S. HRG. 111–58

ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS

HEARING

BEFORE THE

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

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

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

MARCH 10, 2009

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C O N T E N T S

TUESDAY, MARCH 10, 2009

WITNESSES

ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS

TUESDAY, MARCH 10, 2009

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

The Committee met at 10:38 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Let me thank our witnesses for being here this morning, and colleagues as well, and just to notify the room how we will proceed. Again, there are only a handful of us here, but we have eight witnesses, and so we have got a long morning in front of us to go through these issues. And what I would like to do is I will make some opening remarks, turn to Senator Shelby, and then as long as the room does not all of a sudden get crowded with a lot of Members here, I will ask Senator Reed and Senator Bennet if you would like to make a couple of opening comments, and we will get right to our witnesses, who have supplied very thorough testimony. And if they each read all of their testimony, we are going to be here until Friday, in a sense. But it is very, very good and very helpful to us. So we will proceed along those lines and hopefully have a good, engaging morning here on a very, very critical issue.

So I welcome all of you to the hearing this morning entitled "Enhancing Investor Protection and the Regulation of Securities Markets." The purpose of today's hearing is to examine what went wrong in the securities markets and to discuss how we can prevent irresponsible practices that led to our financial system seizing up from ever happening again and how to protect investors, including small investors, from getting burned by the kinds of serious abuses and irresponsible behavior that we have seen in certain quarters of the markets in recent years.

We are going to hear about proposals to regulate the securities market so that it supports economic growth and protects investors rather than threatens economic stability. As important, today we will begin to chart a course forward—a course that acknowledges how complex products and risky practices can do enormous damage to the heart of our financial system, the American people as well, absent a strong foundation of consumer and investor protections.

Half of all U.S. households are invested in some way in securities, meaning the path we choose for regulating this growth and growing segment of our financial system will determine the futures not only of traders on Wall Street but of families, of course, across the country. A year ago this coming Saturday, the collapse of Bear Stearns underscored the importance role that securities play in our financial system today.

When I was elected to the Senate in 1980, bank deposits represented 45 percent of the financial assets of the United States and securities represented 55 percent. Today, the securities sector dominates our financial system, representing 80 percent of financial assets, with bank deposits a mere 20 percent.

As the securities market has expanded, so, too, has its influence on the lives of average citizens. Much of that expansion has been driven by the process known as "securitization," in which everyday household debt is pooled into sophisticated structures, from mortgages and auto loans to credit cards and student loans.

In time, however, Wall Street not only traded that debt, it began to pressure others into making riskier and riskier loans to consumers. And lenders, brokers, and credit card companies were all too willing to comply, pushing the middle-class family in my State of Connecticut and elsewhere across the country who would have qualified for a traditional secure product into a riskier subprime mortgage or giving that 17-year-old college student, who never should have qualified in the first place, a credit card with teaser rates that were irresistible but terms that were suffocating.

As one trader said of the notorious subprime lender, they were moving money out of the door to Wall Street so fast, with so few questions asked, these loans were not merely risky, they were, in fact, built to self-destruct.

As we knew it, securitization did not reallocate risk. It spread risk throughout our financial system, passing it on to others like a high-stakes game of hot potato. With no incentive to make sure these risky loans paid off down the road, each link in the securitization chain—the loan originators, Wall Street firms and fund managers, with the help of credit rating agencies—generated more risk. They piled on layers of loans into mortgage-backed securities, which were piled into collateralized debt obligations, which were in turn piled into CDO squared and cubed, severing the relationship between the underlying consumer and their financial institutions.

Like a top-heavy structure built on shoddy foundations, it all, of course, came crashing down. I firmly believe that had the Fed simply regulated the mortgage lending industry, as Congress directed with the law passed in 1994, much of this could have been averted. But despite the efforts of my predecessor on this Committee, myself, and others over many years, the Fed refused to act.

But the failure of regulators was not limited to mortgage-backed securities. As many constituents in Connecticut and elsewhere have told me, auction rate securities, misleadingly marketed as cash equivalents, left countless investors and city pension funds across the country with nothing when the actions failed and the securities could not be redeemed.

As this Committee uncovered at a hearing about AIG last week, the unregulated credit derivatives market contributed to the largest quarterly loss in history.

In recent months, we have unearthed two massive Ponzi schemes, bilking consumers, investors, charities, and municipal pension funds out of tens of billions of dollars that two separate regulators failed to detect in their examinations. In January, I asked Dr. Henry Backe of Fairfield, Connecticut, to address this Committee about the losses suffered by the employees at his medical practice in the Bernard Madoff fraud. His testimony prompted Senator Menendez and me to urge the IRS to dedicate serious resources to helping victims like Linda Alexander, a 62-year-old telephone operator from Bridgeport, Connecticut, who makes less than $480 a week and lost every penny of her retirement savings. In an instant, the $10,000 she had saved over a lifetime evaporated because regulators has no idea a massive fraud was occurring right under their noses.

This crisis is the result of what may have been the greatest regulatory failure in human history. If you need any further evidence, consider this: At the beginning of the credit crisis in 2008, the SEC regulated five investment banks under the Consolidated Supervised Entity Program: Lehman Brothers, Bear Stearns, Merrill Lynch, Goldman Sachs, and Morgan Stanley—names synonymous with America's financial strength, having survived world wars and the Great Depression. And though the seeds of their destruction have been planted nearly a decade ago, each was sold, converted to a bank holding company, or failed outright inside of 6 months—every single one of them.

Our task today is to continue our examination of how to begin rebuilding a 21st century financial structure. We do so not from the top down, focusing solely on the soundness of the largest institutions, with the hope that it trickles down to the consumer but, rather, from the bottom up, ensuring a new responsibility in financial services and a tough new set of protections for regular investors who thought these protections were already in place.

The bottom-up approach will create a new way of regulating Wall Street. For the securities markets, that means examining everything, from the regulated broker-dealers and their sales practices, to unregulated credit default swaps. It means ensuring that the creators of financial products have as much skin in the game when they package these products as the consumers do when they buy them, so that instead of passing on risk, everyone shares responsibility. And that means we need more transparency from public companies, credit rating agencies, municipalities, and banks.

We are going to send a very clear message that these modernization efforts, the era of "don't ask"—in these modernization efforts, the era of "don't ask, don't tell" on Wall Street and elsewhere is over. For decades, vitality, innovation, and creativity have been a source of genius of our system, and I want to see that come back. It is time we recognized transparency and responsibility are every bit as paramount, that whether we are homebuyers, city managers, entrepreneurs, we can only make responsible decisions if we have the accurate and proper information. We want the American people to know that this Committee will do everything in its power to get us out of this crisis by putting the needs of people first, from constituents like Linda Alexander, who I mentioned a moment ago, to millions more whose hard-earned dollars are tied up in our securities markets.

Today's hearing will provide an opportunity to hear ideas and build a record upon which this Committee can legislate a way forward for the American people to rebuild confidence in these securities markets, and to put our country back on a sound economic footing.

With that, I thank our witnesses again for being here, and let me turn to my colleague, former Chairman, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

I think the greatest challenge in dealing with this financial crisis is understanding its multiple, complex, and interrelated causes. This hearing provides us an opportunity to examine some of the causes that relate to our securities markets and securities regulation.

Without presupposing the specific causes of the financial crisis, I think it is appropriate to conclude that a broad failure of risk management in the financial system led us to where we are today. It appears that everybody assumed that someone else was monitoring the risk. Regulators assumed that financial institutions had properly assessed the risk of their own activities or assumed that other regulators were watching what those entities were doing.

Financial institutions failed to adequately monitor risks across business units and failed to thoroughly understand the risks associated with new financial products. They did not adequately assess either their exposures to or the health of their counterparties.

Very sophisticated investors assumed that someone else had done their due diligence. Less sophisticated investors assumed, unreasonably, that asset prices would only climb. The excessive reliance on credit ratings and the failure of the market to develop a clearinghouse for credit default swaps are just two examples of this widespread market failure. The disastrous consequences of this nearly universal passing of the buck should serve as the guidepost for us and the SEC as we consider reforms.

I think there should be clear lines of responsibility for regulators. Only then can Congress hold regulators accountable for their performance. It is also important not to make changes to the statutory and regulatory framework that would further lull market participants into believing that regulators or other market participants are doing their work for them.

We cannot build a regulator big enough to be everywhere at all times. Market participants need to do their own due diligence before and after they make an investment decision. They need to bear the costs of an unwise investment, just as they reap the benefit of a wise investment. In the end, I believe our markets will be best served by the combined efforts of diligent regulators and responsible market participants working under rules that are clear and consistent.

Uncertainty about the rules impedes the market from working as it should. *Ad hoc* Government actions lead private capital to sit on the sidelines because a change in rules can radically change a market participant's expected return. A consistent legal framework is an essential component of a competitive capital market. Investors will avoid a market if they believe the rules may change in the middle of the game. A clear example of this dynamic is the world of accounting where many are calling for the suspensions of mark-to-market because of the adverse impact that it is presently having on the books of so many companies.

Accounting rules should be designed to ensure that a firm's disclosures reflect economic reality, however ugly that reality may be. Changing the accounting rules now will simply compound investors' wariness about investing in a market where many firms have bad or illiquid assets on their books.

I will be interested in hearing from today's witnesses on this topic and how the SEC can improve its efforts to protect our securities markets while also facilitating continued innovation and responsible risk taking.

Chairman Dodd, I thank you for calling this hearing. I think you are on to something here.

Chairman DODD. Well, Senator, thank you very, very much. We have got quite a row here of witnesses to testify. Let me turn to Jack Reed or Michael Bennet. Any opening quick comments, Jack?

Senator REED. Mr. Chairman, I am very interested in hearing the witnesses assembled. We have an impressive panel. Thank you.

Chairman DODD. Senator Bennet.

Senator BENNET. Mr. Chairman, thanks for holding the hearing. It is from this perspective truly a row of witnesses.

[Laughter.]

Senator BENNET. So I will wait until we are done.

Chairman DODD. Let me invite you as well, Senator, unless others show up, we are more than willing to have you—I am sorry I did not see you. If you want to move on up and join us here.

[Laughter.]

Chairman DODD. If not, I am fearful I may call on you as a witness here.

Senator BENNET. Well, I have a point of view. I would be happy to——

Chairman DODD. I am sure you do—I know you do.

Senator SHELBY. We have all sat there.

Chairman DODD. Senator Shelby just pointed out, we have been in that chair before. In fact, I think I was a chair further back in the room a long time ago along the way.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. I was in that chair on this side. I know very much what it is like.

Thank you very much, Mr. Chairman. I will be very brief. I really appreciate your holding this and the other hearings that you have scheduled. As you know, I am very interested in this issue, and I look forward to working with you. And let's get on with the witnesses.

Chairman DODD. You bet. And I appreciate it. Senator Crapo has had a longstanding interest in reg reform issues, and he has expressed to me on numerous occasions his desire to be involved in this discussion, as has Senator Bennet and others. So we have some very interested Members on the Committee who want to work together on this issue as we move forward in the coming weeks to put together a bill.

I was listening this morning to the speech by Ben Bernanke talking about his ideas—and maybe some of our witnesses—I know you have prepared statements, but certainly feel free in your comments to react to some of his thoughts this morning. That would be welcomed as well, since he made the speech this morning—where was it? Brookings?

Senator SHELBY. Foreign Relations.

Chairman DODD. Oh, Council on Foreign Relations.

With that, let me briefly—again, I think most of our folks here know our witnesses. Very briefly, we have Professor John Coffee, who has been before us many times. He is the Adolf A. Berle Professor of Law at Columbia's Law School; Timothy Ryan, President and CEO of Securities Industry and Financial Markets Association; Paul Schott Stevens, President and CEO of Investment Company Institute; Professor Mercer Bullard, Associate Professors, University of Mississippi School of Law; Robert Pickel, who is the Executive Director and CEO of International Swaps and Derivatives Association; Damon Silvers, the Associate General Counsel of the AFL–CIO; and Thomas Doe, CEO of Municipal Market Advisors; Lynn Turner, the former Chief Accountant, U.S. Securities and Exchange Commission.

So a good row of witnesses here to testify, and we will begin in the order that I have introduced you. Dr. Coffee, you seem to occupy that chair every time you come here.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. Well, good morning, and thank you, Chairman Dodd, Ranking Member Shelby, and fellow Senators. I have prepared an overly long, bulky, 70-page memorandum for which I apologize for inflicting on you. It attempts to synthesize a good deal of recent empirical research by business school scholars, finance scholars, and even law professors, about just what went wrong and what can be done about it.

I cannot summarize all that, but I would add the following two sentences to what Senators Dodd and Shelby very accurately said at the outset. The current financial crisis is unlike others. This was not a bubble caused by investor mania, which is the typical cause of bubbles. It was not a demand-driven bubble; rather, it was more a supply driven bubble. It was the product of a particular business model, a model known as the "originate-and-distribute model," under which financial institutions, including loan originators, mortgage lenders, and investment banks, all behaved similarly and went to the brink of insolvency and beyond, pursuing a model.

What is the key element of this originate-and-distribute model? You make lax loans. You make non-creditworthy loans because—because you do not expect to hold those loans for long enough to matter. You believe that you can transfer these loans to the next link in the transmission chain before you will bear the economic risk.

When everyone believes that—and they correctly believed that for a few years—then all standards begin to become relaxed, and we believe that as long as we can get that investment grade rating from the credit rating agencies, we will have no problem, and weak loans can always be marketed. There is no time for statistics here, but let me add just one.

Between 2001 and 2006, a relatively short period, some of the data that I cite shows you that low-document loans in these portfolios went from being something like 28 percent in mortgage-backed securities in 2001 to 51 percent in 2006—doubling in 4 or 5 years. Investment banks and credit rating agencies are not responding to that change. That is the essential problem.

This gives rise to what I will call and economists call a "moral hazard problem," and this moral hazard problem was compounded by deregulatory policies that the SEC and other institutions followed that permitted investment banks to increase their leverage dramatically between 2004 and 2006, which is only just a few years ago. This is yesterday we are talking about. They did this pursuant to the Consolidated Supervised Entity Program that you have already been discussing, and it led to the downfall of our five largest, most important investment banks.

All right. Essentially, the SEC deferred to self-regulation, by which these five largest banks constructed their own credit risk models, and the SEC deferred to them. The 2008 experience shows, if there ever was any doubt, that in an environment of intense competition and under the pressure of equity-based executive compensation systems that tend to be very short-term oriented, self-regulation alone simply does not work. The simplest way for a financial institution to increase profitability was to increase its leverage, and it did so to the point where they were leveraged to the eyeballs and could not survive the predictable downturn in the economic weather.

So what should be done from a policy perspective? Well, here is my first and most essential point: All financial institutions that are too big to fail, which really means too entangled to fail, need to be subjected to prudential financial oversight, what I would call "financial adult supervision," from a common regulator applying a basically common although risk-adjusted standard to all these institutions, whether they are insurance companies, banks, thrifts, hedge funds, money market funds, or even pension plans, or the financial subsidiaries of very large corporations, like GE Capital. In my judgment, this can only be done by the Federal Reserve Board. That is the only person in a position to serve as what is called the "systemic risk regulator."

I think we need in this country a systemic risk regulator, and specifically to define what this means, let me say there are five areas where their authority should be established. The Federal Reserve Board should be authorized and mandated to do the following five things:

One, establish ceilings on debt-to-equity ratios and otherwise restrict leverage for all major financial institutions.

Two, supervise and restrict the design and trading of new financial products, including, in particular, over-the-counter derivatives and including the posting of margin and collateral for such products.

Three, mandate the use of clearinghouses. The Federal Reserve has already been doing this, formulating this, trying to facilitate this, but mandating it is more important. And they need the authority to supervise these clearing houses, and also if they judge it to be wise and prudent, to require their consolidation into a single clearinghouse.

Four, the Federal Reserve needs the authority to require the writedown of risky assets by financial institutions, regardless of whether accounting rules mandate it. The accountants will always be the last to demand a writedown because their clients do not want it. The regulator is going to have to be more proactive than are the accounting firms.

Last, the Federal Reserve should be authorized to prevent liquidity crises that come from the mismatch of assets and liabilities. The simple truth is that financial institutions hold long-term illiquid assets which they finance through short-term paper that they have to roll over regularly, and that mismatch regularly causes problems.

Now, under this "Twin Peaks" model that I am describing, the systematic risk regulator—presumably, the Federal Reserve—would have broad authority. But the power should not be given to the Federal Reserve to override the consumer protection and transparency policies of the SEC. And this is a co-equal point with my first point, that we need a systemic risk regulator. Too often, bank regulators and banks have engaged in what I would term a "conspiracy of silence" to hide problems, lest investors find out, become alarmed, and create a run on the bank.

The culture of banking regulators and the culture of securities regulators is entirely different. Bank regulators do not want to alarm investors. Securities regulators understand that sunlight is the best disinfectant. And for the long run, just as Senator Shelby said, we need accounting policies that reveal the ugly truth.

We could not be worse off now in terms of lack of public confidence. This is precisely the moment to make everyone recognize what the truth is and not to give any regulator the authority to suppress the truth under the guise of systematic risk regulation.

For that reason, I think SEC responsibilities for disclosure, transparency, and accounting should be specially spelled out and exempted from any power that the systematic risk regulator has to overrule other policies.

Now, two last points. As a financial technology, asset-based securitization, at least in the real estate field, has decisively failed. I think two steps should be done by legislation to mandate the one policies that I think will restore credibility to this field.

First, to restore credibility, sponsors must abandon the originate-and-distribute business model and instead commit to retain at least a portion of the most subordinated tranche, the riskiest assets. Some of them have to be held by the promoter because that is the one signal of commitment that tells the marketplace that someone has investigated these assets because they are holding the weakest, most likely to fail. That would be step one.

Step two, we need to reintroduce due diligence into the process, into the securitization process, both for public offerings and for Rule 144A offerings, which are private offerings. Right now Regulation AB deregulated; it does not really require adequately that the sponsor verify the loans, have the loan documentation in its possession, or to have examined the creditworthiness of the individual securities. I think the SEC can be instructed by Congress that there needs to be a reintroduction of stronger due diligence into both the public and the private placement process.

Last point. Credit rating agencies are obviously the gatekeeper who failed most in this current crisis. The one thing they do not do that other gatekeepers do do is verify the information they are relying on. Their have their rating methodology, but they just assume what they are told; they do not verify it. I think they should be instructed that there has to be verification either by them or by responsible, independent professionals who certify their results to them.

The only way to make that system work and to give it teeth is to reframe a special standard of liability for the credit rating agencies. I believe the Congress can do this, and I believe that Senator Reed and his staff are already examining closely the need for additional legislation for credit rating agencies, and I think they are very much on the right track, and I would encourage them.

What I am saying, in closing, is that a very painful period of deleveraging is necessary. No one is going to like it. I think some responsibility should be given to the Federal Reserve as the overall systematic risk regulator, but they should not have authority to in any way overrule the SEC's policies on transparency.

Thank you.

Chairman DODD. Thank you very much, Professor.

Mr. Ryan, welcome.

STATEMENT OF T. TIMOTHY RYAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. RYAN. Good morning. Thank you for inviting me. I appreciate being here.

Our current financial crisis, which has affected nearly every American family, underscores the imperative to modernize our financial regulatory system. Our regulatory structure and the plethora of regulations applicable to financial institutions are based on historical distinctions between banks, securities firms, insurance companies, and other financial institutions—distinctions that no longer conform to the way business is conducted.

The negative consequences to the investing public of this patchwork of regulatory oversight are real and pervasive. Investors do not have comparable protections across the same or similar financial products. Rather, the disclosures, standards of care, and other key investor protections vary based on the legal status of the intermediary or the product or service being offered.

In light of these concerns, SIFMA advocates simplifying and reforming the financial regulatory structure to maximize and enhance investor protection and market integrity and efficiency.

Systemic risk, as Professor Coffee noted, has been at the heart of the current financial crisis. As I have previously testified, we at SIFMA believe that a single, accountable financial markets stability regulator, a systemic regulator, will improve upon the current system. While our position on the mission of the financial markets stability regulator is still evolving, we currently believe that its mission should consist of mitigating systemic risk, maintaining financial stability, and addressing any financial crisis, all of which will benefit the investing public. It should have authority over all markets and market participants, regardless of charter, functional regulator, or unregulated status. It should have the authority to gather information from all financial institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort. It should probably have a more direct role in supervising systemically important financial organizations, including the power to conduct examinations, take prompt corrective action, and appoint or act as the receiver or conservator of all or part of systemically important organizations.

We also believe, as a second step, that we must work to rationalize the broader regulatory framework to eliminate regulatory gaps and imbalances that contribute to systemic risk by regulating similar activities and firms in a similar manner and by consolidating certain financial regulators.

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for investment advisory, brokerage, and other financial services in order to promote investor protection. SIFMA recommends the adoption of a "universal standard of care" that avoids the use of labels that tend to confuse the investing public and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers. Such a standard could provide a uniform code of conduct applicable to all financial professionals. It would make clear to all individual investors that their financial professionals are obligated to treat them fairly by employing the same core standards whether the firm is a financial planner, an investment adviser, a securities dealer, a bank, an insurance agency, or any other type of financial service provider.

The U.S. is the only jurisdiction that splits the oversight of securities and futures activities between two separate regulatory bodies. We support the merger of the SEC and the CFTC.

We believe that the development of a clearinghouse for credit derivatives is an effective way to reduce counterparty credit risk, facilitate regulatory oversight, and, thus, promote market stability. In particular, we strongly support our members' initiative to establish a clearinghouse of CDS, and we are pleased to note that ICE US Trust opened its doors for clearing CDS transactions yesterday.

Finally, the current financial crisis reminds us that markets are global in nature, and so are the risks of contagion. To promote investor protection through effective regulation and the elimination of disparate regulatory treatment, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in all major markets.

Thank you.

Chairman DODD. Thank you very much for that.

Paul, welcome. It is nice to see you and have you before the Committee.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you very much, Mr. Chairman. On behalf of the Institute and our member funds, I thank you, Chairman Dodd, Senator Shelby, and all the Members of the Committee for making it possible for me to appear today. We serve 93 million American investors, as you know, and we strongly commend the Committee for the attention you are devoting to improving our system of financial regulation.

I believe the current financial crisis provides a very strong public mandate for Congress and for regulators to take bold steps to strengthen and modernize regulatory oversight. Like other stakeholders, and there are many, of course, we have been thinking hard about how to revamp the current system. Last week, we published a white paper detailing a variety of reforms, and in it we recommend changes to create a regulatory framework that provides strong consumer and investor protection while also enhancing regulatory efficiencies, limiting duplication, closing conspicuous regulatory gaps, and frankly, emphasizing the national character of our financial services markets. I would like briefly to summarize the proposals.

First, we believe it is crucial to improve the government's capability to monitor and mitigate risks across the financial system, so ICI supports creation of a Systemic Risk Regulator. This could be a new or an existing agency or interagency body, and in our judgment should be responsible for monitoring the financial markets broadly, analyzing changing conditions here and overseas, evaluating and identifying risks that are so significant that they implicate the health of the financial system, and acting in coordination with other responsible regulators to mitigate these risks.

