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REGULATORY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS, PART I

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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REGULATORY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS, PART I

Wednesday, July 22, 2009

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

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Maloney, Watt, Sherman, Moore of Kansas, Capuano, Baca, Lynch, Miller of North Carolina, Green, Cleaver, Moore of Wisconsin, Klein, Wilson, Perlmutter, Foster, Carson, Speier, Minnick, Driehaus, Kosmas, Himes; Bachus, Castle, Royce, Lucas, Biggert, Miller of California, Capito, Hensarling, Garrett, Neugebauer, McHenry, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will begin. We are very happy today to have before us two Presidential appointees who head important agencies: the Chair of the SEC, Mary Schapiro; and the Chair of the Commodity Futures Trading Commission, Gary Gensler. I want to begin by saying I am very happy that both agency heads are here. I strongly believe that if we were starting from scratch, we would not have two separate agencies, with the extent to which they share a mission. But we do have the two separate agencies. There is no point in wasting energy in trying to consolidate them when there would be no chance of that happening. I am encouraged by the fact that the two Chairs here today have, from the beginning of their appointment, worked closely together to try and avoid friction.

I have to say that in my view, jurisdictional fights—whether between congressional committees or among congressional committees or between or among Federal agencies—represent Washington at our worst, because the job getting done well ought to be the issue. And people who insist that—people's egos get too tied up with their positions. We are working hard to avoid that. I have also been working closely with Chairman Peterson of the Agriculture Committee because there is a shared jurisdiction here. And we have come to a very good agreement on substance. We had the hearing a week ago with the Secretary of the Treasury an unusual hearing with two major full committees. We intend to keep doing this. There will be some disagreements I believe at the edges—I am

reluctant to say margins here because it will get too doubly interpreted—but at the edges, there may be some disagreements.

They clearly are outweighed by the substantial agreement that we have. So one of the questions will be on derivatives. Another will be in our jurisdiction which, we should be clear, is primarily the SEC. I appreciate the fact that Mr. Gensler is here. This committee is not the committee of jurisdiction for him.

Mr. Peterson, in the spirit of cooperation, understands that. If Mr. Peterson would ask Chair Schapiro to appear before Agriculture, I don't know if you have yet, but we would encourage that as well, because we don't want these jurisdictional issues to be there. With regard to derivatives, I will tell you the conceptual approach that Mr. Peterson and I have taken, Mr. Peterson's committee has the jurisdiction over those for whom hedging is a part of their business. That is, the Agriculture Committee are more the end users of this who have a product to sell and who hedge because they want to deal with price volatility. Our jurisdiction is more over the people who do some of the hedging and are in the financial area.

The concept, it seems to me, we ought to be guided by here is what we ought to be thinking about with the financial institution in general. Their role is to be intermediaries, not to be ends in and of themselves. When there is a breakdown in the financial sector, we call it disintermediation. Their job is to be a very important, I was going to say bridge, but bridge understates the creativity involved. There is nothing passive about their role, but their job is to link up essentially people in the end of the economy who are producing goods and services of value and the people with money to invest in them. Their job is to help us in this society agglomerate investment funds so that they are made available to the end users.

Obviously, people aren't going to do that unless they make a profit off it. That is a very important and sometimes complex business. People aren't going to make their money available unless they make a profit. But I do think that over the past couple of decades, there are some examples in the financial sector of the means becoming the ends. We have had people tell us that we should not restrict or regulate this or that because then certain entities would not be able to make money. Yes, it is important that they make money as a by-product of the intermediation function they perform. The fact that a given institution won't make money is, in itself, no reason to be opposed to this. And, in fact, activities whose major justification is that they make a profit for some entity unconnected to that intermediation function are not going to be well received by us.

I will now add, finally, this is not just about derivatives, we have other issues, this committee has been very interested in the whole question of mark-to-market. The gentleman from Pennsylvania has played a major role there. And there is also continued interest in the question of short sale and corporate governance. I will say that two of our members, the gentleman from California, Mr. Campbell, and the gentleman from Michigan, Mr. Peters, in a bipartisan way, have a great interest in corporate governance issues. And I expect the committee will turn to them this fall after we have done some of the major regulatory stuff. But both of those issues are, particu-

larly the short sale and the mark-to-market, are going to be before us today. The gentleman from New Jersey is recognized for 3 minutes.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you, members of the panel. Today's hearing is on the President's financial regulatory reform proposals. You know, your agencies oversee some of the most transparent, efficient, and complex markets in the world that are also responsible for ensuring that our capital markets promote price discovery, capital formation, and investor protection.

Now, the Administration's reform proposals task the SEC and the CFTC with developing a regulatory infrastructure for over-the-counter derivatives and reporting to Congress by September 30th on how the agencies will harmonize two very disparate regulatory approaches. So I look forward to hearing from you to see how well those are coming together and where some of your sticking points are going to be, if there are some, I think there will, and whether you will be able to meet that deadline. You know, with regard to the Administration's proposals, I agree with some of them. I think it is evenhanded and certainly less radical than other ideas that have been proposed so far in Congress.

Still, there are some aspects of the Administration's proposals that trouble me. And I am worried that in the name of systemic risk reduction, requirements that would force more OTC transactions into central clearinghouses or onto exchanges, as well as strident new margin requirements for both centrally cleared and noncentrally cleared transactions will make hedging just too expensive for many end users of derivatives throughout the broader economy. The perverse outcome, therefore, of efforts to reduce systemic risk in these markets can actually increase risk for many companies if they are no longer able to cost effectively engage in a comprehensive risk management practice.

So if you take a step back for a moment, perhaps an even more fundamental question should be asked here: Were standardized derivatives significantly related to the recent meltdown of our financial markets, and if not, why are we prescribing cures for a nonexistent ailment? You know, the failed oversight of one large dealer directly related to broader regulatory failures in the housing finance markets should not cause us to pursue radical fixes for the broader OTC derivative markets and their nondealers participants that had little or really nothing to do with the recent crisis.

What we do need is comprehensive regulatory reform, but it needs to be sensible and we need to make sure that we are addressing actual problems in the way that we are doing it and not causing more harm than good. The risk of mobile capital migrating elsewhere as we overshoot the mark in regulatory reform, I think, is a real one and we should take the time to carefully evaluate the proposals presented to us before we move ahead with legislation.

So once again, thank you both for coming to the panel today, thanks to the people who have been here numerous times in the past as well. Thank you.

The CHAIRMAN. Let me just, to balance, because we have the time, I call on the gentleman from Texas for 1 minute, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I appreciate the witnesses providing us with their views on the Administration's regulatory proposals as well as an update on their efforts to find more harmonization between futures and securities regulation. While there are differences in the products in marketplaces, there is quite a bit of overlap in regulation. One concern I have heard from those with products that fall under both regulators is the length of time it takes to get new products approved in the process for determining whether the product falls under the CFTC or the SEC. We all want our proper transparency and disclosure but we also need the regulatory process to be effective. I am also interested in hearing from Chairman Gensler about the upcoming hearings at the CFTC regarding hedge exemptions and positional limits in energy futures. We have had quite a bit of discussion on this issue in the Agriculture Committee over the past couple of years and added new authorities for the CFTC in the 2008 farm bill.

As the CFTC weighs options, we must maintain efficient price discovery and open market and keep the United States competitive. As we continue to work through these issues, we must remember that government regulations can't substitute for the due diligence for investors and other market participants.

The CHAIRMAN. The gentleman from Pennsylvania, the Chair of the Subcommittee on Capital Markets, Mr. Kanjorski, for 3 minutes.

Mr. KANJORSKI. Thank you very much, Mr. Chairman. Among other matters this morning we will address the need for effective regulatory oversight of the over-the-counter derivatives market estimated at $500 trillion in notional value. These reforms are long overdue. Fifteen years ago, I first advocated for increased regulation of our derivatives market. When I helped to introduce the Derivative Safety and Soundness Supervision Act, we sought to enhance the supervision of derivatives activities of financial institutions. Since then, I have endorsed other legislation aimed at improving transparency in and enhancing the oversight of our derivatives markets. Our witnesses today, SEC Chairman Mary Schapiro and CFTC Chairman Gary Gensler, have an important task before them. They must reposition their agencies to better respond to the crises of today and the problems of tomorrow.

Fortunately, both of these leaders come equipped with extensive experience and a commitment to effective regulation. While this crisis also seems to me the ideal time to merge these two agencies, political judgments have led us down a different path. Thankfully, however, the two seem determined to work together constructively rather than battle over jurisdictional turf. These two Chairmen are working within the Obama Administration which will soon release legislative language on derivatives reform and with Congress can help to create a more transparent, safer, and less risky over-the-counter derivatives market. To increase investor protection and market confidence, we must make this reform effort a top priority.

Most fair-minded observers have acknowledged that unregulated derivatives, such as the credit default swaps, played a significant role in contributing to our present financial crisis. AIG's disastrous abuse of these potentially explosive financial instruments represents the most glaring example of the dangers to our system

posed by derivatives. By moving forward, we should remain sensitive to the highly varied nature of derivatives products. Derivatives that consist of highly accustomed contracts which thousands of nonfinancial businesses, both large and small, employed to managed risk simply do not easily fit within the mandatory clearing and exchange trading regime. By mandating the collection of certain data on such contracts in a repository even where they cannot be cleared, we can achieve transparency and access for regulators in the hope that we can detect warning signs of systemically risky transactions. And by requiring increased capital reserves for those who enter into unique derivatives contracts, we can also provide incentives for markets to standardize these complex financial products going forward.

In closing, Chairman Schapiro and Chairman Gensler can help Congress to sensibly regulate this dark corner of our financial markets. I look forward to their testimony.

The CHAIRMAN. The gentleman from Delaware, Mr. Castle—

Mr. CASTLE. Thank you, Mr. Chairman.

The CHAIRMAN. —for 1 minute.

Mr. CASTLE. I appreciate this opportunity to further explore the Administration's regulatory reform proposal, particularly looking at securities and futures related reforms in particular. A lot has been said about derivatives; currency derivatives, interest rate derivatives, and the like. And I will be interested to hear what the witnesses have to say about the over-the-counter trades and cleared and exchanged trades of derivatives. All of these are issues before this committee and the organizations our witnesses represent. Although I believe registering hedge funds and reforming credit ratings are integral pieces of financial reform, I maintain that we must fully vet the consequences of the entire proposed regulatory reform plan. I hope to hear from the witnesses today about their views on the reform proposal and areas that may need some improvement.

In particular, I am curious to know if you believe that there will still be gaps in regulation between agencies, if investors will be protected as expected, and whether the SEC and the CFTC will have the resources necessary to carry out the requirements proposed under these reforms. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman. Why has the SEC in the course of the past dozen years experienced catastrophic failures in every one of its four core competencies: rule making; filing review; enforcement; and examinations? This was the question raised by former SEC Commissioner Paul Atkins recently. And I think it is a tough question that needs answering prior to giving additional authority to the SEC. Mr. Atkins goes on to note that Enron's corporate filings were not reviewed for years in the late 1990's, enforcement examinations tips were not pursued on Bernie Madoff, and again, potentially in the Allen Stanford fraud case.

In rule making, the Commission proposed in December of 1997, and again in April of 2005, regulations regarding credit rating agencies, but never adopted any of those. According to former SEC Chairman Harvey Pitt, the enforcement examination failures in the

Bernie Madoff case may have been the result of the SEC developing a blind spot because it is overlawyered and lacked the necessary traders, managers, and veterans of the market. This is certainly also the view of Harry Markopolos who, for years, tried to bring this Ponzi scheme to the attention of the SEC. Before increasing the SEC's regulatory authority, I hope we can get to the bottom of these series of failures. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California, Mr. Sherman, for 1½ minutes.

Mr. SHERMAN. Mr. Chairman, thank you for holding this series of hearings on the Obama Administration's White Paper. At yesterday's hearing, I relied on secondary sources to agree with a witness that the resolution authority set forth in the White Paper involved a permanent unlimited bailout authority. In fact, page 77, paragraph 2, of the White Paper, does support that witness' conclusion in large part because the Treasury has been so bold in interpreting whatever statutory authority we give them. Secretary Paulson boasted that he went far beyond any authority.

And of course, the bill has been used to bail out auto companies and to recycle funds, both real stretches of the statute. So the onus is on us to draft a statute that cannot be stretched or manipulated by any Treasury no matter how bold. And it is especially, the onus is on us to make sure that any bill we pass does not provide a permanent bailout authority. Whether that is a fair reading of what the Obama Administration wants or not, it is certainly not what the people of this country expect us to do. So I look forward to revisiting the Chairman's statements that sometimes duplication is better than ambiguity, and in this case, I may argue for triplication. I yield back.

The CHAIRMAN. If the gentleman will yield, we will be glad to do that at a hearing at which that is the subject, which is not today. The gentlewoman from Illinois is recognized for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. Thank you for holding today's hearing. And welcome, Chairman Schapiro and Chairman Gensler. I am very interested in the Administration's evolving ideas regarding regulatory reform. I am interested in hearing from you all today about the discussions with the Administration about OTC derivatives clearing and reporting. How will the Administration define standardized and customized OTC derivatives? Will new rules include trigger mechanisms that will mandate that OTC products be electronically traded, cleared or reported to a central database for review. Which firms or trading will fall into these three buckets?

I think I want to hear your views on the recently House-passed cap and trade bill, which includes a transaction tax. Taxing transactions to raise Federal revenues for more spending or creating an unnecessary burdensome regulatory environment may force U.S. businesses and jobs to move overseas. Our economy can't afford it. I also look forward to you addressing concerns about the SEC-CFTC regulatory harmonization, specifically concerns about the inefficiencies of the SEC's rule-based approach to regulation.

My fear, which I think is shared by many in Chicago, is that an effort to harmonize regulations between the SEC and the CFTC may slow down market innovations and give international competi-

tors an unfair advantage. It is crucial that we strike the right balance, not overreact and fashion sound regulation to address the deficiencies in the current regulatory environment. With that, I yield back.

The CHAIRMAN. The gentleman from California, Mr. Miller, for 1 minute.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. In recent months, it has become increasingly clear that accounting policy has tremendous impacts on the credit markets which are experiencing recovery efforts by the financial stability plan. Specifically, the issue of mark-to-market has not been adequately addressed. In fact, private market activities, lending and investing, as well as recovery efforts, remain hamstrung by pricing challenges while the accounting policymakers have been willing to or are unable to offer the necessary guidance.

The TALF program is an example. Under TALF, assets that investors owned that were placed as collateral are held in non-mark-to-market accounts to shield the investors from the exposure. To me, this indicates the problem with the current pricing regime and accounting policymakers' ability to address the issues in a meaningful manner. More recently, FAS has made changes to the accounting standards that will have a tremendous impact on securitization known as FAS 166 and 167. These enormous changes are occurring at the same time that the Administration is trying to restart the securitized credit markets to facilitate private lending.

It is our understanding that the Federal Reserve has serious concerns with the policy shift that will derail efforts to stabilize financial institutions and get credit flowing. Why is there a disconnect between policymakers who own significant issues at a time when we are experiencing extraordinary economic circumstances. There is tremendous challenge facing the $6 billion—okay, I guess my time is over. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts is recognized for 1½ minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank our panelists. I appreciate the frequency of these hearings to try to get a sense of the Administration's White Paper on regulatory reform. I would like to hear from the panelists during their testimony about the issue of these complex derivatives being traded over-the-counter. I still believe, in spite of the Administration's position, we have a big payday problem with the major banks, so I think a lot of money is going to gravitate to the OTC version of these things. There is no exchange, so we don't have a consistent valuing mechanism in place. And I just think that the complexity here is incentivized under the President's proposal.

I raised these issues with Secretary Geithner in the meetings that the chairman has arranged, but I still don't think the protections are there. So I would like to hear the answer to that in your testimony. And I yield back the balance of my time. Thank you.

The CHAIRMAN. The gentleman from Texas for 1 minute.

