fostering competition among rating agencies was one of the primary goals of the Rating Agency Act, the statute contemplates a single regulatory regime applicable to all NRSROS: big firms and small firms; those operating on an issuer-pay model and those operating on a subscriber-pay model;[1] and those who use quantitative methods, qualitative methods or both to determine their credit ratings. DBRS endorses this commitment to neutrality and believes it fosters a diversity of credit rating opinions that benefits the markets.

Unfortunately, cracks have begun to appear in this foundation. One of the most disturbing of these is that unequal regulatory burdens have begun to be imposed on issuer-pay and subscriber-pay NRSROs. In order to provide users of credit ratings, investors and other market participants with the raw data they need to compare how NRSROs initially rated an obligor or security and how they adjusted those ratings over time, the SEC recently adopted a rule requiring issuer-pay NRSROs to publish ratings history information, on a delayed basis in a user-friendly format, on their public Web sites. The SEC did not impose a similar requirement on subscriber-pay NRSROs, because they protested that any public disclosure of their ratings, even with a substantial time delay, would be antithetical to their business model. The Commission now proposes to perpetuate this disparate treatment by adding another disclosure requirement for issuer-pay NRSROs only.

There has been much debate in the past few years about the relative quality and reliability of ratings determined under the issuer-pay and subscriber-pay business models. Questions also have been raised as to whether the conflicts of interest faced by rating agencies who are paid by issuers are more pronounced than the conflicts faced by rating agencies who are paid by subscribers, who may also have a stake in how an issuer or instrument is rated.

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[1] In an "issuer-pay" model, an NRSRO's credit ratings are paid for by the obligor being rated or by the issuer, underwriter or sponsor of the securities being rated. Issuer-paid credit ratings generally are made available to the public free of charge. By contrast, in a "subscriber-pay" model, the NRSRO's credit ratings are paid for and are available only to parties who subscribe to the NRSRO's services.

This debate cannot be resolved so long as investors and other market participants are unable to verify the ratings accuracy claims made by subscriber-based ratings providers. Anecdotal discussions by subscriber-pay NRSROs of "where they got it right" are no substitute for an objective, independent analysis of the universe of their ratings. Although DBRS appreciates the need to protect the commercial value of subscriber-pay NRSROs' real-time ratings, DBRS believes that absolving such NRSROs from all transparency obligations is not in the best interests of investors or the capital markets.

DBRS also has concerns that as more and more obligations are imposed on NRSROs under the Rating Agency Act, the regulatory regime will become skewed in favor of large rating agencies. While the incremental cost of each new rule might seem modest when viewed in isolation, taken as a whole, the costs of complying with the current regulatory regime are substantial. DBRS understands that balancing the need for robust regulation against the need for affordable regulation is a delicate exercise. But DBRS urges this Committee to be mindful of the fact that at some point, more regulation harms investors by driving reputable and credible rating agencies from the market.

The Need for Regulatory Stability

The freezing of credit and the ensuing turmoil in the global financial markets has sent shock waves through investors, market intermediaries, policy makers and regulators. A critical examination of whether the current regulation of credit rating agencies contributed to this crisis is a necessary and healthy exercise. However, any alteration of the existing regulatory approach must be reasoned and likely to improve the safety and soundness of the capital markets. Change for the sake of change will only make things worse.

The regulatory regime established under the Rating Agency Act was implemented in September 2007, when the first group of NRSROs became registered. This regime focuses not on the substance of credit ratings, but rather on the integrity and objectivity of ratings and on the transparency of the NRSROs' operations. It does this by requiring NRSROs to implement extensive internal controls on their conflicts of interest, their use of material nonpublic information and their business practices; and by requiring such firms to publicly disclose the procedures and methodologies they use in determining credit ratings, along with performance measurement statistics regarding those ratings. NRSROs are also obligated to keep an extensive array of records, which enable the SEC staff to examine registered firms' operations in order to ensure compliance with the Rating Agency Act and related rules.

In response to the subprime crisis, the SEC has recently taken steps to fortify the regulation of NRSROs. These steps include new restrictions on conflicts of interest, new recordkeeping requirements and enhanced disclosure requirements regarding ratings procedures, methodologies and default and transition data. An additional set of SEC rule proposals is pending. These latest proposals include a mechanism to discourage ratings shopping with regard to ratings for structured finance products by facilitating the issuance of unsolicited ratings for such products.

DBRS endorses the fundamental characteristics of the current approach to regulating NRSROs and believes that this approach is reasonably designed to protect the safety and soundness of the financial markets. Since this system is barely eighteen months old and since the enhancements to this system have yet to take effect, DBRS also believes that it would be unwise to significantly overhaul or abandon the current regulatory regime at this time.

No superior alternative to the current approach has been identified. Moreover, the costs of complying with the current requirements have been very high, and smaller NRSROs might be driven from the market if they are required to start over under a new compliance regime less than 2 years after they paid to establish the first one.

DBRS further submits that the regulation of credit rating agencies is most effective when the regulator understands the credit rating industry. For this reason, DBRS sees no benefit in transferring NRSRO jurisdiction from the SEC, which has overseen NRSROs for 34 years, to a regulator who has no experience in this area. Interposing a self-regulatory body between NRSROs and the SEC would be the worst idea of all, since it would lead to duplicative regulation by a costly private bureaucracy that may or may not know anything about the industry. A far better approach would be to make sure that the SEC has the resources it needs to effectively examine NRSROs and to take any enforcement actions that may be warranted under the existing laws and rules.

Recognition of the Global Nature of Credit Ratings

Given recent events, there can be no question that the financial markets are interdependent and global in nature. One of the core benefits of credit ratings is

they are globally comparable. That is, they are designed to help investors understand risk across borders. Because the ratings activities of NRSROs are not confined to the United States, it is important that U.S. policy makers and regulators endeavor to harmonize NRSRO regulation with the regulatory regimes of other major markets, to the extent this can be done without compromising safety and soundness.

In this regard, DBRS notes that while the Rating Agency Act and the SEC's rules thereunder are not identical to international standards such as the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, the U.S. law and rules address the same basic principles as the IOSCO Code and they do so in a way that allows NRSROs to comply comfortably with both.

Ensuring that credit rating agency regulation continues to be as globally consistent as possible will encourage competition in this market among firms of varying size and business models. This, in turn, will help to ensure ratings stability and accuracy and will increase the availability of information to investors for their decision-making. Conversely, a balkanized system of regulation will increase costs and drive smaller rating agencies from the market. The result will be the continuation of the rating agency oligopoly with all the attendant risks to the market that the Rating Agency Act was designed to eliminate.

I appreciate having the opportunity to present DBRS' views here today and I look forward to answering any questions you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MARY L. SCHAPIRO

Q.1. Business Development Companies (BDCs), which are regulated under the Investment Company Act, support more than 10,000 jobs in my home State of New Jersey through their extension of credit and investments in more than 20 small and middle-market companies. I understand that the BDC industry has largely ceased to extend credit due to certain Investment Company Act rules that, in the current market environment, may be having unintended consequences.

Does the Commission intend to address this problem, and if so, could the Committee expect to receive a report on the Commission's actions?

A.1. Over the past year, the greatest challenges to BDCs have resulted from market conditions rather than regulatory restrictions. The dearth of available credit, with the general decline in the value of financial assets, has severely limited the ability of BDCs to raise new capital to invest in small and middle-market companies. During the year ending on March 31, 2009, the net asset value ("NAV") of the four largest BDCs declined an average of 32.5 percent. Declines in the market value of the shares of these BDCs were more severe, and shares of all four BDCs trade at significant discounts to NAV. The two largest BDCs are in default under their loan agreements, and their auditors have raised going concern issues. As detailed below, the staff generally believes that the regulatory requirements for BDCs are operating as intended. The staff also generally believes that improvements in the availability of credit and in the market values of assets held by BDCs are far more likely to enable BDCs to raise additional capital, and extend credit to small and middle-market companies, than regulatory relief.

The Relevant Regulatory Requirement for BDCs Under the Investment Company Act of 1940 ("Act")

BDCs are a type of closed-end investment company regulated under the Act. The Act's capital structure requirements limit the ability of a BDC to raise additional capital by issuing preferred stock or incurring debt. Specifically, the Act prohibits a BDC from issuing or selling preferred stock or incurring debt (or declaring cash dividends on its common stock or repurchasing its common stock), unless immediately thereafter the BDC has asset coverage of its preferred stock plus debt securities of at least 200 percent. These requirements are more permissive than the Act's requirements for other closed-end investment companies whose debt securities must have asset coverage of at least 300 percent. In addition, a BDC may issue multiple classes of debt securities, but other closed-end investment companies may issue only one class of debt security.