In our paper, we stress the need to carefully define the responsibilities of a Systemic Risk Regulator as well as its relationships with other regulators, and I would say, Mr. Chairman, that is one of the points that Chairman Bernanke made in his speech today, to leverage the expertise and to work closely with other responsible regulators in accomplishing that mission.

In our judgment, addressing systemic risk effectively, however, need not and should not mean stifling innovation, retarding competition, or compromising market efficiency. You can achieve all of these purposes, it seems to us, at the same time.

Second, we urge the creation of a new Capital Markets Regulator that would combine the functions of the SEC and the CFTC. This Capital Markets Regulator's statutory mission should focus sharply on investor protection and law enforcement. It should also have a mandate, as the SEC does currently, to consider whether its proposed regulations promote efficiency, competition, and capital formation.

We suggest several ways to maximize the effectiveness of the new Capital Markets Regulator. In particular, we would suggest a need for a very high-level focus on management of the agency, its resources, and its responsibilities, and also the establishment of mechanisms to allow it to stay much more effectively abreast of market and industry developments.

Third, as we discuss more fully in our white paper, effective oversight of the financial system and mitigation of systemic risk will require effective coordination and information sharing among the Systemic Risk Regulator and regulators responsible for other financial sectors.

Fourth, we have identified areas in which the Capital Markets Regulator needs more specific legislative authority to protect investors and the markets by closing regulatory gaps and responding to changes in the marketplace. In my written statement, I identify four such areas: hedge funds, derivatives, municipal securities, particularly to improve disclosure standards, and the inconsistent regulatory regimes that exist today for investment advisors and broker dealers.

Now, as for mutual funds, they have not been immune from the effects of the financial crisis, nor, for that matter, have any other investors. But our regulatory structure, and this bears emphasizing, which grew out of the New Deal as a result of the last great financial crisis, has proven to be remarkably resilient, even through the current one.

Under the Investment Company Act of 1940 and other securities laws, fund investors enjoy a range of vital protections: Daily pricing of fund shares with mark-to-market valuation every business day; separate custody of all fund assets; minimal or no use of leverage in our funds; restrictions on affiliated transactions and other forms of self-dealing; required diversification; and the most extensive disclosure requirements faced by any financial products.

Funds have embraced this regulatory regime and they have prospered under it. Indeed, I think recent experience suggests that policymakers should consider extending some of these very same disciplines that have worked so well for us since 1940 to other marketplace participants in reaction to the crisis that we are experiencing today.

Finally, let me comment, Mr. Chairman, briefly on money market funds. Last September, immediately following the bankruptcy of Lehman Brothers, a single money market fund was unable to sustain its $1 per share net asset value. Coming hard on the heels of a series of other extraordinary developments that roiled global financial markets, these events worsened an already severe credit squeeze. Investors wondered what other major financial institution might fail next and how other money market funds might be affected.

Concern that the short-term fixed income market was all but frozen solid, the Federal Reserve and the Treasury Department took a variety of initiatives, including the establishment of a temporary guarantee program for money market funds. These steps have proved highly successful. Over time, investors have regained confidence. As of February, assets in money market funds were at an all-time high, almost $3.9 trillion.

The Treasury Department's temporary guarantee program will end no later than September 18. Funds have paid more than $800 million in premiums, yet no claims have been made and we do not expect any claims to be made. We do not envision any future role for Federal insurance of money market fund assets and we look forward to an orderly transition out of the temporary guarantee program.

The events of last fall were unprecedented, but it is only responsible that we, the fund industry, look for lessons learned. So in November 2008, ICI formed a working group of senior fund industry leaders to study ways to minimize the risk to money market funds of even the most extreme market conditions. That group will issue a strong and comprehensive set of recommendations designed, among other things, to enhance the way money funds operate. We expect that report by the end of the month. We hope to place the executive summary in the record of this hearing, and Mr. Chairman, I would be delighted to return to the Committee, if it is of interest to you, to present those recommendations at a future date.

Thank you very much.

Chairman DODD. Thank you very much for that. We will welcome that addition to the Committee record, as well.

Professor Bullard, thank you very much for joining us.

STATEMENT OF MERCER E. BULLARD, ASSOCIATE PROFESSOR, UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW, AND PRESIDENT, FUND DEMOCRACY, INC.

Mr. BULLARD. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee for the opportunity to appear here today. I congratulate the Committee for its thorough and deliberate investigation into the causes of the current financial crisis.

Recent events have provided useful lessons on the management of systemic risk, prudential regulation, and investor protection in the investment management industry. The performance of stock and bond mutual funds, for example, has demonstrated the remarkable resiliency of the investment company structure in times of stress. As equity values have plummeted, most shareholders and stock funds have stood their ground, notwithstanding that they have the right to redeem their shares at short notice at their NAVs.

There is no scientific explanation for the stability of mutual funds during this crisis, but I believe it is related to this redemption right, as Paul was describing a moment ago. Mutual fund investors are confident that they will receive the net asset value of their holdings upon redemption and they appear to believe that the net asset value of those shares—the net asset value will be fair and accurate. This confidence in the valuation and redeemability of mutual fund shares reduces the likelihood of the kind of panic selling that creates systemic risk and may provide a useful lesson for the regulation of other financial intermediaries.

The current crisis has exposed certain investor protection issues, however. Many investors in target date and short-term bond funds have experienced investment returns that are not consistent with returns typical of that asset class. If a fund uses the name Target Date 2010, for example, its equity allocation should fall within the generally expected range for someone on the brink of retirement.

Similarly, a 529 plan option that is touted as appropriate for a 16-year-old should not lose 40 percent of its value 2 years before the money will be needed for college.

Investors should be free to choose more aggressive asset allocations than those normally considered most appropriate for this situation. But funds that use a name that most investors will assume reflects a particular strategy should be required to invest consistent with that strategy.

In contrast with other types of mutual funds, the performance of money market funds has raised systemic and prudential regulation concerns. Money market funds constitute a major linchpin in our payment system and therefore a run on these funds poses significant systemic risk. The management of this risk has been inadequate, as demonstrated by the recent run on money market funds following the failure of the reserve primary fund.

There are important lessons to be learned from this experience, but not the lessons that some commentators have found. The Group of 30, for example, has recommended that the money market franchise be eliminated. Former Fed Chairman Volcker explained that if money market funds are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank. The problem with this argument is that money market funds don't fail like banks.

Since 1980, more than 3,000 U.S. banks have failed, costing taxpayers hundreds of billions of dollars. During the same period, two money market funds have failed, costing taxpayers zero dollars. I agree that a regulatory rearrangement is in order, but it is banks that should be regulated more like money market funds. Banks routinely fail because they invest in risky, long-term assets while money market funds invest in safe, short-term assets. Insuring bank accounts may be necessary to protect against the systemic risk that a run on banks poses to the payment system, but there is no good reason why banks should be permitted to invest insured deposits in anything other than the safest assets. And there is no good reason why money market funds that pose the same systemic risk to our payment system should be left uninsured.

I note, Chairman Dodd, you may have picked up this morning on Chairman Bernanke's comments that some kind of interim insurance program may be an appropriate response to the crisis, and I have to disagree with Paul that the program will necessarily end in September. I posted an article on SSRN that deals with one thesis of how to approach money market fund insurance and I hope the Committee and staff will take a look at that.

The current crisis has also exposed significant weaknesses in hedge fund and investment advisor regulation. For example, hedge funds are permitted to sell investments to any person with a net worth of at least $1 million, a minimum that has not been adjusted since 1982. This means that a hedge fund is free to sell interest to a recently retired couple that owns a $250,000 house and has $750,000 in investments, notwithstanding that their retirement income is likely to be around $35,000 a year before Social Security.

Finally, the Madoff scandal has again reminded us of the risks of the SEC's expansive interpretation of the broker exclusion from the definition of investment advisor. It appears that Madoff did not register as an investment advisor in reliance on the SEC's position that managing discretionary accounts could somehow be viewed as solely incidental to related brokerage services. This over-broad exclusion left Madoff subject only to broker regulation, which failed to uncover this fraud.

The SEC has since rescinded its ill-advised position on discretionary accounts, but it continues to read the "solely incidental" exception so broadly as to leave thousands of brokers who provide individualized investment advice subject only to a broker's suitability obligation. These brokers should be subject to the same fiduciary duties that other investment advisors are subject to, including the duty to disclose revenue sharing payments and other compensation that create a potential conflict with their clients' interests.

And finally, I would just add to the comments on the question of systemic or prudential regulator. I agree with Professor Coffee's comments that there is something simply fundamentally inconsistent with the SEC's investor protection role and the prudential role that it has not served particularly well in recent times and that those roles should be separated. I agree that there should be a Federal Prudential Regulator, which is what I would call it, that oversees all of those similar characteristics, such as net capital rules, money market fund rules, banking regulations that share those prudential or systemic risk concerns. It is not clear to me, however, that the particular types of liabilities that insurance companies hold would be suitable for one common prudential regulator, but that is something we don't necessarily need to consider unless the Federalizing of insurance regulation begins to make additional progress.

And I would also add that we need to keep in mind that there is a significant difference between customer protection and investor protection. I think when Paul was talking about a Capital Markets Regulator, the way I would think of capital markets as being a way of talking about a regulator as investor protection regulator, which would serve fundamentally different functions, especially in that it embraces risk and looks to the full disclosure of that risk as its principal objective as opposed to what might be viewed as customer protection, which is really to ensure that promised services are what are delivered in a fully disclosed and honest way.

These and other issues are addressed in greater detail in my written submission. Thank you very much.

Chairman DODD. Thank you very, very much.

Mr. Pickel, we thank you for joining the Committee.

STATEMENT OF ROBERT PICKEL, EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

Mr. PICKEL. Thank you, Mr. Chairman and Ranking Member Shelby and Members of the Committee. Thank you for inviting ISDA to testify here today. We are grateful for the opportunity to discuss the privately negotiated derivatives business, and more specifically, the credit default swaps market.

I have submitted written testimony, and as you noted, Mr. Chairman, it is a lengthy submission and so I would like to summarize some of the key remarks that I included in that testimony.

I think first and foremost, we need to understand that the benefits of the OTC derivatives business are significant for the American economy and American companies. They manage a broad range of risk using these instruments that are not central to their businesses, allowing them to manage these financial risks typically so that they can focus on the business that they run. So a borrower borrowing on a floating basis can use an interest rate swap to manage its exposure to exchange fixed for floating obligations.

Currency exposure—many companies have significant operations around the world and have significant currency exposure and use currency swaps, OTC currency swaps, to manage that risk. ISDA itself uses currency swaps to manage its overseas exposure.

Commodity exposure—airlines have significant exposure to fuel costs and they typically look to utilize OTC derivatives to manage that exposure.

And finally, credit exposure—using credit derivatives, credit default swaps, exposure to suppliers or to customers where credit is a significant concern, companies can use these products to help manage that risk.

These products also create efficiencies in pricing and wider availability of credit, particularly credit default swaps. They facilitate lending at lower rates, and they are critical to have available, and have them widely available, as we come out of this recession. I think they will be an important part of the ability of firms to manage credit risk as they look at these important credit issues that we face in this financial crisis.

As far as the role of the credit default swaps and OTC derivatives generally in the financial crisis, first of all, I think, and this Committee has certainly heard testimony, the fundamental source of the crisis is imprudent lending, particularly in the U.S. housing sector, but extending to other markets, as well, credit cards and commercial lending as an example. We must distinguish between the credit default swap business and the collateralized debt obligation business. There has been reference to the originate to distribute model. That certainly applies to the securitization process and to the CDO process.

In the credit default swap business, a company, a bank that has lent money may use a credit default swap to hedge its exposure on that credit. In that process, it will be maintaining its lending relationship with the borrower and it will also be taking on credit risk and paying a fee to the company that is selling protection. So it is distinctly different from the originate to distribute model.

We certainly have heard testimony, and this Committee heard testimony last week on the AIG situation. I think we need to spend some time and this organization needs to spend some time talking about that. AIG obviously was significantly involved in credit default swaps. It was the means by which it took risk. But we must understand the poor choices, the adverse policies, and the misunderstood risk that were involved there, and this Committee heard a lot about that in the testimony last week, particularly from Mr. Polakoff from the Office of Thrift Supervision.

These were the source of their problems, these misunderstood risks and poor decisions. They were contrary to the best practices in the industry and to the experiences of swap market participants for the past 20 years. The fundamental decision that AIG made was to take on exposure to the housing market. They did that, yes, via credit default swaps. They also did that, as the Committee heard last week, in other means, as well, through their securities lending business, in which they actually continued to lend and take exposure to those markets into 2006 and 2007, when the worst of these securities were generated through the lending process.

They also had a very myopic view of loss. They were only looking at the payout potential, the possibility they would actually have to pay out on these transactions. There was no consideration of the implications of the mark-to-market losses that they could face and to the effects on their capital and their liquidity. They seem to have completely ignored the possible effects of that.

They relied on their AAA rating and refused to provide collateral from the start of their trading relationships. It takes away the discipline that collateral provides in that trading relationship. Collateral is extensively used in the OTC derivatives business to help manage risk and also introduce discipline to the trading relationship. They agreed, on the other hand, to provide collateral on the downgrade of their credit rating. That led to a falling off of a cliff, effectively, leading to substantial liquidity problems which eventually led to the decision to intervene.

So yes, these decisions and policies are important to understand and we need to take steps to make sure that this does not happen again, but those relate to the decisions they made and not to the products themselves. The products, in fact, have performed as the parties intended. In fact, just yesterday, the Senior Supervisors Group, which is a group of senior supervisors from the G-7 countries, talked about how the CDS product had performed multiple times over the course of last fall and into this year in helping to settle transactions, credit default swaps that parties had engaged in, and they acknowledged that this process has been extremely effective.

And then finally, this is a very important week in the credit default swap market. I believe Mr. Ryan referred earlier to the fact that one of the clearinghouses that has been talked about for many, many months has now actually begun to clear transactions, and that is a very significant development. And later this week, ISDA itself will introduce some changes to the standard contract that will facilitate the settlement of these trades in the future and will also facilitate moving more transactions onto a clearinghouse. So that is a very important development.

There is much to be done by ISDA, by the industry, in close consultation with this Committee and other committees in Congress as well as the regulators here in the United States and globally and we are committed to be engaged in that process. We look forward to working with you as you analyze the causes of this financial crisis, and based on that analysis, consider changes to our regulatory structure with a goal to obtaining greater transparency, greater disclosure, and greater coordination among regulators.

Thank you again for your time, and I look forward to your questions.

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

Damon Silvers. Damon, it is good to have you with us. Thank you.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AFL–CIO

Mr. SILVERS. Good morning, Chairman Dodd and Ranking Member Shelby. Thank you for inviting me here today. Before I begin, I would like to note that in addition to my role as Associate General Counsel of the AFL–CIO, I am the Deputy Chair of the Congressional Oversight Panel created by the Emergency Economic Stabilization Act of 2008 to oversee the TARP. While I will describe in my testimony aspects of the Congressional Oversight Panel's report on regulatory reform, my testimony reflects my views alone and the views of the AFL–CIO unless otherwise noted and is not on behalf of the panel, its staff, or its chair.

The vast majority of American investors participate in the markets as a means to secure a comfortable retirement and to send their children to college, as you noted, Mr. Chairman, in your opening remarks. While the spectacular frauds like the Madoff Ponzi scheme have generated a great deal of publicity, the bigger question is what changes must be made to make our financial system a more reasonable place to invest the hard-earned savings of America's working families.

Today, I will address this larger question at three levels: Regulatory architecture, regulating the shadow markets and the challenge of jurisdiction, and certain specific steps Congress and regulators should take to address holes in the investor protection scheme.

First, with respect to regulatory architecture, the Congressional Oversight Panel in its special report on regulatory reform observed that addressing issues of systemic risk cannot be a substitute for a robust, comprehensive system of routine financial regulation. Investor protection within this system should be the focus of a single agency within the broader regulatory framework. That agency needs to have the stature and independence to protect the principles of full disclosure by market participants and compliance with fiduciary duties among market intermediaries. This has been noted by several of the panelists prior to me.

This mission is in natural tension with bank regulators' mission of safeguarding the safety and soundness of the banks they regulate, and that natural tension would apply to a Systemic Risk Regulator that was looking more broadly at safety and soundness issues. Because of these dynamics, effective investor protection requires that any solution to the problem of systemic risk prevention should involve the agency charged with investor protection and not supercede it.

I have a more detailed document on issues associated with creating a Systemic Risk Regulator that I will provide the Committee following the hearing. I should just note that in relation to this, it is my belief that more of a group approach to systemic risk regulation rather than designating the Fed as the sole regulator would be preferable.

Among the reasons for this are the issues of information sharing and coordination that other panelists raised, but most importantly, the fact that the Federal Reserve in its regulatory role fundamentally works through the regional Fed banks, which are fundamentally self-regulatory in nature. Several of the prior witnesses have mentioned some of the problems with self-regulation on critical issues. Furthermore, a Systemic Risk Regulator, as we have learned through the TARP experience, is likely to have to expend public dollars in extreme circumstances. It is completely inappropriate for that function to be vested in a body that is at all self-regulatory. While the Fed could be changed, its governance could be changed to make it fully a public agency, that would have implications, I believe, for the Fed's independence in its monetary policy role.

Now, we have already in the Securities and Exchange Commission a regulator focused on investor protection. Although the Commission has suffered in recent years from diminished jurisdiction and leadership failure, the Commission remains an extraordinary government agency whose human capital and market expertise needs to be built upon as part of a comprehensive strategy for effective re-regulation of the capital markets. This point flows right into the issue of jurisdiction and the shadow markets.

The financial crisis we are currently experiencing is directly connected to the degeneration of the New Deal system of comprehensive financial regulation into a Swiss cheese regulatory system where the holes, the shadow markets, grew to dominate the regulated markets. The Congressional Oversight Panel specifically observed that we need to regulate financial products and institutions, in the words of President Obama, "for what they do and not what they are."

The Congressional Oversight Panel's report further stated that shadow institutions should be regulated by the same regulators that currently have jurisdiction over their regulated counterparts. So, for example, the SEC should have jurisdiction over derivatives that are written using public debt or equity securities as their underlying asset. At a minimum, the panel stated, hedge funds should also be regulated by the SEC in their role as money managers.

There is a larger point here, though. Financial re-regulation will be utterly ineffective if it turns into a series of rifle shots at the particular mechanisms used to evade regulatory structures in earlier boom and bust cycles. What is needed is a return to the jurisdictional philosophy that was embodied in the founding statutes of Federal securities regulation: Very broad, flexible jurisdiction that allowed the Commission to follow changing financial market practices.

If you follow this principle, the SEC should have jurisdiction over anyone over a certain size who manages public securities and over any contract written that references publicly traded securities. Applying this principle would require at least shifting the CFTC's jurisdiction over financial futures to the SEC, if not merging the two agencies under the SEC's leadership, as I gather some of my fellow panelists believe is necessary.

Moving on to substantive reforms, beyond regulating the shadow markets, the Congress and the Securities and Exchange Commission need to act to shape a corporate governance and investor protection regime that is favorable to long-term investors and to the channeling of capital to productive purposes.

First, strong boards of publicly traded companies that the public invests in—having strong boards requires meaningful accountability to long-term investors. The AFL–CIO urges Congress to work with the SEC to ensure that long-term investors can nominate and elect psychologically independent directors to company boards through access to the corporate proxy.

Second, effective investor protection requires comprehensive executive pay reform involving both disclosure governance and tax policy around two concepts. Equity-linked pay should be held significantly beyond retirement. And two, pay packages as a whole should reflect a rough equality of exposure to downside risk as well as to upside gain. Part of this agenda must be a mechanism for long-term shareholders to advise companies on their executive pay packages in the form of an advisory vote.

Finally, Congress needs to address the glaring hole in the fabric of investor protection created by the Central Bank of Denver and Stoneridge cases. These cases effectively granted immunity from civil liability to investors for parties such as investment banks and law firms that are actual co-conspirators in securities frauds.

Now, to address very briefly the international context, the Bush administration fundamentally saw the internationalization of financial markets as a pretext for weakening U.S. investor protections. That needs to be replaced by a commitment on the part of the Obama administration, the Congress, and the regulators to building a strong global regulatory floor in coordination with the world's other major economies. However, Congress should not allow the need for global coordination to be an impediment or a prerequisite to vigorous action to re-regulate U.S. financial markets and institutions.

Obviously, this testimony simply sketches the outline of an approach and notes some key substantive steps for Congress and the administration to take. While I do not speak for the Oversight Panel, I think I am safe in saying that the Panel is honored to have been asked to assist Congress in this effort and is prepared to assist this Committee in any manner the Committee finds useful. I can certainly make that offer on behalf of the AFL–CIO. Thank you.

Chairman DODD. Thank you very much.

Mr. Doe, we thank you for joining us, the Municipal Market Advisors.

STATEMENT OF THOMAS DOE, CHIEF EXECUTIVE OFFICER, MUNICIPAL MARKET ADVISORS

Mr. DOE. Chairman Dodd, Senator Shelby, and Committee Members, is a distinct pleasure that I come before you today to share my perspective on the municipal bond market. My firm, Municipal Market Advisors, has served for the past 15 years as the leading independent research and data provider to the industry. In addition, from 2003 to 2005, I served as a public member of the Municipal Securities Rulemaking Board, the self-regulatory organization of the industry established by Congress in 1975.

There are nearly 65,000 borrowers in the municipal market that are predominantly States and local governments. Recent figures identify an estimated $2.7 trillion in outstanding municipal debt. This is debt that aids our communities in meeting budgets and financing society's essential needs, whether it is building a hospital, constructing a school, ensuring clean drinking water, or sustaining the safety of America's infrastructure.

A distinctive characteristic of the municipal market is that many of those who borrow funds—rural counties and small towns—are only infrequently engaged in the capital markets. As a result, there are many issuers of debt who are inexperienced when entering a transaction and are unable to monitor deals that may involve movement of interest rates of the value of derivative products.

According to The Bond Buyer, the industry's trade newspaper, annual municipal bond issuance was $29 billion in 1975; whereas, in 2007, issuance peaked at $430 billion. In the past 10 years, derivatives have proliferated as a standard liability management tool for many local governments. However, because derivatives are not regulated, it is exceptionally difficult, if not impossible, to identify the degree of systemic as well as specific risk to small towns and counties who have engaged in complex swaps and derivative transactions.

Municipal issuers themselves sought to reduce borrowing costs in recent years by selling bonds with a floating rate of interest, such as auction rate securities. Because States and local governments do not themselves have revenues that vary greatly with interest rates, these issuers employed interest rate swaps to hedge their risk. Issuers use the instruments to transform their floating risk for a fixed-rate obligation.

A key factor in the growth of the leverage and derivative structures was the prolific use of bond insurance. Municipal issuers are rated along a conservative rating scale, resulting in much lower ratings for school districts and States than for private sector financial and insurance companies. So although most States and local governments represent very little default risk to the investor, the penal ratings scale encouraged the use of insurance for both cash and derivatives in order to distribute products to investors and facilitate issuer borrowing.

So instead of requiring more accurate ratings, the municipal industry chose to use bond insurance to enhance the issuer's lower credit rating to that of the higher insurance company's rating.