Mr. HENSARLING. Thank you, Mr. Chairman. I am disappointed in the Administration's regulatory reform plan for a number of reasons, one of which is it doesn't seem to make sense of our current

existing regulatory structure as much as simply adding new regulatory structure on top of it. Again, the premise is wrong that we suffered from a lack of regulation. It wasn't lack of regulation, it was regulators making a mistake, and frankly, some dumb regulation. I know that one of the members brought up the AIG matter. I would have all my colleagues recall that the regulators said, do you know what, we had the expertise, we had the regulatory authority, we had the manpower, we just missed it. And so maybe there are things we can do to help make regulators smarter. I am not sure that necessarily argues for more regulation. I continue to be concerned that if you hamper or customize OTC derivative contracts, firms will find it more challenging to hedge their risk, that means less credit, which means less job opportunities in an economy that has the highest unemployment in 25 years. We must do better.

The CHAIRMAN. We will now begin with our statements. And we will start with Chairman Schapiro.

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Ms. SCHAPIRO. Thank you very much. Chairman Frank, Ranking Member Bachus, members of the committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission. I am especially pleased to be here with my colleague Gary Gensler. I am committed to a long and successful collaboration. President Obama recently unveiled a plan for a stronger and safer financial system. I believe the plan makes real progress in filling gaps in our regulatory landscape that became apparent in the wake of the financial crisis. In particular, it calls for improved regulation, oversight, and transparency for over-the-counter derivatives, more consumer investor focus by financial regulators, and improved macroprudential oversight so that regulators can identify and minimize risks that flow across the financial system.

I believe this plan will strengthen the SEC, build on our internal efforts and, in the process, improve investor protection and help us to begin to restore confidence in our financial system. The most critical regulatory gap we must fill involves the enormous over-the-counter derivatives market. Given the breadth of this market and the importance and interconnectedness of institutions participating in it, the Administration has proposed a comprehensive framework for regulating OTC derivatives with four broad objectives: preventing activities that pose risk to the financial system; promoting efficiency and transparency; preventing market manipulation and other abuses; and ensuring that these products are not marketed inappropriately to unsophisticated parties. The SEC, the CFTC, and the Treasury Department have been working closely and have general agreement on the pressing need for a comprehensive regulatory framework. There is agreement on the need for recordkeeping and reporting requirements, significant transparency, robust margin requirements, clearing systems that monitor and manage risk, comprehensive dealer regulation, business conduct and disclosure standards, and vigorous enforcement.

In fashioning a regulatory framework for OTC derivatives, it is crucial to recognize the close relationship between the regulated se-

curities markets and the now mostly unregulated markets for OTC derivatives. For example, when an OTC derivative references a security, it can be used to establish synthetic long or short positions regarding that underlying security. In this way, market participants can replicate the economics of either a purchase or sale of securities without actually purchasing or selling any securities. Because market participants can use unregulated OTC derivatives to service synthetic substitutes for securities, these securities-based derivatives are closely interconnected with the regulated securities markets. This creates significant regulatory arbitrage opportunities, that is, moving products away from traditionally regulated transparent markets to customized unregulated and opaque bilateral contracts. In deciding how to fill this regulatory gap, it is important that similar products be regulated similarly so that market participants cannot use size and leverage to work around the system.

Accordingly, we believe securities-based swaps should be subject to the Federal securities laws. This approach would incorporate the securities related OTC derivatives market into an existing unified securities regulatory regime. As such, it would be relatively straightforward to implement because these products would be placed under the same umbrella of oversight as the underlying securities. This approach also would establish a clear delineation of primary regulatory responsibility which would help avoid regulatory gaps.

And finally, it provides a workable framework for bringing transparency, clearing, and exchange trading to this market in the near term without creating undue dislocation. In addition to OTC derivatives, the SEC and the CFTC have been working closely together to identify differences between our two regulatory frameworks that might be harmonized. While the cultures and missions of our agencies are, in some ways different, we share many of the same public policy objectives. While I focus largely on my remarks on derivatives, there are many aspects of the Administration's plan as well as complementary proposals that have a direct bearing on the SEC's oversight capabilities. Very briefly, the plan seeks to require that advisers to hedge funds and other private investment pools register with the SEC. Currently, exemptions in the laws have placed hedge funds and many of their advisers outside the purview of regulation.

First, through registration and resulting oversight, we can enable investors, regulators in the marketplace to have more complete and meaningful information about private fund investors, the funds they manage and the impact of their activities on the broader markets. Second, the SEC and the Administration also appreciate that many investors do not realize that they may be treated differently depending on whether they seek investment advice from a broker-dealer or an investment adviser. I fully support the view that financial professionals who provide similar services should be subject to the same standard of care, namely, that they act solely in the interest of their customers or clients and that they be subject to comparable regulatory requirements.

Third, I support the Administration's proposals to strengthen SEC enforcement by giving it expanded authority to compensate

whistleblowers who bring significant enforcement information to our attention, to pursue expanded sanctions against wrongdoers, and to increase the potential grounds for seeking sanctions.

Fourth, I agree with the need to do more to address conflicts of interest in the credit ratings process. To that end, I believe the Administration's legislative proposals are a valuable step forward and will help to better align the interest of credit rating agencies with investors who rely on them. Already, the SEC is taking steps to heighten regulation of rating agencies, including establishing a branch of examiners dedicated specifically to rating agencies.

Finally, I believe there is a need for a systemic risk regulator as well as a strong and robust financial stability oversight council. Such a council would help assess emerging systemic risk by setting standards for liquidity, capital, and risk management practices. There is clearly much to do, but I believe the steps the Administration, the SEC, and the Congress are taking will help restore investor confidence. Thank you, Mr. Chairman.

[The prepared statement of Chairman Schapiro can be found on page 58 of the appendix.]

The CHAIRMAN. Chairman Gensler.

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. GENSLER. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. It is good to be back with you again after 8 years since I was last before this committee. Thank you for inviting me to discuss the White Paper on Regulatory Reform on behalf of the full CFTC. Financial regulatory reform is critical for the health of our economy. As President Obama outlined last month, we must urgently move to enact broad reforms in our financial regulatory structure in order to rebuild and restore confidence in our financial system.

I would like to start by discussing reforms most relevant to the CFTC. First and foremost, this is with regard to bringing broad regulatory reform for the derivatives marketplace. This will require two complementary regimes: One regime that oversees the derivative dealers themselves; and another regime that oversees the market functions. I think it is only with those two complementary regimes that we are able to capture the reforms that are necessary.

For the dealers, we should set capital standards and margin requirements to help lower risk. We should set business conduct standards to guard against fraud, manipulation, and other market abuses. We should also mandate recordkeeping and reporting with an audit trail to promote transparency. The dealer regulation will cover all OTC derivatives, standardized as well as customized derivatives. This, I believe, won't go far enough, though, and we also need to try to lower risk further by mandating that standard contracts be on central clearing and that standard contracts also be on exchanges whether they be fully regulated exchanges or regulated electronic trading systems which promotes transparency. Requiring clearing and trading on exchanges or regulated transparent electronic trading systems will further promote transparency, and will further lower risk in addition to the dealer regime that I talked

about. To fully achieve the objectives, we must enact both of these complementary regimes.

President Obama last month also called for recommendations to change the statutes and regulations that would harmonize the regulation of the futures and securities markets, and I believe this is essential. Specifically, I would just mention three areas where the CFTC and SEC harmonization process, I think, would benefit the American public. First, as we saw last year, there are gaps in our regulatory structure right now. The heart of this hearing today is filling one of the major gaps; over-the-counter derivatives.

Second, I think there are places where we may overlap in regulation. And while in certain circumstances that is appropriate, we look to identify those overlaps and seek to work with this committee and Congress where we can help clarify those overlaps for the marketplace and for all participants.

And third, there are places where we regulate similar products or similar market events or exchanges where we might have inconsistent rules, and we look forward to working together to identify those inconsistencies and try to harmonize them.

Chairman Schapiro and I are committed to doing this and seeking public comment. And in fact, we are looking to have joint hearings between the SEC and the CFTC in August and September to help inform the Commissions on these views as we seek to inform the rest of the Administration and you on our views on these matters. As we work with Congress to apply these regulations to over-the-counter derivatives, I think it is a real opportunity actually to start with harmonization right here on over-the-counter derivatives.

And whether the SEC has jurisdiction or the CFTC, we need to have similar fraud standards and manipulation standards, that the electronic trading systems that we oversee have similar standards and that we embed in statute, the over-the-counter derivative statute, that we have strong vigorous standards with this regard. I would also like to just briefly touch upon hedge funds where the Administration is called to require hedge funds to register and other investment funds with the SEC, which I fully endorse. But I think as we go forward to do that, we have to ensure that the CFTC still can make sure that anyone participating in the futures markets and those markets that we oversee that we are able to have our full ability to police those markets and get ready access to information from the SEC from these hedge funds.

Lastly, I just want to say how fortunate I believe to have a partner in this effort, SEC Chair Mary Schapiro. She brings invaluable expertise which gives me great confidence that we will be able to provide Congress with sound recommendations on comprehensive oversight of OTC derivatives in the markets as a whole. I look forward to your questions, and I am glad to testify in front of you at any time, Mr. Chairman.

[The prepared statement of Chairman Gensler can be found on page 43 of the appendix.]

The CHAIRMAN. Thank you. Ms. Schapiro, one of the issues that you know people have concern about here that is clearly in your jurisdiction is the short sale question. Could you give us the state

of play now before the Commission, what are you thinking about, what is pending, what do you think is going to be happening?

Ms. SCHAPIRO. I would be happy to, Mr. Chairman. As I have told the committee before, that has been the number one issue on which I receive comments and letters from both the public, the industry, and Congress as well. The SEC proposed a rule a couple of months ago and the comment period closed on June 19th, multiple approaches to dealing with short selling in the marketplace. Those approaches broke down roughly to two categories: a set of proposals that would operate as a market-wide mechanism to slow the descent of stocks during a declining market; and the other set akin to the old uptick rule or a bid test.

The first set of proposals were triggered off of a circuit breaker concept so that if the price of a particular stock declined by more than, say, 10 percent in one day, then a circuit breaker would kick in and no more short selling of that stock would be possible for some period of time. As I said, the comment period closed on June 19th on the multiple proposals. We received 4,000 comment letters. We are working our way through those comment letters. In addition, we held a roundtable to solicit views.

The CHAIRMAN. What is your timetable for a decision?

Ms. SCHAPIRO. I am hopeful that we will do some interim steps very quickly with respect to fails to deliver and a number of other rules that were also in play. And I am hopeful that over the next several weeks or next 2 months we will be able to come to closure and, assuming the votes on the Commission, an appropriate response.

The CHAIRMAN. Thank you. I know members may still have some further questions about that. On the registration of hedge funds, let me ask both of you, I think there is a fairly broad consensus among some on our side of the committee that hedge funds should register, but the question is how. That is, hedge funds are not mutual funds. And I know when you are a lawyer and you have to choose, well, we will take this model or that model, A or B or C, but we can make it A-plus or C-minus or ice cream. So we can do whatever we want in terms of the form. When we come to the drafting on registration of hedge funds, should we pick one of the existing models, etc., or would you recommend that we draft a registration for hedge funds that might vary from some of the existing forms taking into account their particular nature? Ms. Schapiro?

Ms. SCHAPIRO. I think, Mr. Chairman, there are obviously, as you suggest, lots of ways to do this. You can register the funds themselves as investment companies and then try to exempt them from a lot of the requirements. You can register the adviser to the hedge fund which is what the SEC has proposed doing which would get us I think virtually everything we need to effectively regulate hedge funds in terms of registration, inspection ability.

The CHAIRMAN. Let me just say, because again, we have the power to write the law, requiring to register and then exempting from some of the requirements of what we register doesn't make a lot of sense, right? We ought to just write it right the first time.

Ms. SCHAPIRO. I don't disagree with that. And I think the concern would be that trying to stuff a hedge fund into the model of an investment company isn't really the most rational way to go.

But registering the investment adviser gets us access to really everything we need as a regulator of these instruments with the exception of the ability to impose on the fund itself capital requirements, diversification requirements that nobody is envisioning, at this time any event, needing to do. So we think adviser registration works.

The CHAIRMAN. I figured that, and depending on how it works, that could conceivably be something that a systemic risk regulator, however it is constructed, might be taking a look at.

Let me ask the last point on derivatives. One of the questions that has come up was mentioned today in one of the publications. What is your view on—well, let's put it this way. What is the function that is served, and there may well be one, when someone who does not own an asset buys insurance against a drop at its value, people buying credit default swaps who don't have an economic interest, in particular, on the item for which they bought the credit default swap. Is that an economically important function? Should we, in any way, try to change that? Mr. Gensler?

Mr. GENSLER. I think that the function of using a derivative to hedge a risk, first and foremost, is generally a risk that is in that commercial enterprise. But there are some times that you are hedging a risk that is similar to a risk you have. So it may be that a commercial bank wants to hedge a portfolio of loans and enters into a credit default swap which is on a portfolio, again, of listed securities that have some correlation or relationship to it. So there are—

The CHAIRMAN. Let me ask you, and finish in writing, is there a third category, that is, you might decide to buy one because you are taking a good guess that something is going to go bad and you will make some money if it does, and is that something that is good or bad or indifferent? Well, let me get that in writing because we don't have time. We have a lot of members who want to ask questions. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. Taking a page out of Mr. Royce's comment, and as I said the last time, we have sort of been here before with regard to having a problem and then coming back to reform it, and we went through a litany of problems in the past of the SEC. Just yesterday, we had a panel, and the idea was we were going to give more authority to the Fed. And I went through a litany of problems where they missed on capital requirements, they missed on regulation, they missed on monetary policy, and yet it is the thought right now in Congress we are going to give even more authority there to the Fed. So in a sentence, why should the American public be watching the hearing today and be sanguine to think that we should be at this point giving more authority to the SEC?

Ms. SCHAPIRO. Congressman, I think it is fair to say that every regulator over the last several years has had episodic failures and missed many of the issues that gave rise to the financial crisis, the SEC included, but certainly not only the SEC. But at the end of the day, there is an enormous amount of work that happens at the SEC that benefits the American investor and taxpayer on a daily basis. Whether it is the review of corporate filings to ensure that they are honest and transparent or ensuring that mutual funds are

actually operating as they have extremely effectively over the last several years.

Mr. GARRETT. I appreciate it. They do some good, but obviously, the failures in the past, present company excepted because you were not there at the time, is something that just raises that question. I don't have much time, so let me go on to the next point, because I know you are going to sing the praises of things that have been done well. A lot of people could have a disparate opinion as to what brought us here. Some people would say it is GSEs and their leveraging issues, other people would say it is the credit rating agencies and they have problems; other people would say it was the regulators or the OTS and what have you that simply missed things and what have you. A lot of people can point out different things. We have not come to a conclusion as to what the problem ultimately was that brought us here. Can you point to one example where it was standardized derivative products that was ultimately part of the cause that brought us here?

Mr. GENSLER. I think that the unregulated derivative dealers, the affiliates at Lehman Brothers and Bear Stearns and, for that matter, even that which was in the back allowed for a great deal extra leverage in the system.

Mr. GARRETT. Okay. That is the—

Mr. GENSLER. And even the standardized product.

Mr. GARRETT. That is the entities. How about the product themselves? What we are talking about here is regulating the product and putting constrictions around the product itself, and its a standardized product as opposed to, because there is a whole host of other proposals out there as far as regulating the brokers and investment advisers, can we point to where it was—

Mr. GENSLER. I am of the firm belief that bringing standardized products onto central exchanges and onto central clearing will lower risk and enhance transparency. Tens of thousands of end users will benefit by that.

Mr. GARRETT. I appreciate we can lower risk, but can we give one example so I can go home and say this was part of the problem that caused it and here is a specific example.

Mr. GENSLER. I think that AIG is Exhibit 1—$180 billion of American taxpayer money for standardized and maximized products.

Mr. GARRETT. Excellent point. AIG, would they be products that would therefore go through and be considered a standardized product that would go through a clearinghouse?