The Act's asset coverage requirement for BDCs exists for the protection of both investors in common stock on one hand and investors in debt securities or preferred stock on the other hand. As the percentage of a BDC's capital from preferred stock or debt increases, the risk to the common stockholders also increases. At the same time, the risk also increases that the BDC will lack the resources to pay promised interest or dividends or the principal or

liquidation preference to the holders of the debt securities or preferred shares. In this regard, Section 1(b) of the Act states that the national interest is adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities [*i.e.,* preferred stock or debt securities] increase unduly the speculative character of their junior securities [*i.e.,* common stock]" or "fail to protect the preferences and privileges of the holders of their outstanding securities." Section 1(b) also states that the Act is to be interpreted "to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

The Regulatory Requirement Generally Is Operating as Intended

The Act does not prohibit a BDC from investing all of its available capital in portfolio companies. If a BDC fully invests its capital, a subsequent decline in the value of those investments that cause asset coverage to dip below 200 percent does not constitute a violation of the Act. (However, as explained above, the Act would prohibit the BDC from taking on additional leverage, declaring cash dividends on its common stock or repurchasing its common stock unless its asset coverage equals at least 200 percent at that time.)

The Act's asset coverage requirement does not limit the ability of BDCs to raise capital by issuing additional common stock. In the past, some of the largest BDCs periodically issued shares priced at a premium to NAV. This additional equity capital, in turn, increased the BDCs' borrowing capacity. Under the Act, a BDC may issue additional shares priced at a discount to NAV, provided that the BDC's board makes certain findings and shareholders approve the offering. A number of BDCs have obtained board and shareholder authorization for such offerings. In fact, Prospect Capital Corporation, one of the ten largest BDCs, recently raised over $60 million in a public offering of its common stock priced below NAV.

To the extent that BDCs have been interested in exploring relief from the Act's asset coverage requirement, the staff has given this issue serious and careful consideration in numerous meetings with BDC representatives, their accounting firms and their lawyers. The staff continues to engage in a dialogue with BDCs and their representatives about regulatory relief. In general, the staff believes that the Act's restriction on further leverage and payment of cash dividends on common shares or repurchase of common shares when asset coverage is less than 200 percent are generally working as intended. Nevertheless, the staff has provided no-action relief from the asset coverage requirement to the largest BDC so that it, and other BDCs in similar circumstances, could make cash dividend payments to the extent necessary to take advantage of IRS relief made available to certain closed-end investment companies earlier this year. The staff also agreed to permit BDCs to use the shelf registration process for sales of shares priced below NAV. Prospect Capital Corporation used a shelf registration for its recent sale of shares priced below NAV.

We hope that this analysis constitutes the report contemplated by this question, but if Senator Menendez or the Committee re-

quires additional information or updates, the staff would be pleased to provide it.

Q.2. Does the Commission need any additional authority to address these problems, or are there legislative solutions that are necessary to make certain that credit continues to be made available to small and middle-market companies?

A.2. The staff does not believe that additional authority would enhance the ability of BDCs to attract additional capital to invest in small and middle-market companies. If Congress were explicitly to authorize the Commission to suspend or eliminate all of the Act's capital structure requirements applicable to BDCs, the staff doubts that lenders would be more willing to extend credit to BDCs or the capital markets more willing to purchase shares issued by BDCs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM RICHARD BAKER

Q.1. Does the concept of the sophisticated investor, which sets certain income and asset-size limitations on investors in hedge funds, need to be revisited? If so, how should it be revisited?

A.1. The Managed Funds Association (MFA) strongly supports limiting investments in hedge funds to sophisticated investors. Rule 501 of Regulation D under the Securities Act of 1933 defines the term "accredited investor" as including:

- (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;
- (6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year . . .

The Commission adopted these standards in 1982. In May 2003, the SEC held a public roundtable meeting to discuss the hedge fund industry. In connection with that roundtable, MFA submitted its "White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds."[1] In the White Paper, MFA proposed that the Commission could increase the dollar thresholds for the accredited investor definition to address concerns that, because of inflation, the thresholds no longer adequately ensured the sophistication of accredited investors. In 2007, the Securities and Exchange Commission proposed modifying the accredited investor definition to account for the effects of inflation on the thresholds.[2] In its comment letter to the proposed rule change, MFA supported increasing these thresholds to account for the effects of inflation.[3] MFA continues to support increasing the accredited investor threshold to ensure that hedge fund investors are sophisticated investors who are capable of understanding the risks associated with

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[1] Available at: *http://www.sec.gov/spotlight/hedgefunds/hedge-mfa2.htm#wpaper2.*

[2] Securities Act Release No. 8828 (August 3, 2007); 72 FR 45116 (August 10, 2007). The Commission has not adopted this proposal.

[3] Letter from John G. Gaine, President, MFA, October 19, 2007, available at: *http://www.managedfunds.org/downloads/MFA%20Regulation%20D%20Comment%20Letter.pdf.*

an investment in a hedge fund and who have the financial wherewithal to withstand the potential losses from an investment. MFA also supports adjusting, as appropriate, the accredited investor threshold to account for inflation on a going forward basis, to ensure that the threshold appropriately limits investing in hedge funds to sophisticated investors.

The SEC has noted on several occasions that the objective income test in Regulation D strikes an appropriate balance between limiting private offerings to sophisticated investors only and promoting capital formation for companies. Prior to the SEC's adoption of Rule 242 under the Securities Act of 1933, which was replaced by the adoption of Regulation D under the Securities Act, issuers relying on the private offering exemption had to make a subjective determination of the sophistication of the investors to whom they offered or sold securities. The requirement to make this subjective determination, however, "created uncertainty about whether the exemption was available and thus posed problems for issuers, primarily small issuers, about potential rescission liability should the exemption turn out to be unavailable."[4] To address this concern, the SEC incorporated the objective standard for accredited investors in Regulation D. In its 2007 proposed rulemaking to amend the accredited investor standards, the Commission again recognized the appropriateness of objective thresholds,

> Before 1982, our rules generally required an issuer seeking to rely on section 4(2) to make a subjective determination that each offeree had sufficient knowledge and experience in financial and business matters to enable that offeree to evaluate the merits of the prospective investment or that such offeree was able to bear the economic risk of the investment. In part because of a degree of uncertainty as to the availability of the section 4(2) exemption, the Commission adopted Regulation D under the Securities Act in 1982 to establish nonexclusive "safe harbor" criteria for the section 4(2) private offering exemption.[5]

We recognize that asset and income tests do not necessarily guarantee the level of sophistication of investors, but we agree with the SEC that such tests do achieve an appropriate balance between investor protection and market certainty. Bright line, easy to understand thresholds promotes certainty, which is important to market participants and also promotes efficient and effective oversight by regulators. Investors who meet significant income or asset thresholds are more likely to have greater investment experience and sophistication, and therefore are better able to protect their interests than are retail investors. At the very least, these thresholds help ensure that investors who do not personally have such experience and sophistication have the means to engage fiduciaries who do have such experience to assist them in making investment decisions. Further, investors who meet such tests are likely to have the financial wherewithal to withstand losses that may arise from their investment decisions. As such, we believe that limiting hedge funds

[4] Securities Act Release No. 8041 (December 19, 2001); 66 FR 66841 (December 27, 2001).
[5] Securities Act Release No. 8766 (December 27, 2006); 72 FR 403-404 (January 4, 2007) (footnote omitted).

to investors who meet significant income or asset thresholds is an effective, if not perfect, means to ensure that only sophisticated investors invest in hedge funds.

In 1996, Congress amended the Investment Company Act of 1940 to, among other things, introduce an additional, heightened sophisticated investor standard, the "qualified purchaser"[6] standard, which is applicable to investors in certain kinds of hedge funds (so-called "3(c)(7) hedge funds"). In practice, investors in 3(c)(7) hedge funds must meet both the accredited investor and qualified purchaser thresholds. Like the accredited investor test, the qualified purchaser test sets out an objective standard ($5,000,000 in investments for an individual). We believe that the qualified purchaser standard has worked well since its inception; however, Congress may want to consider whether it is appropriate to adjust the standard to account for inflation. If Congress does decide to make an adjustment to the qualified purchaser standard, it is important for the new standard to be objective, transparent and easy to understand.

Q.2. What level of standardization of disclosures might help investors in hedge funds? What is the balance between disclosure for the protection of investors and the protection of hedge funds' intellectual property?

A.2. MFA and its members strongly support hedge funds providing an appropriate level of disclosure to investors and potential investors in hedge funds, to allow those investors to make informed investment decisions. Hedge funds do disclose a significant amount of information to investors because of regulatory requirements and

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[6] The term qualified purchaser is defined in section 2(a)(51) of the Investment Company Act of 1940 to mean:

(A)(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a-3 (c)(7) of this title with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;

(ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;

(iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or

(iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

(B) The Commission may adopt such rules and regulations applicable to the persons and trusts specified in clauses (i) through (iv) of subparagraph (A) as it determines are necessary or appropriate in the public interest or for the protection of investors.