The last 18 months have exposed the risks of this choice when insurance company downgrades, and auction rate security failures, forced numerous leveraged investors to unwind massive amounts of debt into an illiquid secondary market. The consequence was that issuers of new debt were forced to pay extremely high interest rates and investors were confused by volatile evaluations of their investments.

The 34-year era of the municipal industry's self-regulation must come to an end. Today, the market would be in a much better place if:

First, the regulator were independent of the financial institutions that create the products and facilitate issuers' borrowing. Municipal departments represent a relatively small contribution to a firm's revenue, and this inhibits MSRB board members from seeking regulatory innovation.

Second, if the regulator were integrated into the national regime of regulation. Since the crisis began, we have discovered a limited market knowledge here in D.C., in the Federal Reserve, Treasury, Congress, and the SEC. I might add that when the crisis began to emerge in August 2007, we were immediately contacted by the New York Federal Reserve and the Federal Reserve itself, and are quite impressed in the last 18 months with their vigilance and interest in this sector. So integration, we believe, would speed market recovery by the shared information.

Third, the regulator's reach and authority needs to be extended to all financial tools and participants of the municipal transaction. This meant ratings agencies, insurers, evaluators, and investment and legal advisors for both the cash and swaps transactions. This need has become more apparent as we uncover the damaged issuers, and States such as Alabama, Tennessee, and Pennsylvania are suffering relative to interest rate swaps.

Fourth, if the regulator were charged with more aggressively monitoring market data with consumers' interests in mind. When I think of consumers, I think of both investors and the issuers. In 2008, there were specific instances of meaningful transactions and price irregularities that should have prompted regulatory investigation to protect consumers.

The good news is that this new era of regulatory oversight can be funded by the MSRB's annual revenue in 2008 of $20-plus million, collected from the bond transactions themselves, and can be staffed by the current MSRB policy and administrative infrastructure.

I should be clear. The innovations of derivatives and swaps have a useful application and have been beneficial for those for which they are appropriate. However, it is also important that these instruments become transparent and regulated with the same care as the corresponding municipal cash market.

It is critical to get this right. There is simply too much at stake.

Thank you for having me here today, and I look forward to participating in the questions of the session.

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

Lynn Turner is the former Chief Accountant at the Securities and Exchange Commission. Mr. Turner, we thank you.

STATEMENT OF LYNN E. TURNER, FORMER CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION

Mr. TURNER. Thank you, Chairman Dodd and Ranking Member Shelby. It is always good to be here in this particular case, so I must commend both of you for holding this hearing on an issue that has not only impacted millions of investors but just literally everyone that has been devastated from this economy.

I would ask that my written testimony be included in the record.

Chairman DODD. Yes, let me make that clear. There is a lot of additional documentation, and some of you may want to add as well, and so all of that will be included as part of the record. We thank you for that.

Mr. TURNER. It is only 17 pages, so it is a little bit quicker read than Professor Coffee's.

Senator Dodd, I think you are right. There are really three root causes of this problem: people made bad loans, gatekeepers sold out, and a lack of regulation or regulators missing in action, quite frankly. And it is not the first time. As an auditor in the Southwest, in Denver, I lived through this with the S&Ls, had to do restructurings, workouts at that point in time. And those issues were all existent then, and we are back to a repeat.

So, as Mr. Doe and Mr. Silvers indicated, I think it is especially important that this go-round the Committee get it right. I know that there is some push to try to get something done by an August recess. I would say it is more important to hit this target. We have seen the markets are serviced, a trustee of two large institutional investors. We have seen legislation come out that has not instilled that confidence to date. And we need to get it right this time so we instill that confidence and do not see a market of 5,000, quite frankly. So I would ask you to take your time, whatever is necessary, sooner better than late, but I am not sure this is one that can be both fast and right.

Senator Shelby, you asked someone to comment on the mark-to-market accounting. Being the one accountant, the one green eyeshade on this, let me say I could not agree more with you. The mark-to-market accounting that we are debating now is the same issue we debated two decades ago during the S&L crisis, and as the 1991 GAO report stated, the failure of the banks and the S&Ls during that travesty, to turn around, take marks down in a timely manner resulted in lax regulator action, people not getting on top of managing the assets and problems quick enough, and contributed to a significant increase in the cost to the taxpayers of that bailout. And so I would again urge you to push for transparency here, not step on those accounting standards, and let us get the real numbers.

When you look at banks like Citigroup, who are trading at a stock price for less than what you can buy a Happy Meal these days at McDonald's, we know that the market clearly is not viewing those financials as credible, and we need to get that credibility back into the system.

Certainly, as my fellow panelists mentioned, there are also gaps in regulation. Without a doubt, the credit derivatives market—we all know about that. You certainly have all heard about that as recently as this last week. But it was not so much the failure of a regulatory system, although things need to be fixed, as it was a failure of regulators to act. The Office of the Comptroller of the Currency, the SEC, both had risk management offices. The Federal Reserve had examiners day in, day out at Citigroup, and this was not the first time Citigroup became, for all practical purposes, insolvent and in need of a bailout. When I was at the Commission two decades ago, the exact same thing happened. And you ask, How can the Fed turn around and allow that to happen?

I remember being in a meeting with banking regulators and the Chairman of the Fed some time ago, and I was asked, along with the Chairman of the SEC at the time, What is wrong if the banks are allowed to fudge the numbers a little bit? Now I think we know. If you turn around and ask me is that who you are going to make our systemic regulator, I would turn around and say, "I would hope not." Rather, I think the notion that Professor Goldsmith, the former SEC Commissioner, has advocated as the council or commission—I think Damon talked on it as well—is a much better approach. You have got to give us this in investors, someone regulating that we can trust in. The notion of prudential supervision needs to be a notion that dies. What we want is actual regulators doing their job. That is what we are turning around and paying them for.

Now, while certainly the SEC has fallen off the track here recently, I must say that over the years it has been very successful in its mission to protect investors and gain their confidence. I think investors would be ill served and very concerned if some other regulator with a mission other than investor and consumer protection, first and foremost, was given that leading role to protect them.

As the Committee crafts a solution, I simply believe a focus on a systemic regulator in and of itself and doing regulation around just a systemic regulator does not get the job done. I think a more comprehensive single bill is the right way to go after that. And in doing so, I think you should focus on a few key principles that you need to ensure are established: independence in the system, transparency, accountability, enforcement of law, and making sure those responsible for doing the job have adequate resources.

Following these key principles, as more specifically spelled out in the written statement, I think there needs to be a closure of the regulatory gaps such as with credit derivatives; SEC oversight over the investment banks; certainly the mortgage brokers who brought this problem upon us; greater accountability established through governance and investor rights, including private right of actions, as Damon has mentioned, for credit rating agencies; assisting others in the commission of fraud. Regulators simply cannot do it all and will never have enough resources, so we have to give institutional investors a chance to get justice and recover money when there has been fraud involved.

We need to enhance transparency and disclosure, not only by the issuers but also by the regulators. The testimony last week where the Fed would not give us the names and the details behind the credit derivatives and who are really getting bailed out at AIG was most concerning and disappointing. There needs to be improvements in self-regulation, and there obviously needs to be better enforcement of the laws and regulation.

But in the end, no agency here, neither the CFTC, SEC, the banking regulators, can do it without adequate resources. For example, the Office of Compliance and Inspections at the SEC, you are asking them to inspect 16,000 mutual funds, 11,000-plus investment advisers with 440 people. It simply cannot be done. At a minimum, the SEC needs $100 million to get the type of technology that just brings them up to what we use on the street in the market. If they do not even have those tools, there is no way they can supervise and stay on top of it—$100 million in technology, and then they need about another $85, $90 million, just to bring staffing up to the levels they were 4 to 5 years ago. And they need it now. They do not need it on October 1 of 2010. That needs to go into the budget now, not a year and a half from now.

So I would certainly urge—and I know this is not the Appropriations Committee, but I would certainly urge the Senate to find a way to get them the resources. Without that, you are asking them to go into a gunfight with an empty gun, and we all know what happens then.

So, with that, I will close and be happy to answer any questions. Thank you.

Chairman DODD. Well, thank you very much, Mr. Turner, and what I will do in terms of time—and I will not rigidly hold people to it, obviously, but try and do 5 or 6 minutes, and it will give us a chance at least to get a round. If you go over that, don't worry about it so much. We will just try to move along, because, again, we want to get our witnesses involved.

The temptation here is to focus on sort of one aspect of this. There are a lot of issues, obviously, across the spectrum from obviously credit default swaps, transparency, corporate governance issues, conflicts of interest, credit rating agencies—just a lot of matters to pick out, so I am going to try and ask a broader question and then ask each one of you to comment on a broader question. And I think I know the answer to this one, having listened to all of you and I looked at your testimony. But I would like to ask, beginning with you, Dr. Coffee—and I think you identified this. But if you could make one recommendation as we are looking at this—and obviously we have got our hands full here in the coming weeks.

By the way, I take the point that was raised, either by Mr. Doe or Mr. Turner, of getting this right and, obviously, there is a sense of urgency, but I think the Committee would agree that we want to get it done, we want to work at this very hard, but we do want to get it right. And so striking that balance between moving with some haste but not to such a degree that that becomes the goal rather than producing a product here that has been well thought out.

But if you could make one recommendation that you feel is the most important legislative or regulatory action that the Committee could take to improve investment protection or the quality of securities regulation in the light of the financial crisis we are experiencing, what would it be? What is your one recommendation for us? Just go down the line.

Mr. COFFEE. I would tell you that you should endorse——

Chairman DODD. I need that microphone on.

Mr. COFFEE. I would tell you that is the twin peaks model for securities regulation, that is, having separate peaks—one, the systematic risk regulator, the prudential supervisor. I do not think the SEC is the best agency for that. By training or culture, it is a lawyer-dominated agency focused on enforcement and disclosure, which it does well. It is not able to deal with financial institutions, at least in terms of its first-line responsibilities. Someone else can do that better, presumably the Federal Reserve.

But as was said by other people today, I think there is always the danger that the cultures of securities and banking regulation are so different, and if you put them all in one agency, the centralized regulator, much like the British model, the FSA, you are going to have tensions and tradeoffs between investor protection and the protection of bank solvency.

Thus, I think you have to have a separate investor protection agency. You could merge the SEC and the CFTC, or you could transfer financial futures to the SEC. That is going to be costly in terms of the political process. I do not know whether it is feasible. But the first step, I would say, is to try to have a systematic risk regulator and to not give it the authority to override the disclosure regulators on questions of accounting or on investor protection. So that is the structural issue from 40,000 feet, and I would start there.

Chairman DODD. Gene Ludwig I have talked to, and he has talked about a similar twin peaks structure that you have just described. Are you familiar with his thoughts on this?

Mr. COFFEE. Well, this term “twin peaks” has been used by a number of people. Around the world we see two models: the centralized regulator, which is what the U.K. has, and it has not worked that well there, either; and we have the twin peaks models which Australia, the Netherlands, and other countries have.

We in the U.S. have a unique fragmented system that is virtually Balkanized, with a different regulator for every class of institution. We have got to move one of those two, and I am telling you that the twin peaks model, I think, is vastly superior.

Chairman DODD. OK. I agree with you.

Tim Ryan.

Mr. RYAN. This is unique. We basically agree with the professor. I mean, we have not worked out most of the details on both aspects of the twin peak, but we know that the No. 1 recommendation we have today—and actually, the country needs it. We need confidence in the system. There is no confidence today. We need a systemic risk regulator for the major institutions, and we would urge you to do that in a timely fashion. And we would define “timely” by the end of this year, and to do it right.

Thank you.

Chairman DODD. Mr. Stevens.

Mr. STEVENS. We, as you know, endorse with some cautions the idea of a systemic risk regulator, but if you push me to say what one thing, Mr. Chairman, I would say that we need a capital markets regulator that is really at the top of its game. This problem would not have grown unless the securities markets made available, through packaging and reselling and all the rest of it, a vast opportunity to take these mortgages and distribute them to financial institutions globally.

I in 30 years have been a close observer of the SEC, and I think it is a remarkable agency. But it has seen challenges in keeping up with the growth and the complexity and the linkages, the internationalization of our capital markets. What we need to do is give it the right tools, give it the right range of authority, and make sure there is a very strong management focus there that keeps it on its mission. And I agree with you, investor protection is mission one, but it also has a very important regulatory role, and so it needs to understand and be able to keep pace with these market changes in the way that has, I think, proven to be very, very difficult.

So that would be my recommendation.

Chairman DODD. OK. Professor Bullard.

Mr. BULLARD. Mine would be to—probably to expand on what Professor Coffee was saying, I think that from an investor protection point of view, what is important to understand is that investor protection actually assumes that we want investors to take risk. And, therefore, investor protection is about making sure that the risks that they take are consistent with their expectations.

That is fundamentally inconsistent with a prudential oversight role. Prudential oversight is what you want when somebody buys life insurance and expects the money to be there if their spouse dies. They invest in a banking account, and they expect those assets to be there. They buy a money market fund, and they expect that to be a safe investment.

That is antithetical to investor protection risk because there sometimes the disclosure of the truth undermines the confidence that you need that those people rely on to keep their investments in banks—to keep their assets in banks and money market funds. So I would say those have to be separated, and investor protection needs to be, again, as I mentioned earlier, kept distinct from customer protection, which again is not something that needs to be regulated with an eye to promoting risk taking—that is, risk taking based on high expected value investments.

And then, finally, I would say that I am a little concerned about mixing the systemic issue and the prudential issue. The way I have always thought about prudential oversight is that you are making sure that the promises made with respect to generally liabilities on one side are matched by the kind of assets that are created to support those liabilities.

Systemic oversight is where you assume that prudential regulation, being necessarily imperfect, will sometimes lead to a breakdown, and the question is: What is the role of the Government going to be to prevent that breakdown under a prudential system, which will happen sometimes, and what will it do when it steps in? I think that that is a fundamentally separate function from prudential regulation, and that is why—and I am not sure what a systemic regulator is as apart from a prudential regulator. But that is something, I think, that it would help to have more clarity on.

Chairman DODD. Yes, Mr. Pickel.

Mr. PICKEL. I think the requirement for greater coordination among the regulators is very important. I think that one of the things we are looking at here in the financial crisis is the ability to connect the dots across different products and across different markets, both nationally and globally. I think that is the root of some of the suggestions for the systemic risk regulator. But I think it could also be achieved, as I think Mr. Silvers and Mr. Turner suggested, through greater coordination or some collection of supervisor who would look at these issues and connect those dots.

Chairman DODD. Mr. Silvers.

Mr. SILVERS. I find myself in the unusual position of having really nothing to disagree with in what I have heard so far at the table.

I would say, though, that the single item that I would put to you, I would put differently than my co-panelists have done so far.

I think that conceptually the thing you want to be most focused on is ensuring that we no longer have a Swiss cheese system, that we no longer have a system where you can do something like insure a bond, either in a completely regulated fashion, in which there are capital requirements and disclosure requirements and pre-clearance, or in a completely unregulated fashion through essentially a derivative and where you have none of these things; that the content of what a financial market actor does should determine the extent and type of that regulation.

Closing regulatory loopholes, ending the notion that we have shadow markets, I think is the most important conceptual item for Congress to take up, because, otherwise, if it continues to be possible to essentially undertake the same types of activity with the same types of risk but to do so in an unregulated fashion, we will replay these events with a fair degree of certainty. And I believe that much of what the discussion about structure here has been is all about how we do that ending of shadow markets and regulatory gaps.

I think in certain respects, some of the how is less important than actually getting it done. I would say, though, that I really strongly endorse what Mercer said about the different functions of regulation, that there is investor protection, disclosure and fiduciary duty oriented; there is consumer protection, although I think, Mercer, you had a different phrase for it, but protection around the public buying financial services which does not want to take risk; and then there is safety and soundness regulation. Those things are different, and it is dangerous to blend them.

Chairman DODD. Yes. Mr. Doe.

Mr. DOE. As I have listened to my fellow panelists, I am reminded of a book called "Why Most Things Fail" by a U.K. economist named Paul Oremerod, where he draws comparisons between species extinction models and those of corporate and market failures. And in it, he cites two conditions where we have failure of a species. And one is when it gets soft and is not challenged. The second is when there is not incremental learning that is constantly being done.

And I think what I have gathered in the last 18 months—and, again, in our small niche in the municipal bond industry, which is smaller than others that have been addressed here today. But it is that the idea of a regulator that has an inspired inquisitiveness and a sense of purpose so that they are eager to pursue an understanding of the markets that they regulate. If there has been one— and this is where I hope that if we have a consolidated or a sharing of information across the different asset classes or the different products, whether they be cash, whether they be swaps, whether they are equity, whether they are fixed income, that this provides an opportunity of being able to identify the first hints of failure that might occur in a system, and that way we might be faster to act.

I think what is very interesting about, again, the industry that I have been involved with in the municipal bond sector is that when innovation of products finally makes its way into the public sector, it is almost the last place, again, because the revenue relatively is small compared to the other asset classes in the taxable markets. But I think it becomes magnified because you are starting to deal now with the public trust in the most intimate form.

And I think so that when we start looking at regulation, it is, again, how do you inspire that trust, but how do you inspire that inquisitiveness of the regulator, and maybe it is the pride that is associated with doing the job that they feel that they are really able to accomplish something and make a difference. And I think that is what we are all trying to do here.

Thank you.

Chairman DODD. Yes. Last, Mr. Turner.

Mr. TURNER. I actually think if I could just pick up a magic wand and do one single thing here, it would make sure that inside the agencies, the regulators, we had competent people who were in the right mind-set to go do their jobs. Bad loans, the Fed had the law that you all passed in 1994 giving them clear-cut authority to go eliminate those. They did not do it. Enforcement agencies have not done enforcement.

The bottom line here is much of this could have been prevented without a single additional piece of legislation being done if people had just done their jobs back here. And I would urge you, go back, let us make sure we get the right people in, and then let us make sure, quite frankly, there is more active, proactive oversight by the appropriate committees of those responsible.

Aside from that, I would turn around and say the No. 1 thing in the system has to be independence. These agencies have to clearly understand they are independent and free to go do what they need to do to protect investors and consumers. There should have been independence in the credit rating agencies. They clearly sold out. The e-mails and all show it. That was not there.

There needs to be independence in the compliance officers in these businesses, in these banks. Clearly, that was not there.

So aside from making sure you got people doing the job, we can have one peak, we can have two peaks. We can have 52—the 14,000 peaks that we have got in Colorado. But if you have got bad people sitting on the top of each of those peaks, it is not going to matter what you legislate here.

Chairman DODD. With that encouraging note, let me turn to Senator Shelby.

[Laughter.]

Senator SHELBY. Mr. Turner, we are glad you are here. Thank you. Thank you very much.

Professor Coffee, I would like to direct this to you, if I could. Thank you, and welcome to the Committee again. You spend a lot of time here, and we welcome you, and you have added a lot to us.

You recommend giving the Federal Reserve Board authority to regulate capital adequacy, safety and soundness, and risk management of all financial institutions that are "too big to fail." Is this suggestion based on a careful examination of the Federal Reserve's track record as a prudential supervisor up to this point, which I think is lacking? Did you take into consideration the fact that the Fed already has responsibility for monetary policy, bank supervision, and lender-of-last-resort functions? And are you concerned about the implications of the fact that, as you noted, the Fed is not politically accountable in the way other agencies are?

I know that is a lot of question, but you are a distinguished professor and you can handle it.

[Laughter.]

Mr. COFFEE. Those are all good points.

Senator SHELBY. Can you bring your microphone up a little bit? It is not on yet.

Mr. COFFEE. The problem is that the Fed is not perfect. It is far from perfect. I think it is better positioned than agencies like the SEC. The SEC is focused on transparency and enforcement, not on prudential supervision, and the second-tier functions of an agency are the functions that are most likely to be captured by the industry.

Also, frankly, there no longer are any investment banks. They have all moved someplace else. There is nothing left for the SEC to exercise prudential supervision over. Therefore, I have got to think we have to start, warts and all, with the Federal Reserve as the only body that has this capacity and has the orientation and has the competence. It may not always have performed well.

Your point about political accountability is very important, and that is why I keep insisting that investor protection should not be subordinated and should be given to a very independent agency, the SEC or the SEC/CFTC, because I do not think you can count on the Fed with its orientation to ever be a champion of the investor's rights. The culture is one of secrecy, and you saw this all in the AIG. I think AIG is representative of the problems you will have if you depend upon the Fed for transparency. But I do not think the SEC is going to do much better than it did in the Consolidated Supervised Entity Program.

Senator SHELBY. Professor Coffee, are you concerned that when you identify institutions as too big to fail, that will dull the market discipline of those firms which the market will view as having a Federal guaranty? Is that a concern always in the marketplace?

Mr. COFFEE. I am not testifying that every organization should be bailed out. I think the ones that most merit this are the ones that are so entangled that you get the true problem of systemic risk. Systemic risk is the danger of interconnected failures, the chain of falling dominoes. I am not telling you whether or not AIG should get more money. I am telling you only that where we have companies that are too entangled to fail, that is where we most need prudential supervision and a Systemic Risk Regulator.

Senator SHELBY. Mark-to-market accounting, Mr. Turner wrote this up and I think he is right. Do you believe the current attacks on mark-to-market accounting, Mr. Turner, are motivated by a similar understandable desire to avoid taking painful write-downs?

Mr. TURNER. I think, without a doubt, Senator Shelby, they are a problem here. You know, if you make a loan at $100 and you are only going to get $70 back, that is OK once or twice, but we did it millions and millions of times. The bottom line is they just aren't worth what they were, and to report to the public, to investors, regulators that you have got a balance sheet that is substantially different than what it is really worth is just flat out misleading, if not straightforward fraudulent.

Senator SHELBY. Mr. Ryan, your testimony recommends a Financial Market Stability Regulator that, among other things, would have a direct role in supervising, quote, your words, "systemically important financial organizations." What are the criteria, Mr. Ryan, that you would recommend for identifying systemically important entities, and do you believe that there would be any competitive implications for firms that are not so designated?

Mr. RYAN. Thank you for your question. We have given a lot of thought to a number of issues, and on some of these issues we do not have final decisions. I am talking now within the industry. For instance, we spent a lot of time talking about should we recommend the Fed immediately as the systemic regulator, and we have not come to that conclusion yet. If we had to do it right away, they are probably the best qualified to do it, but we think that the industry and the Congress, the American people, deserve a really comprehensive view.

The same is true of who is systemically important. It is pretty easy to identify the early entrants because they meet the test that Professor Coffee has enunciated. They are too interconnected. They are very large. They are providing consolidated services to the citizens of this country and we need a better understanding of their interconnected aggregated risks.

So the first group will be easy. The second group will be more difficult because they may not be so interconnected. They may not even be that large. But they may be engaged in practices which could have a very dramatic impact on our health.

So our hope would be that we anoint a systemic regulator, maybe it is a new entity, maybe it is within Treasury, maybe it is the Fed, that we orient them in legislation toward preselection of the people who are very obvious, and that we give them the flexibility to include and actually to have people move out of systemically important status going forward. So once you are in it doesn't necessarily mean that you will stay in it.

I think it is pretty clear, though, we all know the basic early entrants and they are our larger financial institutions. We, by the way, would not limit this by charter at all, so there will be banks, there will be insurance companies, there will be hedge funds, there could be private equity players. It is people who could have a dramatic effect on our lives.