Mr. GENSLER. Many of their products would. Some of them were so customized they couldn't. But all of them would be regulated for capital and margin. All of them would be regulated as a derivative deal.

Mr. GARRETT. Wasn't most of the problem with the AIG situation with their credit default swaps which were based upon the subprime problem and the mortgage problem? They would not be standardized product.

Mr. GENSLER. Also, there was no effective Federal regulation for capital or margin. So last September, Congress was put in a terrible position we should never put Congress in to have to think about the TARP bill and then the Federal Reserve and the Treas-

ury loan, you know, this $180 billion of the Fed specifically. We want to avoid that in the future. And that is for standardized products as well as customized products. We need capital and margin requirements to do that.

Mr. GARRETT. Well, I have never heard anyone say that the problems over at AIG were with their standardized product.

Mr. GENSLER. It was actually both. The customized product get a lot more publicity obviously because they are so exotic. But it was also the standard. It is the amount of leverage that you can put in the system, how much debt you can put on a very small basic capital.

Mr. GARRETT. Very quickly, I have heard a lot of people from the business community say even with the nonstandardized products which would raise the capital requirements or the marginal requirements that this would basically make it impossible for them to use them and hedge their businesses. You only have 30 seconds.

Mr. GENSLER. I think that it is a very good question, but they could absolutely—end users could use the products. We are saying there should be customized products. I think that by bringing transparency to the standard part it would actually lower costs because they should see where the spreads are and they could price off the standard product.

Mr. GARRETT. Thank you.

The CHAIRMAN. I recognize the gentleman from Pennsylvania and take 15 seconds to say, Mr. Gensler, when you said that the AIG thing put Congress in a terrible position, yes, but only as spectators. I do want to emphasize. We voted on the TARP, but the Administration came to us, the Secretary of the Treasury and the Chairman of the Federal Reserve last September, and informed us that they decided to advance money to AIG. There was never any congressional input into that. A few jaws dropped but no votes were taken. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman. And should we add that there was a different President at that time?

The CHAIRMAN. Yes.

Mr. GARRETT. We don't want to get partisan, do we?

Mr. KANJORSKI. No, no. Just timeframe. First of all, the relationship between the two of you is something we should compliment, and I do. And I anticipate that because of this good relationship we are going to have very positive things. I understand because of prior meetings and other testimony that you have made that you have worked out and harmonized a great deal of the conflict between the two agencies but that you have not resolved all of those conflicts. And you are down to what really I would like to ask, what are the remaining disagreements between the SEC and the CFTC that have not yet been harmonized and are still open in the air, and do you have a suggestion where they are going to come down and are they resolvable at a given time?

Ms. SCHAPIRO. Let me take the first crack at that and then ask Gary obviously to fill in. I think you point out correctly that we have tremendous agreement around most issues. There is a very narrow area where we are not in full accord, and that is with respect to whether broad-based indices, OTC derivatives or swaps on broad-based indices should be regulated by the SEC or the CFTC.

Our view is that securities-related derivatives ought to be under the SEC's jurisdiction.

The Commodity Futures Modernization Act, while exempting these products broadly from regulation, did retain with the SEC antifraud authority over anything securities based. As Gary will point out, under the Shad-Johnson Accord reached quite a few years ago, there was a drawing line between narrow-based and broad-based indices. Broad-based went to the CFTC and narrow-based went to the SEC for the purposes of options and futures. I would say that is the one area that we still are trying to work through. As we go through our harmonization process, and as Gary said, we are going to hold joint hearings to get public input on this, we will discover there are lots of areas where our rules approach things differently.

And on those I don't even know that we will have particular disagreement. Some won't be able to be harmonized because the nature of the markets and the products is quite different. But that is what we are working through right now.

Mr. GENSLER. I would agree with that. I think that we are in agreement. And the products, the interest rate, currency, and commodity products, the CFTC would take the lead on. On the narrow-based, the SEC would take the lead. This is broad-based product area. Currently, there are over 150 broad-based futures contracts. There are five or six that trade actively that are regulated by the CFTC. There are about 60 options on those futures, again, regulated by us. So broad-based implicate those. But there is a second category that I should mention. I do think we can go in and harmonize for the trading platforms. And working with Congress and working together we can do that, but we haven't yet, between our agencies, been able to get to that level of detail. But I think that would be important.

Mr. KANJORSKI. I did hear, though, in Chairman Schapiro's testimony, that there is a concession that there will be some areas that cannot be harmonized and will take some other action. And that is consistent with other things that I have seen in the last week or so where regulators have not been able to agree as to where a problem should lie in terms of who has the responsibility of solving or moving in. I am particularly referring to the CIT. There seemed to be three Federal regulating entities that were not quite in agreement as to who had the responsibility to take action if any.

As a result of that, and the fact that we have a concession, you cannot harmonize, have you thought of the possibility of our creating an Uber-regulator so that there is a final resolver of conflict of disagreement in the regulatory community of the United States if the problem gets—rather than just waiting around for months and having the Congress enact some special features because of a disaster. Can we close it down as if there is an actual decider and a peak and have you given any consideration to that?

Ms. SCHAPIRO. I think it is certainly worth exploring. And I do think, to the extent Congress might move forward with some sort of financial stability oversight council, whether as the systemic risk regulator or as a body over the systemic risk regulator as we would propose that might be a forum for broader discussion of the dif-

ferences with other regulators. It might help us achieve some kind of a consensus on how to go forward.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. I noticed that both of you, in your opening statements, said that you were working together as colleagues and in partnership and I think that is going to be critical and I was glad to hear that. I think the key in doing this, we are going to continue to have two separate agencies, that is apparent. We are the only country in the world that really has that dual set of securities and futures, and you know they are regulated quite differently.

So I think there is obviously a need for harmonization. I think the key is going to be the leadership of you two. I think that will really set the tone and will determine how successful we are. So I applaud you for your opening statements. I also want to focus on something, and I agree that Chairman Schapiro said, she said I want to emphasize to the committee that the SEC and other financial regulatory agencies have been making solid progress using our existing authority to address the financial regulatory problems that face this country.

You do have a lot of existing authority, and I think it is important that we as a Congress realize that. And actually, in all this regulatory reform, my concern has been that we are telling you what to do as opposed to you looking at your authority you have, looking at the problems that we now all realize, and they are very complex problems, and saying to us this is what we need, you know this is how we are going to discharge that authority or we need additional statutory authority. As opposed to, particularly with some of the banking regulators, saying we are going to totally change our approach to regulation and some good, but maybe not so good ways.

I am going to ask one question and one question only. Having to do this by September 30th is to me an overwhelming and unrealistic goal. Now, I know that the problems are there, but you have already taken steps. And other regulators have already taken steps, I think, to minimize a recurrence of what we saw last year.

I don't think in the current climate that businesses are going to take that kind of risk, number one, or that regulators are allowing that kind of risk. But tell me, I will ask both of you, how realistic is that? And will you not hesitate to ask for more time?

Mr. GENSLER. We certainly will not hesitate to ask for more time, but what we are trying to do—and I think why the President and Secretary Geithner asked for that time—is to help inform Congress as they are embarking upon legislative process. So we are going to have joint public hearings to hear from the public. We are doing what I will call a "gap analysis" to see where the gaps are right now. And then we are going to try to have as many meetings as we can fit into our schedule to try to resolve those and make recommendations. But again, we might have an interim step on September 30th, and then have more to report, but to help you in your legislative process as well.

Mr. BACHUS. Chairman?

Ms. SCHAPIRO. I would agree with that completely. We are really committed to getting as much done as we can by September 30th.

And if we need more time, we will ask for more time. It is very important that we get this right. These are, as many of you have pointed out, massively important markets, and we want to be sure we are thoughtful about it.

Mr. BACHUS. And I endorse this idea of trying to get at least an interim report, but I would caution you as well as you cautioned, I think, in your statements, how complex these matters are and that you want to get it right because these have tremendous implications for our economy if they are not done right.

So I thank you and look forward to what I hope will be an interim report September 30th.

But I would caution you also, you are going to be asked to speak to all sorts of forums and all sorts of public addresses. You need to limit some of that. You need to set your priorities because there is a lot of hard work back at the agencies. And I hope that the public and the Congress will realize that the agencies are going to have to do a lot of hard work, a lot of concentration, and a lot of study in a very short period of time.

Mr. GENSLER. Thank you.

The CHAIRMAN. I just would say, I think the gentleman from Alabama has just shared with you the advice he probably gets from his scheduler, as we all do: Don't speak at every forum of your priorities. So you are getting passed on what every one of us hears every day.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. And I thank our presenters for being here today.

As you know, I have introduced H.R. 3145, a bill to ban credit default swaps. And that has caused a lot of conversation with many saying, well, they should not be banned but we should have the central exchange and there should be transparency. But the more I learn about them, the more concerned I am. I just want to cite this particular situation.

McClatchy Company provides the most recent example of credit default swaps hindering our lending markets. This California-based newspaper publisher with large holdings in North Carolina and Minnesota recently offered bondholders an above-market price for its outstanding debt. The company made this offer in order to offset declining advertising revenues with reduced costs. More than 90 percent of bondholders have turned down this offer.

According to an industry analyst, the debt offer failed because many of the bondholders also had substantial credit default swap positions. These bondholders stood to gain more from McClatchy's demise than from its continued operation.

While the company still exists today, it carries massive amounts of debt, thanks to the many empty creditors who stand to profit from McClatchy's bankruptcy.

Some say we should only be concerned about naked credit default swaps. I say we should be concerned with all credit default swaps, particularly when they function as an incentive to drive a company into bankruptcy.

Ms. Schapiro, if your agency was given authority over security-based swap agreements, how would you deal with this very controversial question of credit default swaps? And if you could, com-

ment on other types of swaps, such as interest rate and currency swaps.

Ms. SCHAPIRO. Thank you. I will ask Chairman Gensler to talk about the latter two since those are CFTC-related products.

You raise a very important question, and you and I have had a little bit of a chance to discuss this previously. There is no question but your economic interest, when you are on a credit default swap, may dictate that you have less incentive to cooperate with a troubled company entering bankruptcy, because you are going to be paid when that credit event happens in any event. And perhaps to make things worse, there may also be an incentive to even short the stock on top of that.

I think transparency would help tremendously in this regard. And I think attaching some greater costs, frankly, to doing credit default swaps via regulatory oversight, which obviously has a cost to it, the provision of capital and margin requirements.

I do think that as we explore this issue—and we are spending a lot of time thinking about it, and whether at a minimum there ought to be some kind of an insurable interest—we have to think about the complexities even of just that piece of it, putting aside whether you would ban the product entirely.

A bondholder has an underlying economic interest. Yet in this instance, they were not incented to cooperate in the bankruptcy. Does an equity holder have an economic underlying insurable interest? What about a large supplier to the company who would see their revenues disappear if the company declares bankruptcy? Might not they want to ensure that revenue stream through the purchase of a credit default swap? So I think the complexities are very significant and ones we have to work through.

I would say that if Congress decides to go down the path of banning naked credit default swaps, it would be good to think about doing something like that prospectively, given the size of the marketplace that already exists and the potential disruption of unwinding those kinds of positions. But again, I think these are very difficult questions.

Ms. WATERS. Thank you. I still have time.

Would you like to comment on that, please, Mr. Gensler?

Mr. GENSLER. Well, I do think that on the credit default swaps—and this is one of the reasons why we agree—the credit default swaps on single issuers like McClatchy that you mentioned, are very related to their stock, are very related to their bond. And appropriately, all of these interplay on investor protection and should be regulated, I think, jointly by the SEC. And just as they are looking very closely at the short sale roles on equity, there is some similarity of the short sale or naked sales in credit default swaps.

I think as it relates to interest rate swaps and currency swaps, what really are far more about broad interest rates or broad—you know, where currencies are, that there is a role for both hedgers and speculators. And speculators play an important role in the marketplace, even if they are naked, so to speak—if that term is all right—because they provide the other side, so that hedgers can find somebody that may, in essence, provide that insurance to them who want to protect themselves in currency and interest rate markets.

Ms. WATERS. Thank you very much.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Chairman Gensler, I understand that the CFTC is going to have some public hearings regarding hedge exemptions and position limits in the energy markets. As you are aware, in the 2008 farm bill we had quite a bit of discussion about that, and we expanded some of the CFTC's authority in that area. There is a lot of disagreement about the role of speculators in the marketplace. And my opinion is that they provide liquidity and price discovery by the fact that they are in the marketplace.

But what do you think might be the impact if you move to limit, and in some cases prohibit, some institutional investors from actually being in the energy commodities?

Mr. GENSLER. I thank you, and I thank you for the support in last year's farm bill for the additional authorities.

The CFTC, under a statute that had been in place for some 70 years, sets limits in the agricultural space—corn, wheat, soy, and so forth—and has the authority, in fact, it says that we shall set them in other markets.

And so what we have raised as a question is, we do it in the agricultural stock, we don't do it in the energy markets. The philosophy really is to protect against the burdens that may come from excess speculation. Speculators are good, they provide the other side for hedgers to hedge their transactions. But conceptually, it is that we have at least a minimum number of participants in a market place. If there is a diversity, if you had that 10 percent limit, then you would have at least 10 participants in a marketplace and lower the risk that there are dislocations. If they have to liquidate those positions, it actually lowers the risk in clearinghouses that we have been talking about today.

So we are going to have hearings starting next week—I see Commissioner Dunn from the CFTC is here also today—and we will be looking at this over the next several weeks and then trying, if appropriate, to move on it during the fall.

Mr. NEUGEBAUER. One of the issues, though, that I get concerned about, when you talk about beneficial interest and whether someone is hedging or they are speculating, I would submit to you that in the energy business, everybody in this room has some beneficial interest when it comes to energy. So one of the concerns I have is if we move in this direction, what impact could that potentially have on commercial hedging if we begin to limit the participants in that? Because, as you know, it is a fairly large market.

Mr. GENSLER. And our mission is to make sure that the markets are fair and orderly and provide the risk management for those hedgers. But through position limits, Congress gave us the authority many years ago to set position limits to protect those markets, so that they are fair and orderly and they represent the price discovery that you are so—so I think we are aligned on that, and it is whether this promotes market integrity along that front.

Mr. NEUGEBAUER. And then there is the question out there that there are other places for the investors to go and trade energy. Obviously, the United States doesn't have a lock on that. What im-

pacts, if we get two prescriptive, too overly protective here, could that have on U.S. markets down the road?

Mr. GENSLER. It is a very good point. It is why we have asked Congress and this committee to consider in over-the-counter derivatives regulation that we also make sure that the position limit authority for commodities of finite supply, that we also be able to do that in the over-the-counter market if it serves a price discovery function back into the other regulated markets.

Because you are right that you could move from the futures to the over-the-counter derivatives. And we saw that in a number of cases in the last several years.

Mr. NEUGEBAUER. Quickly, a question to both of you. You know, we see in this regulatory proposal that the Administration is putting out, you have the clearinghouses, you have the regulators, and you have obviously the investors. There has been a lot of discussion about bringing more equity and margin to the marketplace. Do you support a more aggressive setting of margin requirements from the regulator, or still leaving that decision to be made by the individual clearers, and basically with the regulators primarily looking at the capital structure of the clearing entities?

Mr. GENSLER. I think we need to start with having in statute, mandatory centralized clearing for the standardized product as contrasted today—it is voluntary—and that there be rigorous risk management standards and that clearinghouses have open access to members to be part of that.

Margin could first be set by the clearinghouse, but that the regulators, the SEC and the CFTC overseeing those clearinghouses should be able to prescribe through rules those risk management standards and, where appropriate, if we find that a clearinghouse—just as we have in the futures clearing and an options clearing now, the regulators do have authority to go in and comment on that.

Mr. NEUGEBAUER. Mr. Chairman, could I ask Ms. Schapiro to quickly answer that? Could I ask unanimous consent to have an additional 30 seconds?

The CHAIRMAN. We have members low down who don't get to ask questions. If everybody gets an extra 30 or 45 seconds, then they are not permitted. That is why I would object. People can answer in writing.