(C) The term "qualified purchaser" does not include a company that, but for the exceptions provided for in paragraph (1) or (7) of section 80a-3 (c) of this title, would be an investment company (hereafter in this paragraph referred to as an "excepted investment company"), unless all beneficial owners of its outstanding securities (other than short-term paper), determined in accordance with section 80a-3 (c)(1)(A) of this title, that acquired such securities on or before April 30, 1996 (hereafter in this paragraph referred to as "pre-amendment beneficial owners"), and all pre-amendment beneficial owners of the outstanding securities (other than short-term paper) of any excepted investment company that, directly or indirectly, owns any outstanding securities of such excepted investment company, have consented to its treatment as a qualified purchaser. Unanimous consent of all trustees, directors, or general partners of a company or trust referred to in clause (ii) or (iii) of subparagraph (A) shall constitute consent for purposes of this subparagraph.

the requirements of investors.[7] We believe that the appropriate balance between disclosure to investors and protection of intellectual property is best determined between sophisticated hedge fund investors and hedge fund managers. Investors who believe that they do not have sufficient information about a hedge fund should not make an investment in that fund. The balance between disclosure to investors and protection of intellectual property is, of course, set in the context of the anti-fraud provisions of the federal securities laws.

We believe that because the class of investors who can invest in hedge funds is limited to sophisticated investors only, those investors are able to request and receive any information they believe to be relevant to their investment decisions. Further, we believe that sophisticated investors are better able than regulators to determine what information they need and how they want that information to be presented. Any investor who fails to receive the information that it believes is material to an investment decision can choose not to make an investment. Because sophisticated investors are best able to determine what information they need, and they have the ability to request and receive that information (or not make an investment if they do not), we believe that it is neither necessary nor advisable to require standardized disclosures by hedge funds.

While hedge funds provide a significant amount of information to investors, we do not believe that detailed public disclosure about hedge funds should be required. Public disclosure of such information could be misleading, as it would likely be incomplete data that would be viewed by the public outside of the proper context. Public investors may be inclined to take action based on this data without fully understanding the information, which could lead to adverse consequences for those public investors, for investors in the relevant hedge funds, and for the stability of the financial system as a whole. Public disclosure of proprietary information also harms the ability of market participants to establish and exit from investment positions in an economically viable manner. We believe that investors in hedge funds can receive the information they need to make informed investment decisions (and regulators can receive information reported on a confidential basis to allow them to fulfill their investor protection, oversight, monitoring and other regulatory functions) without the adverse consequences that would result from public disclosure of the intellectual property of hedge funds.

Q.3. Is it reasonable that regulators could review detailed information such as trading positions of hedge funds overall to see where there might be concentrations, or is this level of analysis too difficult? If so, why?

A.3. MFA supports the notion of a central systemic risk regulator (SRR) and believes that such a regulator should be responsible for oversight over the key elements of the entire financial system,

[7] 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.*

across all relevant structures, classes of institutions and products of all financial system participants.[8] Factors a SRR should consider in determining whether an entity is systemically important should include the amount of assets of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants.

While we 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; we believe that most hedge funds are not systemically significant entities and, thus, hedge funds, as a class, should not be singled out for greater scrutiny. A SRR should have the authority to request and receive, on a confidential basis, from those entities that it determines to be of systemic relevance, including any hedge funds, information that the regulator determines necessary or advisable to enable it to adequately assess potential risks to the financial system. We don't mind reporting information within reason if systemically relevant, provided that the SRR provides assurance of confidentiality.

In this respect, we also believe a SRR should not equate systemically relevant entities with entities that are too big, or too interconnected, to fail. An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against its failure.

With respect to whether a regulator could assess an entity's trade concentrations through reviewing trade positions, we provide the following example for comparison:

The Commodity Futures Trading Commission currently performs analysis of the trading positions of market participants, including hedge funds, as part of its market surveillance program. For example, the CFTC operates a large-trader reporting system (LTRS) through which it collects daily market data and position information from clearing members, futures commissions merchants, and foreign brokers.[9] In this way, the CFTC conducts real-time surveillance of market participants.

We understand that the CFTC reviews the position information daily and will contact a market participant that exceeds an accountability level or position limit to conduct an inquiry (note: an accountability level is a soft limit and exceeding it is not *per se* illegal, whereas a position limit is a hard limit). If a market participant exceeds an accountability level, the CFTC will inquire into the market participant's positions, strategy or other rationale for exceeding the accountability level. If the CFTC is not satisfied with its finding, it may require the market participant to decrease its

[8] See Testimony of the Honorable Richard H. Baker, President and Chief Executive Officer, Managed Funds Association, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 26, 2009; and Testimony of the Honorable Richard H. Baker, President and Chief Executive Officer, Managed Funds Association, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, March 5, 2009.

[9] Section 4g of the Commodity Exchange Act (CEA); 17 CFR Parts 15, 16, 17, 18, 19, and 21.

position. All of this is done quietly and privately to avoid alarming or putting other market participants on notice and creating a market impact.

The CFTC provides the public with aggregated data of reported positions via its weekly Commitments of Traders reports. The Commodity Exchange Act protects market participants by prohibiting the CFTC from disclosing any person's positions, transactions, or trade secrets (except in limited circumstances).[10]

As provided in the above example, it is possible for regulators to review detailed information to assess position concentrations. Similar to the CFTC's market surveillance program, we believe it would be more meaningful for a SRR to review trading positions across all market participants that it deems systemically significant, rather than single out specific types of market participants, such as hedge funds. While we believe it is useful for the public to receive aggregated position information for specific markets (*i.e.,* commodities), we strongly believe information reported to a systemic risk regulator by market participants should be kept confidential for the reasons discussed in our written testimony.

A SRR is also likely to need sufficient authority and flexibility to adapt to changing conditions and take a forward-looking view toward risk regulation. Attempting to pre-determine what information a regulator would need would not provide sufficient flexibility and likely would be ineffective as a tool to address potential future risks. As a starting point, however, a SRR may consider collecting aggregated trade data from counterparties, such as banks, broker-dealers and exchanges. MFA and its members are actively engaged in an effort to identify the types of information and data that would be relevant to a SRR. While we don't have recommendations yet, we are committed to being constructive participants in the regulatory reform discussions and working with policy makers to develop smart regulation.

A systemic risk regulator's challenge will be to understand the interplay and use of various financial instruments across classes of institutions to assess the soundness of the financial system. For this reason, we believe it is important that a systemic risk regulator's mandate should be focused on the protection of the financial system and that other regulatory entities should continue to focus on investor protection and market integrity.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JAMES CHANOS

Q.1. You summarized the failures we have seen during this downturn in the financial markets. From your perspective, what led to such a disintegration of market discipline?

A.1. While all market participants bear some degree of responsibility for where we are today in the global equity, credit and asset-backed markets, the root cause of the severe difficulties we face can be found in the massive debt and the large volume of unsound loans made and secured beyond any reasonable level by heavily regulated organizations. This created a massive credit bubble that

[10] Section 8 of the CEA.

could but only burst. Market discipline was lost as businesses sought ever-increasing returns in a highly competitive market, and rating agencies made the implausible seem highly possible which in turn created higher returns which fed the bubble in prices for assets. Transparency of value and pricing was lost which also played a role in the disintegration of market discipline.

Q.2. If market discipline needs to be coupled with regulatory oversight, as you state in your testimony, what is the industry doing to improve market discipline—as the government is working to improve the regulatory structure?

A.2. The recommendations for hedge fund best practices of the President's Working Group Asset Managers' Committee and the Institutional Investors' Committee represent an important step by industry participants to raise the bar on disclosure, transparency and valuation. These best practices in many areas such as valuation exceed the norms of other market participants engaged in similar activities.

Q.3. Does the concept of the sophisticated investor, which sets certain income and asset-sized limitations on investors in hedge funds, need to be revisited? Is so, how should it be revisited?

A.3. That is a complex question which also opens up a discussion of funds of funds registered under the Investment Company Act that invest only in hedge funds. Since they are registered, they are open to retail investors without any minimum financial qualifications. CPIC did not oppose the SEC proposal to revise 3(c)(1) eligibility levels for individuals. For a full discussion please see our comment letter to the SEC dated March 9, 2007, a copy of which is attached.

Q.4. What level of standardization of disclosures might help investors in hedge funds? What is the balance between disclosure for the protection of investors and the protection of hedge funds' intellectual property?

A.4. Better transparency, particularly for investors, is a good thing. Having recently served on one of the President's Working Group's Committees to develop best practices for asset managers and institutional investors, there are enhanced disclosures that could be adopted or, if necessary, codified. For example, managers should disclose more data regarding how their funds derive income and losses from FAS 157 Level 1, 2, and 3 assets. A fund's annual financial statement should be audited by an independent audit firm subject to PCAOB oversight. Additionally, provisions could be adopted to assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers and placement agents), and policies as to investment and trade allocations. Required disclo-

sures to regulators and counterparties could also include information regarding counterparty risk, lender risk and systemic risk. Finally, Congress also should require safeguards that I have advocated for many years—simple, common-sense protections relating to custody of fund assets and periodic audits.