Senator SHELBY. Professor Coffee, why should we continue to prop up banks that are basically insolvent, some of our large banks that are walking dead, so to speak, give them a transfusion, and there is no end in sight? Why should we do that rather than take over some of their—guarantee some of their assets and whatever we have to do and wind them down?

Mr. COFFEE. Again, it is a perfectly fair question and I am not telling you that every bank should be bailed out, not even every large bank. But if we are going to get the financial system working again, we have to move credit through banks.

Senator SHELBY. Sure.

Mr. COFFEE. You can nationalize them. There still has to be a management.

Senator SHELBY. I have never advocated that.

Mr. COFFEE. The government can't run a bank. It might be that if you want to name institutions that may not deserve further bailouts, AIG is an example. It is not a bank and basically the government is spending $160 billion there to pay off the counterparties, most of whom are foreign banks.

Senator SHELBY. Obviously poorly regulated.

Mr. COFFEE. I am saying that the key bank institutions are the only way we can get a corporate capital system moving again. The money has to flow through the system, and if they are part of the basic transmission belt, then there is a strong argument for ensuring their survival.

Senator SHELBY. Mr. Ryan, you and your organization, the Securities Industry and Financial Markets Association, have advocated a merger of the SEC and the CFTC. You are not by yourself there. If a merger, should it go forward, should it occur simultaneously with whatever broader regulatory restructuring we undertake in this Committee? Should it be part of the overall comprehensive structure, restructure?

Mr. RYAN. I would sort your—because I think the biggest issue Congress has right now, you obviously have many, many issues on your plate and sorting them by priority is an essential component of your work right now, I am sure. So our recommendation is that you sort them with the systemic regulator being first and immediately come behind that with cleaning up the many regulatory agencies that have overlapping authority. If I was the new regulator, I may actually ask you to do those simultaneously so I would know my job.

May I also——

Senator SHELBY. It would send certainty to the market, would it not?

Mr. RYAN. Yes, sir. I think that is possible. May I also just provide one comment based on your last question to the professor to my right?

Senator SHELBY. Go ahead.

Mr. RYAN. Because I am probably—because I spent an awful lot of time in this Committee when I was the OTS regulator——

Senator SHELBY. You did.

Mr. RYAN. ——dealing with the RTC, and what I learned through those 3 years brings me to a very firm view on opposition totally to nationalization of financial institutions. We have a process in this country through the FDIC where we, in a sense, nationalize. We call them bridge banks. We know that if you put very large institutions into bridge banks and they stay there for a very long period of time, the cost escalates enormously. You can look back to the RTC experiences. If we ask the government to take control of a large financial institution and run them, the cost of resolution is going to dramatically increase. The way we are doing it right now is much better. Thank you.

Senator SHELBY. One last question, Mr. Chairman, if I can, to Mr. Silvers. Mr. Silvers, you advocate a greater role for long-term investors in the election, I will use your term, of psychologically independent directors on corporate boards. What measures would you take to ensure, sir, that these directors whose responsibilities would flow to all shareholders of the corporation are independent not only of management, which is important, but also the shareholder group responsible for their election?

Mr. SILVERS. Senator Shelby, I think that there are several specific ways of doing that. The first is that those mechanisms, as my testimony indicated, need to be tied to a certain amount of tenure as a shareholder. I think that is a way of ensuring that it is not captive to individuals who are looking for liquidity.

Senator SHELBY. What do you mean by tenure of a shareholder?

Mr. SILVERS. Holding, a holding period, that anyone who could use such a mechanism would have to be a fairly long-term holder so that you ensure that it is not used by people who are seeking a liquidity event as opposed to people who are seeking the long-term health of the corporation.

Second, I think obviously that there needs to be, depending on exactly what mechanism one uses, that all discussions in this area have required that anyone who used such a mechanism would be either by themselves or as part of a group a significant set of holders. Certainly in large corporations, more than 1 percent of the shares, and in very large public corporations, it is a very large collection of money, or at least it used to be until recently market events.

And then third, the most important protection here is a very simple one, which is that we are talking about a nomination mechanism, not an election mechanism. The majority of stockholders would have to vote for such a person, and the corporation, the management, at least under Delaware law, has the right to use pretty much limitless resources to campaign against them. I think that is the fundamental barrier.

Senator Shelby, if you would allow me, I want to say a word or two to you about the Federal Reserve in response to your questions to Professor Coffee.

Senator SHELBY. Yes, sir.

Mr. SILVERS. I believe that the concerns you raise are profound and important ones and that they are profound in relation to the question of whether we want—the task we are asking a Systemic Risk Regulator to take on a fundamentally public task. The Oversight Panel that I serve on its regulatory reform recommendations specifically stated, if we are going to ask the Fed to take those obligations on, the Fed must be governed differently.

I would be comfortable, personally, with that arrangement, with a greater degree of accountability and doing away with the self-regulatory aspects of some of what the Fed does. But I am convinced that that is probably not the best way to do this, and the reason why I am convinced about that is because, A, I am think that the Fed—there are tradeoffs with the Fed and the other things we ask the Fed to do. And the second reason is because, while I agree with Professor Coffee that the SEC is not suited to be the Systemic Risk Regulator, that that job is going to—as long as we have a twin peaks-type model where information about our markets is flowing from different directions within the regulatory system, that that coordination of information and openness to information is critical. If we ask one body to take it on, that is going to have an impact on the flows from the other bodies.

The best answer, I think, in light of that is an agency with staff that is governed by the heads of our twin peaks or our three peaks. I hope we don't get to 14. How many hundred peaks are we talking about, Lynn?

[Laughter.]

Mr. SILVERS. But an agency that is governed by the independent regulators but has its own staff and mission in this area. And I think the Fed would play a very large role there because they are——

Senator SHELBY. And they can't be overridden by the Fed?

Mr. SILVERS. Yes. That is——

Senator SHELBY. That is important.

Mr. SILVERS. I don't think we can give the power to override fully public bodies charged with issues like investor protection to the Fed. Thank you, Senator. I appreciate your indulgence.

Senator SHELBY. Thank you.

Chairman DODD. Thank you, Senator, very much, and that is a question that many of us have raised, given the already full plate that the Fed has, in addition to roles they are taking on. The obvious problem is that if you move away from the Fed as the model, creating a whole new entity raises another whole set of issues and that is the quandary I find myself in. I don't disagree with Richard Shelby's point. We have all talked about it here at various other times. And then I quickly say to myself, so what is your alternative? And when I come to my alternative, I find myself almost in as much of a quandary.

And so we find ourselves in this position of trying to make a choice between an existing structure in which I can see how this could fit—I think your point, as well—although you would have to make some changes in this thing, or trying to create something altogether new, which has also got its difficulties. But it is a very critical point, obviously, and one that we are talking about, obviously, at this point.

Anyway, with that point, Senator Bennet, I thank you for your patience.

Senator BENNET. Thank you, Mr. Chairman.

I want to start broadly and then ask a couple of narrow questions. Professor Coffee talked about the difference between the culture of the banking regulator and the culture of the securities regulator, which has been a theme that we have heard about in this Committee, and in thinking about the new structure, we want to make sure that that culture shifts, I think, so that we get the kind of oversight that all of us will feel comfortable with.

In addition to that, there is the issue of no matter what structure you have, the constant innovation that goes on in the market and having some assurance that the regulator is keeping up with that innovation, as well. We want the innovation but we also want to make sure we understand it.

And then Mr. Turner's observation that what is really critical, as it is with all human institutions, is that you get the right people in the job, and unfortunately, neither he nor we have the magic wand that he called for.

But I guess the question I have is, are there thoughts from you, Professor Coffee or others on the panel, about what we could do in this legislation to assure that we have the kind of attention to the changes in the market knowledge about approach and the right people so that we can really get the job done?

Mr. COFFEE. First of all, you and Senator Shelby are definitely focused on the proper issue. The Federal Reserve may have to change. You may have to give it a very different staff, a very different accountability structure. You are certainly going to want it to monitor, but I don't think you can ever make the Fed into a strong enforcement agency. I don't think you could ever make the SEC into a strong prudential supervisor.

What I think you have to recognize is in terms of new market developments, the Fed has a more universal view. The SEC, at least as it stands today, doesn't have jurisdiction over swaps, over-the-counter derivatives, or futures. It is not going to know inherently what is going on in those areas. Yes, you could merge the SEC and the CFTC, but that compounds the political difficulties of achieving our solution by, I think, several orders of magnitude.

And I would agree with the prioritization model that Mr. Ryan just discussed. First create the optimal kind of Systemic Risk Regulator, which may require changing the Fed, changing its accountability structure, giving it a permanent staff that would do the kind of monitoring we have in mind. But I think that is the smaller change than designing something totally from scratch.

Mr. STEVENS. Senator, could I comment on that? I know that many have not had a chance to absorb it, but I am very struck by what Chairman Bernanke had said today, because everyone is talking about his agency, of course, and he says, and I am quoting now, "Any new systemic risk authority should rely on the information assessments and supervisor and regulatory programs of existing financial supervisors and regulators whenever possible."

What that means to me is they don't want to take all these functions aboard themselves. They want a very strong Capital Markets Regulator. They want a very strong bank regulator. They probably want a very strong Federal insurance regulator that they can work with. The notion that they can pull all of that inside the Fed and at the same time accomplish their traditional missions is something I think, as I read the speech, and this is more subtext than text, is unsettling to the Chairman of the Fed, and with good reason, I believe.

I would say also in commenting on Chairman Dodd's quandary, and I don't know if this is useful or not, but I spent a considerable period of time as Chief of Staff of the National Security Council and I have reflected a lot on that innovation in our government. It came online after World War II and our experience as a nation of the inability to coordinate and integrate the efforts of our Diplomatic Service, our Armed Forces, and the like at a time when we had burgeoning global responsibilities as the superpower in the aftermath of World War II. It is a Cabinet-level Council that is chaired by the President. It has a staff whose professionalism and abilities have been built up over time. And its function is there to collect information, to monitor developments, to integrate and coordinate the efforts of government.

I think it is not out of the question that you could create a similar coordinating mechanism, and I think this is part of what

Damon is pointing toward, at a very high level with the regulatory agencies that would pull all their expertise together, give the chairmanship of it to someone, and maybe that is the Chairman of the Fed, give it a permanent staff, and allow it to be monitoring and collecting data and doing the analysis, but in conjunction with those who are the front-line regulators and whose expertise has got to be leveraged. At least that is, I think, a reasonable concept on which to reflect.

Senator BENNET. A completely unrelated question. I didn't come here to ask it, but the Ranking Member asked about mark-to-market and your answer is very clear. This is a place where I have gone back and forth. If our markets were lubricated and were doing what they were supposed to be doing, we wouldn't be sitting here talking about investing taxpayers' money the way we are talking about investing it to create stability in the market.

And I wonder whether there are others here that have a different point of view on mark-to-market in this sense. It seems to me that there is a legitimate distinction between assets that are held by these banks that have no collateral behind them or very little collateral and assets that are held by our banks that have collateral but simply have no market right now and therefore aren't trading at all. I know there is a pure view that says that should tell you that the assets don't have value, but the thing I keep stumbling over is that some have collateral and some don't have collateral and shouldn't we be taking notice of that?

Mr. SILVERS. I do not, in general, share Lynn's complete enthusiasm for mark-to-market accounting. I think that there are a wide range of areas in financial accounting where historical cost accounting is actually more indicative of the life of the business than mark-to-market. However, the financial institutions, particularly those with demand deposits where in theory the funds can walk out the door, are ones that seem uniquely kind of attuned to mark-to-market principles.

In the course of the work of the Congressional Oversight Panel, we have done two oversight—two hearings, two field hearings in relation to our mortgage crisis, which I believe and I think most economists believe is at the heart of what has gone wrong here in our economy, that underlies the financial crisis, and it is clear from those field hearings, in P.G. County not ten miles from here and in Nevada, that even at this late date, we do not seem to be able to get rational outcomes out of private ordering in terms of non-performing mortgages. We can't get the mortgage providers and the servicers to negotiate rational outcomes with homeowners.

Now, I believe that this is related to the remnants of non-mark-to-market accounting in banking, that effectively loans that are never going to be worth—the banks are carrying loans that are never going to be worth full value, even though they are capped at high values maybe not at par, but at close to par. And the one thing that would force them to mark them down would be a rational settlement with the homeowner, because then you would have to admit what you actually had.

Now, you asked about collateral. You walk through the subdivisions and not all of them are new. In P.G. County, you have got a lot of people who have been effectively exploited and stripped of their homes. That is Prince George's County, for those who are not Washingtonians, here in Maryland. You look at those properties. There may be collateral, but it will never support par value, never. It may return—it may recover value. It may, 10 years from now, if the last very serious real estate collapse is indicative, and I am afraid this is clearly worse, in many areas, it took 10 years to recover from the bust of the late 1980s and early 1990s. But returning to par in 10 years means you are never really worth par present value basis, you are not going to be there.

And so I am in favor of sort of—I am kind of in the middle of the road on these issues, but I think we need to recognize that there could be very, very serious broad economic consequences of indulging the fantasy that subprime loans backed up by collapsed residential property are ever going to be worth par. They are just not. And the consequences of that pretense is actually throwing people out of their homes.

Senator BENNET. Mr. Chairman, could I ask one more quick question——

Chairman DODD. Certainly.

Senator BENNET. ——for Mr. Doe. I was very interested in your testimony. This is a line of conversation that Senator Warner and I have been having. I assume that your view is that there is Federal authority now to be able to intercede, either through the Treasury or the Fed, with the VRDO market in some way that may give hospitals, public hospitals, schools, and other municipal credit some relief from the lack of market that exists for variable rate debt——

Mr. DOE. Well, I think one of the key issues associated with that is that many of the issuers that have—that are confronted now with challenges of restructuring their debt in the variable rate market, as I pointed out in my testimony, these variable securities have links to interest rate swaps which have created all sorts of issues. And one of the things that these—the cost of termination of the swap transaction has become overly penal, and in some of these small towns and counties where it is arguably there was a mismatch in terms of appropriateness. And again, remember that the regulatory body of the municipal industry doesn't have purview—has limited purview, only on dealers and only on cash securities. So here you have these cash transactions linked to swaps. It makes it a little bit of a conundrum.

But one of the things we think where the Treasury could step in and make a big impact is to provide subsidized loans to municipal issuers that would help them terminate those swap transactions, and then over time, the cost of those loans could be recouped in future transactions and discriminate fee, and I think that would be a really important step. So I think those are the people and the institutions that have been most adversely impacted.

Senator BENNET. I would like to thank the witnesses for their testimony.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, gentlemen, for excellent testimony.

Just as two preliminary points, first, I want to thank Professor Coffee for his kind words about our credit rating legislation. Thank you very much and thanks for your help.

And then to Mr. Turner's point about the need for resources regardless of what we do, this omnibus we are debating contains an additional $38 million for the Securities and Exchange Commission and the proposed budget of the President is around a 13 percent increase over the 2008 marks going forward, so I completely concur. We can make all the structural and legislative changes in the world, but if they don't have the resources and the will to do the job, it won't get done.

One of the impressions I had listening to your comments is that I think we were in this sort of false logic where regulators of all ilk were looking at the capital of institutions, saying we don't have to be too sensitive to their risk evaluation assessments because they have got capital. Of course, the capital was risk-based, so you are in this circle around where if you don't do a good job evaluating capital based on risk, then you don't have the capital, *et cetera*.

Part of this goes to Basel, the efficacy or the effectiveness of Basel. I think that has to be looked at.

And the other issue I think has to be looked at, too, is just the managerial capacity to run these organizations. I think one of the issues of size is do you really have the wherewithal, the computer systems, the structural managerial skills to run them?

This is a long sort of preface to be saying that it appears that this, in my view, twin peaks model we will probably adopt in some form, that by default, perhaps the Federal Reserve will become the regulator, and unless we make some significant changes in the culture and the operating standards of the Federal Reserve, we might be exactly where we were before, that this sort of just looking at risks—not looking at risks, not looking really well at management.

So I don't know if you have comments, Professor Coffee and gentlemen?

Mr. COFFEE. I think that is the danger. I think you are correct and I think it does justify what I think Senator Shelby was going for, some modification of the charter and the requirements and responsibilities of the Federal Reserve. I think the best way to protect transparency is to make sure that the SEC's authority to require full disclosure is not circumscribed. But I do think that we are now in the world where the price of all bank stocks has fallen so low, with Citicorp trading at $1.50, this is the time to pursue mark-to-market because the market doesn't believe these banks have any value. You might as well bring the accounting in accord with the reality as the market reflects it.

I think your concern is that changes in the Federal Reserve is a sound concern, and I can't tell you, because I am not a Federal Reserve expert, of what the five things I would do first to the Federal Reserve are.

Senator REED. Does anyone else want to comment? Mr. Ryan?

Mr. RYAN. We have been talking about resources, and many of the panelists have talked about whatever changes we make here, let us make sure that we have the right people doing the job, that they have adequate resources.

One specific topic I think deserves the Committee's attention and Congress's attention is whoever is going to do this job has to have the technology resources to get the job done, because when we ask someone to be the systemic regulator for our most important financial institutions, we are also, I think, asking them to do a job that regulators have not really done well at all, which is to look over the horizon. They are pretty good at looking back and looking at what went wrong and let us see if we can fix it. But we are going to ask this new entity or the Fed to do a job that we have not really done before and they need to have the tools to do it.

They really need to think about the technology demands, because right now, we do not have a full understanding of the aggregated or collective risks of all of these interconnected entities. We have the capacity to do it from a technology, hardware, software standpoint, but we don't really have that done. It is going to be very expensive and it is very important that you spend some time on that.

Senator REED. One of the points I would note is that when Chairman Donaldson became Chairman of the SEC, he tried to establish a risk assessment operation. That initiative was undone by his successor. But I think we should consider along those lines, Mr. Ryan, requiring the systemic regulator to have a rather independent risk assessment group that on a periodic basis will publish to the Congress and to the people what they consider to be the most significant pending risk and the likelihood. That might force discussion and maybe even sometimes action.

Professor Bullard, and then Mr. Silvers and then Mr. Turner, and then I have one last point.

Mr. BULLARD. I just wanted to add that, again, to me, the systemic risk question is one of someone who has oversight over a range of prudential regulatory regimes. The Fed already is our systemic regulator. It may not have that aggregated information as Paul was talking about, but it has the discount window, it has the open market transactions, it has the ability essentially to create money, although the Treasury has shown remarkable ingenuity in creating money recently, as well.

So it already serves in that role. I think it is a separate question as to as it sits back and decides where it needs to take action to affect credit markets, it sees some hot spots over here with respect to the support for some area, that it also should not necessarily be expected to be the prudential regulator that is in charge of monitoring what stands behind that particular area of our financial services, because those really are separate functions.

The systemic regulator is one who can go in and fix it with ultimately taxpayer dollars and then tries to find situations where it can mitigate that risk and reduce it. The prudential regulator is the one who writes the rules that says, to back these kinds of liabilities, these are the kinds of assets we expect you to have, and I am not sure that those are necessarily ones that should be or have to be housed in the same agency.

Senator REED. Mr. Silvers, then Mr. Turner, then I have one final unrelated question.

Mr. SILVERS. Senator Reed, first, I share your concerns about Basel II. I think that is clearly part of the causal fabric here for our crisis. There are three points about the sort of managerial and task challenges associated with systemic risk regulation.

First, the Congressional Oversight Panel in its regulatory reform report suggested that the notion of intelligence, of looking over the horizon in relation to financial market systemic risk, should perhaps be delegated not to a regulatory body but to a panel of outside experts—some of my fellow panelists here might make good members of such a panel—whose sole job was to look ahead and that were not intertwined in the politics of the regulatory landscape.

Second—and this is a concern that Senator Shelby raised—our view was it would be a very bad idea to name who is systemically significant. In fact, it is not only a bad idea in terms of moral hazard, but it is actually impossible to do; that in a crisis people will—institutions will turn out to be systemically significant that you had no idea were. And Exhibit 1 for that is Bear Stearns.

And there are other times, calm times, when very large institutions may be allowed to fail, and probably should be; and that rather than naming institutions, we ought to have the capacity—and this comes to your point—the capacity for the systemic risk regulator to work with other regulators to set ratchets around capital requirements and around insurance costs to discourage people getting essentially too big to fail and to set up the financial basis to rescue them if they do.

Finally, there is, I think, some—I am not a Fed expert, but I think there is some confusion about where the money comes from for bailouts and rescues and so forth. The Fed does not have the authority, as far as I know—although you all maybe can educate me. The Fed does not have the authority to simply expend taxpayer dollars. The Fed lends money. It is the lender of last resort.

In a true systemic crisis, as we have just learned, we get beyond the ability of liquidity to solve the problem, and in that circumstance we start expending taxpayer dollars.

It is hard not to look at the TARP experience and what preceded it and not conclude that the *ad hoc* quality of those experiences did not build public confidence or political support for what had to be done.

Given all of that, I think we need to understand that when we ask a body to take on the role of systemic risk regulator, that also means we are asking them to take on the role of rescuer, and potentially to expend taxpayer dollars. And that I think requires a set of governance mechanisms and capacities, to your question, Senator, that we have yet really to build. And it also requires, I think, a careful balance between genuine public accountability and transparency, on the one hand, and genuine independence from the all too eager desire of everyone around to bail out their friends.

Senator REED. Mr. Turner, do you have comments?

Mr. TURNER. Just like Damon, I would say Basel II needs to be re-examined. I expressed concern almost 8 years ago to the Fed that it would not work, and I think if it stays the way it is, it will contribute to further problems. I think Sheila Bair has been very insightful on that in that regard.

As far as managing the risk, I have actually had to run a large international semiconductor company, and in the technology area, we had a lot of risk, and it changed very dramatically, much faster than what it even does in the banking industry. And what we found was, if we are going to be successful in managing the risk, we could not do it with the same people that we had necessarily running the operational, the manufacturing side of the company. You needed a group of people that were much more focused on the future and where things were going. They needed to be looking not just ahead, but much further ahead, and have a pulse not only what was going on but where that turned around and took you.

After Donaldson formed the Risk Management Office, I went and visited with him for a while. Certainly that type of mentality plus the tools were not in that group at that point in time. I have not seen that at the Fed in my dealings with the Fed over the last couple decades either.

I am not sure you can get that without a major wholesale change, and so I come back to—having gone through this and having to manage risk myself, I come back to probably what Damon has said, and probably the best way to put this together across the broad spectrum would be to create the separate organization, chaired with the board of the major chairmen of the major agencies, but with real staff and real resources and focused on that aspect of the business. I just do not think we are going to get it if you put it inside one of these agencies.

And, in fact, think about it. We have had risk management—a Risk Management Office in the Fed, in the OCC, in the SEC, and it has not worked. And why would we turn around, given what this devastation and travesty has cost us all, why would we go back and say let us try it again? You know, this is not one where I give people another swing at the bat.

Senator REED. Mr. Chairman, you have been very kind. I have one question, if I may.

Chairman DODD. Sure.

Senator REED. I will address it to Professor Coffee, because it might be way off the beaten track. In fact, it sounds like an extra credit question in a law exam.