The gentlewoman from New York.

Mrs. MALONEY. I first grant 30 seconds to Ms. Schapiro to answer his question.

Ms. SCHAPIRO. Thank you.

I very much agree. I think that margin levels can be set in the initial instance at clearinghouses. I think it will be very important for the regulators to have very robust oversight of those clearinghouses to ensure that they themselves don't become systemic risk concerns over time. And that will involve, obviously, making sure they are stress-testing those marginal levels and their capital levels, as well as ensuring they have all the proper systems and backup and books and records and transparency.

Mrs. MALONEY. First, I would like to welcome our witnesses—particularly Mary Schapiro, a former constituent, a resident of New York; New Yorkers are very proud of your service and your current

appointment—and to Gary Gensler, the Chairman, who was part of the Clinton team that brought us the longest period of economic expansion in our country's history of balanced budgets and surpluses. I am glad that you are back on the economic team. And welcome, it is good to see you again.

First of all, I want to say that I truly believe that reforming the financial markets and system is the most important issue before our country. And getting it right will determine our economic growth and expansion for the next—probably 50 years.

And I want to go on record in support of the many honest hard-working men and women in the financial services industry. Many people have made mistakes, and they feel like they are unjustly being attacked when they are trying very, very hard to be part of the solution and part of moving our economy forward.

I also want to state how important financial services are in terms of our exports. Along with Boeing, it is one of the largest areas that we export goods and services that helps with our trade deficit. So moving forward in a correct way is tremendously important.

I for one would like to wait until the report comes back from the Commission that we have put in place that will tell us what was really the problem, so that we can make sure we are addressing what is the thoughtful process of what caused the crisis. I truly believe the best chapter in government since I have been in Congress was the 9/11 Commission report that expertly pointed out what caused the problem, with concrete recommendations of what should be done. And I would like to see what this Commission has to say.

But the first road map we saw was AIG. And it clearly showed markets were out of control. No one knew what was going on. At the beginning of the week, they said they didn't need help. By the end of the week, they needed $50 million. By the end of the weekend, they needed another $30 million, and then it just continued.

Former Chairman Fuld testified before this committee on the Lehman disaster and crisis and said if he had one recommendation, it would be that there would be one central clearinghouse so that you had control of what your exposure is internationally and nationally so you understood the exposure. I don't think you are going to get that with capital requirements and margin requirements and leverage requirements.

And my question, really to Mr. Gensler is, in these clearinghouses are you proposing one central clearinghouse, which is what he suggested, or several clearinghouses? And then what do you determine is going to be over the counter, what is going to be in a clearinghouse? But do we have one area where we are going to be able to track the exposure of investors and the economy of our country?

Mr. GENSLER. I thank you. And I thank you for that warm welcome. And having met my wife and having my three daughters born in New York, I feel some closeness, too.

I think that we must bring the standard product into clearinghouses, but the reason for the regulation of the full dealers is so we can also regulate the customized as well as standard—

Mrs. MALONEY. Would it be one clearinghouse or many clearinghouses? How many clearinghouses?

Mr. GENSLER. What we would envision is that we would allow the market—right now there are three or four clearinghouses sort of, as I say, competing for this. They need not to be voluntary, but they need to be mandated, and that the regulators would be able to see them and rigorously oversee them. If they meet the standards, they would be able to compete. I believe over time you might see a consolidation and a concentration in this, but initially the statute would allow for more than one clearinghouse.

Mrs. MALONEY. Very clearly, my time has almost expired.

Brooksley Born fought very hard to keep derivatives, particularly energy derivatives, on the exchange. I put forward an amendment that mirrored her recommendation, which failed primarily because the regulators were opposed to it. Where does that stand now? Are the energy derivatives back on the exchange?

The CHAIRMAN. Quick answer.

Mr. GENSLER. We believe that energy derivatives need to be brought onto the exchange if they are standardized. With the exempt commercial markets through the farm bill, we have more authorities than we used to have.

The CHAIRMAN. The gentleman from Delaware. And remember, our witnesses are encouraged to respond in writing in greater detail, and we will have plenty of time this summer to read it before we get to any legislative activity.

The gentleman from Delaware.

Mr. CASTLE. Chairman Schapiro, you and others—even us up here—expressed some concern with the revolving-door issue of employees at the SEC. Actually, I don't see employees of the SEC. I see you or your predecessors, or whatever. But as you know, the concern has always been that people go to work at the SEC, they are relatively young, they are relatively inexperienced, and they may then be looking for offers from Wall Street, so that may taint what they are doing—not to suggest there is anything wrong with what they have been doing, but it may taint their thinking on it. And the thinking was—and you stated—that we need more experienced people.

Is that starting to happen with the economy and with your desire to change that? Can you give us a brief answer on that subject?

Ms. SCHAPIRO. Yes, very much so, Congressman. We have been able to take advantage of some of Wall Street's woes by bringing on board tremendously experienced people with a broad range of skill sets.

I am sorry Congressman Royce isn't still here, but we aren't just hiring lawyers and accountants, we are actually bringing in financial analysts, forensic accountants, people with expertise in trading and derivatives, in a wide range of areas, and we are very much the beneficiaries of Wall Street's woes in that regard right now. And that is very much by design that we are bringing in those skill sets.

Mr. CASTLE. Thank you. Let me jump to another subject. When you talk about hedge funds—and I think there are other private pools of capital you were talking about—you indicated they should be registered. And I couldn't find it in your written testimony, but in your oral testimony you suggested that registration would lead to other oversight of those particular entities.

Can you elaborate on that a little bit? I mean, I can understand and I am all for the registration—I am probably for the oversight as well—but does that automatically lead to other regulatory supervision of these entities?

Ms. SCHAPIRO. Not automatically, but I think there is an expectation on the part of the public that if an entity would be registered with us, we would have some regulatory oversight, including reporting to the SEC and, ultimately, if there is a systemic risk regulator, to the systemic risk regulator about trading activity.

We would expect to have the ability to examine the books and records of a hedge fund, potentially to write rules that might require the provision of certain kinds of information to their investors or to counterparties.

But our commitment is also, though, not to try to force hedge funds, PE firms, venture capital firms, into a model that doesn't fit for them. We recognize these are different types of investment vehicles, but I think we need to bring them under the umbrella of regulation.

Mr. CASTLE. And if you could share with us what is happening with respect to credit-rating agencies, without going through all the details of that. We all know that there have been some concerns about the ratings of various products that ended up falling flat on their faces, etc. And should we be doing more with transparency registration of some of the credit-rating agencies? Where does that stand right now from the SEC?

Ms. SCHAPIRO. Well, as you know, since the agency got authority under the 2006 Act, it has engaged in no less than five rulemakings to try to put some structure around the regulatory regime for rating agencies. And many of those rules are new and we are seeing how they work.

But I will say that we are going to go forward later this summer with some additional rules that we think will be very useful. One would propose to require issuers to disclose preliminary ratings they have received as a way to get at this issue, which I find really pernicious, of ratings shopping.

Another would require disclosure of the underlying data in structured products that are being rated to all other rating agencies so they can perform an unsolicited rating as a check on the conflicts that exist in the issuer-pays business model.

We are going to look at sources of revenue disclosure, again, to get at the conflicts issue. More performance history, how the ratings have performed over 1-, 5-, and 10-year periods of time. And we are beginning a road map to explore how the SEC and its own rules can lessen reliance on ratings as a way to hopefully get investors to do additional due diligence on their own as well.

So we have quite a lot in the works. And of course the Administration has a new proposal that came out yesterday to require mandatory registration and a number of other things.

Mr. CASTLE. Well, thank you. I believe there are a lot of legitimate concerns with credit-rating agencies, and we should be trying to help with that as well.

I thank you for your testimony and yield back.

Mr. KANJORSKI. [presiding] We will now hear from Mr. Watt of North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Let me go back to a question that was raised earlier by Mr. Kanjorski. A lot of people have said that if we were starting from scratch, we would have only one agency. And I understand the political realities of two existing agencies, the history that exists there.

And you addressed the process that the two of you engaged in cooperatively to define what turf should be in the SEC and what turf should be in the CFTC. You said you have come to fairly good understandings about existing products.

I guess the question I want to ask is, with respect to a new product and the possibility—probability—that at some point in the future the two administrators of these agencies won't be as nice and kind and cooperative with each other as the two of you are, how should we be assuring in this legislation that there is not the potential for future conflict and legislating a way to resolve that conflict if in fact it does occur?

Ms. SCHAPIRO. I am happy to take the first shot at that.

I think you have identified a real issue for sure. And we have this concern now. We have products that are not clearly on the futures side or the securities side, and it takes the agencies a very long time—really in some ways an unacceptably long time—to resolve where these products will trade and under which regulatory regime. And we disadvantage commercial entities who are trying to propose these new instruments.

I think we are of good will here. I think we will try and we will be more successful in working those issues out.

Mr. WATT. I have the utmost confidence in the two of you, as I said, but I am not sure that I have the utmost confidence in the future. And we are trying to draw a process that will last, as this process did until the meltdown, for 75 years or more.

Ms. SCHAPIRO. I think short of merging the agencies—which is also not in the cards—that one option would be to use something like the Financial Stability Oversight Council that has been proposed by the Administration as a mechanism or a forum for the resolution of these kinds of issues.

Mr. WATT. And we can write that into this legislation.

What is your opinion on it?

Mr. GENSLER. I think if we limit the differences, if we harmonize going in, Congress writes clear, statutory guidelines on the clearinghouses and on the exchanges, it sort of limits a little bit more whether a product is under one set of Presidentially appointed people and career staff and another set of Presidentially appointed people and career staff—I mean, to the extent that we harmonize going in. And so that is, I believe, a challenge for all of us.

Mr. WATT. But you acknowledge that we need to address that probably in this legislation; do both of you agree on that?

Mr. GENSLER. Yes.

Mr. WATT. Mr. Gensler, you actually led to the next question I want to try and get some further clarification on, because I am not clear in my own mind. You have referred to clearinghouses, and I think you also referred to electronic platforms. I want to get a clearer understanding of the difference between those two as you

see it. Just give us a little education here so the members of the committee, including myself, fully understand.

Mr. GENSLER. I thank you. Both are very important. They serve different functions, though. Both, I think, should be regulated by the market regulators. The exchange is where buyers and sellers meet, and there is transparency on the transactions themselves. And what we are proposing is that after any transaction in a sort of real-time basis, just like we have in the corporate bond market now and the equity markets and the futures markets, those trades are reported, so there is transparency between buyers and sellers, and then that the trades are announced.

Clearinghouses have lower risk because it is where, after the trade, after the transaction had happened—and some of these transactions will go on for 30 years if it is a 30-year interest rate swap—that we can lower risk because the transaction has to do with a lot of things like marking it to market, posting collateral, to make sure that the transaction can live those 30 years regardless of market events.

Mr. WATT. My time has expired. If you would just give me some more written information about that distinction, because I am still a little unclear—electronic platforms, clearinghouses, electronic exchanges. I would like to kind of—

Mr. GENSLER. And I would also be glad to come and see you in your office anytime you want us to come by.

Mr. WATT. Thank you, Mr. Chairman. I yield back.

Mr. KANJORSKI. The Chair recognizes Mr. Royce of California.

Mr. ROYCE. Thank you, Mr. Chairman.

Ms. Schapiro, Allen Stanford, who has been accused of being a mini-made office, has been in the headlines for the last few weeks as people have been trying to get a handle on exactly what happened to $8 billion and the full extent of the damage of his actions. And recently an alleged Stanford whistleblower, Layla Wydler, was interviewed on the matter. And she detailed her initial concerns with the Stanford firm, her termination—which was allegedly tied to her unwillingness to sell their offshore certificate of deposits coming out of Antigua, which she had had concerns about—and her attempts to bring what she believed was a Ponzi scheme to the attention of NESB, now FINRA and the SEC. This was some 5 years ago.

According to a complaint filed by the SEC in February of this year, the Stanford bank allegedly touted "improbable if not impossible returns" while selling $8 billion in those very same, apparently cryptic, CDs to investors for more than a decade.

On going to the SEC in 2004, Ms. Wydler said, "I had a list of everything, all my concerns. I wrote down the document, and I sent it to them and told them these are my concerns; this is what happened, look into it. This might save people's savings in the future because we can stop this." And it was just sent to them, and that's it.

Now, I understand there is a criminal investigation going on. But what can you tell us about this allegation? Are you aware of any evidence legitimizing Ms. Wydler's claim that she did, in fact, approach the SEC 5 years ago raising concerns over this Ponzi

scheme, laying out how they were doing it, with respect to Allen Stanford's firm?

Ms. SCHAPIRO. Congressman, I am happy to address it.

I don't know about her specific claim, so let me be clear about that. But I will tell you that prior to the SEC opening its formal investigation in 2005 into Stanford, the Agency had looked into tips that had come its way. But at the time, my understanding is that the staff believed that these were largely foreign investors investing in foreign certificates of deposit issued by a foreign bank.

So those jurisdictional issues presented significant hurdles, offshore CDs issued by a foreign bank. And those jurisdictional issues, we now understand, were significantly complicated by the fact that the Antiguan securities regulator, who had jurisdiction and authority over Stanford International Bank, was on the payroll of Mr. Stanford, and has been sued by the SEC, but was clearly subverting the SEC's investigation into this matter.

There is also a period of time of significant coordination with other Federal agencies, which also took time—undoubtedly longer than it should have. But as soon as it became clear to the SEC that there was adequate information for us to go forward and that we could overcome those jurisdictional hurdles, the case was brought. Nine people and entities have been sued, and, as I said, including the CEO of the Antiguan Financial Services Regulatory Commission.

Mr. ROYCE. Well, I would like to ask you if you could then address the questions raised by Mr. Atkins, which I raised in my opening statements; specifically, why do you think the SEC, in the course of the past 12 years, experienced, in his words, "catastrophic failures in every one of its four core competencies." He started with rulemaking, filing review, enforcement, and examinations.

Ms. SCHAPIRO. I would be happy to do that. I would also be happy to come and talk with you directly about these. Needless to say, I don't agree with Commissioner Atkin's characterization of the SEC's failures over the last number of years during that period he was a Commissioner of the Agency.

I do think all of the Federal financial regulators missed issues related to the economic crisis in the last several years, but I also think that an enormous amount of positive work and important things have happened also under those same years.

Mr. ROYCE. Let's do it this way, then. For the benefit of members, you can do it in writing.

Ms. SCHAPIRO. I would be happy to.

Mr. ROYCE. And I would add two more questions in writing, if you could submit. I think going forward it would help the committee members. What led to failures in financial institutions to recognize the inadequacy of their own risk management systems and strategy in time to avert a collapse? And second, how did many investors get lulled into complacency and not adequately do their own due diligence as well?

You probably will have some perspectives at the SEC on those two questions, and I think a better understanding of the failure on that front as well.

Ms. SCHAPIRO. I would be very happy to do that.

Mr. ROYCE. Thank you.

Mr. KANJORSKI. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Chairman Schapiro, I hope I have time to focus on the SEC's—what I would hope would be a policy, it is not your policy now—to surf the Internet, pose as an investor, and deal with all the unregistered activity. Because too much of the SEC's attitude seems to be, well, if they don't register with us, we don't focus on them. And that is especially necessary because we have relied on State regulation. But now with the Internet, it is easy to steal half a million dollars in each of 50 States; whereas in the past, if you were going to steal several million dollars, you had to do it pretty much in one area.

But I want to use my time to focus on derivatives. Derivatives offer the potential to make huge fortunes to those who are very powerful. And so they are defended because there is the tiniest argument that they do some good some of the time. And I refer here to over-the-counter derivatives.

Secretary Geithner reserved the right to use taxpayer funds to the full extent of the law not only to bail out old derivatives but to bail out derivatives that are issued tomorrow. So they operate with that subsidy, or implied subsidy, that maybe Treasury will figure out a way to bail out counterparties.