As for disclosure of a fund's positions, particularly short positions, it is not problematic to disclose positions on a confidential basis to the prudential or systemic risk regulator. Such information could also be aggregated on a confidential basis and used by the regulators. Public disclosure, however, even on a delayed basis, would jeopardize proprietary information/intellectual property and drastically undercut liquidity in the market along with the financial detective role played by short sellers. Short sellers also would be exposed to retaliation and trading could move to less transparent markets.

Q.5. Is the ideal regulator someone from the industry, who understands how it works? If so, who is willing to perform this public service at this point in our country's economic turmoil?

A.5. It is imperative that regulatory staff, from examiners to enforcement, have more experience and training in the day-to-day operations of the markets they are overseeing. Staff should either be—or be trained by—people who have sat on trading desks, who have run hedge funds or who have run investment firms. While the pool of potential trainers may not be large, there may be some seasoned, possibly retired, Wall Street professionals who could serve the nation by teaching the well-schooled and well-meaning staff what to look for now and what to look for in the future in order to safeguard investments and the financial system.

Q.6. Is it reasonable that regulators could review detailed information such as trading positions of hedge funds overall to see where there might be concentrations, or is this level of analysis too difficult? If so, why?

A.6. It is possible, dependent on the criteria used to select the funds or trading strategies to be targeted. And all market participants with similar investments, from commercial and investment banks to mutual funds, should be subject to the same level of scrutiny.

COALITION OF PRIVATE INVESTMENT COMPANIES

March 9, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-25-06; Rel. Nos. 33-8766, IA-2576
Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles;
Accredited Investors in Certain Pooled Investment Vehicles

Dear Ms. Morris:

The Coalition of Private Investment Companies ("CPIC") is pleased to submit its comments regarding the rule changes proposed by the Securities and Exchange Commission ("SEC" or "Commission") in the above-referenced release (the "Release").[1] CPIC is a membership organization of 19 private investment companies and other associate members, with more than $60 billion under management. Our members are diverse in size and in the investment strategies they pursue.[2] On behalf of our members, we thank the Commission for this opportunity to provide our views on the proposals, and we hope our comments are helpful to you.

The Release describes two proposed changes to the Commission's rules. The first proposal, if adopted, would constitute a new Rule 206(4)-8 under the Investment Advisers Act of 1940[3] ("Advisers Act") to prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles.[4] The Release explains that the new rule is intended to clarify the Commission's authority under the Advisers Act to protect investors and potential investors in pooled investment

1 72 Fed. Reg. 400 (Jan. 4, 2007).

2 For example, while most of our members are multi-strategy funds that trade a range of financial products, some are long-short equity funds, some pursue strategies that are event-driven, and several are fundamental short funds.

3 15 U.S.C. § 80b-20, *et. seq.*

4 72 Fed. Reg. at 400.

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vehicles against fraud, in light of any potential ambiguity caused by the decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*,[5] which held that, for purposes of section 203(b)(3) of the Advisers Act,[6] the "client" of an investment adviser managing a pooled investment vehicle could only be such a pool, and not the investors therein.

The second proposal, proposed Rules 509 and 216, if adopted, would revise the definition of "accredited investor" in Regulation D[7] as applied to natural persons by creating a new named category of investor, the "accredited natural person," but only for purposes of private offerings of investments in pooled investment vehicles, excluding business development companies.[8] The Release explains that inflation and an increase in real estate values has expanded the number of individuals who qualify as "accredited investors" under existing rules, and it therefore is necessary to establish additional criteria to assure that investors in privately-placed pooled investment vehicles have appropriate financial means and sophistication.[9]

CPIC supports the Commission's proposal to modernize the standards for determining who is an "accredited investor" with the requisite level of sophistication to invest in a private offering under Regulation D. However, in this proposal the Commission has focused on the accredited investor standards for some, but not all, "pooled investment vehicles" and for some, but not all, exempt offerings. Going forward, the Commission may wish to consider whether it has evaluated sufficient data

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5 451 F.3d 873 (D.C. Cir. 2006).

6 Section 203(b)(3) provides, in relevant part, that an investment adviser with fewer than fifteen clients in the preceding year is not required to be registered with the Commission. 15 U.S.C. § 80b-3(b)(3).

7 17 C.F.R. §§ 230.501 to 230.508.

8 72 Fed. Reg. at 403-408. Business development companies are investment companies that Congress established in the Small Business Investment Incentive Act of 1980 in order to make capital more readily available to small companies. Pub. L. No. 96-477, 94 Stat. 2274 (1980) (codified at scattered sections of the United States Code). *See generally* Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, Investment Company Act Release No. 27,538, 71 Fed. Reg. 64,086 (Oct. 31, 2006); Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, Investment Company Act Release No. 27,539, 71 Fed. Reg. 64,093 (Oct. 31, 2006).

9 72 Fed. Reg. at 400, 404.

on Regulation D offerings to justify providing differing accredited investor standards for investors in such offerings. We also observe that the proposal expands the existing and somewhat confusing categories of qualified or accredited investors determined to be more sophisticated and more capable of bearing varying degrees of investment risk.

CPIC also supports the Commission's goal of preventing fraudulent or misleading conduct by investment advisers against investors in pooled investment vehicles, and we support proposed Rule 206(4)-8 to the extent that it addresses any potential gap in the Commission's authority to bring enforcement actions against unregistered investment advisers who commit fraud. However, this proposal, like the accredited natural person proposal, is limited in scope.

In this letter, CPIC suggests approaches for the Commission's consideration that we believe would help assure that investments in hedge funds and other private placements are limited to sophisticated parties, would afford greater protection to investors in pooled investment vehicles, and would preserve sufficient flexibility so that the alternative investment industry may continue to provide the benefits to the financial markets that investors, academics, and members of the President's Working Group on Financial Markets (including the Commission itself) have acknowledged. In addition, one of our suggestions would address the concern, stated repeatedly by the Commission, that there is a lack of reliable data regarding the number of hedge funds that are currently in operation and the types of investors that they accept. This lack of information (which also is apparent with respect to other issuers of securities distributed under Regulation D) hampers the SEC's ability to ascertain where and how to allocate regulatory resources.

We understand the Commission's interest in moving to address its authority to protect investors in pooled investment vehicles against fraud by investment advisers, as well as to update the accredited investor standards. Our comments below are not intended to delay action on these matters but to suggest ideas for further consideration, perhaps in a future rulemaking or concept release. We also believe the ideas we offer for the Commission's consideration are wholly consistent with the February 22 guidance and principles issued by the President's Working Group on Financial Markets.[10]

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[10] Press Release, Dep't. of Treasury, Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital, (Feb. 22, 2007) *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

Modernizing the Accredited Investor Standard

By way of background, certain issuers, including "start-up" enterprises, private equity funds, venture capital funds, business development companies and hedge funds, sell their securities in accordance with Rule 506 of Regulation D[11] under Section 4(2) of the Securities Act of 1933 (the "Securities Act"), in order to ensure that sales of their securities are not deemed to be a public offering and thus not subject to registration requirements. Rule 506 provides, in part, that an offering will not be deemed a public offering if the issuer limits sales of its securities to "accredited investors" and no more than thirty-five persons who are not accredited investors.[12] In brief, accredited investors are persons who are deemed to have the requisite financial means and sophistication to understand and withstand the risks of investment in securities without the protections that registration under the Securities Act would otherwise afford. The Commission, in order to provide bright-line tests for financial sophistication, generally has established minimum amounts for an investor's income, net worth, or investment assets.

With respect to natural persons, Rule 501(a) under Regulation D currently defines an "accredited investor" as any person who meets, or whom the issuer reasonably believes meets, either of the following criteria:

- A natural person whose individual net worth, or joint net worth with their spouse, at the time of purchase exceeds $1,000,000.
- A natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with their spouse in excess of $300,000 in each of those years, and who has a reasonable expectation of reaching the same income level in the current year.[13]

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11 17 C.F.R. § 230.506.

12 17 C.F.R. § 230.506(b)(2). In addition to the accredited investor limitation, the offering may not be effected by means of a general solicitation or advertising, and any non-accredited investors in the issuer must receive disclosures of the same types of information that would appear in Part I of a registration statement filed under the Securities Act. Rule 502(d) of Regulation D also provides that securities purchased pursuant to Rule 506 may not be resold unless they are registered or exempt from registration under the Securities Act. 17 C.F.R. § 230.502(d).

13 17 C.F.R. § 230.501(a).