[Laughter.]

Senator REED. So here it goes. Whatever happened to Rule 10b-5? I mean, I have been listening to discussions of potential fraud in the marketplace, securities that had no underlying underwriting. And I grew up thinking that material omissions as well as material commissions gives the SEC in every capacity, as long as it is a security, to go in vigorously to investigate, a private right of action, and yet I have been before the Committee now for 2 and 3 years, and I do not think anyone has brought up, you know, Rule 10b-5 actions. Can you just sort of——

Mr. COFFEE. I am glad you asked that question because it is a good question, but there are two major limitations on Rule 10b-5. As you have heard from others on this panel, it does not apply to aiders and abetters, even those who are conscious co-conspirators in a fraud. That is one limitation that Congress can address. And, two, when you try to apply Rule 10b-5 to the gatekeepers, whether it is the accountants or the credit rating agencies, you run up against the need to prove scienter. It is possible to have been stupid and dumb rather than stupid and fraudulent, and that is basically the defense of accountants and credit rating agencies.

I think you need to look to a standard of scienter that will at least create some threat of liability when you write an incredibly dumb AAA credit report on securities that you have not even investigated, because you do not do investigations as a credit rating agency. You just assume with the facts that you are given by management.

So I do think there is some need for updating the anti-fraud rules for the reasons I just specified.

Senator REED. Thank you.

Chairman DODD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. A fascinating panel. First of all, I commend you for asking that "What is the one take-away?" question from each of these gentlemen. And while I think there was a consensus that we need to get rid of this shadow market, we need to make sure we get rid of this Swiss cheese approach to regulation, I think we will be challenged, taking some of these broad overviews and taking them into specific legislation.

Chairman DODD. I agree.

Senator WARNER. And I appreciate your asking that question.

I want to follow up, before I get to my quick question, on Senator Shelby's comments along the notion of the institutions that have posed this systemic risk, the "too big to fail" excuse, and Damon's comments about perhaps not publishing those that are systemic risks, but this problem we are in the middle of the crisis now of too big to fail. And I would be curious perhaps in a written question to the Members—I know Senator Shelby has, I think, provocatively raised a number of times the issue of, well, how much more on Citi and should we go ahead and let it go through some kind of process? And the quick response normally being, well, no, that is too big to fail.

Well, I would love to hear from the panel, perhaps in written testimony, if you were to see the transition, dramatic transition—and I know we are sometimes afraid of the terminology, whether it is "receivership" or "nationalization," some other way to get it out of the current ditch that it is in—you know, how you would take one of these institutions that fall into this "too big to fail" category that appears to have real solvency issues and get it through a transition? And I perhaps would work with the Senator on submitting that type of written question.

So we have seen, you know, the big take-aways on how we regulate and where we put this prudential or systemic risk oversight. We have seen the question of how we deal with the current challenging institution. I want to come with my question, and I know our time is about up, but I will start with Mr. Pickel, but would love to hear others' comments on this, and that is, maybe come at this from the other end.

Even if we get the risk right, with the great people that Mr. Turner has advocated, where and how should we look at the products? I would argue that intellectually I understand the value of derivatives and the better pricing of risk. I candidly would love somebody to say, How much societal value have we gained from this additional pricing of this risk when we have seen all of the downside that the whole system is now absorbing because, to use your terms, you know, actions by AIG and others of misunderstanding of the products and not taking appropriate hedging?

I guess I have got a series of questions. How do we prevent the current products or future products from being abused? Should we have standards whereby if an AIG, a future AIG, either misunderstood or went beyond protocols, that that would set off more than an alarm bell and would require some kind of warning? Is it simply enough to say we are going to move toward some level of a clearinghouse? Is clearing alone enough security? As some of the European regulators have talked about for those products and contracts that do not go through a clearinghouse, should there be needs of additional capital requirements?

You know, I am all for innovation, but in some cases I think under the guise of financial innovation and financial engineering, we have ended up with a lot of customers, including customers that Mr. Doe represents in terms of some of the muni market, getting in way over their head. And I just fear on a going-forward basis that regulation and transparency alone may not solve the problem.

So rather than coming at it at the macro level on regulation or on the specific issues that I think Senator Shelby has wonderfully raised about how do we unwind one of the "too big to fail" institutions, I would like to look at it from the bottom up on the products line, starting with Mr. Pickel and then anybody else can comment.

Mr. PICKEL. Yes, I think as far as the products themselves, if you look, for instance, at the credit default swap market, there is information that has been published by the Depository Trust and Clearing Corporation through their trade information warehouse, which encompasses 80 to 90 percent of credit default swaps engaged in around the world. And the information there is that virtually all the trades in that warehouse, essentially all, 100 percent, are done involving at least one dealer party who is, in fact, a regulated institution, and actually 86 percent of them are between two dealer institutions. So you have got that structure of the institutional regulation there, of the oversight of those individual firms looking at the activities of those firms. And I think the Committee, again, heard testimony from the OTS last week admitting some shortcomings in their enforcement and in their execution of their authority, but perhaps we should look at making sure that they have got the ability to understand and get more detail on the products that those individual entities are——

Senator WARNER. Just a quick question, Mr. Pickel. But those 86 percent of institutions that are involved in using these products, are you saying the market knows all the terms and conditions and that we have got a transparent market there?

Mr. PICKEL. The parties who engage in those transactions have access to information and have the transparency to engage in those transactions. I think you also have regulators who have the authority—whether they have exercised it and what they have done with that, we should discuss further. But they have the authority to understand what those institutions are doing.

I think the other thing is—and we have got a very good example of this in the credit default swap market, an effort that goes back to September 2005, started by now——

Treasury Secretary Geithner, to pull in the regulators in a global initiative, regulators from around the world, as well at that time 18 major credit default swap players, dealers, and also buy-side entities as well, to talk about issues that were serious and needed to be addressed in the credit default swap market at that time. And significant progress was made very quickly, with the implicit threat—or, actually, explicit threat, I think, from the regulators, that if you do not get your act in order on these backlogs and assignment issues, that they will actually stop people from trading. So the regulators indicated that they would take that action, and the industry responded.

The experience that we have gone through in settling credit default swaps over the past 6 to 8 months has been significantly facilitated by the foresight of Secretary Geithner at that time to anticipate these problems. So that was an important step at that time.

So I think looking at those kind of public-private interactions where regulators and the industry work together to identify these issues is very important going forward as well.

Senator WARNER. Mr. Stevens, I would love to hear from you, Mr. Ryan, and Mr. Silvers.

Mr. STEVENS. Thank you, Senator. I think it is a really excellent question, and I have asked myself this, and it is not intended as a competitive observation.

If Franklin Roosevelt were to come back today and he would find we had these enormous pooled funds that were outside, virtually outside of any form of regulation, I think he would say, “I thought we solved that problem in 1940.”

We need to make sure that the evident developments—and these are not secrets—the evident developments, major developments in our capital markets are addressed as they arise. Hedge fund investing is no doubt a tremendous innovation that can be of great value. But there were trillions of dollars in hedge funds that had no form of regulation. I think that is something that Congress was aware of, certainly the SEC was aware of.

You could say the same about the major pooled funds in the money markets that will be part of the subject of our report when it is issued. Money market mutual funds are about a $4 trillion intermediary, but we're only about a third of the money market, which has many other pooled funds.

So I think it is a problem—and this is how I envision it—of making sure that the capital markets regulator is staying even with market developments, and that is going to require not only nimbleness at a regulatory level, but, frankly, Mr. Chairman, it requires—it puts a burden on Committees like yours, because in many instances it is going to require the tough work of closing regulatory gaps, providing new authority, and even providing new resources.

I do not think, however, that the answer, Senator is creating a new agency that only looks at products, because those products arise and exist in the context of a larger marketplace, and they need to be understood in that context.

Senator WARNER. Mr. Ryan.

Mr. RYAN. Bob Pickel and I have basically overlapping membership. He is very domain oriented, very specific to derivatives, and we are basically almost all of the other products and oversight.

We have spent a lot of time, I would say, over the last 6 months trying to figure out what should we be recommending for a new regulatory structure. And I would say it is a uniform view among the core members of our group and of his group that we feel comfortable recommending a systemic risk regulator that would have no real limits on their authority. So they would have all markets, they would have all market participants who are significant. It would not make any difference of their charter, so it could be a bank, it could be an insurance company, it could be a hedge fund. And included therein would be their authority to deal with, for instance, derivative products.

So we can see that there is a lack of confidence in the system. There is a lack of confidence among Members of this Committee, Members of Congress, members of other statutory developing entities around the globe, and we need to address that.

So our first attempt at this is to say let us do it through the systemic regulator. Through the systemic regulator, we will also expand the activity, expand the breadth and depth of what is done from a regulatory standpoint to cover areas that have been discussing during this panel, some of the stuff that Paul has raised. That is the best way to do it.

We are also going to, in a very early phase, be able to address most of the key issues and do it in a thoughtful manner.

Senator WARNER. Mr. Silvers and Mr. Doe.

Mr. SILVERS. Senator, these are very acute observations you have made about this set of questions.

First, I am pleased to see that a moment of disagreement has emerged. My colleagues on the panel who wish to put the burden of regulating unregulated markets, like hedge funds and derivatives, on the systemic risk regulator are, in my opinion, making a grave mistake. What we need is routine regulation in those areas. That is what closing the Swiss cheese system is about, is routine regulation, not emergency regulation, not, you know, looking at will they kick off a systemic crisis. Just an observation about that.

I think that the Fed's refusal to regulate mortgages was rooted somehow in the sense that consumer protection was a kind of—something that was not really a serious subject for serious people. It turned out to be, of course, the thread that unraveled the system. I think that we should learn something from that.

When we talk about routine regulation in these areas, I think to your question, we have got to understand that it is more than one thing. For example, a credit default swap contract is effectively a kind of insurance. And if someone is writing that insurance, they should probably have some capital behind the promise they are making. That is what we learned not just in the New Deal but long before it about insurance itself, which was once an exotic innovation. But we learned we had to have capital behind it.

But that is not the extent of what we need to do. If, for example, there are transparency issues, there are disclosure issues associated with these kinds of contracts, for contracts in which public securities are the underlying asset, it is clear that we need to have those kinds of disclosures, because if we do not, then we have essentially taken away the transparency from our securities markets.

Now—two final points. One, derivatives and hedge funds have something profound in common. They do not have any substantive content as terms. They are legal vehicles for undertaking anything imaginable. You can write a derivative contract against anything. You can write it against the weather, against credit risk, against currency risk, against securities, against equity, against debt. It is just a legal vehicle for doing things in an unregulated fashion.

A hedge fund is the same thing. The hedge fund is not an investment strategy. It is just a legal vehicle, and it is a legal vehicle for managing money any way you can imagine, in a way that essentially evades the limits that have historically been placed on bank trusts and mutual funds and so on and so forth.

What is smart regulation here is not specific to those terms. It is specific to those activities. It is specific to money management. It is specific to insurance. It is specific to securities. And that is why it is so important that when we talk about filling these regulatory gaps, we do so in a manner that is routine, not extraordinary.

Thank you.

Mr. DOE. Senator Warner, if I could just offer an example, I like Mr. Silvers' comment about the subject of regulation being routine, because I think that brings vigilance. Let me give you just a quick example of why when I hear you ask the question about products, why I think that is so important.

After the Lehman bankruptcy in September, on the Wednesday following there was a liquidation, an unannounced liquidation by a money market fund of substantial holdings of cash-equivalent securities which had been created in the municipal market through leverage programs and which were used—essentially synthetics securities, so derivatives.

The liquidation, unannounced—again, a trying time in the market in mid-September—resulted in the following day of there being no liquidity in the municipal secondary market, where one transaction that occurred in a distressed situation resulted in the repricing of the entire holdings of investors that were in mutual funds that were in individual holdings.

We estimated that, in a back-of-the-envelope kind of way, about $5.5 billion were lost on that September 18th, solely because an illiquid market, because of liquidation of a cash security that was synthetic in order to fulfill the needs of having short-term investments for these money market funds, is that created a crisis in confidence that—and a confusion among investors as to what was the security of the credits of the States, of the towns that were, you know, issuing municipal debt. And that type of concern—and that lasted through September and October, and municipal issuers who were trying to come to market and raise important funds for capital projects and for operations were really inhibited by extraordinarily penal rates.

So here we had this, you know, single event and this cascaded, touching upon cash securities, derivative securities, and then also tied to the supposedly the most secure cash equivalents in these money market funds.

The other thing I think is really important and not to be lost here, as we are talking about cash securities, we are talking about derivatives, and a lot has been talked about credit default swaps, the municipal market, predominantly it is interest rate swaps. Here, again, there is not transparency. And yet these are linked intimately with cash transactions. And when we talk about, gee, the taxpayer is coming in and helping to bail out the various transgressions that have occurred in the banking system or in the financial system is that here we have taxpayers—and I think, Senator Shelby, you had some instances with some derivatives in your State that are getting a lot of headlines. And taxpayers are on the hook most directly right there. And I would argue and suggest to you the notion of really examining this opportunity that we have in our U.S. municipal bond market, where all these products have come to roost, and the credit default swap market is emerging. It is in its nascent stage in the municipal bond market. Yet it is there, and it is creating perhaps a thinness or an illiquid market that those derivative products is maybe creating misconceptions about the soundness of our States and our towns and our counties.

And so I think that when we start looking at how do we gain transparency on these securities that are now part of the risk management of our municipalities and how do we help so we can understand them, so we can see them, so investors that are putting their—are facilitating the borrowing by buying these securities, they can see what is going on, and we can also help to protect these issuers who, as Mr. Turner was saying—well, as we were talking about broadly in this financial regulation of the separation of risk management and operation, is that here we have these—our States and our towns and counties that are serving—wearing both hats and using complex securities that they may not have fully understood.

So I guess when I hear you talk about products, I applaud that, because I think that it just cannot be the people involved. We have to look at what is being used, but also being—the word has been used—"nimble" so that we can adapt regulation and be flexible so that as new innovations come in that can be very positive but also can be seen and understood.

Senator WARNER. And I think our time has expired, and my only last comment would just be that I think we will get to some stance where we will have some level of regulatory oversight. My hope is that we will adhere to Mr. Turner's suggestion that it is a nimble and well-funded regulator.

But I would say from the industry, we are going to need your help on setting standards not just retrospectively but prospectively. With the complexity and financial engineering that goes on, I just do not want to be here 5 years later looking at what the next round of new products would be and say, "Why didn't we see that ahead of time?" and helping us see what those standards—so that you do not end up with having to pre-clear every new product at some regulator. You know, you are going to have to really step up on this one and give us some assistance.

Thank you, Mr. Chairman.

Chairman DODD. Well, thank you as well, Senator Warner. Very good questions.

Before I turn to Senator Shelby for any closing comments or questions he has, I am struck by a couple of things. It is exactly the point that Senator Warner was concluding with. There is this debate about whether or not we have a principle-based system or a rule-based system in the country. And I have always felt I was sort of in a small, tiny minority that is attracted to the principle-based system for the simple reason that it seems to me almost in a way a bit more intimidating than a rule-based system for the very reason that Senator Warner suggested, that you end up setting standards or rules, and within a matter of literally hours, in some cases, very creative, imaginative people can come up and figure out some way just to get around that rule, legally and ethically and every other reason. And so you are back at it again because someone has come up—now, I think the idea of a clearinghouse makes a lot of sense, by the way, new product lines, and I know Senator Shelby feels as strongly as I do about that.

But that in itself sort of is an indication of a problem you have with a rule-based system, and I wonder if just quickly any of you have any quick comments on a rule-based versus a principle-based system that you would care to share at this point. Professor Coffee.

Mr. COFFEE. Well, I have written a long article on this that is currently posted on SSRN. I do not think any workable system can exist without being a combination of both. You need the principles to backstop the rules, but you can really only enforce rules, and particularly in our litigation-oriented system, we want rules that let you know you are within the safe harbor and you have done what you are supposed to do.

So I think there has to be a combination of both with principles backstopping the rules.

Chairman DODD. Yes. Anyone else want to comment on that?

Mr. TURNER. Senator Dodd, I would agree with Jack on this one. First of all, you know, if you look at the Ten Commandments, half the people tell you they are principles, half them tell you they are rules.

[Laughter.]

Mr. TURNER. So I am not sure anyone knows really what a principle or rule is. I think it does take a combination. Principles get so broad that you just never get enforcement. Rules get so detailed that people just skirt around them. So it takes some common sense and a combination.

Chairman DODD. Mr. Silvers, do you have a comment you want to make?

Mr. SILVERS. Only that one of the reasons why this discussion has become sort of hard to follow or hard to understand is because the concept of a principles-based system became code, became a code word for a weak regulatory system.

Chairman DODD. Yes.

Mr. SILVERS. And, in reality, a true principles-based system would be the strongest possible regulatory system, but it would be one no one could live in for the reasons that my two colleagues on the panel have outlined.

Chairman DODD. Yes.

Mr. PICKEL. I would agree in general that we prefer a principles-based approach. There may be certain circumstances such as with retail investors where having clearer rules for those who engage in those markets would be appropriate. But for the markets that I think people are engaged in derivatives, in OTC derivatives, I think the principles approach is the best one.

Chairman DODD. Yes.

Mr. BULLARD. I would just add, putting on a private practice hat for a moment, that principles-based regulation is intimidating, as you described, because what it means is that regulators have enormous enforcement discretion, and what you typically have, at least at the SEC, it means that they play "gotcha" and bring cases that are based on specific rules that are made up under those principles as opposed to opposed to having known ahead of time exactly how the SEC might interpret certain positions.

Chairman DODD. Senator Shelby.

Senator SHELBY. I will be brief. Mr. Chairman, thank you for assembling this panel. We could be here all day and probably learn a heck of a lot.

Principles matter, but rules matter, too. I like the idea of what Professor Coffee is saying. We might need a hybrid in some way. If you just have principles and no rules, you know, gosh, who is going to define them to a certain extent? But just rules, people say, "Well, we have got a rule. How can we get around it? How can we evade it in some way?"

So maybe it is a combination. Who knows? But thank you for your input, and, you know, we have an awesome task ahead of us here. We have got to do this right. We cannot rush to it. We have both met with the President on this and many meetings. It has got to be comprehensive. It cannot cover every contingency. But I think we can do better than we have been doing.

I wish my friend Senator Warner was still here, because we agree on a lot of things, but some of the product approvals, some of these products have got to be approved before they do irreparable damage to, I think, the marketplace myself.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Shelby, and again, you have been a terrific panel and offered some wonderful advice. We will probably submit some additional questions for you over the coming days, and we look forward to your continuing involvement with us. We have a formal setting here, but my intention is to also have some informal settings with interested members here and other members who are not on the Committee, necessarily, who would like to be a part of the discussion as we move forward on this, because there is a growing interest, obviously, not just on the part of this Committee but others who care about this issue and are interested in how we proceed.

So I am very, very grateful to all of you for your knowledge, your background, your experience, and the thoughtfulness with which you have prepared your testimony today and contributing to this very, very difficult task.

Let me just say as well how much I appreciate Senator Shelby and the other Members of the Committee. Always from time to time we have our differences, but Senator Shelby has made the point and I make it as well: This is one where the barriers that we traditionally see along political lines have to really evaporate and disappear. I personally have said I am agnostic on the question of—I do not bring any ideological framework whatsoever to this. I want to do something that works, that closes gaps, that does not have that Swiss cheese look to it where people can forum shop, in a sense, in order to avoid the regulatory process, to make sure we have good people who are being adequately compensated for the jobs that they are doing, and then doing what has to be done, is engaging on a consistent basis. These things are never done forever. There are always new products, new ideas, new—which is the genius of this in many ways. That is not a liability. That is an asset, in a sense. I have often said our goal here is to, one, make sure that we have a solid, sound system that reflects the times we are in, but not so rigid that it in any way strangles the kind of creativity and imagination that has drawn the world and others to come here to make their investments, because we are creative and imaginative. But at the same time, we do not want to be at such creativity and imagination that we lose the kind of protections.

Striking that balance is never perfect. It is never perfect. It is always tilting one way or the other. And our job is to constantly try and keep that balance, if we can, as we go forward. And that is the challenge we have in front of us, and so we welcome your involvement and thank you immensely for your participation.

The Committee will stand adjourned.

[Whereupon, at 1:16 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF JOHN C. COFFEE, JR.

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MARCH 10, 2009

ENHANCING INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS

"When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."
——CHARLES PRINCE, CEO OF CITIGROUP
Financial Times, July 2007

Chairman Dodd, Ranking Member Shelby, and Fellow Senators, I am pleased and honored to be invited to testify here today.

We are rapidly approaching the first anniversary of the March 17, 2008, insolvency of Bear Stearns, the first of a series of epic financial collapses that have ushered in, at the least, a major recession. Let me take you back just one year ago when, on this date in 2008, the U.S. had five major investment banks that were independent of commercial banks and were thus primarily subject to the regulation of the Securities and Exchange Commission: Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns. Today, one (Lehman) is insolvent; two (Merrill Lynch and Bear Stearns) were acquired on the brink of insolvency by commercial banks, with the Federal Reserve pushing the acquiring banks into hastily arranged "shotgun" marriages; and the remaining two (Goldman and Morgan Stanley) have converted into bank holding companies that are primarily regulated by the Federal Reserve. The only surviving investment banks not owned by larger commercial banks are relatively small boutiques (*e.g.,* Lazard Freres). Given the total collapse of an entire class of institutions that were once envied globally for their entrepreneurial skill and creativity, the questions virtually ask themselves: Who failed? What went wrong?

Although there are a host of candidates—the investment banks, themselves, mortgage loan originators, credit-rating agencies, the technology of asset-backed securitizations, unregulated trading in exotic new instruments (such as credit default swaps), *etc.*—this question is most pertinently asked of the SEC. Where did it err? In overview, 2008 witnessed two closely connected debacles: (1) the failure of a new financial technology (asset-backed securitizations), which grew exponentially until, after 2002, annual asset-backed securitizations exceeded the annual total volume of corporate bonds issued in the United States,[1] and (2) the collapse of the major investment banks. In overview, it is clear that the collapse of the investment banks was precipitated by laxity in the asset-backed securitization market (for which the SEC arguably may bear some responsibility), but that this laxity began with the reckless behavior of many investment banks. Collectively, they raced like lemmings over the cliff by abandoning the usual principles of sound risk management both by (i) increasing their leverage dramatically after 2004, and (ii) abandoning diversification in pursuit of obsessive focus on high-profit securitizations. Although these firms were driven by intense competition and short-term oriented systems of executive compensation, their ability to race over the cliff depended on their ability to obtain regulatory exemptions from the SEC. Thus, as will be discussed, the SEC raced to deregulate. In 2005, it adopted Regulation AB (an acronym for "Asset-Backed"), which simplified the registration of asset-backed securitizations without requiring significant due diligence or responsible verification of the essential facts. Even more importantly, in 2004, it introduced its Consolidated Supervised Entity Program ("CSE"), which allowed the major investment banks to determine their own capital adequacy and permissible leverage by designing their own credit risk models (to which the SEC deferred). Effectively, the SEC abandoned its longstanding "net capital rule"[2] and deferred to a system of self-regulation for these firms, which largely permitted them to develop their own standards for capital adequacy.