The defense of derivatives is that on rare occasions they are actually purchased by someone who has a risk they are trying to hedge; and that on even rarer occasions, they can't hedge that risk efficiently on an exchange-traded derivative, so they need the over-the-counter derivative.

I don't know if either of you have done any studies. But what percent of the over-the-counter derivatives are purchased by those who really are hedging a risk rather than the more common case of somebody just placing a casino bet? I mean, I could wake up today and think pork bellies are going up and place a bet, and I would love—those who like gambling would think that is a wonderful idea, but I don't own any pigs. I will ask either of you.

Do either of you know what percentage of this multitrillion-dollar industry, conducted in part at the risk of the U.S. taxpayer, is serving its alleged legitimate, societal purposes?

Ms. SCHAPIRO. I think because this has been such an opaque market and it is such a broadly unregulated market, that it is very hard for regulators to actually—

Mr. SHERMAN. What if we simply said a derivative was illegal unless you were really hedging a risk, and we basically said you can't use over-the-counter derivatives as a casino?

Mr. GENSLER. We actually need—and this has been a concept in our financial markets for many decades, if not over 100 years—for those that want to hedge a risk, you need speculators on the other side—

Mr. SHERMAN. One of the two parties has to have a real risk.

Mr. GENSLER. And so the vast majority of end users—and there are tens of thousands of end users—whether it is a small municipality, a small hospital, or a large consumer products—

Mr. SHERMAN. Although the vast majority of those end users can and do use the exchange-traded derivatives.

Mr. GENSLER. And we believe and we share your view that we have to bring the over-the-counter derivatives market onto ex-

changes. And in that regard, I have heard various estimates. The low estimate is about half, and the high estimate is about 80 percent of the over-the-counter derivatives marketplace could be considered standardized and on to exchanges. That would accommodate all end users. They would be able to see in real-time the pricing of these transactions and to be able to then decide to use those—

Mr. SHERMAN. So we could ban over-the-counter derivatives without major harm to the legitimate users of derivatives?

Mr. GENSLER. No, no. I would have to say I think that the tens of thousands of end users are able to hedge risk in their day-to-day business—it could be interest rate risk, it could be risk related to a certain energy product—but we want to bring transparency and lower the risk by the reforms we are calling for.

Mr. SHERMAN. Well, under these reforms, Wall Street will continue to have trillions of dollars of societally useless betting, using over-the-counter derivatives, and the taxpayer may very well be called upon to bail out these derivatives and their counterparties.

What I am asking is, given the risk to taxpayers, are there enormous benefits to our economy to have these over-the-counter derivatives where neither party has an insurable interest?

Chairman Schapiro?

Ms. SCHAPIRO. I think it is a very good question. And it is very hard to answer when you are trying to balance societal risk with trading, where neither party has an insurable interest.

I guess I would go back to what I said to Congresswoman Waters, that defining insurable risk is a very difficult question and one we need to think about very carefully.

I do think it is important where a party does have an insurable risk, that there is some flexibility to have a customized over-the-counter product, that they not absolutely be forced onto the exchange.

But I think where there is no insurable risk and it is merely a matter of two parties speculating, if we don't ban them—and that is a question for the Congress, obviously—I think the answer is that there has to be sufficient capital and dealer regulation and protections in place to ensure that we don't end up walking down this same path again.

Mr. SHERMAN. I would think we might ban them, and then we could open the door later.

Ms. SCHAPIRO. Exemptive authority actually might be a possible thing for Congress to consider.

Mr. KANJORSKI. The gentleman's time has expired.

Now I recognize the gentleman from California, Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you very much, Mr. Chairman.

FASB has made changes to accounting standards that will have tremendous impacts on securitizations known as FAS 166 and 167, as I said in my opening statement. These changes are occurring at the same time that the Administration is trying to restart the securitized credit markets through programs like TAF to private lending. On the other hand, it is our understanding that the Federal Reserve has serious concerns with this policy shift that could

derail efforts to stabilize financial institutions and get credit flowing.

And, I guess, is that accurate; and what are their concerns?

Ms. SCHAPIRO. Thank you, Congressman. I guess I have a couple of comments on this.

I would say that FASB walked down the path of reviewing off balance sheet accounting, really as a result of a concern expressed by the Fed and the Treasury and the President's Working Group, that more transparency and improvement to all balance sheet accounting was absolutely essential; that it had been the lack of transparency; the ability to push all these products off balance sheet had, in fact, been a contributor and perhaps a significant one to the financial crisis.

So I am surprised to learn that the Fed is not comfortable with where FASB landed with the guidance that it issued in June. I guess I would also say that these new standards were actually—the assumptions underlying these new standards were actually even incorporated into the stress-testing that was done of the banks. So the Fed has been quite involved and quite aware of what FASB was doing here and had quite a lot of input throughout this process.

With respect to what the Fed might do regarding capital rules, I think that is a question, obviously, best perhaps directed to Chairman Bernanke.

Mr. MILLER OF CALIFORNIA. That is applying stress tests to basically the banks with that slice of the market. How do you plan to apply it to the rest? Basically applying the stress test to banks is only a slice of the market.

Ms. SCHAPIRO. Yes. I brought that up only to indicate that the Fed has had active involvement in these discussions.

Mr. MILLER OF CALIFORNIA. Okay. We discussed in Chairman Bernanke's hearing yesterday about the challenges facing the $6 trillion commercial marketplace that we see coming in the future. Many of these accounting regulation changes—aimed most at the residential market—hit the commercial real estate capital market especially hard, which in turn impacts business and provides jobs.

Are the accounting policymakers communicating with the financial regulators who oversee the economy and recovery efforts? And I guess that would be Chairman Schapiro.

Ms. SCHAPIRO. Very much so. There is very great sensitivity at FASB—and I will say on the international level, the International Accounting Standards Board—that while financial statements are prepared for investors so that they can make rational decisions about the allocation of capital and where and how to invest, that there are other constituents that have interests. And so they have been very open to receiving input from bank regulators, from the SEC, as well as from investor groups and others.

Mr. MILLER OF CALIFORNIA. My concern is, if you look at the situation the banks were in at the beginning of the situation with the subprime and the residential marketplace, the reserves were much healthier than they are today and I think they were in a healthier than they are today.

And if you look at the commercial-backed mortgage securities, they are starting to hit about the fourth quarter this year; about

$5 billion worth of loans are maturing and coming due. And then about January, the default rate on the commercial sector was about one-quarter of 1 percent. It is about 2 percent today. In the coming days, it is expected to rise dramatically.

The loans due by about 2012 are about $1 trillion. The growing expectation is that default rates will be between 12 and 15 percent. How do we realistically handle that when most of these loans are 30-year loans, 5-year calls and you have gone from a 7 percent cap rate in 2006 to a 10 percent cap rate today. Whereby a lender is stuck in a situation where they might have a $14 million loan on a piece of property that based on a declining marketplace, as we see in a 10 percent cap rate, might value at $8 million when they should only get 5 on it, how are you going to deal with them trying to extend that loan when you have to apply mark-to-market to it, which would require a $9 million set-aside?

Ms. SCHAPIRO. I guess I am not exactly the right person to answer that question. But if I could take a step back and say that the SEC staff conducted a pretty extensive review of fair value and mark-to-market accounting last year and published their report before I arrived at the agency in early January. And what they found through their efforts is that investors value greatly fair-value accounting. It is what allows them to make decisions to invest at all.

Mr. MILLER OF CALIFORNIA. I understand that. But the situation we are facing is you are hitting a second round of residential foreclosures that is occurring right now. And that is the people who have good loans, but have lost their jobs. Or they are business people who are no longer able to make their payments who are losing their homes today.

You have about 70 percent of the lending marketplace is commercial; you have lenders that are not in a situation they were in 4 years ago as far as liquidity and reserves. I am not talking about a new loan that somebody wants to make for a piece of commercial investor property. I am talking about a current situation that the banking and lending industry is going be in today when these 5-year calls come due. And based on accounting standards, you have to apply mark-to-market—I mean, that is the rule today. And based on that rule alone, the banking industry is going to be absolutely upside down. I don't know how they weather this, or the economy weathers this next round of commercial foreclosures.

And my question is—I am not saying new loans—I am saying for existing loans that are coming due, how are we going to deal with them? We can't just say, "well, mark-to-market requires." We are faced with a financial situation that could be devastating.

Ms. SCHAPIRO. I guess I don't have a quick answer to your question. I would be more than happy to come up and maybe bring our chief accountant with me and spend some time to talk with you about that.

Mr. MILLER OF CALIFORNIA. I would love to, because this is a serious situation for the economy that is going to occur very rapidly, and I don't think banks can handle it.

Ms. SCHAPIRO. I would be very happy to do that.

Mr. MILLER OF CALIFORNIA. I would love to meet with you. Thank you.

Mr. KANJORSKI. Thank you, Mr. Miller.

We will now hear from Mr. Moore of Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

In light of the Madoff scandal and other Ponzi schemes, what can and should we do to improve the return of funds for defrauded investors? Chairman Schapiro, are the SEC's fair funds fulfilling this mission and should Congress consider additional steps for helping out defrauded investors?

Ms. SCHAPIRO. I think, Congressman, the fair funds program has been largely successful. It has returned billions and billions of dollars to investors. I think it was actually a brilliant idea on the part of this committee and the Congress to enable the SEC to get money back to investors through that mechanism.

That said, I think it takes us sometimes a little bit too long to get that done. We have a new Director of Enforcement who has responsibility for fair funds administration, and he is looking at how we can try to speed that process up to get the money back as quickly as we possibly can.

Mr. MOORE OF KANSAS. Thank you.

Chairman Gensler, do you have any comments, sir?

Mr. GENSLER. Not specifically on the fair funds proposal. But I do think that in working to harmonize our roles, that we should look very closely at whether our fraud standard between the CFTC and the SEC should be the same. We bring about a third of our fraud cases with the SEC, we do a lot jointly, and I think it would be helpful.

Mr. MOORE OF KANSAS. Thank you.

Some people have suggested we should require the largest financial firms to undergo an annual stress test that would have aggregate information publicly released even in good times, not just bad times. Is this something Congress should require, Chairman Gensler? And what about leverage? Any thoughts on how best to create incentives for firms to maintain reasonable leverage ratios?

Mr. GENSLER. Well, I think that one of the ways with regard to over-the-counter derivatives is that we be explicit. In the past, I think this is one of the assumptions that was sorely tested. We assumed that our overall capital standards would take into consideration these derivatives. And I think that we should be explicit in—whether it be the bank regulators or the SEC overseeing the broker dealers where most of the derivatives take place, there should be explicit capital standards for these derivatives. And then beyond that, we lower risk, of course, with centralized clearing.

Mr. MOORE OF KANSAS. Chairman Schapiro, do you have any comments?

Ms. SCHAPIRO. I guess I would add that I think stress-testing is critically important. And one of the failures was perhaps to include enough low-probability, high-impact events in stress tests historically. And that would be important for the regulators to insist upon with respect to clearinghouses, as well as with respect to dealers and other participants in the financial markets.

Mr. MOORE OF KANSAS. Thanks to our witnesses, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you, Mr. Moore.

We will now hear from the gentleman from Florida Mr. Posey.

Mr. POSEY. I thank you very much, Mr. Chairman.

Madam Chairwoman, I know we have the IG report that we should be receiving to give us more information. But I am curious as to whether or not we can know if anyone has been fired or even reprimanded over the way the Madoff fiasco was mishandled?

Ms. SCHAPIRO. Congressman, we are waiting, obviously, for the release of the Inspector General Report, which has been quite comprehensive and quite extensive and is due to be released at the end of the summer. And based upon whatever is in that report, we will have to make decisions about whether any kind of personnel actions are appropriate. We do not want to interfere in any way with the independent review of the Inspector General.

I will say, though, that I have not wanted to wait for the Inspector General's Report to make really extensive changes in the Securities and Exchange Commission, both in how we are organized—

Mr. POSEY. I know we are going to make changes in the future, hopefully, but I think there should be some accountability for the people who did not do their jobs. And I think that we made the illustration before: If you report a bank robbery to the local police department and the bank robbery has gone on for 10 years and they never walk over to the bank to investigate the robbery, somebody ought to lose their job, somebody ought to be reprimanded.

And it is just incredible that hasn't happened yet and that we have to wait for a report to take any action against the negligence that cost people, arguably, $70 billion in losses. Because your agency would not take any action, even after Barron's Magazine writes a feature story about this guy. I mean, it was worldwide news.

The smart hedge fund managers and the money managers know to stay away from him, but gullible members of the public were still lured in by this because he was allowed to continue doing business.

I just would think that there should be some discipline taken for the employees who allowed that to happen.

Ms. SCHAPIRO. Congressman, I think it is really critical that we have the full story of exactly what happened, and that is what the Inspector General has been charged with doing. There has not been a separate inquiry down to the level of employee conduct because that investigation is going on. And no one has wanted, and myself included, to interfere in any way with that.

But we are not just making changes in the future, we are making changes right now and have, over the last 6 months, made extensive changes at the SEC. We have a new Enforcement Director, a new Deputy, a new head of the New York office. We have new technology, we have new rules—

Mr. POSEY. But the question is, when employees don't do their job to protect the public, do we have to have an Inspector General come in there and tell us if it is okay to fire people? I mean, wouldn't that be a normal management routine if you have an employee who is incompetent or lazy, or for whatever other reason doesn't do his job to protect the public clearly like he should be doing, that we just don't fire those people? I mean, isn't there a policy in place to do that?

Ms. SCHAPIRO. I believe deeply in holding employees accountable for their work, but I can't do that until I have the facts and the details about how they conducted their work and what the issues

were. And that is what needs to wait for the Inspector General Report.

Mr. POSEY. But don't they have supervisors? Isn't there somebody in the organization that already—I mean, I know in any business—and I know government doesn't have competition like a business, but in any business where someone made a business blunder that big, the whole department would be gone, the senior manager would be gone. Doesn't that happen anywhere in government? I mean, doesn't anybody have the authority to get rid of incompetent employees, people who refuse or for whatever reason don't do their jobs?

Ms. SCHAPIRO. We do certainly have the ability to get rid of incompetent employees, but I have to have the evidence that shows me that employees were incompetent. I can't fire hundreds of people or tens of people without having a basis for doing that, and I don't have that basis at this point. That is the purpose, in part, of the Inspector General's Report, to understand—as was by my predecessor, Chairman Cox—to understand what went wrong; what did the SEC do; what did it fail to do; and where does the responsibility lie? And that is a necessary precondition, from my perspective, to taking any kind of personnel action.

Mr. POSEY. And with all due respect—and I am not aiming this at you—but I think the failure to know what went wrong and who is responsible for things that go wrong is culpable negligence on the part of management.

Ms. SCHAPIRO. I understand that concern. And there are things that we do know went wrong. We know that, for example, the agency receives 1.5 million tips a year and has no capability to really manage them or manage that process, so we have attacked that. We know we have gaps.

Mr. POSEY. We know twice they blew off Mr. Markopolos, even after Barrons Magazine did a big feature cover story on this fraud. I mean, anybody with half a brain in the agency, that should have been plenty to know right there. I mean, this is not one of a million tips that got ignored. This guy took a big file down there, he was a qualified, experienced investigator—I am talking about Mr. Markopolos—he took it down there and laid it in their hands, and they did nothing. He went back, and they did nothing. It was exposed in Barrons; they did nothing.

I mean, I can't imagine any excuse. It is just a matter of finding out who all had a fingerprint on this thing and getting rid of them.

Ms. SCHAPIRO. There is no question but that the agency did not appropriately follow up on the information that he gave them; I am not defending that at all. And that is why we are in this process. And that is why we have devoted extraordinary resources both to the Inspector General's investigation, but also to filling all the gaps that we can, putting in place all the processes and procedures, and bringing in many senior new people to the agency to try to ensure that we can protect against this ever happening again.

This is a tragedy of epic proportions, I fully appreciate that. And we are doing everything we can do—

Mr. POSEY. When do we expect the IG's report?

Ms. SCHAPIRO. The Inspector General has said that he would hope to release his report by the end of the summer.