The Release states that, due to the effects of inflation and an increase in wealth (including real estate values) from the time they were established in the 1980s, the income and net worth tests in the definition of "accredited investor" have become outdated.[14] As a result, according to the Release, private offerings of securities under Regulation D may now be extended to a larger number of natural persons than when the accredited investor standards were established, and therefore the current standards may not be sufficient to safeguard these investors.[15] The Commission's proposal would not make uniform adjustments for investors in all securities distributed under Regulation D, but would revise these standards *only* for investors in one particular sub-type of security - investments in pooled vehicles that are excluded from the definition of an "investment company" pursuant to Section 3(c)(1) of the Investment Company Act of 1940 (the "Company Act")[16] ("3(c)(1) Funds") and that are not "venture capital funds," defined as business development companies (as defined in Section 202(a)(22) of the Investment Advisers Act of 1940) (the "Advisers Act").[17] For investments in such a 3(c)(1) Fund, a natural person would be required to qualify as an "accredited natural person" by meeting either the income or net worth tests currently required for an individual who is an "accredited investor" under Regulation D *and* by owning at least $2.5 million in investments.[18] This required amount of investments would be periodically adjusted for

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14 72 Fed. Reg. at 404.

15 *Id.* The Commission's staff estimates that the percentage of United States households that qualify for accredited investor status has increased from approximately 1.87% when the standards were established, to approximately 8.47% in 2003. 72 Fed. Reg. at 406 n.57.

16 15 U.S.C. § 80a-3(c)(1).

17 The proposed rule describes 3(c)(1) Funds that are not "venture capital funds," but then defines the term "venture capital funds" to mean a "business development company" as defined in Advisers Act Section 202(a)(22) (15 U.S.C. § 80b-2(a)(22)) and described *supra* n. 8. 72 Fed. Reg. at 407-408, 414, 416.

18 The proposed rule change would not apply with respect to investments in the other main form of hedge funds, the "3(c)(7) Fund," because such Funds are already restricted to accepting only "Qualified Purchasers" as investors, which, with respect to natural persons, requires ownership of at least $5 million in investments. *See* Company Act §§ 2(a)(51), 3(c)(7); 15 U.S.C. §§ 80a-2(a)(51), 80a-3(c)(7).

inflation, and the proposed rule would value investments differently from other SEC regulations that apply in comparable situations.[19]

The Commission and the Staff in recent years have voiced a range of investor protection concerns regarding hedge funds, such as in the 2003 Staff Report on the *Implications of the Growth of Hedge Funds* (the "Staff Report")[20] and the Commission's release accompanying its proposed hedge fund adviser registration rule.[21] Modernizing the accredited investor standard appears to be aimed at the "retailization" concern, described in the Staff Report as the potential phenomenon of "significant numbers of less sophisticated investors ... investing in hedge funds."[22]

As the Commission considers adoption of the proposal, it is instructive to note that the Commission Staff stated in its 2003 report that it had "not uncovered evidence of significant numbers of retail investors investing directly in hedge funds."[23] There is no information in the Release to indicate that this situation has changed. Therefore, the

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19 The definition of "investments" in the proposed rules at first appears to be the same as the definition of "investments" used in Rule 2a51-1 under the Company Act for purposes of defining a "Qualified Purchaser." 17 C.F.R. § 270.2a51-1. However, the definition has been altered with respect to investments that a natural person owns jointly with a spouse or as part of a shared community interest with a spouse. While Rule 2a51-1 permits all of such investments to be counted in the determination of whether a natural person is a "Qualified Purchaser," the proposed rule would provide that when a natural person acts on their own behalf (and not jointly with a spouse), only one-half of such investments could be counted in the determination of whether they qualify as an accredited natural person.

20 *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sept. 29, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds.htm. The Staff Report noted concerns not only with the test for "accredited investor" status, but also with the retail offering of registered funds-of-hedge-funds and the exposure that individual investors may have to hedge funds through investments in pension plans. Other concerns described by the Report included the protection of hedge fund investors from fraud or deficient disclosure, the methods employed by hedge funds to solicit investors, questionable valuations by advisers of hedge fund portfolios, and a lack of transparency with respect to advisers' valuation policies. *Id.* at 79-87.

21 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,266, 69 Fed. Reg. 45,172 (July 28, 2004).

22 Staff Report, at 80.

23 *Id.* at 80.

Commission's concern that the accredited investor standard may no longer suffice to protect investors is *prospective* in nature. The proposed rule change therefore presents challenges in that it represents only the Commission's best guess as to what an appropriate standard might be, rather than one based upon empirical data.

Of course, the Commission also has expressed concerns about a lack of accurate information about how many hedge funds operate in the United States, their assets and who controls them, which the Commission says has impeded its ability to formulate public policy.[24] This lack of data also presents challenges to the Commission in formulating the scope of its revised accredited investor standard.

To illustrate, although the proposal to revise the "accredited investor" standard is focused exclusively on 3(c)(1) Funds that are not business development companies, the Commission acknowledges that it cannot state with certainty how many such entities are currently in operation. The Release explains that in order to estimate the number of 3(c)(1) Funds that might be affected by the proposal, the Staff reviewed the 19,250 filings submitted to the Commission on Form D in 2006, but that "Form D does not contain sufficient information ... to determine whether a filer is an operating company, a 3(c)(7) Pool or a 3(c)(1) Pool."[25] The Staff estimates that about twenty percent (or 3,850) of these filings were made by 3(c)(7) or 3(c)(1) Funds and that about ten percent of that number (or 385) were made by 3(c)(1) Funds, although the bases for these estimates are not stated.[26] Still further, the Commission has not indicated whether it has the data to know how many of these 385 filers were not also business development companies. Finally, the Commission cannot ascertain how many of these potential 3(c)(1) Funds already impose higher suitability standards than basic accredited investor status. Indeed, it seems likely that they would do so, for in order for a manager to charge an incentive fee (which most hedge fund managers do) to investors in a 3(c)(1) Fund, such investors must not only be "accredited," but must also be "Qualified Clients" as defined in Rule 205-3(d)(1).[27] Accordingly, the Commission does not know how many issuers and

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24 *Id.* at 77-78.

25 72 Fed. Reg. at 409 n. 83,413 n. 105.

26 *Id.*

27 17 C.F.R. § 275.205-3(d). In brief, unless a natural person is an officer of the Fund, they may only be deemed a Qualified Client if (a) they have at least $750,000 under the management of the investment adviser in question, (b) the adviser reasonably believes that they have a net worth

Footnote continued on next page

investors will be affected by the proposed rule change, nor will it be able to gauge the success or failure of its efforts if the proposal is implemented.

CPIC Proposal: Give Further Consideration to Accredited Investor Standard

CPIC agrees with the Commission that the qualifications required for "accredited investor" status should be updated. Indeed, we testified in support of this concept last year.[28] Yet, if the Commission is truly concerned that current rules allow offerings to natural persons that are not sufficiently sophisticated or able to withstand financial risks without the protections otherwise afforded by the registration provisions of the Securities Act, then the Commission should evaluate whether it is advisable to update the standards for other Regulation D private placements, and not just those of one particular type of issuer. Moreover, we believe that revisions to the accredited investor standards could be made less complex and more consistent with comparable SEC rules.

Put another way, if the Staff's estimate that 3,850 of the 2006 Form D filers were hedge funds is correct, then it is also correct that there were 15,400 filers that were not hedge funds. Under the Commission's proposal, these 15,400 issuers would be free to solicit investors that meet the accredited investor thresholds of the 1980's. CPIC's expertise does not extend beyond pooled investment vehicles, so we take no position on the appropriate accredited investor standard for these other Form D filers. We believe an appropriate question for the Commission to address, however, is whether such issuers, which may include non-diversified "start-up" ventures, are any less speculative or hard to understand than a securities trading pool with fewer than 100 owners.

We believe the same questions should be asked about the rationale for only raising the thresholds for purposes of investments in 3(c)(1) Funds that are not business development companies. The Release states that this exclusion for business development companies is meant to preserve their ability to provide managerial assistance and capital

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Footnote continued from previous page

(including assets held jointly with a spouse) of more than $1,500,000, or (c) the adviser reasonably believes that they are a Qualified Purchaser. *Id.*

28 *Hedge Fund Industry: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs* (May 16, 2006) (statement of James Chanos, Chairman, Coalition of Private Investment Companies), *available at* http://banking.senate.gove/_files/ACF82BA.pdf.

to small firms. Yet this rationale does not relate in any way to the stated motivation for this proposed rule change, which is to ensure that potential investors are able to understand and withstand the risks of an investment. Indeed, the Commission has not identified any reason to believe that business development companies are any less risky or difficult for an investor to analyze than a 3(c)(1) Fund. On the contrary, such issuers are frequently non-diversified companies that feature a high degree of risk.