For the future, it is less important to allocate culpability and blame than to determine what responsibilities the SEC can perform adequately. The recent evidence suggests that the SEC cannot easily or effectively handle the role of systemic risk regulator or even the more modest role of a prudential financial supervisor, and it

[1] See John C. Coffee, Jr., Joel Seligman & Hillary Sale, SECURITIES REGULATION: Cases and Materials (10th ed. 2007) at 10.

[2] See Rule 15c3-1 ("Net Capital Requirements for Brokers and Dealers"), 17 CFR §240.15c3-1.

may be more subject to capture on these issues than other agencies. This leads me to conclude (along with others) that the U.S. needs one systemic risk regulator who, among other tasks, would have responsibility for the capital adequacy and safety and soundness of all institutions that are too "big to fail."[3] The key advantage of a unified systemic risk regulator with jurisdiction over all large financial institutions is that it solves the critical problem of regulatory arbitrage. AIG, which has already cost U.S. taxpayers over $150 billion, presents the paradigm of this problem because it managed to issue billions in credit default swaps without becoming subject to regulation by any regulator at either the federal or state level.

But one cannot stop with this simple prescription. The next question becomes what should be the relationship between such a systemic risk regulator and the SEC? Should the SEC simply be merged into it or subordinated to it? I will argue that it should not. Rather, the U.S. should instead follow a "twin peaks" structure (as the Treasury Department actually proposed in early 2008 before the current crisis crested) that assigns prudential supervision to one agency and consumer protection and transparency regulation to another. Around the globe, countries are today electing between a unified financial regulator (as typified by the Financial Services Authority ("FSA") in the U.K.) and a "twin peaks" model (which both Australia and The Netherlands have followed). I will argue that the latter model is preferable because it deals better with serious conflict of interest problems and the differing cultures of securities and banking regulators. By culture, training, and professional orientation, banking regulators are focused on protecting bank solvency, and they historically have often regarded increased transparency as inimical to their interests, because full disclosure of a bank's problems might induce investors to withdraw deposits and credit. The result can sometimes be a conspiracy of silence between the regulator and the regulated to hide problems. In contrast, this is one area where the SEC's record is unblemished; it has always defended the principle that "sunlight is the best disinfectant." Over the long-run, that is the sounder rule.

If I am correct that a "twin peaks" model is superior, then Congress has to make clear the responsibilities of both agencies in any reform legislation in order to avoid predictable jurisdictional conflicts and to identify a procedure by which to mediate those disputes that are unavoidable.

What Went Wrong?

This section will begin with the problems in the mortgage loan market, then turn to the failure of credit-rating agencies, and finally examine the SEC's responsibility for the collapse of the major investment banks.

The Great American Real Estate Bubble

The earliest origins of the 2008 financial meltdown probably lie in deregulatory measures, taken by the U.S. Congress at the end of the 1990s, that placed some categories of derivatives and the parent companies of investment banks beyond effective regulation.[4] Still, most accounts of the crisis start by describing the rapid inflation of a bubble in the U.S. housing market. Here, one must be careful. The term "bubble" can be a substitute for closer analysis and may carry a misleading connotation of inevitability. In truth, bubbles fall into two basic categories: those that are demand-driven and those that are supply-driven. The majority of bubbles fall into the former category,[5] but the 2008 financial market meltdown was clearly a supply-driven bubble,[6] fueled by the fact that mortgage loan originators came to realize that underwriters were willing to buy portfolios of mortgage loans for asset-

[3] I have made this argument in greater detail in an article with Professor Hillary Sale, which will appear in the 75th Anniversary of the SEC volume of the Virginia Law Review. See Coffee and Sale, "Redesigning the SEC: Does the Treasury Have a Better Idea?" (available on the Social Science Research Network at *http://ssrn.com/abstract=1309776*).

[4] Interestingly, this same diagnosis was recently given by SEC Chairman Christopher Cox to this Committee. See Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing and Urban Affairs, United States Senate, September 23, 2008. Perhaps defensively, Chairman Cox located the origins of the crisis in the failure of Congress to give the SEC jurisdiction over investment bank holding companies or over-the-counter derivatives (including credit default swaps), thereby creating a regulatory void.

[5] For example, the high-tech Internet bubble that burst in early 2000 was a demand-driven bubble. Investors simply overestimated the value of the Internet, and for a time initial public offerings of "dot.com" companies would trade at ridiculous and unsustainable multiples. But full disclosure was provided to investors and the SEC cannot be faulted in this bubble—unless one assigns it the very paternalistic responsibility of protecting investors from themselves.

[6] This is best evidenced by the work of two University of Chicago Business School professors discussed below. See Atif Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis", (*http://ssrn.com/abstract=1072304*) (May 2008).

backed securitizations without any serious investigation of the underlying collateral. With that recognition, loan originators' incentive to screen borrowers for creditworthiness dissipated, and a full blown "moral hazard" crisis was underway.[7]

The evidence is clear that, between 2001 and 2006, an extraordinary increase occurred in the supply of mortgage funds, with much of this increased supply being channeled into poorer communities in which previously there had been a high denial rate on mortgage loan applications.[8] With an increased supply of mortgage credit, housing prices rose rapidly, as new buyers entered the market. But at the same time, a corresponding increase in mortgage debt relative to income levels in these same communities made these loans precarious. A study by University of Chicago Business School professors has found that two years after this period of increased mortgage availability began, a corresponding increase started in mortgage defaults—in exactly the same zip code areas where there had been a high previous rate of mortgage loan denials.[9] This study determined that a one standard deviation in the supply of mortgages from 2001 to 2004 produced a one standard deviation increase thereafter in mortgage default rates.[10]

Even more striking, however, was its finding that the rate of mortgage defaults was highest in those neighborhoods that had the highest rates of securitization.[11] Not only did securitization correlate with a higher rate of default, but that rate of default was highest when the mortgages were sold by the loan originator to financial firms unaffiliated with the loan originator.[12] Other researchers have reached a similar conclusion: conditional on its being actually securitized, a loan portfolio that was more likely to be securitized was found to default at a 20 percent higher rate than a similar risk profile loan portfolio that was less likely to be securitized.[13] Why? The most plausible interpretation is that securitization adversely affected the incentives of lenders to screen their borrowers.

Such a conclusion should not surprise. It simply reflects the classic "moral hazard" problem that arises once loan originators did not bear the cost of default by their borrowers. As early as March, 2008, The President's Working Group on Financial Markets issued a "Policy Statement on Financial Market Developments" that explained the financial crisis as the product of five "principal underlying causes of the turmoil in financial markets":

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies' assessment of subprime residential mortgages . . . and other complex structured credit products, . . .
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses.[14]

Correct as the President's Working Group was in noting the connection between the decline of discipline in the mortgage loan origination market and a similar laxity among underwriters in the capital markets, it did not focus on the direction of the causality. Did mortgage loan originators fool or defraud investment bankers? Or did investment bankers signal to loan originators that they would buy whatever the loan originators had to sell? The available evidence tends to support the latter hypothesis: namely, that irresponsible lending in the mortgage market was a direct

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[7] Interestingly, "moral hazard" problems also appear to have underlain the "savings and loan" crisis in the United States in the 1980s, which was the last great crisis involving financial institutions in the United States. For a survey of recent banking crises making this point, see Note, Anticipatory Regulation for the Management of Banking Crises, 38 Colum. J. L. & Soc. Probs. 251 (2005).

[8] See Mian and Sufi, *supra* note 6, at 11 to 13.

[9] *Id.* at 18-19.

[10] *Id.* at 19.

[11] *Id.* at 20-21.

[12] *Id.*

[13] See Benjamin J. Keys, Tanmoy K. Mukherjee, Amit Seru, and Vikrant Vig, "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans," (*http://ssrn.com/abstract=1093137*) (April, 2008). These authors conclude that securitization did result in "lax screening."

[14] The President's Working Group on Financial Markets, "Policy Statement on Financial Market Developments," at 1 (March 2008).

response to the capital markets' increasingly insatiable demand for financial assets to securitize. If underwriters were willing to rush deeply flawed asset-backed securitizations to the market, mortgage loan originators had no rational reason to resist them.

The rapid deterioration in underwriting standards for subprime mortgage loans is revealed at a glance in the following table:[15]

Underwriting Standards in Subprime Home-Purchase Loans, 2001–2006

Year	Low/No-Doc Share	Debt Payments/ Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

Source: Freddie Mac, obtained from the International Monetary Fund.

The investment banks could not have missed that low document loans (also called "liar loans") rose from 28.5 percent to 50.8 percent over the 5 year interval between 2001 and 2006 or that "interest only" loans (on which there was no amortization of principal) similarly grew from 6 percent to 22.8 percent over this same interval.

Thus, the real mystery is not why loan originators made unsound loans, but why underwriters bought them. Here, it seems clear that both investment and commercial banks saw high profits in securitizations and believed they could quickly sell on a global basis any securitized portfolio of loans that carried an investment grade rating. In addition, investment banks may have had a special reason to focus on securitizations: structured finance offered a level playing field where they could compete with commercial banks, whereas, as discussed later, commercial banks had inherent advantages at underwriting corporate debt and were gradually squeezing the independent investment banks out of this field.[16] Consistent with this interpretation, anecdotal evidence suggests that due diligence efforts within the underwriting community slackened in asset-backed securitizations after 2000.[17] Others have suggested that the SEC contributed to this decline by softening its disclosure and due diligence standards for asset-backed securitizations,[18] in particular by adopting in 2005 Regulation AB, which covers the issuance of asset backed securities.[19] From this perspective, relaxed discipline in both the private and public sectors overlapped to produce a disaster.

Credit Rating Agencies as Gatekeepers

It has escaped almost no one's attention that the credit rating agencies bear much responsibility for the 2008 financial crisis, with the consensus view being that they inflated their ratings in the case of structured finance offerings. Many reasons have been given for their poor performance: (1) rating agencies faced no competition (be-

[15] See Allen Ferrell, Jennifer Bethel and Gang Hu, Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis (Harvard Law & Economics Discussion Paper No. 612, Harvard Law School Program in Risk Regulation Research Paper No. 08-5) at Table 4.

[16] See text and notes infra at notes 56 to 61.

[17] Investment banks formerly had relied on "due diligence" firms that they employed to determine whether the loans within a loan portfolio were within standard parameters. These firms would investigate and inform the underwriter as to the percentage of the loans that were "exception" loans (*i.e.,* loans outside the investment bank's normal guidelines). Subsequent to 2000, the percentage of "exception loans" in portfolios securitized by these banks often rose from the former level of 25 percent to as high as 80 percent. Also, the underwriters scaled back the intensity of the investigations that they would authorize the "due diligence" firm to conduct, reducing from 30 percent to as few as 5 percent the number of loans in a portfolio that it was to check. See Vikas Bajaj & Jenny Anderson, "Inquiry Focuses on Withholding of Data on Loans," *N.Y. Times,* January 12, 2008, at p. A-1.

[18] See Richard Mendales, "Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown And How To Fix It" (Working Paper 2008) at 36 (forthcoming in 2009, U. Ill. L. Rev.).

[19] See Securities Act Release No. 8518 ("Asset-Backed Securities") (January 7, 2005, 79 FR 1506). Regulation AB codified a series of "no action" letters and established disclosures standards for all asset-backed securitizations. See 17 C.F.R. §§ 229.1100-1123 (2005). Although it did not represent a sharp deregulatory break with the past, Regulation AB did reduce the due diligence obligation of underwriters by eliminating any need to assure that assets included in a securitized pool were adequately documented. See Mendales, *supra* note 18.

cause there are really only three major rating agencies); (2) they were not disciplined by the threat of liability (because credit rating agencies in the U.S. appear never to have been held liable and almost never to have settled a case with any financial payment); (3) they were granted a "regulatory license" by the SEC, which has made an investment grade rating from a rating agency that was recognized by the SEC a virtual precondition to the purchase of debt securities by many institutional investors; (4) they are not required to verify information (as auditors and securities analysts are), but rather simply express views as to the creditworthiness of the debt securities based on the assumed facts provided to them by the issuer.[20] These factors all imply that credit rating agencies had less incentive than other gatekeepers to protect their reputational capital from injury. After all, if they face little risk that new entrants could enter their market to compete with them or that they could be successfully sued, they had less need to invest in developing their reputational capital or taking other precautions. All that was necessary was that they avoid the type of major scandal, such as that which destroyed Arthur Andersen & Co., the accounting firm, that had made it impossible for a reputable company to associate with them.

Much commentary has suggested that the credit rating agencies were compromised by their own business model, which was an "issuer pays" model under which nearly 90 percent of their revenues came from the companies they rated.[21] Obviously, an "issuer pays" model creates a conflict of interest and considerable pressure to satisfy the issuer who paid them. Still, neither such a conflicted business model nor the other factors listed above can explain the dramatic deterioration in the performance of the rating agencies over the last decade. Both Moody's and Standard & Poor were in business before World War I and performed at least acceptably until the later 1990s. To account for their more recent decline in performance, one must point to more recent developments and not factors that long were present. Two such factors, each recent and complementary with the other, do provide a persuasive explanation for this deterioration: (1) the rise of structured finance and the change in relationships that it produced between the rating agencies and their clients; and (2) the appearance of serious competition within the ratings industry that challenged the long stable duopoly of Moody's and Standard & Poor's and that appears to have resulted in ratings inflation.

First, the last decade witnessed a meteoric growth in the volume and scale of structured finance offerings. One impact of this growth was that it turned the rating agencies from marginal, basically break-even enterprises into immensely profitable enterprises that rode the crest of the breaking wave of a new financial technology. Securitizations simply could not be sold without "investment grade" credit ratings from one or more of the Big Three rating agencies. Structured finance became the rating agencies' leading source of revenue. Indeed by 2006, structured finance accounted for 54.2 percent of Moody's revenues from its ratings business and 43.5 percent of its overall revenues.[22] In addition, rating structured finance products generated much higher fees than rating similar amounts of corporate bonds.[23] For example, rating a $350 million mortgage pool could justify a fee of $200,000 to $250,000, while rating a municipal bond of similar size justified only a fee of $50,000.[24]

Beyond simply the higher profitability of rating securitized transactions, there was one additional difference about structured finance that particularly compromised the rating agencies as gatekeepers. In the case of corporate bonds, the rating agencies rated thousands of companies, no one of which controlled any significant volume of business. No corporate issuer, however large, accounted for any significant share of Moody's or S&P's revenues. But with the rise of structured finance, the market became more concentrated. As a result, the major investment banks acquired considerable power over the rating agencies, because each of them had "clout," bringing highly lucrative deals to the agencies on a virtually monthly basis. As the following chart shows, the top six underwriters controlled over 50 percent of the mortgage-backed securities underwriting market in 2007, and the top eleven

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[20] For these and other explanations, see Coffee, GATEKEEPERS: The Professions and Corporate Governance (Oxford University Press, 2006), and Frank Partnoy, "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers" (*http://ssrn.com/abstract=900257*) (May 2006).

[21] See Partnoy, *supra* note 20.

[22] See In re Moody's Corporation Securities Litigation, 2009 U.S. Dist. LEXIS 13894 (S.D.N.Y. February 23, 2009) at *6 (also noting that Moody's grossed $1.635 billion from its ratings business in 2006).

[23] See Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times,* December 7, 2008, at p. 1, 40.

[24] *Id.*

underwriters each had more than 5 percent of the market and in total controlled roughly 80 percent of this very lucrative market on whom the rating agencies relied for a majority of their ratings revenue:[25]

MBS Underwriters in 2007

Rank	Book Runner	Number of Offerings	Market Share	Proceed Amount + Overallotment Sold in U.S. ($mill)
1	Lehman Brothers	120	10.80%	$100,109
2	Bear Stearns & Co., Inc.	128	9.90%	91,696
3	Morgan Stanley	92	8.20%	75,627
4	JPMorgan	95	7.90%	73,214
5	Credit Suisse	109	7.50%	69,503
6	Bank of America Securities LLC	101	6.80%	62,776
7	Deutsche Bank AG	85	6.20%	57,337
8	Royal Bank of Scotland Group	74	5.80%	53,352
9	Merrill Lynch	81	5.20%	48,407
10	Goldman Sachs & Co.	60	5.10%	47,696
11	Citigroup	95	5.00%	46,754
12	UBS	74	4.30%	39,832

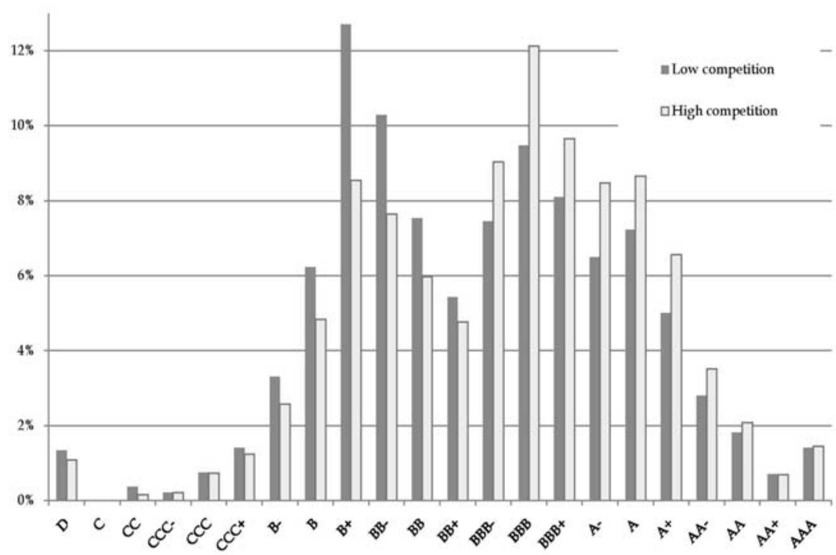
If the rise of structured finance was the first factor that compromised the credit rating agencies, the second factor was at least as important and had an even clearer empirical impact. Until the late 1990s, Moody's and Standard & Poor's shared a duopoly over the rating of U.S. corporate debt. But, over the last decade, a third agency, Fitch Ratings, grew as the result of a series of mergers and increased its U.S. market share from 10 percent to approximately a third of the market.[26] The rise of Fitch challenged the established duopoly. What was the result? A Harvard Business School study has found three significant impacts: (1) the ratings issued by the two dominant rating agencies shifted significantly in the direction of higher ratings; (2) the correlation between bond yields and ratings fell, suggesting that under competitive pressure ratings less reflected the market's own judgment; and (3) the negative stock market reaction to bond rating downgrades increased, suggesting that a downgrade now conveyed worse news because the rated offering was falling to an even lower quality threshold than before.[27] Their conclusions are vividly illustrated by one graph they provide that shows the correlation between grade inflation and higher competition:

[25] See Ferrell, Bethel, and Hu, *supra* note 15, at Table 2. For anecdotal evidence that ratings were changed at the demand of the investment banks, see Morgenson, *supra* note 23.

[26] Bo Becker and Todd Milburn, "Reputation and Competition: Evidence from the Credit Rating Industry," Harvard Business School, Working Paper No. 09-051 (2008) (*http://ssrn.com/abstract=1278150*) at p. 4.

[27] *Id.* at 17.

Figure 2.
Firm credit ratings distribution: high and low competition in the credit rating industry



Under high competition, lower ratings declined and investment grade rations soared. The authors conclude that increased competition may impair "the reputational mechanism that underlies the provision of good quality ratings."[28]

The anecdotal evidence supports a similar conclusion: the major rating agencies responded to the competitive threat from Fitch by making their firms "more client-friendly and focused on market share."[29] Put simply, the evidence implies that the rapid change toward a more competitive environment made the competitors not more faithful to investors, but more dependent on their immediate clients, the issuers. From the standpoint of investors, agency costs increased.

The Responsibility of the SEC

Each of the major investment banks that failed, merged, or converted into bank holding companies in 2008 had survived prior recessions, market panics, and repeated turmoil and had long histories extending back as far as the pre-Civil War era. Yet, each either failed or was gravely imperiled within the same basically 6 month period following the collapse of Bear Stearns in March 2008.[30]

If their uniform collapse is not alone enough to suggest the likelihood of regulatory failure, one additional common fact unites them: each of these five firms voluntarily entered into the SEC's Consolidated Supervised Entity ("CSE") Program, which was established by the SEC in 2004 for only the largest investment banks.[31] Indeed, these five investment banks were the only investment banks permitted by the SEC to enter the CSE program. A key attraction of the CSE Program was that it permitted its members to escape the SEC's traditional net capital rule, which placed a maximum ceiling on their debt to equity ratios, and instead elect into a

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[28] *Id.* at 21.

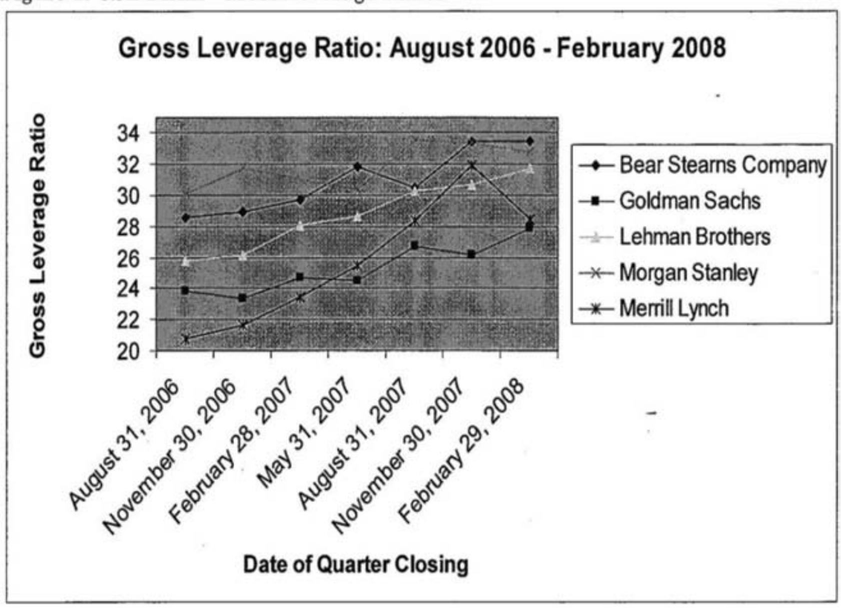
[29] See "Ratings Game—As Housing Boomed, Moody's Opened Up," *The Wall Street Journal,* April 11, 2008, at p. A-1.

[30] For a concise overview of these developments, see Jon Hilsenrath, Damian Palette, and Aaron Lucchetti, "Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid To Ride Out Crisis," *The Wall Street Journal,* September 22, 2008, at p. A-1 (concluding that independent investment banks could not survive under current market conditions and needed closer regulatory supervision to establish credibility).