Mr. KANJORSKI. By September 30th, Mr. Posey. And as soon as he does, we anticipate having a special session.

We have five votes on the Floor, and we have another committee hearing starting at 2 p.m., so I am going to pose the question to the members, do they wish to return and poll the panel for an additional hour and then start up, which would only give us about 40 minutes? Or should we have one more individual on questions and then recess the hearing until a further date or some other time? Are there any preferences?

Mr. BACA. Continue, and have the hearing some other time.

Mr. KANJORSKI. You are next.

Mr. BACA. That is why I want to continue.

Mr. KANJORSKI. I am not suggesting we do not have you. The question is, after you have had your opportunity, should we come back in an hour from now after votes? Is there anyone terribly in favor of that? Mr. McHenry says no.

Mr. MCHENRY. I am in favor of Mr. Baca getting his time, though. He is a good pitcher.

Mr. KANJORSKI. We follow seniority, so Mr. Baca gets the next question.

Ms. MOORE OF WISCONSIN. I guess I will write my questions to them, Mr. Chairman. Whatever you decide, Mr. Chairman.

Mr. KANJORSKI. And return in an hour? That is what we will do. We will hear Mr. Baca, and then take a recess for an hour and then return. And we will give the opportunity for the witnesses to have lunch or something in the meantime.

Mr. Baca.

Mr. BACA. Thank you very much, Mr. Chairman. And thank you for holding this meeting, along with the ranking member. And thank you, Chairwoman Schapiro and also Chairman Gensler.

My question is to either one of you two, or both of you can answer this. I have a question regarding both of your agencies' roles in the Consumer Financial Protection Agency. The bill states that CFPA will be required to coordinate with both of your agencies in an effort to promote consistent regulatory treatment of consumers' investment product and services.

Can you comment on your role in coordinating with CFPA? That is one question. And how do you envision this taking place? And what level of interaction would you like to see?

And finally, would you like to see the interactions be limited solely to derivatives, regulations; or does it expand beyond that?

Ms. SCHAPIRO. I am happy to start with that.

I think it is going to be critically important for the SEC to coordinate pretty closely with the CFPA. We both have investor or consumer protection missions at our core, and there is a possibility for there to be products or issues that arise where we will both have an interest. So I think a high level of pretty continuous coordination will be important.

The President's plan actually calls for, I think, a quarterly meeting, at a minimum, between the leadership of those agencies and the FTC and others, to make sure we are sharing information and that no gaps are able to arise between our authorities to protect investors.

Mr. GENSLER. I would concur with that. And while the CFTC principle focuses on markets and risk management, there is a clear consumer piece in protecting against fraud and manipulation where we would envision coordination.

The second part of your question was about derivatives, and I am sorry—

Mr. BACA. Would you like to see interaction be limited solely to derivatives regulation or does it expand beyond that?

Mr. GENSLER. I think it really does expand beyond that probably for both of our agencies because derivatives are a new product. But whether it be futures, options, or securities, there is some interplay.

I can even think of it in terms of how foreign currency transactions that are marketed to the retail public, which is very much something that we look at and try to protect the public on. But this consumer agency, as a bank product, might possibly get involved. So I think we need coordination as well on other product areas.

Mr. BACA. And the other question I have, I was wondering if you could speak to the concerns that a quick transaction to either a mandatory clearing process or a mandatory exchange process for all derivatives may cause a disruption in the market? Do you share this concern? And what can be done to counter this potential problem?

Mr. GENSLER. I think that bringing derivatives onto centralized clearing and exchanges will actually be an enormous benefit to the market. I think it will promote transparency and efficiency, and end users will get the benefit of seeing those prices, where right now they can't. And I think it will lower risk.

So, though I might not have understood the question, but I don't see it as a disruption, I see it as an enormous benefit to markets.

Mr. BACA. Chairman Schapiro?

Ms. SCHAPIRO. I agree.

Mr. BACA. Thank you.

Mr. Gensler, I want to follow up for a question that was asked by one of my colleagues earlier about the clearinghouses. Chairman Gensler, you said that you were in favor of having several different clearinghouses compete. Wouldn't this create the same problem as credit-rating agencies' experience with conflict of interest, and how do you safeguard against this?

Mr. GENSLER. I think that your analogy is a very apt one. And how we safeguard against it is it should be mandatory regulation. Not only do they have to register—which right now there is voluntary registration of the rating agencies—but we have to have regulation to manage the risk management. Rating agencies have very real conflicts of interest.

And I will defer to Chair Schapiro on whether she has the right authorities. But if she needs more, I would certainly support that.

But in this case, we should make sure that these clearinghouses have open access, that any member who can meet the rigorous risk management standards be able to be there and we not allow them to be sort of too clubby or controlled by the dealer community, but that they have to meet the rigorous risk management standards that we would lay out.

Mr. BACA. Ms. Schapiro, how would you answer that?

Ms. SCHAPIRO. I agree with that.

Mr. BACA. What do you agree with?

Ms. SCHAPIRO. That we have to have rigorous oversight of the clearing agencies in order to assure that, to the extent any conflicts of interest arise, that they are fully disclosed and, to the greatest extent possible, eliminated.

Mr. BACA. How will we monitor the oversight? You said that we need oversight. How will we monitor that we actually do have the oversight and that oversight is really occurring right now and the accountability that needs to be done?

Ms. SCHAPIRO. Both the SEC and the CFTC currently oversee clearinghouses for other products, for securities at the SEC, for futures at the CFTC, for options at the SEC. So we have pretty extensive programs in place to review the governance models of clearinghouses, the risk management systems, the technology, because if they have a major technology failure it can hugely disrupt markets. And so those programs exist. And my view would be we would expand them to cover any new clearing platforms or agencies that are created.

Mr. BACA. Thank you very much. I know that my time has expired. I yield back the balance of my time.

Mr. KANJORSKI. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record. Quite different from what we had originally decided, we decided not only to give you a lunch break but to give you the afternoon off to enjoy yourselves on the golf course.

Since we have votes, we are going to recess the meeting at this point and ask you to return in the future, probably in September, for the SEC as soon as the Inspector General's report is out, Ms. Schapiro. And we will annoy you, Gary. We won't let you feel abandoned. But with no further questions before the committee, the committee stands adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

A P P E N D I X

July 22, 2009

FOR MORE INFORMATION, call:202-225-4465 • www.house.gov/garrett

EMBARGOED UNTIL DELIVERY
Wednesday, July 22, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Financial Services Committee Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's Financial Services Committee hearing with SEC Chairman Schapiro and CFTC Chairman Gensler, "Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals":**

"Thank you, Mr. Chairman, for holding this hearing on the President's financial regulatory reform proposals, and thanks to Chairman Schapiro and Chairman Gensler for being with us this morning. Your agencies oversee some of the most transparent, efficient and complex markets in the world. They also are responsible for ensuring that our capital markets promote price discovery, capital formation and investor protection.

"The Administration's regulatory reform proposals task the SEC and CFTC with developing a regulatory infrastructure for over-the-counter derivatives and reporting to Congress by September 30, 2009, on how the agencies will harmonize two very disparate regulatory approaches. I look forward to hearing from you today on the progress being made on these tasks, as well as areas that are proving to be sticking points in your negotiations.

"While in some ways the Administration's proposal for regulating the OTC derivatives market is even-handed and certainly less radical than others that have already advanced in this Congress, there are still aspects of it that trouble me.

"I am worried that in the name of systemic risk reduction, requirements that would force more OTC transactions into central clearinghouses or onto exchanges, as well as stringent new margin requirements for both centrally cleared and non-centrally cleared transactions, will make hedging risk too expensive for many end-users of derivatives throughout the broader economy. The perverse outcome, therefore, of efforts to reduce systemic risk in these markets could actually increase risk for many companies if they are no longer able to cost-effectively engage in comprehensive risk management practices.

"Taking a step back, perhaps an even more fundamental question should be asked. Were standardized derivatives significantly related to the recent meltdown of our financial markets? If

not, why are we prescribing cures for a non-existent ailment? The failed oversight of one large dealer directly related to broader regulatory failures in the housing finance markets should not cause us to pursue radical "fixes" for the broader OTC derivatives markets and their non-dealer participants that had little or nothing to do with the recent crisis.

"We do need comprehensive regulatory reform, but it needs to be sensible and we need to make sure we are addressing actual problems in a way that we aren't doing more harm than good. The risk of mobile capital migrating elsewhere if we overshoot the mark in regulatory reform is a very real one. We should take the time to carefully evaluate all the proposals presented to us before we move forward with legislative action.

"I look forward to hearing from the witnesses on these and other issues."

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Representative Carolyn McCarthy
Financial Services Committee
Hearing on "Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals"

The lack of regulation, transparency and accountability in the over-the-counter derivatives market played a significant role in the economic crisis we are now facing. As the Committee moves forward on reforming the current regulatory regime to promote efficiency and reduce the risk of future economic meltdowns, we must provide the CFTC and the SEC with the tools they need to accurately regulate the OTC market.

I am pleased that the SEC and the CFTC agencies have come together to standardize regulations and work through regulatory differences, and I look forward to working with them and my colleagues on the Committee in achieving that goal.

STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE

July 22, 2009

Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. I am here today testifying on behalf of the Commission.

Financial regulatory reform is critical for the health of our economy. As President Obama outlined last month, we must urgently enact broad reforms in our financial regulatory structure in order to rebuild and restore confidence in our financial system.

Such reforms must comprehensively regulate both derivative dealers and the markets in which derivatives trade. I look forward to working with the Congress to ensure that all derivatives markets are transparent and free from fraud, manipulation and other abuses.

This effort will require close coordination between the SEC and the CFTC to ensure the most appropriate regulation. I'm fortunate to have as a partner in this effort, SEC Chair Mary Shapiro. She brings invaluable expertise in both the security and commodity futures area, which gives me great confidence that we will be able to provide the Congress with a sound recommendation for comprehensive oversight of the OTC derivatives market. We also will work collaboratively on recommendations on how to best harmonize regulatory efforts between agencies as requested by President Obama.

Comprehensive Regulatory Framework

A comprehensive regulatory framework governing OTC derivative dealers and OTC derivative markets should apply to all dealers and all derivatives, no matter what type of derivative is traded or marketed. It should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, it should apply to dealers and derivatives no matter what type of swaps or other derivatives may be invented in the future. This framework should apply regardless of whether the derivatives are standardized or customized.

A new regulatory framework for OTC derivatives markets should be designed to achieve four key objectives:

- Lower systemic risks;
- Promote the transparency and efficiency of markets;
- Promote market integrity by preventing fraud, manipulation, and other market abuses, and by setting position limits; and
- Protect the public from improper marketing practices.

To best achieve these objectives, two complementary regulatory regimes must be implemented: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves – including regulated exchanges, electronic trading systems and clearing houses. Only with these two complementary regimes will we ensure that federal regulators have full authority to bring transparency to the OTC derivatives world and to prevent fraud, manipulation, and other types of market abuses. These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved.

Regulating Derivatives Dealers

I believe that institutions that deal in derivatives must be explicitly regulated. In addition, regulations should cover any other firms engaged in derivatives whose activities in these markets can create large exposures to counterparties.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. The AIG subsidiary that dealt in derivatives – AIG Financial Products – for example, was not subject to any effective regulation. The derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks were not subject to mandatory regulation either.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we can oversee and regulate the entire derivatives market. I believe that our laws should be amended to provide for the registration and regulation of all derivative dealers.

The full, mandatory regulation of all derivatives dealers would represent a dramatic change from the current statutory system in which some dealers can operate with limited or no effective oversight. Specifically, all derivative dealers should be subject to capital requirements, margining requirements, business conduct rules and reporting and recordkeeping requirements. Standards that already apply to some dealers, such as banking entities, should be strengthened and made consistent, regardless of the legal entity where the trading takes place.

Capital and Margin Requirements. Congress should explicitly require regulators to promulgate capital requirements for all derivatives dealers, and margin requirements for all derivatives dealers. Imposing prudent and conservative capital and margin requirements on all derivatives dealers will help prevent the types of systemic risks that AIG created. No longer

would derivatives dealers or counterparties be able to amass large or highly leveraged risks outside the oversight and prudential safeguards of regulators.

Congress should also consider explicitly authorize regulators to require derivatives dealers and counterparties to segregate, or set aside, from their own funds, the margin required. This segregation or set-aside requirement will help ensure that counterparties are protected, if either counterparty to the customized OTC transaction experiences financial difficulties.

Also, Congress should consider amending the Bankruptcy Code to ensure that, if a derivatives dealer or counterparty of a customized OTC transaction that is not cleared becomes insolvent, either party can make themselves whole by accessing margin, and can continue economic activity without major disruption by moving positions to another derivatives dealer.

Imposing segregation requirements, and making relevant amendments to the Bankruptcy Code, will help prevent the failure of one derivatives dealer or counterparty to a customized OTC transaction that is not cleared from jeopardizing other parties. Appropriate segregation or set-aside requirements and bankruptcy protections should be developed for both standardized and cleared and or customized and not cleared OTC transactions.

Business Conduct and Transparency Requirements. Business conduct standards should include measures to both protect the integrity of the market and lower the risk (both counterparty and operating) from OTC derivatives transactions.

To promote market integrity, the business conduct standards should include prohibitions on fraud, manipulation and other abusive practices. For OTC derivatives that come under CFTC jurisdiction, these standards should require adherence to position limits when they perform or affect a significant price discovery function with respect to regulated markets.

Business conduct standards should ensure the timely and accurate confirmation, processing, netting, documentation, and valuation of all transactions. These standards for "back office" functions will help reduce risks by ensuring derivative dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

Derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories complement central clearing by providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions, and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the information recorded meets regulatory needs and that the repositories have strong business conduct practices.

The application of these business conduct standards and the transparency requirements will enable regulators to have timely and accurate knowledge of the risks and positions created by the dealers. It will provide authorities with the information and evidentiary record needed to take any appropriate action to address such risks and to protect and police market integrity. In this regard, the CFTC and SEC should have clear, unimpeded oversight and enforcement authority to prevent and punish fraud, manipulation and other market abuses.

Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public. No longer should the public be in the dark about the extensive positions and trading in these markets. This public information will improve the price discovery process and market efficiency.

Regulating Derivatives Markets

In addition to the significant benefits to be gained from broad regulation of derivatives dealers, I believe that additional safety and transparency must be afforded by regulating derivative market functions as well. All derivatives that can be moved into central clearing should be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing and trading on exchanges or through regulated electronic trading systems will promote transparency and market integrity and lower systemic risks. To fully achieve these objectives, both of these complementary regimes must be enacted. Regulating both the traders and the trades will ensure that both the actors and the actions that may create significant risks are covered.

Exchange-trading and central clearing are the two key and related components of well-functioning markets. Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. The practice of having the agency which regulates an exchange or trade execution facility also regulate the clearing houses for that market has worked well and should continue as we extend regulations to cover the OTC derivatives market.

Central Clearing. Central clearing should help reduce systemic risks in addition to the benefits derived from comprehensive regulation of derivatives dealers.

Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks. Currently, most of the contracts entered into in the OTC derivatives market are not cleared, and remain as bilateral contracts between individual buyers and sellers. In contrast, when a contract between a buyer and seller is submitted to a clearinghouse for clearing, the contract is "novated" to the clearinghouse. This means that the clearinghouse is substituted as the counterparty to the contract and then stands between the buyer and the seller.

Clearinghouses then guarantee the performance of each trade that is submitted for clearing. Clearinghouses use a variety of risk management practices to assure the fulfillment of this guarantee function. Foremost, derivatives clearinghouses lower risk through the daily discipline of marking to market the value of each transaction. They also require the daily posting of margin to cover the daily changes in the value of positions and collect margin as extra protection against potential market changes that are not covered by the daily mark-to-market.

The regulations applicable to clearing should require that clearinghouses establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Working with Congress, we should consider possible amendments to the CEA to expand and deepen the core principles that registered derivatives clearing organizations must meet to achieve these goals to both strengthen these systems and to reduce the possibility of regulatory arbitrage. Clearinghouses should have transparent governance arrangements that incorporate a broad range of viewpoints from members and other market participants.