Establishing the Proper Quantitative Standard

Determining the proper quantitative standards for a natural person to qualify as an accredited investor is a separate matter. CPIC recognizes that the accredited investor standard serves primarily a public policy function more than a pure economic function. This standard is a proxy for the Commission's best estimate for an investor who either has the knowledge to understand the risks associated with investing without the protection afforded by Securities Act registration or who has the financial capacity to hire expert advice sufficient to apprise the investor of the risks associated with such an investment. Consequently, any such standard will be rough justice at best and must be viewed in such a context. There is no single standard that could possibly encompass all of the individual exceptions to the rule.

We note that there are alternatives the Commission could consider. Rather than add a new category of named investor and a complicated minimum investment ownership component to an already complex set of regulations, the Commission could consider a direct approach by raising the existing income and net worth tests, while excluding the value of a person's home and/or place of business from the calculation of net worth.[29]

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[29] To this end, in order to exclude the value of real estate that is not held for investment purposes from the calculation of net worth, the Commission should, for the sake of consistency, continue to use the standard employed for that purpose in Rule 2a51-1 under the Company Act with respect to the definition of a "Qualified Purchaser. Rule 2a51-1(b)(2) includes real estate held for investment purposes within the definition of investments. 17 C.F.R. § 270.2a51-1(b)(2). Real estate is not considered held for investment purposes if it used as a place of business or for "personal purposes." Rule 2a51-1(c)(1); 17 C.F.R. § 270.2a51-1(c)(1). The term "personal purposes" is derived from the Internal Revenue Code. In brief, residential property is not deemed to be used for "personal purposes" and may be treated as an investment if it is not treated as a residence for tax purposes. This allows prospective investors to determine if residential real estate is an investment based on the same tests used for determining whether certain property-related expenses are tax-deductible. *See* Privately Offered Investment Companies, Investment Company Act Release No. 22,597, 62 Fed. Reg. 17,512, 17,516 (Apr. 9, 1997) (adopting Rule 2a51-1).

For example, the Commission could round upwards the figures identified by the Commission's Office of Economic Analysis ("OEA") to adjust for inflation (*i.e.*, $2 million [net worth]; $400,000 [individual income]; $600,000 [joint income]).[30]

Alternatively, or in addition, the Commission could consider, instead of a minimum investment ownership requirement, a cap, expressed as a percentage of net worth, on the amount of a natural person's investment in any one private offering. This limitation could easily be added to the subsections of Rule 501 that apply to natural persons, and would be easy for issuers to administer. Institutional investors and experienced personal investment advisers already employ comparable limitations as prudential safeguards.[31]

Complexities of the Accredited Natural Person Proposal

We note that the proposal also has unnecessary complexities. For example, the proposed investment ownership requirement is very similar to the familiar investment ownership test that is presently employed for purposes of the definition of a Qualified Purchaser, but the proposed rules' definition of "investment" and valuation with respect to spousal assets are actually quite different.[32] Given time, we believe it is almost a certainty that the similarity will result in mistakes by investors and Fund managers which, though made in good faith, may result in a potential violation of the securities laws, and the issuer's loss of the exclusion from coverage of the Securities Act and Company Act. In addition, requiring the minimum investment ownership amount to be periodically adjusted for inflation is unduly complex and a burden that will require fund managers to revise the questionnaires that they use to screen investors with new and confusing

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30 We note that the Commission's Office of Economic Analysis estimated the number of households that would qualify as "accredited investors" if the proposal were adopted as it stands. The Commission should publish any estimate by OEA of the number of households that would qualify as "accredited investors" if the Commission simply raised the income and net worth tests to these levels (excluding, of course, the values of homes and places of business).

31 For example, pursuant to its investment policies, the California Public Employees' Retirement System (CalPERS) limits investments in hedge funds to a percentage of the funds that it allocates for investment in given asset categories. *See* CalPERS *Statement of Investment Policy for Hybrid and Hedge Fund Investment Vehicles – Externally Managed* (Feb. 18, 2003) *available at* http://www.calpers.ca.gov/eip-docs/investments/policies/alternative/hyb-hed-fun-inv-vhs-ex-mn.pdf.

32 See, *supra at n. 19.*

questions -- especially if the Commission retains the proposal to define "investments" one way for an existing named category of investor and a second way for the new named category of investor.

As Commissioner Atkins noted at the Commission meeting announcing its proposed new "accredited natural person" category, there is already a confusing number of defined categories that are meant to serve the same purpose: describing investors with a high degree of sophistication and the financial wherewithal to withstand a greater degree of risk. The proliferation of different categories and tests of wealth has become overwhelming, and now results in subscription agreements that confuse and irk investors.

As part of an overall review of this area, the Commission should consider paring back on the Byzantine complexity of the current set of similar and overlapping, yet different investor qualification standards that apply under the federal securities laws. The objective should be to reduce transactions costs and thereby improve economic efficiency while maintaining investor protections. The Commodity Futures Trading Commission has already made significant strides in this regard by aligning certain of its commodity pool exemption rules with SEC Rules. We recommend that the Commission maintain these investor qualification standards in a simple and relatively uniform fashion.[33]

For Further Consideration: Revise Form D

To the extent the Commission is focusing on the standards for investors in Regulation D offerings, it may wish to consider revisions to Form D itself, to provide the Commission and other Federal regulators with some of the critical "census" data it has

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[33] If the Commission moves forward on its current rulemaking, we also recommend that the Commission recognize the knowledgeable employees of an issuer as accredited investors (similar to the approach of Rule 3c-5 under the Company Act, 17 C.FR. § 270.3c-5) without resort to net worth or income tests. Such employees, due to their positions with the issuer, have sufficient knowledge as to the operations and status of the issuer to provide them with the requisite degree of sophistication as to the nature of the investment. We also recommend that a "grandfather clause" be included in any revisions to the accredited investor standards adopted pursuant to this proposal. Without such a provision, managers will be required to re-analyze the financial status of current investors in order to ascertain whether they may place new sums where they are already investors. Such re-reviews would yield no significant investor protections. In addition, we suggest the Commission amend its regulations to provide that a "Qualified Institutional Buyer" (as defined in Rule 144A, 17 C.F.R. §230.144A) falls within the definition of a "Qualified Purchaser" in Section 2(a)(51)(A) of the Company Act. 15 U.S.C. § 80a-2(a)(51)(A).

said that it lacks with respect to pooled investment vehicles that invest in securities. The *Goldstein* Court struck down a registration rule that was meant to provide the SEC with census data regarding hedge funds and their advisers, and to provide hedge fund investors with a certain degree of protection through SEC oversight and inspections.[34] Comments filed in connection with the Commission's adviser registration proposal argued at the time that the Commission could achieve its interest in obtaining census and other data without resorting to a full-blown registration rule.[35] The SEC can no longer obtain this information through a registration requirement, unless Congress provides appropriate authority.

We do not believe legislation in this area is the only choice, and we would not recommend it when other alternatives are available. As an example, the Commission could consider the utility of modernizing the filing requirements associated with Regulation D offerings so that the filings yield census information regarding pooled investment vehicles that offer securities using Form D.[36] As a coalition of private investment companies, we do not take a position on whether the Commission needs this information on issuers other than pooled investment vehicles. However, if it chooses to address the lack of information on Form D filers noted in the Release, the Commission could consider revising Form D to require the submission and periodic updating of information from all pooled investment vehicles[37] utilizing Form D, such as the following (much of which is already required on Form D):

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34 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,266 69 Fed. Reg. 45,172 (July 28, 2004).

35 For example, comments filed by Kynikos Associates LP, recommended that the SEC, by rule, make the safe harbor counting rule utilized by hedge fund managers under SEC Rules 203(b)(3)-1 and 222-2 under the Advisers Act, which implement the counting rules of Sections 203(b)(3) and 203A of that Act, contingent upon written receipt by the SEC of certain basic census information about the fund, as well as certification by the fund's managers of certain key investor protections in the Advisers Act and related SEC rules. *See* Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) *available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf).

36 Of course, pooled investment vehicles also may be offered pursuant to Section 4(2) of the Securities Act and not pursuant to Regulation D.

37 The Coalition would note that the Commission may also wish to consider improving the information available generally from all issuers utilizing Form D, but for the purposes of this letter, we confine our recommendations to pooled investment vehicles.

- The name and address of the issuer, its legal form and its date and jurisdiction of formation;
- The names of senior management and control persons;
- The types of securities being issued;
- The issuer's prior names (if any);
- The States where the issuer's investors are located;
- The number of investors and amounts of their investments in each state;
- The issuer's disciplinary history under state and federal securities laws and regulations; and
- The payment of any referral or placement fees, together with the identities of placement agents that are paid to offer and sell interests in the issuer, and whether such placement agents are registered broker-dealers.

For pooled investment vehicles in particular, we believe the following additional information would be useful to the Commission and investors:

- The identities of the Fund's manager, custodians, and independent auditors;
- The Fund's fee structure and expense information;
- The Fund's assets under management;
- The Fund's general categories of investment strategies and assets;
- Information as to any exemptions that the Fund relies upon under the Company Act and/or Commodity Exchange Act; and
- The Fund's policies as to the use of "soft dollars" and brokerage allocations.