[31] See Securities Exchange Act Release No. 34-49830 (June 21, 2004), 69 FR 34428 ("Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities").

more relaxed “alternative net capital rule” that contained no similar limitation.[32] The result was predictable: all five of these major investment banks increased their debt-to-equity leverage ratios significantly over the brief two year period following their entry into the CSE Program, as shown by Figure 1 below:[33]

Figure 1. CSE Firms- Gross Leverage Ratios



For example, at the time of its insolvency, Bear Stearns’ gross leverage ratio had hit 33 to 1.[34]

The above chart likely understates the true increase in leverage because gross leverage (*i.e.,* assets divided by equity) does not show the increase in off-balance sheet liabilities, as the result of conduits and liquidity puts. Thus, another measure may better show the sudden increase in risk. One commonly used metric for banks is the bank’s value at risk (VaR) estimate, which banks report to the SEC in their annual report on Form 10-K. This measure is intended to show the risk inherent in their financial portfolios. The chart below shows “Value at Risk” for the major underwriters over the interval 2004 to 2007:[35]

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[32] The SEC’s “net capital rule,” which dates back to 1975, governs the capital adequacy and aggregate indebtedness permitted for most broker-dealers. See Rule 15c3-1 (“Net Capital Requirements for Brokers and Dealers”). 17 C.F.R. § 240.15c3-1. Under subparagraph (a)(1)(i) of this rule, aggregate indebtedness is limited to fifteen times the broker-dealer’s net capital; a broker-dealer may elect to be governed instead by subparagraph (a)(1)(ii) of this rule, which requires it maintain its net capital at not less than the greater of $250,000 or two percent of “aggregate debit items” as computed under a special formula that gives “haircuts” (*i.e.,* reduces the valuation) to illiquid securities. Both variants place fixed limits on leverage.

[33] This chart comes from U.S. Securities and Exchange Commission, Office of the Inspector General, “SEC’s Oversight of Bear Stearns and Related Entities: The Consolidated Entity Program” (‘Report No. 446-A, September 25, 2008) (hereinafter “SEC Inspector General Report”) at Appendix IX at p. 120.

[34] See SEC Inspector General Report at 19.

[35] See Ferrell, Bethel, and Hu, *supra* note 15, at Table 8. Value at risk estimates have proven to be inaccurate predictors of the actual writedowns experienced by banks. They are cited here not because they are accurate estimates of risk, but because the percentage increases at the investment banks was generally extreme. Even Goldman Sachs, which survived the crisis in better shape than its rivals, saw its VaR estimate more than double over this period.

Value at Risk, 2004–2007

Firms	2004 ($mil)	2005 ($mil)	2006 ($mil)	2007 ($mil)
Bank of America	$44.1	$41.8	$41.3	-
Bear Stearns	14.8	21.4	28.8	$69.3
Citigroup	116.0	93.0	106.0	-
Credit Suisse	55.1	66.2	73.0	-
Deutsche Bank	89.8	82.7	101.5	-
Goldman Sachs	67.0	83.0	119.0	134.0
JPMorgan	78.0	108.0	104.0	-
Lehman Brothers	29.6	38.4	54.0	124.0
Merrill Lynch	34.0	38.0	52.0	-
Morgan Stanley	94.0	61.0	89.0	83.0
UBS	103.4	124.7	132.8	-
Wachovia	21.0	18.0	30.0	-

VaR statistics are reported in the 10K or 20F (in the case of foreign firms) of the respective firms. Note that the firms use different assumptions in computing their Value of Risk. Some annual reports are not yet avaialble for 2007.

Between 2004 and 2007, both Bear Stearns and Lehman more than quadrupled their value at risk estimates, while Merrill Lynch's figure also increased significantly. Not altogether surprisingly, they were the banks that failed.

These facts provide some corroboration for an obvious hypothesis: excessive deregulation by the SEC caused the liquidity crisis that swept the global markets in 2008.[36] Still, the problem with this simple hypothesis is that it may be too simple. Deregulation did contribute to the 2008 financial crisis, but the SEC's adoption of the CSE Program in 2004 was not intended to be deregulatory. Rather, the program was intended to compensate for earlier deregulatory efforts by Congress that had left the SEC unable to monitor the overall financial position and risk management practices of the nation's largest investment banks. Still, even if the 2004 net capital rule changes were not intended to be deregulatory, they worked out that way in practice. The ironic bottom line is that the SEC unintentionally deregulated by introducing an alternative net capital rule that it could not effectively monitor.

The events leading up to the SEC's decision to relax its net capital rule for the largest investment banks began in 2002, when the European Union adopted its Financial Conglomerates Directive.[37] The main thrust of the E.U.'s new directive was to require regulatory supervision at the parent company level of financial conglomerates that included a regulated financial institution (*e.g.,* a broker-dealer, bank or insurance company). The E.U.'s entirely reasonable fear was that the parent company might take actions that could jeopardize the solvency of the regulated subsidiary. The E.U.'s directive potentially applied to the major U.S. investment and commercial banks because all did substantial business in London (and elsewhere in Europe). But the E.U.'s directive contained an exemption for foreign financial conglomerates that were regulated by their home countries in a way that was deemed "equivalent" to that envisioned by the directive. For the major U.S. commercial banks (several of which operated a major broker-dealer as a subsidiary), this afforded them an easy means of avoiding group-wide supervision by regulators in Europe, because they were subject to group-level supervision by U.S. banking regulators.

U.S. investment banks had no similar escape hatch, as the SEC had no similar oversight over their parent companies. Thus, fearful of hostile regulation by some European regulators,[38] U.S. investment banks lobbied the SEC for a system of

[36] For the bluntest statement of this thesis, see Stephen Labaton, "S.E.C. Concedes Oversight Plans Fueled Collapse," *New York Times,* September 27, 2008, at p. 1. Nonetheless, this analysis is oversimple. Although SEC Chairman Cox did indeed acknowledge that there were flaws in the "Consolidated Supervised Entity" Program, he did not concede that it "fueled" the collapse or that it represented deregulation. As discussed below, the SEC probably legitimately believed that it was gaining regulatory authority from the CSE Program (but it was wrong).

[37] See Council Directive 2002/87, Financial Conglomerates Directive, 2002 O.J. (L 35) of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives. For an overview of this directive and its rationale, see Jorge E. Vinuales, The International Regulation of Financial Conglomerates: A Case Study of Equivalence as an Approach to Financial Integration, 37 Cal. W. Int'l L.J. 1, at 2 (2006).

[38] Different European regulators appear to have been feared by different entities. Some commercial banks saw French regulation as potentially hostile, while U.S. broker-dealers, all largely

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"equivalent" regulation that would be sufficient to satisfy the terms of the directive and give them immunity from European oversight.[39] For the SEC, this offered a serendipitous opportunity to oversee the operations of investment bank holding companies, which authority the SEC had sought for some time. Following the repeal of the Glass-Steagall Act, the SEC had asked Congress to empower it to monitor investment bank holding companies, but it had been rebuffed. Thus, the voluntary entry of the holding companies into the Consolidated Supervised Entity program must have struck the SEC as a welcome development, and Commission unanimously approved the program without any partisan disagreement.[40]

But the CSE Program came with an added (and probably unnecessary) corollary: Firms that entered the CSE Program were permitted to adopt an alternative and more relaxed net capital rule governing their debt to net capital ratio. Under the traditional net capital rule, a broker-dealer was subject to fixed ceilings on its permissible leverage. Specifically, it either had to (a) maintain aggregate indebtedness at a level that could not exceed fifteen times net capital,[41] or (b) maintain minimum net capital equal to not less than two percent of "aggregate debit items."[42] For most broker-dealers, this 15 to 1 debt to net capital ratio was the operative limit within which they needed to remain by a comfortable margin.

Why did the SEC allow the major investment banks to elect into an alternative regime that placed no outer limit on leverage? Most likely, the Commission was principally motivated by the belief that it was only emulating the more modern "Basel II" standards that the Federal Reserve Bank and European regulators were then negotiating. To be sure, the investment banks undoubtedly knew that adoption of Basel II standards would permit them to increase leverage (and they lobbied hard for such a change). But, from the SEC's perspective, the goal was to design the CSE Program to be broadly consistent with the Federal Reserve's oversight of bank holding companies, and the program even incorporated the same capital ratio that the Federal Reserve mandated for bank holding companies.[43] Still, the Federal Reserve introduced its Basel II criteria more slowly and gradually, beginning more than a year later, while the SEC raced in 2004 to introduce a system under which each investment bank developed its own individualized credit risk model. Today, some believe that Basel II represents a flawed model even for commercial banks, while others believe that, whatever its overall merits, it was particularly ill-suited for investment banks.[44]

Yet, what the evidence demonstrates most clearly is that the SEC simply could not implement this model in a fashion that placed any real restraint on its subject CSE firms. The SEC's Inspector General examined the failure of Bear Stearns and the SEC's responsibility therefor and reported that Bear Stearns had remained in compliance with the CSE Program's rules at all relevant times.[45] Thus, if Bear Stearns had not cheated, this implied (as the Inspector General found) that the CSE Program, itself, had failed. The key question is then what caused the CSE Program to fail. Here, three largely complementary hypotheses are plausible. First, the Basel II Accords may be flawed, either because they rely too heavily on the banks' own self-interested models of risk or on the highly conflicted ratings of the major credit rating agencies.[46] Second, even if Basel II made sense for commercial banks, it may

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based in London, did not want their holding companies to be overseen by the U.K.'s Financial Services Agency (FSA).

[39] See Stephen Labaton, "Agency's '04 Rule Let Banks Pile Up Debt and Risk," *New York Times,* October 3, 2008, at A-1 (describing major investment banks as having made an "urgent plea" to the SEC in April, 2004).

[40] See Securities Exchange Act Release No. 34-49830, *supra* note 31.

[41] See Rule 15c3-1(a)(1)(i)("Alternative Indebtedness Standard"), 17 C.F.R. § 240.15c3-1(a)(1).

[42] See Rule 15c3-1(a)(1)(ii)("Alternative Standard"), 17 C.F.R. § 240.15c3-1(a)(1)(ii). This alternative standard is framed in terms of the greater of $250,000 or 2 percent, but for any investment bank of any size, 2 percent will be the greater. Although this alternative standard may sound less restrictive, it was implemented by a system of "haircuts" that wrote down the value of investment assets to reflect their illiquidity.

[43] See SEC Inspector General Report at 10-11. Under these standards, a "well-capitalized" bank was expected to maintain a 10 percent capital ratio. *Id.* at 11. Nonetheless, others have argued that Basel II "was not designed to be used by investment banks" and that the SEC "ought to have been more careful in moving banks on to the new rules." See "Mewling and Puking: Bank Regulation," The Economist, October 25, 2008 (U.S. Edition).

[44] For the view that Basel II excessively deferred to commercial banks to design their own credit risk models and their increase leverage, see Daniel K. Tarullo, BANKING ON BASEL: The Future of International Financial Regulation (2008). Mr. Tarullo has recently been nominated by President Obama to the Board of Governors of the Federal Reserve Board. For the alternative view, that Basel II was uniquely unsuited for investment banks, see "Mewling and Puking," *supra* note 43.

[45] SEC Inspector General Report, 10.

[46] The most prominent proponent of this view is Professor Daniel Tarullo. See *supra* note 44.

have been ill-suited for investment banks.[47] Third, whatever the merits of Basel II in theory, the SEC may have simply been incapable of implementing it.

Clearly, however, the SEC moved faster and farther to defer to self-regulation by means of Basel II than did the Federal Reserve.[48] Clearly also, the SEC's staff was unable to monitor the participating investment banks closely or to demand specific actions by them. Basel II's approach to the regulation of capital adequacy at financial institutions contemplated close monitoring and supervision. Thus, the Federal Reserve assigns members of its staff to maintain an office within a regulated bank holding company in order to provide constant oversight. In the case of the SEC, a team of only three SEC staffers were assigned to each CSE firm[49] (and a total of only thirteen individuals comprised the SEC's Office of Prudential Supervision and Risk Analysis that oversaw and conducted this monitoring effort).[50] From the start, it was a mismatch: three SEC staffers to oversee an investment bank the size of Merrill Lynch, which could easily afford to hire scores of highly quantitative economists and financial analysts, implied that the SEC was simply outgunned.[51]

This mismatch was compounded by the inherently individualized criteria upon which Basel II relies. Instead of applying a uniform standard (such as a specific debt to equity ratio) to all financial institutions, Basel II contemplated that each regulated financial institution would develop a computer model that would generate risk estimates for the specific assets held by that institution and that these estimates would determine the level of capital necessary to protect that institution from insolvency. Thus, using the Basel II methodology, the investment bank generates a mathematical model that crunches historical data to evaluate how risky its portfolio assets were and how much capital it needed to maintain to protect them. Necessarily, each model was *ad hoc,* specifically fitted to that specific financial institution. But no team of three SEC staffers was in a position to contest these individualized models or the historical data used by them. Effectively, the impact of the Basel II methodology was to shift the balance of power in favor of the management of the investment bank and to diminish the negotiating position of the SEC's staff. Whether or not Basel II's criteria were inherently flawed, it was a sophisticated tool that was beyond the capacity of the SEC's largely legal staff to administer effectively.

The SEC's Inspector General's Report bears out this critique by describing a variety of instances surrounding the collapse of Bear Stearns in which the SEC's staff did not respond to red flags that the Inspector General, exercising 20/20 hindsight, considered to be obvious. The Report finds that although the SEC's staff was aware that Bear Stearns had a heavy and increasing concentration in mortgage securities, it "did not make any efforts to limit Bear Stearns mortgage securities concentration."[52] In its recommendations, the Report proposed both that the staff become "more skeptical of CSE firms' risk models" and that it "develop additional stress scenarios that have not already been contemplated as part of the prudential regulation process."[53]

Unfortunately, the SEC Inspector General Report does not seem realistic on this score. The SEC's staff cannot really hope to regulate through gentle persuasion. Unlike a prophylactic rule (such as the SEC's traditional net capital rule that placed a uniform ceiling on leverage for all broker-dealers), the identification of "additional stress scenarios" by the SEC's staff does not necessarily lead to specific actions by the CSE firms; rather, such attempts at persuasion are more likely to produce an extended dialogue, with the SEC's staff being confronted with counter-models and interpretations by the financial institution's managers.

The unfortunate truth is that in an area where financial institutions have intense interests (such as over the question of their maximum permissible leverage), a government agency in the U.S. is unlikely to be able to obtain voluntary compliance. This conclusion is confirmed by a similar assessment from the individual with perhaps the most recent experience in this area. Testifying in September, 2008 testimony before the Senate Banking Committee, SEC Chairman Christopher Cox emphasized the infeasibility of voluntary compliance , expressing his frustration with attempts to negotiate issues such as leverage and risk management practices with

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[47] See "Mewling and Puking," *supra* note 43.

[48] The SEC adopted its CSE program in 2004. The Federal Reserve only agreed in principle to Basel II in late 2005. See Stavros Gadinis, The Politics of Competition in International Financial Regulation, 49 Harv. Int'l L. J. 447, 507 n. 192 (2008).

[49] SEC Inspector General Report at 2.

[50] *Id.* Similarly, the Office of CSE Inspectors had only seven staff. *Id.*

[51] Moreover, the process effectively ceased to function well before the 2008 crisis hit. After SEC Chairman Cox re-organized the CSE review process in the Spring of 2007, the staff did not thereafter complete "a single inspection." See Labaton, *supra* note 39.

[52] SEC Inspector General Report at ix.

[53] SEC Inspector General Report at ix.

the CSE firms. In a remarkable statement for a long-time proponent of deregulation, he testified:

> Beyond highlighting the inadequacy of the . . . CSE program's capital and liquidity requirements, the last six months—during which the SEC and the Federal Reserve worked collaboratively with each of the CSE firms . . . —have made abundantly clear that voluntary regulation doesn't work.[54]

His point was that the SEC had no inherent authority to order a CSE firm to reduce its debt to equity ratio or to keep it in the CSE Program.[55] If it objected, a potentially endless regulatory negotiation might only begin.

Ultimately, even if one absolves the SEC of "selling out" to the industry in adopting the CSE Program in 2004, it is still clear at a minimum that the SEC lacked both the power and the expertise to restrict leverage by the major investment banks, at least once the regulatory process began with each bank generating its own risk model. Motivated by stock market pressure and the incentives of a short-term oriented executive compensation system, senior management at these institutions affectively converted the process into self-regulation.

One last factor also drove the rush to increased leverage and may best explain the apparent willingness of investment banks to relax their due diligence standards: competitive pressure and the need to establish a strong market share in a new and expanding market drove the investment banks to expand recklessly. For the major players in the asset-backed securitization market, the long-term risk was that they might be cut off from their source of supply, if loan originators were acquired by or entered into long-term relationships with their competitors, particularly the commercial banks. Needing an assured source of supply, some investment banks (most notably Lehman and Merrill, Lynch) invested heavily in acquiring loan originators and related real estate companies, thus in effect vertically integrating.[56] In so doing, they assumed even greater risk by increasing their concentration in real estate and thus their undiversified exposure to a downturn in that market. This need to stay at least even with one's competitors best explains the now famous line uttered by Charles Prince, the then CEO of Citigroup in July, 2007, just as the debt market was beginning to collapse. Asked by the *Financial Times* if he saw a liquidity crisis looming, he answered:

> When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.[57]

In short, competition among the major investment banks can periodically produce a mad momentum that sometimes leads to a lemmings-like race over the cliff.[58]

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[54] See Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing, and Urban Affairs, United States Senate, September 23, 2008 ("Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions"), at p. 4 (available at *www.sec.gov*) (emphasis added). Chairman Cox has repeated this theme in a subsequent Op/Ed column in the *Washington Post,* in which he argued that "Reform legislation should steer clear of voluntary regulation and grant explicit authority where it is needed." See Christopher Cox, "Reinventing A Market Watchdog," the *Washington Post,* November 4, 2008, at A-17.

[55] Chairman Cox added in the next sentence of his Senate testimony: "There is simply no provision in the law authorizes the CSE Program, or requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis, or to submit to SEC requirements regarding leverage." *Id.* This is true, but if a CSE firm left the CSE program, it would presumably become subject to European regulation; thus, the system was not entirely voluntary and the SEC might have used the threat to expel a non-compliant CSE firm. The SEC's statements about the degree of control they had over participants in the CSE Program appear to have been inconsistent over time and possibly defensively self-serving. But clearly, the SEC did not achieve voluntary compliance.

[56] See Terry Pristin, "Risky Real Estate Deals Helped Doom Lehman," *N.Y. Times,* September 17, 2008, at C-6 (discussing Lehman's expensive, multi-billion dollar acquisition of Archstone-Smith); Gretchen Morgenson, "How the Thundering Herd Faltered and Fell," *N.Y. Times,* November 9, 2008, at B4-1 (analyzing Merrill Lynch's failure and emphasizing its acquisitions of loan originators).

[57] See Michiyo Nakamoto & David Wighton, "Citigroup Chief Stays Bullish on Buy-Outs," *Financial Times,* July 9, 2007, available at *http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html*

[58] Although a commercial bank, Citigroup was no exception this race, impelled by the high fee income it involved. From 2003 to 2005, "Citigroup more than tripled its issuing of C.D.O.s to more than $30 billion from $6.28 billion." See Eric Dash and Julie Creswell, "Citigroup Pays for a Rush to Risk" *New York Times,* November 22, 2008, at 1, 34. In 2005 alone, the *New York Times* estimates that Citigroup received over $500 million in fee income from these C.D.O. transactions. From being the sixth largest issuer of C.D.O.s in 2003, it rose to being the largest

This in essence had happened in the period just prior to the 2000 dot.com bubble, and again during the accounting scandals of 2001–2002, and this process repeated itself during the subprime mortgage debacle. Once the market becomes hot, the threat of civil liability—either to the SEC or to private plaintiffs in securities class actions—seems only weakly to constrain this momentum. Rationalizations are always available: "real estate prices never fall;" "the credit rating agencies gave this deal a 'Triple A' rating," *etc.* Explosive growth and a decline in professional standards often go hand in hand. Here, after 2000, due diligence standards appear to have been relaxed, even as the threat of civil liability in private securities litigation was growing.[59]

As an explanation for an erosion in professional standards, competitive pressure applies with particular force to those investment banks that saw asset-back securitizations as the core of their future business model. In 2002, a critical milestone was reached, as in that year the total amount of debt securities issued in asset-backed securitizations equaled (and then exceeded in subsequent years) the total amount of debt securities issued by public corporations.[60] Debt securitizations were not only becoming the leading business of Wall Street, as a global market of debt purchasers was ready to rely on investment grade ratings from the major credit rating agencies, but they were particularly important for the independent investment banks in the CSE Program.

Although all underwriters anticipated high rates of return from securitizations, the independent underwriters had gradually been squeezed out of their traditional line of business—underwriting corporate securities—in the wake of the step-by-step repeal of the Glass-Steagall Act. Beginning well before the formal repeal of that Act in 1999, the major commercial banks had been permitted to underwrite corporate debt securities and had increasingly exploited their larger scale and synergistic ability to offer both bank loans and underwriting services to gain an increasing share of this underwriting market. Especially for the smaller investment banks (*e.g.,* Bear Stearns and Lehman), the future lay in new lines of business, where, as nimble and adaptive competitors, they could steal a march on the larger and slower commercial banks. To a degree, both did, and Merrill eagerly sought to follow in their wake.[61] To stake out a dominant position, the CEOs of these firms adopted a "Damn-the-torpedoes-full-speed-ahead" approach that led them to make extremely risky acquisitions. Their common goal was to assure themselves a continuing source of supply of subprime mortgages to securitize, but in pursuit of this goal, both Merrill Lynch and Lehman made risky acquisitions, in effect vertically integrating into the mortgage loan origination field. These decisions, plus their willingness to acquire mortgage portfolios well in advance of the expected securitization transaction, left them undiversified and exposed to large writedowns when the real estate market soured.

C.D.O. issuer worldwide by 2007, issuing in that year some $49.3 billion out of a worldwide total of $442.3 billion (or slightly over 11 percent of the world volume). *Id.* at 35.

What motivated this extreme risk-taking? Certain of the managers running Citigroup's securitization business received compensation as high as $34 million per year (even though they were not among the most senior officers of the bank). *Id.* at 34. This is consistent with the earlier diagnosis that equity compensation inclines management to accept higher and arguably excessive risk. At the highest level of Citigroup's management, the *New York Times* reports that the primary concern was "that Citigroup was falling behind rivals like Morgan Stanley and Goldman." *Id.* at 34 (discussing Robert Rubin and Charles Prince's concerns). Competitive pressure is, of course, enforced by the stock market and Wall Street's short-term system of bonus compensation. The irony then is that a rational strategy of deleveraging cannot be pursued by making boards and managements more sensitive to shareholder desires.

[59] From 1996 to 1999, the settlements in securities class actions totaled only $1.7 billion; thereafter, aggregate settlements rose exponentially, hitting a peak of $17.1 billion in 2006 alone. See Laura Simmons & Ellen Ryan, "Securities Class Action Settlements: 2006, Review and Analysis" (Cornerstone Research 2006) at 1. This decline of due diligence practices as liability correspondingly increased seems paradoxical, but may suggest that at least private civil liability does not effectively deter issuers or underwriters.

[60] For a chart showing the growth of asset-backed securities in relation to conventional corporate debt issuances over recent years, see J. Coffee, J. Seligman, and H. Sale, SECURITIES REGULATION: Case and Materials (10th ed. 2006) at p. 10.