Central counterparties should also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm. Additionally, central clearinghouses should implement rules that allow indirect participation in central clearing. By novating contracts to a central clearinghouse coupled with effective risk management practices, the failure of a single trader, like AIG, would no longer jeopardize all of the counterparties to its trades.

One of the lessons that emerged from this recent crisis was that institutions were not just "too big to fail," but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled.

In implementing new responsibilities for CCPs clearing swaps, it will be appropriate to consider possible additional oversight requirements that may be imposed by any systemic risk regulator that Congress may establish.

Under the Administration's approach, the systemic regulator would be charged with ensuring consistent and robust standards for all systemically important clearing, settlement and payment systems. For clearinghouses overseen comprehensively by the CFTC and SEC, the CFTC or SEC would remain the primary regulatory, but the systemic regulator would be able to request information from the primary regulator, participate in examinations led by the primary regulator, make recommendations on strengthening standards to the primary regulator and ultimately, after consulting with the primary regulator and the new Financial Services Oversight

Council, use emergency authority to compel a clearinghouse to take actions to address financial risks.

Requiring clearing for standard products will promote market integrity and lower risk. Individual firms will become less interconnected as OTC transactions are netted out through centralized clearing. Furthermore, mandated clearing will bring the discipline of daily valuation of transactions and the posting of collateral.

Exchange-trading. Beyond the significant transparency afforded the regulators and the public through the record keeping and reporting requirements of derivatives dealers, market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated transparent electronic trading systems. I believe that this should be required of all standardized contracts.

Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. A complete audit trail of all transactions on the exchanges or trade execution systems should be available to the regulators. Through a trade reporting system there should be timely public posting of the price, volume and key terms of completed transactions. The Trade Reporting and Compliance Engine (TRACE) system currently required for timely reporting in the OTC corporate bond market may provide a model.

The CFTC and SEC also should have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation and other abuses.

In contrast to long established on-exchange futures and securities markets, there is a need to encourage the further development of exchanges and electronic trading systems for OTC derivatives. In order to promote this goal and achieve market efficiency through competition, there should be sufficient product standardization so OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another.

Position Limits. Position limits must be applied consistently across all markets, across all trading platforms, and exemptions to them must be limited and well defined. The CFTC should have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market, including international markets.

Standardized and Customized Derivatives

It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated. Regulations should ensure that customized derivatives are not used solely as a means to avoid the clearing and exchange requirements. This could be accomplished in two ways. First, regulators should be given full authority to prevent fraud, manipulation and other abuses and to impose recordkeeping and transparency requirements with respect to the trading of all swaps, including customized swaps. Second, we must ensure that

dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.

One way to ensure this would be to establish objective criteria for regulators to determine whether, in fact, a swap is standardized. For example, there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearinghouse, then it should be required to be cleared. Additional potential criteria for consideration in determining whether a contract should be considered to be a standardized swap contract could include:

- The volume of transactions in the contract;
- The similarity of the terms in the contract to terms in standardized contracts;
- Whether any differences in terms from a standardized contract are of economic significance; and
- The extent to which any of the terms in the contract, including price, are disseminated to third parties.

Criteria such as these could be helpful in ensuring that parties are not able to avoid the requirements applicable to standardized contracts by tweaking the terms of such contracts and then labeling them "customized."

Regardless of whether an instrument is standardized or customized, or traded on an exchange or on a transparent electronic trade execution system, regulators should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation and other market abuses. No matter how the instrument is traded, the CFTC and SEC as appropriate also should have clear, unimpeded authority to impose position limits, including aggregate limits, to prevent excessive

speculation. A full audit trail should be available to the CFTC, SEC and other Federal regulators.

Authority

To achieve these goals, the Commodity Exchange Act and securities laws should be amended to provide the CFTC and SEC with clear authority to regulate OTC derivatives. The term "OTC derivative" should be defined, and clear authority should be given over all such instruments regardless of the regulatory agency. To the extent that specific types of OTC derivatives might overlap agencies' existing jurisdiction, care must be taken to avoid unnecessary duplication.

As we enact new laws and regulations, we should be careful not to call into question the enforceability of existing OTC derivatives contracts. New legislation and regulations should not provide excuses for traders to avoid performance under pre-existing, valid agreements or to nullify pre-existing contractual obligations.

Achieving the Five Key Objectives

Overall, I believe the complimentary regimes of dealer and market regulation would best achieve the four objectives outlined earlier. As a summary, let me review how this would accomplish the measures applied to both the derivative dealers and the derivative markets.

Lower Systemic Risk. This dual regime would lower systemic risk through the following four measures:

- Setting capital requirements for derivative dealers;

- Establishing margin requirements for derivative dealers (whether dealing in standardized or customized swaps);
- Establishing segregation or set aside requirements for derivatives dealers and counterparties to customized OTC transactions, and creating appropriate bankruptcy protections;
- Requiring centralized clearing of standardized swaps; and
- Requiring business conduct standards for dealers.

Promote Market Transparency and Efficiency. This complementary regime would promote market transparency and efficiency by:

- Requiring that all OTC transactions, both standardized and customized, be reported to a regulated trade repository or central clearinghouses;
- Requiring clearinghouses and trade repositories to make aggregate data on open positions and trading volumes available to the public;
- Requiring clearinghouses and trade repositories to make data on any individual counterparty's trades and positions available on a confidential basis to regulators;
- Requiring centralized clearing of standardized swaps;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring the timely reporting of trades and prompt dissemination of prices and other trade information;

Promote Market Integrity. It would promote market integrity by:

- Providing regulators with clear, unimpeded authority to impose reporting requirements and to prevent fraud, manipulation and other types of market abuses;
- Providing regulators with authority to set position limits, including aggregate position limits;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring business conduct standards for dealers.

Protect Against Improper Marketing Practices. It would ensure protection of the public from improper marketing practices by:

- Business conduct standards applied to derivatives dealers regardless of the type of instrument involved; and
- Amending the limitations on participating in the OTC derivatives market in current law to tighten them or to impose additional disclosure requirements, or standards of care (e.g. suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

Conclusion

The need for reform of our financial system today has many similarities to the situation facing the country in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress "the enactment of legislation providing for the regulation by the Federal Government of the

operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation." The Congress swiftly responded to the clear need for reform by enacting the Securities Exchange Act of 1934. Two years later it passed the Commodity Exchange Act of 1936.

It is clear that we need the same type of comprehensive regulatory reform today. Today's regulatory reform package should cover all types of OTC derivatives dealers and markets. It should provide regulators with full authority regarding OTC derivatives to lower risk; promote transparency, efficiency, and market integrity and to protect the American public.

Finally, I would note that we are working closely with our international partners to make sure that the legislative, regulatory and policy developments outlined today occur in tandem with our international partners. We are therefore working closely with our colleagues in Europe and Asia on areas of particular concern in order to try to prevent regulatory arbitrage.

Today's complex financial markets are global and irreversibly interlinked. We must work with our partners in regulating markets around the world to promote consistent rigor in enforcing standards that we demand of our markets.

I look forward to working with this Committee, and others in Congress, to accomplish these goals.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I look forward to answering any questions.

Testimony Before the
United States House of Representatives Committee on Financial Services

"Regulatory Perspectives on the Obama Administration's
Financial Regulatory Reform Proposals"
Wednesday, July 22, 2009
by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

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

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("Commission" or "SEC"). I sincerely appreciate the support this Committee has shown the Commission, and I am pleased to have the opportunity to discuss the Commission's perspective with respect to the Administration's Financial Regulatory Reform Proposals.

Overview

President Obama recently unveiled his plan to build the foundation for a stronger and safer financial system. I believe the plan makes real progress in filling gaps in our financial regulatory framework that became apparent in the wake of the financial crisis. Although the Commission is just one part of that landscape, in my view the proposals described in the Administration's white paper and laid out in several recent legislative drafts do much to strengthen the Commission and improve investor protection in the process, as well as to help to restore confidence in the soundness and integrity of our financial system as a whole.

The Administration's plan covers an extraordinarily broad spectrum of issues that impact the U.S. financial regulatory system. Today, I will focus on those proposals that most directly bear on the SEC's regulatory mission, including those concerning:

- over-the-counter ("OTC") derivatives;
- harmonization of securities and futures regulation;
- hedge funds;
- broker-dealers and investment advisers;
- Commission enforcement;
- credit rating agencies; and
- the need to identify and address emerging systemic risks that pose a threat to the stability of our financial system.

At the outset, I want to emphasize to the Committee that I believe that the SEC and other financial regulatory agencies have been making solid progress using our existing authority to address the financial regulatory problems that face the country. These

problems did not arise overnight and can be extremely complex. To address these problems appropriately, there is no substitute for hard work and a focused determination to get the job done right. The SEC is devoted to meeting this challenge.

As I noted in my recent testimony before the Subcommittee on Capital Markets, the Commission is acting promptly and decisively on a number of different fronts. Some of the changes we have proposed through rulemaking concern topics that are not new: for example, short selling, money market funds, and shareholder rights. But we also are focused on the early identification of emerging risks to market integrity and efficiency that may need to be addressed, including, for example, issues surrounding dark pools and stock lending. Dark pools generally refer to automated trading systems that do not display quotes in the public quote stream. We have heard concerns that dark pools may lead to a lack of transparency, may result in the development of significant private markets, and may potentially impair the public price discovery function. Given the potential risks posed by dark pools, the Commission will take a serious look at what regulatory actions may be warranted to respond to the potential investor protection and market integrity concerns dark pools may raise. Similarly, we also are examining market related practices associated with securities lending to determine what, if any, future regulatory action is appropriate. Rest assured that the SEC is committed to using its existing tools and authority to address as best it can the financial regulatory issues the country now faces.

Despite this, it has become clear that some regulatory gaps and market issues cannot be fully addressed without statutory changes. This Committee, through its hearings and other work, already has made important progress on this essential task. As the Committee continues to move forward in the coming months, we are committed to assisting you to the best of our abilities as you fashion the landmark legislation necessary to rebuild a solid foundation for the U.S. financial system.

OTC Derivatives

One of the gaps exposed by the financial crisis concerns the lack of regulation of OTC derivatives, which are largely excluded from the securities regulatory framework by the Commodity Futures Modernization Act of 2000.[1] As the country's capital markets regulator, the SEC is primarily concerned about OTC derivatives products that are directly related to or based on securities or securities issuers, and as such are directly connected with the SEC's statutory mandate. A core principle of the approach we advocate to OTC oversight is to reduce the opportunity for regulatory arbitrage by ensuring that economically equivalent products are regulated in a similar manner.

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[1] Section 2A of the Securities Act, Section 3A of the Exchange Act, and related provisions prohibit the SEC from: (1) promulgating, interpreting, or enforcing rules in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud or manipulation with respect to any security-based swap agreement; and (2) registering or requiring the registration of any security-based swap agreement. As noted below, some OTC derivatives products, such as certain equity-linked notes, always have been considered securities and currently are covered by the securities regulatory regime.

The Administration's proposals would establish a comprehensive framework for regulating OTC derivatives. The framework is designed to achieve four broad objectives: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

The Administration's plan recognizes that multiple federal regulatory agencies play critical roles in implementing the proposed framework, including the SEC and the CFTC. Among other things, it emphasizes that the securities and commodities laws should be amended to ensure that the SEC and CFTC, consistent with their respective missions, have the authority to achieve – together with the efforts of other regulators – the four policy objectives for OTC derivatives regulation.

What we recommend is a straightforward and principled approach to help the Administration achieve its policy objectives. Stated simply, primary responsibility for all "securities-related" OTC derivatives would be retained by the SEC, which is already responsible for the oversight of markets affected by this subset of OTC derivatives. Primary responsibility for all other OTC derivatives, including derivatives related to interest rates, foreign exchange, commodities, energy, and metals, would rest with the CFTC.

Under this functional and sensible approach to regulation, OTC derivatives markets that are interconnected with the regulated securities markets would be incorporated within a unified securities regulatory regime. The direct link between securities-related OTC derivatives and securities is such that SEC regulation of the former is essential to the effectiveness of the SEC's statutory mission with respect to the securities markets. The securities regulatory regime is specifically designed to promote the Congressional objectives for capital markets, which include investor protection, the maintenance of fair and orderly markets, and the facilitation of capital formation. Securities-related OTC derivatives should be subject to the federal securities laws so that the risk of arbitrage and manipulation of interconnected markets is minimized.

Over the years, Congress has fashioned a broad and flexible regulatory regime for securities that long has accommodated a wide range of products and trading venues. The products include equities, debt, other fixed income securities, options on securities, exchange-traded funds and other investment companies, and many other types of derivative contracts on securities. Some of these securities products are among the most actively traded financial products in the world, with exchange-listed US equities currently trading approximately 11 billion shares per day. Many other securities products trade rarely, if at all. In addition, securities products trade in many different ways in a wide variety of venues, depending on the particular features of the product. These venues include 11 national securities exchanges with self-regulatory responsibilities, more than 70 alternative trading systems that execute OTC transactions, and hundreds of broker-dealers that execute OTC transactions. Finally, securities products are cleared and settled in a variety of ways depending on the particular characteristics of the product.

The current securities laws are broad and flexible enough to regulate all of these varied securities products and trading venues. The regulatory requirements are specifically tailored to reflect the particular nature of products and venues and to promote the Congressional objectives for capital markets. Accordingly, under our proposal, securities-related OTC derivatives would be brought under the same umbrella of oversight as the related, underlying securities markets in a relatively straightforward manner with little need to "reinvent the wheel." Specifically, Congress could make a limited number of discrete amendments to the statutory definition of a security and certain other provisions to cover securities-related OTC derivatives. With these changes, securities-related OTC derivatives could be incorporated within an existing regulatory framework that is appropriate for these products.

The Administration's plan stresses the importance of a "robust and appropriate regime of prudential supervision and regulation" for OTC derivatives dealers. Under our proposal, all dealers in securities-related OTC derivatives would be subject to prudential supervision and regulation to ensure there are no gaps. To reduce duplication, OTC derivatives dealers that are banks would be subject to prudential supervision by their federal banking regulator. All other dealers in securities-related OTC derivatives would be subject to supervision and regulation by the SEC.

The SEC also would have authority to establish business conduct standards and recordkeeping and reporting requirements (including an audit trail) for all securities-related OTC derivatives dealers and other firms with large counterparty exposures in securities-related OTC derivatives ("Major OTC Participants"). This "umbrella" authority would help ensure that the SEC has the tools it needs to oversee the entire market for securities-related OTC derivatives. Major OTC Participants also would be required to meet appropriate standards for the segregation of customer funds and securities.

In addition, under our approach, clearinghouses for securities-related OTC derivatives would be subject to oversight as clearing agencies by the SEC and trading markets would be subject to oversight by the SEC. To achieve the important goal of clearing standardized OTC derivatives through central counterparties, the SEC should be provided authority to establish which securities-related OTC derivatives or class of securities-related OTC derivatives are standardized. Such a determination would have to take into account whether the product can be effectively risk managed by a central counterparty, whether there is a liquid market for the product, and whether there are fair, reliable and generally accepted pricing sources. In carrying out this responsibility, the SEC would, of course, consult with the Commodity Futures Trading Commission and the Federal Reserve Board. It is also important to consider whether there are certain standardized OTC derivatives that are clearing-eligible but nonetheless may not need to be centrally cleared, such as trades between related parties.

In fashioning a regulatory framework for OTC derivatives, it is crucial to recognize the close relationship between the regulated securities markets and the now mostly

unregulated markets for securities-related OTC derivatives. Securities-related OTC derivatives can be used to establish either a synthetic "long" exposure to an underlying security or group of securities, or a synthetic "short" exposure to an underlying security or group of securities. In this way, market participants can replicate the economics of either a purchase or sale of securities without purchasing or selling the securities themselves.