This basic census data could be supplied through a modified, web-based version of Form D that could be shared with other appropriate regulatory authorities, such as the members of the President's Working Group on Financial Markets, state securities regulators, the National Association of Securities Dealers and the National Futures Association. Because this enhanced Form D information would be available to state regulators, the SEC could also take action on its long-stalled rulemaking relating to preemption of state law for sales of securities to qualified purchasers, as mandated by the

1996 National Securities Market Improvement Act ("NSMIA").[38] We offer these ideas for the Commission's consideration only to the extent it believes it currently has insufficient census data. We encourage the Commission to work with investors and the industry to find reasonable means to achieve its policy goals.

Proposed New Rule 206(4)-8

Proposed new Rule 206(4)-8 under the Advisers Act would prohibit investment advisers, whether or not they are required to be registered, from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles. As noted earlier in this letter, this proposed rule is intended to clarify the Commission's authority under the Advisers Act to protect investors and potential investors in pooled investment vehicles in light of any potential ambiguity caused by the *Goldstein* decision.[39] The Commission has stated that it believes the *Goldstein* opinion could be read to support an argument that the anti-fraud provisions of the Advisers Act in subsections (1) and (2) of Section 206, which prohibit advisers from defrauding "clients," do not apply to investors in pooled investment vehicles. The Commission, therefore, proposes a new antifraud rule using its rulemaking authority under Subsection 206(4), which gives the Commission rulemaking authority to "prescribe means reasonably designed to prevent . . . acts, practices or courses of business that are fraudulent, deceptive or manipulative" by any investment adviser.

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38 As amended by NSMIA, Section 18 of the Securities Act preempts state registration and review of offers or sales of securities to qualified purchasers "as defined by the Commission by rule." Securities Act § 18(b)(3); 15 U.S.C. § 77r(b)(3). The Commission proposed a rule to define the term "qualified purchaser" for this purpose in December 2001 but has never acted upon it, due in part to objections by state regulators. Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Release No. 33-8041, 66 Fed. Reg. 66,839 (Dec. 27, 2001); *see* Comments of Joseph P. Borg, President and Director, Alabama Securities Commission, on behalf of the North American Securities Administrators Association, Inc. (Mar. 4, 2002), available at http://www.sec.gov/rules/proposed/S72301/borg1.htm.

39 The Court in *Goldstein* considered the meaning of the term "client" for purposes of Section 203 of the Advisers Act (15 U.S.C. § 80b-3) which, in relevant part, exempts from registration under the Advisers Act any adviser who has fewer than fifteen clients. The court rejected the Commission's argument that the "clients" of an investment adviser managing a pooled investment vehicle are individual investors in the pool. 451 F.3d at 878-84.

The proposed new rule would apply to all investment advisers as defined in the Advisers Act, whether or not they are required to be registered,[40] but it would not apply to those financial managers that the Advisers Act specifically excludes from the definition of "investment adviser," such as banks or trust companies. We believe that the coverage of the proposed rule in this regard is appropriate, and we support adoption of the rule. Even if they are exempt from registration, investment advisers should be subject to this prohibition against abusive conduct.

Additional Observations on the Commission's Authority under Section 206

In addition to our support for the proposed new antifraud rule, CPIC wishes to offer further comments on the nature of the Commission's authority under Section 206. We offer these comments in light of the threat of action by individual states who may believe there is an investor protection gap at the federal level[41] and also in response to suggestions that the only way to address that gap is through federal legislation, empowering the Commission to register hedge fund advisers. We think neither action is necessary at this time.

As the Commission notes in the Release, Congress amended the Advisers Act in 1960 to make the antifraud provisions applicable to all investment advisers, whether registered or not, and to give the Commission express rulemaking authority over unregistered advisers in subsection 206(4).[42] Using this authority -- to "prescribe means reasonably designed to prevent" fraudulent and deceptive acts, practices or courses of business[43] -- the Commission may write rules for the prevention of fraud without resort to creation of a registration regime. For example, the Commission has the power to promulgate minimum protections for hedge fund investors -- protections that are "best

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40 72 Fed. Reg. at 401.

41 *See, e.g.*, S.B. No. 1171, 2007 Leg., Jan. Sess. (Conn. 2007)("An Act Concerning Hedge Funds").

42 Pub. L. No. 86-750, §9, 74 Stat. 885 (1960).

43 The statutory provision on which the Commission relies as authority for its proposed new antifraud rule states: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6.

practices" for any reputable hedge fund manager and which reduce the opportunities for unscrupulous managers to abscond with investor funds or defraud investors with misvaluations.[44] While proposed new Rule 206(4)-8 will allow the Commission to bring after-the-fact enforcement actions in cases of fraud by unregistered (as well as registered) advisers, an approach in which the Commission prescribes minimum practices as means reasonably designed to prevent fraud could have a significant investor protection impact.

The Commission has used this authority in the past to write prophylactic rules applicable to unregistered, as well as registered, investment advisers. For example, in 1962, the Commission issued Rule 206(4)-2 which, in a previous form, stipulated that it was a fraudulent, deceptive or manipulative act, practice or course of business under Section 206(4) of the Advisers Act for an investment adviser who had custody or possession of client funds or securities to take any action with respect to such funds or assets unless the securities were segregated and kept in a safe place, funds were deposited at a bank, periodic account statements were provided to clients, and the funds and securities were subject to surprise examination by an independent accountant.[45] Other rules promulgated pursuant to Section 206(4) that once applied to all investment advisers, whether registered with the Commission or not, were prohibitions on certain abusive advertising practices (Rule 206(4)-1),[46] and requirements to disclose information relating to an adviser's disciplinary history and financial condition (Rule 206(4)-4).[47]

In 1997, however, the Commission decided to confine the application of these rules to SEC-registered investment advisers. As the Commission explains in the Release, it removed unregistered advisers from the coverage of these rules in order to correspond to amendments to the Advisers Act by Title III of NSMIA (the "Investment Advisers

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44 *See e.g.* SEC v. Samuel Israel III, SEC Litigation Release No. 19,406, 2005 WL 2397234 (Sept. 29, 2005) (managers of a group of hedge funds known as the Bayou Funds grossly exaggerated claims regarding funds' performance, when in fact, the funds had never posted a year-end profit, and misappropriated funds); SEC v. Haligiannis, SEC Litigation Release No. 18,853, 2004 WL 1908196 (Aug. 25, 2004) (fund and its general partners systematically defrauded investors by misrepresenting performance to investors and potential investors and distributing phony account statements that showed fictitious gains and account balances).

45 17 C.F.R. § 275.206(4)-2; *Custody or Possession of Funds or Securities of Clients,* Release No. 40IA-123 Fed. Reg. 2,149 (Mar. 6, 1962).

46 17 C.F.R. § 275.206(4)-1 (1996).

47 17 C.F.R. § 275.206(4)-4 (1996).

Supervision Coordination Act"),[48] which, in brief, delegated the responsibility for regulating smaller advisers to state securities authorities. The Commission took this action as a matter of comity with the states, notwithstanding the fact that Congress intended that the Commission would continue to apply its general antifraud authority under Section 206 to state-registered advisers.[49]

We understand that the Commission must be cognizant of the scope of its statutory authority, as well as its policy of coordination with State regulators. Nonetheless, because Section 203 of the Advisers Act exempts investment advisers with fewer than fifteen clients from registration, an investment adviser with a small number of clients (including pooled investment vehicles) that manages large amounts of investor assets could, depending on the requirements of applicable state law, operate without being subject to the minimal types of investor protections that laws such as the Advisers Act might otherwise afford.[50] Thus, it may be appropriate for the Commission to examine the extent to which investors in private investment pools are not protected by federal or state requirements and whether the industry cannot, on its own, adopt best practices in critical areas. The Commission could then consider whether it should exercise its rulemaking authority under Section 206(4) of the Advisers Act and apply certain base-level requirements to advisers of funds who are not registered under state or federal law, or who manage (or purport to manage) over $25 million in private investment funds.

For example, any investment adviser to a pooled investment vehicle should hold the assets that they control at, and make transfers of such assets only through, a bank or trust company, broker-dealer, futures commission merchant, or certain well-regulated foreign banks and broker-dealers. Placing custody of fund assets with a bank, trust company or broker-dealer is a sound practice that is currently required of investment

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48 72 Fed. Reg. at 402. *See also* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28,112 (May 22, 1997).

49 72 Fed. Reg. at 402 n.17 (citing S. Rep. No. 293, 104th Cong., 2d Sess. 3-4 (1996) at 4). *See also* 62 Fed. Reg. at 28,128, n.172, Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1601, 61 Fed. Reg. 68,480, 68,481 (Dec. 27, 1996).

50 Specifically, Section 203 exempts from registration any investment adviser who during any twelve-month period has fewer than fifteen clients and that does not holds itself out to the public as an investment adviser or act as an adviser to any mutual fund. 15 U.S.C. § 80b-3.

advisers that are registered or required to be registered under the Advisers Act.[51] Such a custody requirement should not impose any undue regulatory burdens. It is simply reflects good practice by any reputable adviser to a pooled investment vehicle.

Similarly, using its antifraud rulemaking authority, the Commission could consider extending to such unregistered advisers certain of the key investor protections that presently apply only to investment advisers that are registered or required to be registered with the Commission. As with the custody rule, some of these requirements were previously applied, in some fashion, to advisers that are not registered with the Commission. More importantly, they are fundamentally sound ways of doing business that would not impose substantial burdens on legitimate private investment funds or their advisers. These include:

- Requiring private investment pools -- whether or not their advisers are required to register with the Commission -- to undergo an annual audit by an independent accounting firm and to provide their investors with audited financial statements on a yearly basis, and un-audited financial reports on a quarterly basis.[52] Such requirements would serve to detect and deter fraud and would give investors assurance that the financial information that they receive from a Fund is fair and accurate.

- Requiring that prospective fund investors receive information relating to the adviser's disciplinary history and financial condition, similar to the disclosures required by Rule 206(4)-4.[53]

- Requiring advisers, whether or not registered, to adopt and disclose written supervisory and compliance policies and procedures and codes of ethics.[54] Such policies and procedures, at a minimum, would address the disclosure of financial arrangements between advisers and other interested parties such as prime brokers, the disclosure of an adviser's allocation policies so investors know how an adviser with multiple clients allocates investment opportunities,

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51 Advisers Act Rule 206(4)-2; 17 C.F.R. § 275.206(4)-2.

52 *See* id.

53 17 C.F.R. § 275.206(4)-4.

54 *See* Rules 204A-1, 206(4)-7; 17 C.F.R. §§ 275.204A-1, 275.206(4)-7.

and disclosure of objective standards for the calculation of unit values for investor reports, fees, admissions and withdrawals.[55]

The requirements generally discussed above would be non-intrusive, consistent with best practices and impose little or no burden on advisers. However, because they depart from the proposed rule, they should be considered and proposed only after additional input from investors, the hedge fund industry, and others and in connection with a concept release or a new SEC rulemaking.

Broader Issues for Regulators and Policy Makers

When CPIC testified before Congress last year, we identified a number of issues for legitimate focus and review by Congress and financial regulators. Certain investor protection issues, such as the issues discussed in this letter, are best addressed by the Commission, acting pursuant to its statutory authority. Others, such as systemic risk, are best addressed through coordinated review and consultation of members of the President's Working Group on Financial Markets, of which the Commission is a member. In this regard, we were encouraged to review the recent report by the Working Group on Private Pools of Capital, which identified a number of standards and practices for all market participants -- including private pools of capital, pool investors and fiduciaries, counterparties and creditors -- as well as regulators and supervisors.

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55 *See generally* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003). We do not suggest that all the rules that apply to investment advisers that are registered or required to be registered with the Commission should be extended to hedge fund managers. Rather, the Commission should consider select protections that would help prevent flagrant or criminal misconduct, such as theft. To illustrate, we believe that hedge fund advisers should not have to adopt and disclose proxy voting policies, as do investment advisers that are registered or required to be registered. Rule 206(4)-6; 17 C.F.R. § 275.206(4)-6. This requirement does not serve the purpose of preventing flagrant misconduct, and if investors in private placements care for such information, they may always ask for it.

Conclusion

We thank the Commission for this opportunity to provide our thoughts with respect to this latest of its continuing efforts to protect investors within a framework of flexible regulation. We urge the Commission to carefully consider the options presented in these comments, and we would be happy to discuss them with the Commission at any time.

Sincerely,

James Chanos
Chairman

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable Kathleen L. Casey, Commissioner
Andrew J. Donohue, Director, Division of Investment Management

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM RITA M. BOLGER

Q.1. What recourse do investors have today to take action if they are frustrated about what they see as a lack of diligence on your part in reviewing information that is used in determining your ratings?

A.1. Investors have ample opportunity to influence the rules under which NRSROs like S&P operate as regulated entities under the Credit Rating Agency Reform Act of 2006. That Act provides the Securities and Exchange Commission—acting on behalf of investors—with authority to require NRSROs to adhere to their established procedures and methodologies for assigning credit ratings, and otherwise to comply with a comprehensive set of SEC rules, including new rules that became effective just this month. Moreover, as part of this comprehensive regulatory regime, the Commission has powerful tools at its disposal, including the ability to subject NRSROs to rigorous examinations and to impose fines and other sanctions, including revocation of our status as an approved NRSRO.

It is also worth noting that numerous private law suits that relate to our ratings have been filed on behalf of investors against S&P. In numerous cases currently pending across the nation, investors are asserting legal claims against S&P under Section 10(b) of the Securities Exchange Act of 1934; Sections 11, 12 and 15 of the Securities Act of 1933; the ERISA laws; and common law principles sounding in negligence, negligent misrepresentation, breach of fiduciary duty, fraud, breach of contract and aiding and abetting the alleged misconduct of others. Additionally, legal claims have been made by the State of Connecticut for alleged breach of that State's consumer protection statute. Investors have also filed complaints with Attorneys General of various states who have considered and in some cases commenced investigations relating to alleged misconduct by S&P.

On the specific issue of the quality of information that is used to determine ratings, S&P has recently taken steps to address data quality issues with respect to U.S. RMBS by strengthening our criteria to take account of the due diligence procedures employed by RMBS issuers and their agents, and other criteria enhancements relating to the originators and sellers of securitized loans. These steps were taken following discussions with both investors and issuers. However, S&P does not, and cannot, practically audit the information we receive from corporations, governmental entities, structured finance issuers and others in our credit rating process. The market has not traditionally looked to S&P to assume this role and it would simply not be feasible for us to do so, given the extent of debt issued in this country and around the world.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM DANIEL CURRY

Q.1. What recourse do investors have today to take action if they are frustrated about what they see as a lack of diligence on your part in reviewing information that is used in determining your ratings?

A.1. The answer to this question depends the reason for the investors' frustration and the nature of the perceived lack of diligence.

Frustration that derives from a misapprehension about the nature of credit ratings or the role of credit rating agencies is best addressed by educating investors. Credit ratings are opinions that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation. Ratings for structured finance vehicles reflect an opinion on the ability of the pooled assets to fund repayment to investors according to each security's priority of payments. Credit ratings are not buy, sell or hold recommendations, and they do not address the market price or trading liquidity risk of a security.

Credit rating agencies base their ratings opinions on quantitative and qualitative analyses of information the rating agencies receive from issuers, obligors or arrangers. Although rating agencies believe the information they use is accurate and reliable, the agencies do not audit or verify that information. In other words, credit rating agencies are not auditors.

DBRS makes a concerted effort to educate investors about the nature of credit ratings and the limitations on using ratings to make investment decisions. In this regard, DBRS posts a plain-English discussion of this topic under the Rating Policies section of its public Web site [*www.dbrs.com*]. DBRS also clearly discloses the fact that it does not verify or audit the information it relies on in formulating its credit ratings. In addition, DBRS publishes its Information Review Policy, which describes the measures the firm has adopted to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating.

The primary recourse for an investor who is frustrated by the nature of credit ratings or the function of credit rating agencies is to avoid overrelying on credit ratings in making investment decisions. Admittedly, this is easier to do in the corporate market, where investors have access to ample information on which to base their investment decisions, than it is in the structured finance market, where such public information can be hard to come by. For this reason, DBRS has urged the Securities and Exchange Commission (SEC) to take steps, such as amending Regulation AB, to require issuers and arrangers to provide investors with more information about the structure or underlying assets of securitized products.

Competition among rating agencies provides another avenue of recourse for an investor frustrated with a particular agency's behavior. There are currently ten registered Nationally Recognized Statistical Rating Organizations (NRSROs), each of whom is required to make information about its ratings policies and performance available to the public. DBRS strongly believes that maintaining a transparent and competitive credit ratings market allows investors to assess the sufficiency of rating agencies' respective procedures and to select the agencies they feel produce the highest quality credit ratings.

Another avenue of recourse involves the SEC. Investors whose frustration derives from a belief that a rating agency is not following its stated policies regarding the review of information can lodge a complaint about the rating agency with the SEC. Although

the Credit Rating Agency Reform Act of 2006 does not provide a private right of action, it does empower the SEC to take action against an NRSRO that issues credit ratings in material contravention of the NRSRO's published procedures.

Finally, if a rating agency's conduct involves fraud, recklessness or the violation of certain securities laws and rules, a frustrated investor has recourse to the courts.

We hope that this information assists you in your examination of investor protection and the regulation of the securities markets. DBRS would be pleased to answer any additional questions you may have in this area.