For example, an equity swap on a single equity security or on an index, such as one of the Dow stocks or the Dow itself, would give the holder of the "long" position all of the economic exposure of owning the stock or index, without actual ownership of the stock or index. This would include exposure to price movements of the stock or index, as well as any dividends or other distributions. Similarly, credit default swaps ("CDS") can be used as synthetic substitutes for the debt securities of one or more companies. In addition, market participants also may use a securities-related OTC derivative to establish a short position with respect to the debt of a specific company. In particular, a market participant that does not own a bond or other debt instrument of a company may purchase a CDS as a way to short that company's debt. Trading practices in the CDS market, whether legitimate or abusive, can affect the securities markets, including rules designed to regulate short sales.

Because market participants can readily use securities-related OTC derivatives to serve as synthetic substitutes for securities, the markets for these OTC derivatives directly and powerfully implicate the policy objectives for capital markets that Congress has established in the federal securities laws. These objectives include investor protection, the maintenance of fair and orderly markets, and the facilitation of capital formation.

Bringing securities-related OTC derivatives under the umbrella of the federal securities laws would be based on sound principles of functional regulation, would be relatively straightforward to implement, and would promote Congressional policy objectives for the capital markets. A clear delineation of primary regulatory responsibility for OTC derivatives also would help avoid regulatory gaps from arising in the future. Finally, integrating oversight of securities-related OTC derivatives with oversight of the related, underlying securities markets would minimize the extent of dislocation with respect to existing participants and current practices in the OTC derivatives markets, while still achieving the objectives for OTC derivatives regulation set forth in the Administration's proposals.

Harmonization

The SEC and CFTC have been working closely together this year, and I am confident that we will make progress on the goals expressed in the Administration's white paper as we seek to build a common foundation for market regulation. While the cultures and mission of the two agencies are in some ways different, we agree on the need for a robust regulatory framework for our financial markets.

As is noted in the Administration's white paper, securities regulation and futures regulation share many of the same public policy objectives. In this regard, we appreciate the benefits that could be achieved through greater coordination and harmonization between the SEC and the CFTC for regulation and oversight of economically equivalent instruments. More efficient oversight consistent with the protection of investors could be achieved by filling regulatory gaps and fostering harmonization between the SEC and the CFTC with respect to similar financial instruments.

To advance this initiative, the SEC staff has undertaken a coordinated effort to identify and explain significant differences in oversight and regulation of similar types of financial instruments such as options and futures in light of the underlying public policy objectives. The SEC staff is also working with the CFTC staff in developing a coordinated approach to this task.

Hedge Funds

Over the past two decades, private funds, including hedge, private equity and venture capital funds, have grown to play an increasingly significant role in our capital markets both as a source of capital and the investment vehicle of choice for many institutional investors. Our staff estimates that advisers to hedge funds have almost $1.4 trillion under management. Since many hedge funds are very active and often leveraged traders, this amount understates their impact on our trading markets. Hedge funds reportedly account for 18-22 percent of all trading on the New York Stock Exchange. Venture capital funds manage about $257 billion of assets,[2] and private equity funds raised about $256 billion last year.[3]

The securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles. Sponsors of private funds—typically investment advisers—are able to organize their affairs in such a way as to fall within certain exemptions or exceptions to the registration requirements of the federal securities laws. The Commission only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes we administer. Private funds, however, often structure their operations to take advantage of certain exemptions from registration of the offer or sale of securities under the Securities Act of 1933, registration of the funds under the Investment Company Act of 1940, and in many cases registration of their advisers under the Investment Advisers Act of 1940. Consequently, private funds and many of their advisers are outside the purview of the SEC, and we have no detailed

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[2] The National Venture Capital Association (NVCA) estimates that 741 venture capital firms and 1,549 venture capital funds were in existence in 2007, with $257.1 billion in capital under management. NVCA, Yearbook 2008 at 9 (2008). In 2008, venture capital funds raised $28.2 billion down from $35.6 billion in 2007. Thomson Reuters & NVCA, News Release (Apr. 13 2009). In 2007, the average fund size was $166 million and the average firm size was $347 million. Id. at 9.

[3] U.S. private equity funds raised $256.9 billion in 2008 (down from $325.2 billion in 2007). Private Equity Analyst, 2008 Review and 2009 Outlook at 9 (2009) (reporting Dow Jones LP Source data), available at http://fis.dowjones.com/products/privateequityanalyst.html.

insight into how they manage their trading activities, business arrangements or potential conflicts-of-interest.

Furthermore, the private funds data that we are often requested to provide members of Congress (including the data provided above) or other federal regulators are based on industry sources, which frequently have proven over the years to be unreliable and inconsistent because neither the private funds nor their advisers are required to report even the most basic census-type information.

In my view, this situation presents a significant regulatory gap in need of closing. I support the recommendation discussed in the Administration's white paper that advisers to hedge funds and other private pools of capital should be required to register with the SEC under the Investment Advisers Act. I believe the bill the Treasury Department put forth last week, titled the "Private Fund Investment Advisers Registration Act of 2009," would accomplish this important goal. I look forward to working with Congress on issues regarding the level of additional resources that would be necessary if private fund managers were required to register with the SEC, as well as ensuring that any law passed would provide the Commission with sufficient time to establish and make effective any necessary recordkeeping requirements. I firmly believe that such registration and the resulting oversight would better protect our markets and would enable investors, regulators and the marketplace to have more complete and meaningful information about private fund advisers, the funds they manage and their market activities.

Broker-Dealers and Investment Advisers

The Commission has been closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct or the regulatory requirements applicable to broker-dealers and investment advisers. When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to the same standard of conduct and equivalent regulatory requirements, regardless of the label attached to the providers.

I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients and be subject to equivalent regulation. As such, I support the standard contained in the Department of the Treasury bill recently put forth entitled the "Investor Protection Act of 2009." That bill explicitly would enable the Commission to promulgate rules to provide all broker-dealers and investment advisers providing investment advice to retail customers act solely in the interest of their customers or clients without regard to the financial or other interests of the financial service professional. The establishment of this investor-focused approach as a consistent standard for all broker-dealers and investment advisers providing investment advice would represent a significant step forward in the protection of retail investors.

The Treasury bill also calls for the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals. This disclosure could further buttress an investor-oriented standard of care and greatly enhance investor understanding of the nature of the services various financial service professionals provide.

The Treasury bill also authorizes the SEC to promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries that are contrary to the public interest and the interest of investors. This authority would enable the SEC to better rationalize the regulatory landscape applicable to broker-dealers and investment advisers and eliminate practices that subvert, rather than further, investor interests.

To the extent that additional authority would be necessary to further harmonize the broker-dealer and investment adviser regulatory regime, we would expect to work with Congress on that issue.

Enhancing Enforcement

The Administration's proposals in the white paper and the "Investor Protection Act of 2009" would also seek to enhance the SEC's enforcement powers. Specifically, the SEC would gain expanded authority to pay whistleblowers who bring significant information to the Enforcement Division, pursue expanded sanctions against wrongdoers, and to increase the potential grounds for seeking sanctions.

Whistleblowers

Whistleblowers can be a source of high quality evidence leading to enforcement actions. The bill provides the SEC with the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards using funds collected in enforcement actions not otherwise distributed to investors. Currently, the SEC has the authority to compensate sources in insider trading cases; the Administration's proposal would extend that authority to compensate whistleblowers who bring substantial evidence of other securities law violations, which I believe would greatly enhance the SEC's ability to enforce the securities laws.

Expanded Sanctions

Currently, a securities professional barred from being an investment adviser for serious misconduct could still participate in the industry as a broker-dealer. I believe that the SEC should be permitted to impose collateral bars against such regulated persons. The Administration's proposal gives the SEC the authority to bar a regulated person who violates the securities laws in one part of the industry, for example a broker-dealer who misappropriates customer funds, from access to customer funds in another part of the securities industry (such as an investment adviser). By expressly empowering the SEC to impose broad prophylactic relief in one action in the first instance, the Administration's

proposal would enable the SEC to more effectively protect investors and the markets while more efficiently using SEC resources.

Grounds for Seeking Sanctions

The Exchange Act and the Investment Advisers Act permit the SEC to bring actions for aiding and abetting violations of those statutes in civil enforcement actions.
The Administration's proposal would provide the SEC with authority to bring actions for aiding and abetting violations of the Securities Act and the Investment Company Act, which authority the SEC currently does not have. This would close a gap and create consistent remedies that the SEC can seek and eliminates significant limitations on the SEC's ability to pursue serious misconduct. In addition, the proposal would clarify that the Investment Advisers Act expressly permits imposition of penalties on aiders and abetters.

Oversight of Credit Rating Agencies

We are committed to working with Congress to ensure a strong and robust regulatory framework for credit rating agencies. In particular, my personal belief is that legislation to require mandatory registration by credit rating agencies would be a significant step forward in making sure that this sector of the market is brought under regulatory oversight without the danger that some credit rating agencies may fail to register in order to avoid regulation.

Operating under the current regulatory framework, we have already taken multiple steps to improve regulatory oversight of credit rating agencies. In response to the credit market turmoil, in February the Commission adopted several measures to increase transparency and accountability at nationally recognized statistical rating organizations' ("NRSROs") in order to address concerns about the integrity of their credit rating procedures and methodologies.[4] The requirements are designed to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions.

In conjunction with the adoption of these new measures, the Commission proposed an additional amendment which would require NRSROs to disclose ratings history information for 100% of all issuer-paid credit ratings.[5] Finally, on the same date, the Commission re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or

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[4] *See* "Amendments to Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/final/2009/34-59342.pdf.

[5] *See* "Re-proposed Rules for Nationally Recognized Statistical Rating Organizations," February 2, 2009, http://www.sec.gov/rules/proposed/2009/34-59343.pdf ("February 2, 2009 Re-proposing Release").

underwriter unless the information about the product provided to the NRSRO is made available to other NRSROs.[6]

To provide greater oversight of the NRSROs, I have also allocated additional resources to establish a branch of examiners dedicated specifically to conducting examination oversight of the NRSROs. This branch will conduct routine, special and cause examinations of the ratings agencies to review their activities and NRSRO compliance with the Credit Rating Agency Reform Act of 2006 and SEC rules.

In addition, I have directed the Commission staff to explore possible new regulations in this area, including limiting the potential for rating shopping. One possible approach would be to require disclosure by issuers of all pre-ratings obtained from NRSROs prior to selecting a firm to conduct a rating, as well as requiring NRSROs to provide additional disclosures.

Role of Financial Stability Oversight Council

I believe a multi-disciplinary group of financial regulators can play a critical role in assessing emerging systemic risks by setting standards for liquidity, capital and risk management practices. While a systemic risk regulator should play a critical role in this process (such as by working to implement and help set standards), in my view it is vital that its role be complemented by the creation of a strong and robust systemic risk council of primary financial regulators ("Financial Stability Oversight Council" or "Council").

I believe the Council should have authority to identify institutions, practices, and markets that create potential systemic risks, and also should be authorized to set standards for liquidity, capital and other risk management practices at firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness. A Council also would provide a forum for analyzing and recommending harmonization of certain standards at other significant financial institutions.

Importantly, however, a systemic risk regulator could collect information and be well informed on key matters, such as holding company liquidity and risk exposures, to be well positioned to respond quickly and effectively to any future crisis. In my view, a systemic risk regulator should have clearly defined authority to collect information and implement standards developed by the Council on capital, liquidity, and risk management. Further, I believe the systemic risk regulator also could be given narrow authority in extraordinary circumstances to act for a limited period of time when the holding company is at elevated risk to direct the sale of assets, reduce business, or cease activity. Beyond these extraordinary circumstances, all systemic risk regulator actions should be taken in coordination with the primary regulator of all significant U.S. subsidiaries and the Council.

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[6] *See* February 2, 2009 Re-proposing Release.

I and many others feel that we must act now to restore investor confidence in our nation's markets and financial systems. I believe the steps the Administration, the SEC and other agencies are taking, in conjunction with Congress' extensive efforts, will help restore investor confidence through the creation of a robust financial regulatory framework better designed to withstand future periods of market or economic volatility.

I want to thank you for your continued strong support for the SEC and its critical mission, and would be happy to answer any questions you may have.

Questions from Representative Royce
Pages 65-67 of draft transcript

Q: Well, I would like to ask you if you then could address the questions raised by Mr. Atkins, which I raised in my opening statements; specifically, why do you think the SEC, in the course of the past twelve years, experienced, in his words, "catastrophic failures in every one of its four core competencies." He started with rulemaking, filing review, enforcement and examinations.

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Let's do it this way, then. For the benefit of members, you can do it in writing.

As I stated previously, while I disagree with Commissioner Atkins' characterizations, I do firmly believe that there is always room for improvement within any government agency. For example, to improve our enforcement efforts, the SEC is implementing several initiatives that will make us more knowledgeable, better coordinated, and more efficient in attacking the causes of the recent financial crisis. These initiatives also will better arm us to address current and future market practices that may be of concern. Highlights of the current changes include:

Specialization. We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, including Asset Management (including hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (including various derivative products), Foreign Corrupt Practices Act cases, and Municipal Securities and "Pay-to-Play" issues.

Management Restructuring. The Division is adopting a flatter, more streamlined organizational structure eliminating an entire layer of middle management; redeploying staff who were first line managers to the mission-critical work of conducting front-line investigations.

Streamlining. To facilitate timely investigations, the agency is streamlining internal processes and procedures by, among other things, delegating to senior officers the authority to initiate the issuance of subpoenas for documents and testimony.

Office of Market Intelligence. We are creating an Office of Market Intelligence to improve the Enforcement Division's handling of tips and complaints. This new office dovetails with the agency-wide effort to revamp the way in which the SEC handles the large number of letters, emails and complaints it receives each year. This office will be a key part of the agency's efforts to collect, analyze, triage, refer and monitor the information the agency receives. The office also will draw on the expertise of the agency's various offices to help analyze the tips and identify wrongdoing while greatly

increasing our communication with other divisions and offices about how to respond to tips and complaints.

Other Initiatives. The agency is enhancing training and supervision and developing tools to encourage cooperation from company insiders that will enable the agency to build stronger cases and file them sooner than would otherwise be possible.

In addition, although a long-term effort, the SEC has taken a number of steps to transform its culture and approach to regulation so as to more appropriately calibrate the costs and benefits of regulation with short-and-longer term risks. Among the changes are new leadership within our Divisions, streamlining within the Enforcement Division (as outlined above), and significant expansion of cross-divisional and multi-disciplinary teams.

Q: And I would add two more questions in writing, if you could submit. I think going forward it would help committee members. What led to failures in financial institutions to recognize the inadequacy of their own risk management systems and strategy in time to avert a collapse? And second, how did investors get lulled into complacency and not adequately do their own due diligence as well?

You probably will have some perspective at the SEC on those two questions, and I think a better understanding of the failure on that front as well.

When I became Chairman of the SEC in late January 2009, the agency and financial markets were still reeling from the events of the fall of 2008. Since that time, the SEC has worked tirelessly to review its policies, improve its operations and address the legal and regulatory gaps – and in some cases, chasms – that came to light during the crisis. It is my view that the crisis resulted from many interconnected and mutually reinforcing causes, including:

- The rise of mortgage securitization (a process originally viewed as a risk reduction mechanism) and its unintended facilitation of weaker underwriting standards by originators and excessive reliance on credit ratings by investors;

- A wide-spread view that markets were almost always self-correcting and an inadequate appreciation of the risks of deregulation that, in some areas, resulted in weaker standards and regulatory gaps;

- The proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood;

- Perverse incentives and asymmetric compensation arrangements that encouraged significant risk-taking;

- Insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products; and

- A siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets.

In short, there were many causes and lessons to be learned from the financial crisis. The enormity and worldwide scope of the crisis, and the unprecedented government response required to stabilize the system, demands a full and careful evaluation of every aspect of our financial system. We cannot hesitate to admit mistakes, learn from them and make the changes needed to address the identified shortcomings and reduce the likelihood that such crises reoccur. More vigorous regulation and a new culture or approach are essential.

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