[61] For a detailed description of Merrill, Lynch's late entry into the asset-backed securitization field and its sometimes frenzied attempt to catch up with Lehman by acquiring originators of mortgage loans, see Gretchen Morgenson, "How the Thundering Herd Faltered and Fell," *New York Times,* November 9, 2008, at BU-1. Merrill eventually acquired an inventory of $71 billion in risky mortgages, in part through acquisitions of loan originators. By mid-2008, an initial writedown of $7.9 billion forced the resignation of its CEO. As discussed in this *New York Times* article, loan originators dealing with Merrill believed it did not accurately understand the risks of their field. For Lehman's similar approach to acquisitions of loan originators, see text and note, *supra*, at note 56.

Regulatory Modernization: What Should Be Done?

An Overview of Recent Developments

Financial regulation in the major capital markets today follows one of three basic organizational models:

The Functional/Institutional Model: In 2008, before the financial crisis truly broke, the Treasury Department released a major study of financial regulation in the United States.[62] This document (known as the "Blueprint") correctly characterized the United States as having a "current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures."[63] Unfortunately, even this critical assessment may understate the dimensions of this problem of fragmented authority. In fact, the U.S. falls considerably short of even a "functional" regulatory model. By design, "functional" regulation seeks to subject similar activities to regulation by the same regulator. Its premise is that no one regulator can have, or easily develop, expertise in regulating all aspects of financial services. Thus, the securities regulator understands securities, while the insurance regulator has expertise with respect to the very different world of insurance. In the Gramm-Leach-Bliley Act of 1999 ("GLBA"), which essentially repealed the Glass-Steagall Act, Congress endorsed such a system of functional regulation.[64]

Nonetheless, the reality is that the United States actually has a hybrid system of functional and institutional regulation.[65] The latter approach looks not to functional activity, but to institutional type. Institutional regulation is seldom the product of deliberate design, but rather of historical contingency, piecemeal reform, and gradual evolution.

To illustrate this difference between functional and institutional regulation, let us hypothesize that, under a truly functional system, the securities regulator would have jurisdiction over all sales of securities, regardless of the type of institution selling the security. Conversely, let us assume that under an institutional system, jurisdiction over sales would be allocated according to the type of institution doing the selling. Against that backdrop, what do we observe today about the allocation of jurisdiction? Revealingly, under a key compromise in GLBA, the SEC did not receive general authority to oversee or enforce the securities laws with respect to the sale of government securities by a bank.[66] Instead, banking regulators retained that authority. Similarly, the drafters of the GLBA carefully crafted the definitions of "broker" and "dealer" in the Securities Exchange Act of 1934 to leave significant bank securities activities under the oversight of bank regulators and not the SEC.[67] Predictably, even in the relatively brief time since the passage of GLBA in 1999, the SEC and bank regulators have engaged in a continuing turf war over the scope of the exemptions accorded to banks from the definition of "broker" and "dealer."[68]

None of this should be surprising. The status quo is hard to change, and regulatory bodies do not surrender jurisdiction easily. As a result, the regulatory body historically established to regulate banks will predictably succeed in retaining much of its authority over banks, even when banks are engaged in securities activities that from a functional perspective should belong to the securities regulator.

"True" functional regulation would also assign similar activities to one regulator, rather than divide them between regulators based on only nominal differences in the description of the product or the legal status of the institution. Yet, in the case of banking regulation, three different federal regulators oversee banks: the Office of the Controller of the Currency ("OCC") supervises national banks; the Federal Re-

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[62] The Department of the Treasury, Blueprint for Modernized Financial Regulatory Structure (2008) (hereinafter, "Blueprint").

[63] *Id.* at 4 and 27.

[64] The Conference Report to the Gramm-Leach-Bliley Act clearly states this: Both the House and Senate bills generally adhere to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities. It is inefficient and impractical to expect a regulator to have or develop expertise in regulating all aspects of financial services. H.R. Rep. No. 106-434, at 157 (1999), reprinted in 1999 U.S.C.C.A.N. 1252.

[65] For this same assessment, see Heidi Mandanis Schooner & Michael Taylor, United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets, 38 Tex. Int'l L. J. 317, 328 (2003).

[66] See 15 U.S.C. § 78o-5(a)(1)(B), 15 U.S.C. § 78(c)(a)(34)(G), and 15 U.S.C. § 78o-5(g)(2).

[67] See 15 U.S.C. § 78(c)(a)(4),(5).

[68] See Kathleen Day, Regulators Battle Over Banks: 3 Agencies Say SEC Rules Overstep Securities-Trading Law, *Wash. Post,* July 3, 2001, at E3. Eventually, the SEC backed down in this particular skirmish and modified its original position. See Securities Exch. Act Release No. 34-44570 (July 18, 2001) and Securities Exchange Age Release No. 34-44291, 66 Fed. Reg. 27760 (2001).

serve Board ("FRB") oversees state-chartered banks that are members of the Federal Reserve System and the Federal Deposit Insurance Corporation ("FDIC") supervises state-chartered banks that are not members of the Federal Reserve System but are federally insured.[69] Balkanization does not stop there. The line between "banks," with their three different regulators at the federal level, and "thrifts," which the Office of Thrift Supervision ("OTS") regulates, is again more formalistic than functional and reflects a political compromise more than a difference in activities.

Turning to securities regulation, one encounters an even stranger anomaly: the United States has one agency (the SEC) to regulate securities and another (the Commodities Future Trading Commission (CFTC)) to regulate futures. The world of derivatives is thereby divided between the two, with the SEC having jurisdiction over options, while the CFTC has jurisdiction over most other derivatives. No other nation assigns futures and securities regulation to different regulators. For a time, the SEC and CFTC both asserted jurisdiction over a third category of derivatives—swaps—but in 2000 Congress resolved this dispute by placing their regulation largely beyond the reach of both agencies. Finally, some major financial sectors (for example, insurance and hedge funds) simply have no federal regulator. By any standard, the United States thus falls well short of a true system of functional regulation, because deregulation has placed much financial activity beyond the reach of any federal regulator.

Sensibly, the Blueprint proposes to rationalize this patchwork-quilt structure of fragmented authority through the merger and consolidation of agencies. Specifically, it proposes both a merger of the SEC and CFTC and a merger of the OCC and the OTS. Alas, such mergers are rarely politically feasible, and to date, no commentator (to our knowledge) has predicted that these proposed mergers will actually occur.

Thus, although the Blueprint proposes that we move beyond functional regulation, the reality is that we have not yet approached even a system of functional regulation, as our existing financial regulatory structure is organized at least as much by institutional category as by functional activity. Disdaining a merely "functional" reorganization under which banking, insurance, and securities would each be governed by their own federal regulator, the Blueprint instead envisions a far more comprehensive consolidation of all these specialized regulators. Why? In its view, the problems with functional regulation are considerable:

> A functional approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected.[70]

But beyond these concerns about systemic risk, the architects of the Blueprint were motivated by a deeper anxiety: regulatory reform is necessary to maintain the capital market competitiveness of the United States.[71] In short, the Blueprint is designed around two objectives: (1) the need to better address systemic risk and the possibility of a cascading series of defaults, and (2) the need to enhance capital market competitiveness. As discussed later, the first concern is legitimate, but the second involves a more dubious logic.

The Consolidated Financial Services Regulator: A clear trend is today evident towards the unification of supervisory responsibilities for the regulation of banks, securities markets and insurance.[72] Beginning in Scandinavia in the late 1980s,[73] this trend has recently led the United Kingdom, Japan, Korea, Germany and much

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[69] This is all well described in the Blueprint. See Blueprint, *supra* note 62, at 31–41.

[70] Blueprint, *supra* note 62, at 4.

[71] In particular, the Blueprint hypothesizes that the U.K. has enhanced its own competitiveness by regulatory reforms, adopted in 2000, that are principles-based and rely on self regulation for their implementation. *Id.* at 3.

[72] For recent overviews, see Ellis Ferran, Symposium: Do Financial Supermarkets Need Super-Regulators? Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model, 28 Brook. J. Int'l L. 257, 257–59 (2003); Jerry W. Markham, A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: A Comparative Analysis of Securities and Derivative Regulation in the United States, the United Kingdom, and Japan, 28 Brook. J. Int'l L. 319, 319–20 (2003); Giorgio Di Giorgio & Carmine D. Noia, Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?, 28 Brook. J. Int'l L. 463, 469–78 (2003).

[73] Norway moved to an integrated regulatory agency in 1986, followed by Denmark in 1988, and Sweden in 1991. See D. Giorgio & D. Noia, *supra* note 72, at 469–478.

of Eastern Europe to move to a single regulator model.[74] Although there are now a number of precedents, the U.K. experience stands out as the most influential. It was the first major international market center to move to a unified regulator model,[75] and the Financial Services and Markets Act, adopted in 2000, went significantly beyond earlier precedents towards a "nearly universal regulator."[76] The Blueprint focuses on the U.K.'s experience because it believes that the U.K.'s adoption of a consolidated regulatory structure "enhanced the competitiveness of the U.K. economy."[77]

Yet it is unclear whether the U.K.'s recent reforms provide a legitimate prototype for the Blueprint's proposals. Here, the Blueprint may have doctored its history. By most accounts, the U.K.'s adoption of a single regulator model was "driven by country-specific factors,"[78] including the dismal failure of a prior regulatory system that relied heavily on self-regulatory bodies but became a political liability because of its inability to cope with a succession of serious scandals. Ironically, the financial history of the U.K. in the 1990s parallels that of the United States over the last decade. On the banking side, the U.K. experienced two major banking failures—the Bank of Credit and Commerce International ("BCCI") in 1991 and Barings in 1995. Each prompted an official inquiry that found lax supervision was at least a partial cause.[79]

Securities regulation in the U.K. came under even sharper criticism during the 1990s because of a series of financial scandals that were generally attributed to an "excessively fragmented regulatory infrastructure."[80] Under the then applicable law (the Financial Services Act of 1986), most regulatory powers were delegated to the Securities and Investments Board (SIB), which was a private body financed through a levy on market participants. However, the SIB did not itself directly regulate. Rather, it "set the overall framework of regulation," but delegated actual authority to second tier regulators, which consisted primarily of self-regulatory organizations (SROs).[81] Persistent criticism focused on the inability or unwillingness of these SROs to protect consumers from fraud and misconduct.[82] Ultimately, the then chairman of the SIB, the most important of the SROs, acknowledged that self-regulation had failed in the U.K. and seemed unable to restore investor confidence.[83] This acknowledgement set the stage for reform, and when a new Labour Government came into power at the end of the decade, one of its first major legislative acts (as it had promised in its election campaign) was to dismantle the former structure of SROs and replace it with a new and more powerful body, the Financial Services Authority (FSA).

Despite the Blueprint's enthusiasm for the U.K.'s model, the structure that the Blueprint proposes for the U.S. more closely resembles the former U.K. system than the current one. Under the Blueprint's proposals, the securities regulator would be restricted to adopting general "principles-based" policies, which would be implemented and enforced by SROs.[84] Ironically, the Blueprint relies on the U.K. experience to endorse essentially the model that the U.K. concluded had failed.

The "Twin Peaks" Model: As the Blueprint recognizes, not all recent reforms have followed the U.K. model of a universal regulator. Some nations—most notably Australia and the Netherlands—instead have followed a "twin peaks" model that places responsibility for the "prudential regulation of relevant financial institutions" in one

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[74] See Bryan D. Stirewalt & Gary A. Gegenheimer, Consolidated Supervision of Banking Groups in the Former Soviet Republics: A Comparative Examination of the Emerging Trend in Emerging Markets, 23 Ann. Rev. Banking & Fin. L. 533, 548–49 (2004). As discussed later, in some countries (most notably Japan), the change seems more one of form than of substance, with little in fact changing. See Markham, *supra* note 72, at 383–393, 396.

[75] See Ferran, *supra* note 72, at 258.

[76] See Schooner & Taylor, *supra* note 65, at 329. Schooner and Taylor also observe that the precursors to the U.K.'s centralized regulator, which were mainly in Scandinavia, had a "predominantly prudential focus." *Id.* at 331. That is, the unified new regulator was more a guardian of "safety and soundness" and less oriented toward consumer protection.

[77] Blueprint, *supra* note 62 at 3.

[78] Ferran, *supra* note 72, at 259.

[79] *Id.* at 261–262.

[80] *Id.* at 265.

[81] *Id.* at 266. The most important of these were the Securities and Futures Authority (SFA), the Investment Managers' Regulatory Organization (IMRO), and the Personal Investment Authority (PIA).

[82] Two scandals in particular stood out: the Robert Maxwell affair in which a prominent financier effectively embezzled the pension funds of his companies and a "pension mis-selling" controversy in which highly risky financial products were inappropriately sold to pension funds without adequate supervision or disclosure. *Id.* at 267–268.

[83] *Id.* at 268.

[84] See infra notes—and accompanying text.

agency and supervision of "business conduct and consumer protection" in another.[85] The term "twin peaks" derives from the work of Michael Taylor, a British academic and former Bank of England official. In 1995, just before regulatory reform became a hot political issue in the U.K., he argued that financial regulation had two separate basic aims (or "twin peaks"): (1) "to ensure the soundness of the financial system," and (2) "to protect consumers from unscrupulous operators."[86] Taylor's work was original less in its proposal to separate "prudential" regulation from "business conduct" regulation than in its insistence upon the need to consolidate "responsibility for the financial soundness of all major financial institutions in a single agency."[87] Taylor apparently feared that if the Bank of England remained responsible for the prudential supervision of banks, its independence in setting interest rates might be compromised by its fear that raising interest rates would cause bank failures for which it would be blamed. In part for this reason, the eventual legislation shifted responsibility for bank supervision from the Bank of England to the FSA.

The Blueprint, itself, preferred a "twin peaks" model, and that model is far more compatible with the U.S.'s current institutional structure for financial regulation. But beyond these obvious points, the best argument for a "twin peaks" model involves conflict of interests and the differing culture of banks and securities regulators. It approaches the self-evident to note that a conflict exists between the consumer protection role of a universal regulator and its role as a "prudential" regulator intent on protecting the safety and soundness of the financial institution. The goal of consumer protection is most obviously advanced through deterrence and financial sanctions, but these can deplete assets and ultimately threaten bank solvency. When only modest financial penalties are used, this conflict may sound more theoretical than real. But, the U.S. is distinctive in the severity of the penalties it imposes on financial institutions. In recent years, the SEC has imposed restitution and penalties exceeding $3 billion annually, and private plaintiffs received a record $17 billion in securities class action settlements in 2006.[88] Over a recent ten year period, some 2,400 securities class actions were filed and resulted in settlements of over $27 billion, with much of this cost (as in the Enron and WorldCom cases) being borne by investment banks.[89] If one agency were seeking both to protect consumers and guard the solvency of major financial institutions, it would face a difficult balancing act to achieve deterrence without threatening bank solvency, and it would risk a skeptical public concluding that it had been "captured" by its regulated firms.

Even in jurisdictions adopting the universal regulator model, the need to contemporaneously strengthen enforcement has been part of the reform package. Although the 2000 legislation in the U.K. did not adopt the "twin peaks" format, it did significantly strengthen the consumer protection role of its centralized regulator. The U.K.'s Financial Services and Markets Act, enacted in 2000, sets out four statutory objectives, with the final objective being the "reduction of financial crime."[90] According to Heidi Schooner and Michael Taylor, this represented "a major extension of the FSA's powers compared to the agencies it replaced,"[91] and it reflected a political response to the experience of weak enforcement by self-regulatory bodies, which had led to the creation of the FSA.[92] With probably unintended irony, Schooner and Taylor described this new statutory objective of reducing "financial crime" as the "one aspect of U.K. regulatory reform in which its proponents seem to have drawn

[85] Blueprint, *supra* note 62, at 3. For a recent discussion of the Australian reorganization, which began in 1996 (and thus preceded the U.K.), see Schooner & Taylor, *supra* note65, at 340–341. The Australian Securities and Investments Commission (ASIC) is the "consumer protection" agency under this "twin peaks" approach, and the Australian Prudential Regulatory Authority (APRA) supervises bank "safety and soundness." Still, the "twin peaks" model was not fully accepted in Australia as ASIC, the securities regulator, does retain supervisory jurisdiction over the "financial soundness" of investment banks. Thus, some element of functional regulation remains.

[86] Michael Taylor, Twin Peaks: A Regulatory Structure for the New Century i (Centre for the Study of Financial Institutions 1995). For a brief review of Taylor's work, see Cynthia Crawford Lichtenstein, The Fed's New Model of Supervision for "Large Complex Banking Organizations": Coordinated Risk-Based Supervision of Financial Multinationals for International Financial Stability, 18 Transnat'l Law. 283, 295–296 (2005).

[87] Lichtenstein, *supra* note 86, at 295; Taylor, *supra* note 86, at 4.

[88] See Coffee, Law and the Market: The Impact of Enforcement, 156 U. of Pa. L. Rev. 299 (2007) (discussing average annual SEC penalties and class action settlements).

[89] See Richard Booth, The End of the Securities Fraud Class Action as We Know It, 4 Berkeley Bus. L. J. 1, at 3 (2007).

[90] See Financial Services and Markets Act, 2000, c. 8, pt. 1, 6, *http://www.opsi.gov.uk/ACTS/acts2000/pdf/ukpga_20000008_en.pdf*

[91] See Schooner & Taylor, *supra* note 65, at 335.

[92] *Id.*

direct inspiration from U.S. law and practice." [93] Conspicuously, the Blueprint ignores that "modernizing" financial regulation in other countries has generally meant strengthening enforcement.

A Preliminary Evaluation: Three preliminary conclusions merit emphasis:

First, whether the existing financial regulatory structure in the United States is considered "institutional" or "functional" in design, its leading deficiency seems evident: it invites regulatory arbitrage. Financial institutions position themselves to fall within the jurisdiction of the most accommodating regulator, and investment banks design new financial products so as to encounter the least regulatory oversight. Such arbitrage can be defended as desirable if one believes that regulators inherently overregulate, but not if one believes increased systemic risk is a valid concern (as the Blueprint appears to believe).

Second, the Blueprint's history of recent regulatory reform involves an element of historical fiction. The 2000 legislation in the U.K., which created the FSA as a nearly universal regulator, was not an attempt to introduce self-regulation by SROs, as the Blueprint seems to assume, but a sharp reaction by a Labour Government to the failures of self-regulation. Similarly, Japan's slow, back-and-forth movement in the direction of a single regulator seems to have been motivated by an unending series of scandals and a desire to give its regulator at least the appearance of being less industry dominated. [94]

Third, the debate between the "universal" regulator and the "twin peaks" alternative should not obscure the fact that both are "superregulators" that have moved beyond "functional" regulation on the premise that, as the lines between banks, securities dealers, and insurers blur, so regulators should similarly converge. That idea will and should remain at the heart of the U.S. debate, even after many of the Blueprint's proposals are forgotten.

Defining the Roles of the "Twin Peaks" (Systemic Risk Regulator and Consumer Protector)—Who Should Do What?

The foregoing discussion has suggested why the SEC would not be an effective risk regulator. It has neither the specialized competence nor the organizational culture for the role. Its comparative advantage is enforcement, and thus its focus should be on transparency and consumer protection. Some also argue that "single purpose" agencies, such as the SEC, are more subject to regulatory capture than are broader or "general purpose" agencies. [95] To the extent that the Federal Reserve would have responsibility for all large financial institutions and would be expected to treat monitoring their capital adequacy and risk management practices as among its primary responsibilities, it does seem less subject to capture, because any failure would have high visibility and it would bear the blame. Still, this issue is largely academic because the SEC no longer has responsibility over any investment banks of substantial size.

The real issue then is defining the relationships between the two peaks so that neither overwhelms the other.

The Systemic Risk Regulator (SRR): Systemic risk is most easily defined as the risk of an inter-connected financial breakdown in the financial system—much like the proverbial chain of falling dominoes. The closely linked insolvencies of Lehman, AIG, Fannie Mae and Freddie Mac in the Fall of 2008 present a paradigm case. Were they not bailed out, other financial institutions were likely to have also failed. The key idea here is not that one financial institution is too big to fail, but rather that some institutions are too interconnected to permit any of them to fail, because they will drag the others down.

What should a system risk regulator be authorized to do? Among the obvious powers that it should have are the following:

a. Authority To Limit the Leverage of Financial Institutions and Prescribe Mandatory Capital Adequacy Standards. This authority would empower the SRR to pre-

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[93] *Id.* at 335–36.

[94] Japan has a history and a regulatory culture of economic management of its financial institutions through regulatory bodies that is entirely distinct from that of Europe or the United States. Although it has recently created a Financial Services Agency, observers contend that it remains committed to its traditional system of bureaucratic regulation that supports its large banks and discourages foreign competition. See Markham, *supra* note 72, at 383–92, 396. Nonetheless, scandals have been the primary force driving institutional change there too, and Japan's FSA was created at least in part because Japan's Ministry of Finance (MOF) had become embarrassed by recurrent scandals.

[95] See Jonathan Macey, Organizational Design and Political Control of Administrative Agencies, 8 J. Law, Economics, and Organization 93 (1992). It can, of course, be argued which agency is more "single purpose" (the SEC or the Federal Reserve), but the latter does deal with a broader class of institutions in terms of their capital adequacy.

scribe minimum levels of capital and ceilings on leverage for all categories of financial institutions, including banks, insurance companies, hedge funds, money market funds, pension plans, and quasi-financial institutions (such as, for example, G.E. Capital). The standards would not need to be identical for all institutions and should be risk adjusted. The SRS should be authorized to require reductions in debt to equity ratios below existing levels, to consider off-balance sheet liabilities (including those of partially owned subsidiaries and also contractual agreements to repurchase or guarantee) in computing these tests and ratios (even if generally accepted accounting principles would not require their inclusion).

The SRR would focus its monitoring on the largest institutions in each financial class, leaving small institutions to be regulated and monitored by their primary regulator. For example, the SEC might require all hedge funds to register with it under the Investment Advisers Act of 1940, but hedge funds with a defined level of assets (say, $25 billion in assets) would be subject to the additional and overriding authority of the SSR.

b. Authority To Approve, Restrict and Regulate Trading in New Financial Products. By now, it has escaped no one's attention that one particular class of over-the-counter derivative (the credit default swap) grew exponentially over the last decade and was outside the jurisdiction of any regulatory agency. This was not accidental, as the Commodities Futures Modernization Act of 2000 deliberately placed over-the-counter derivatives beyond the general jurisdiction of both the SEC and the CFTC. The SRR would be responsible for monitoring the growth of new financial products and would be authorized to regulate such practices as the collateral or margin that counter-parties were required to post. Arguably, the SRR should be authorized to limit those eligible to trade such instruments and could bar or restrict the purchase of "naked" credit default swaps (although the possession of this authority would not mean that the SRR would have to exercise it, unless it saw an emergency developing).

c. Authority To Mandate Clearing Houses. Securities and options exchanges uniformly employ clearing houses to eliminate or mitigate credit risk. In contrast, when an investor trades in an over-the-counter derivative, it must accept both market risk (the risk that the investment will sour or price levels will change adversely) and credit risk (the risk that the counterparty will be unable to perform). Credit risk is the factor that necessitated the bailout of AIG, as its failure could have potentially led to a cascade of failures by other financial institutions if it defaulted on its swaps. Use of the clearing house would eliminate the need to bail out a future AIG because its responsibilities would fall on the clearing house to assume and the clearing house would monitor and limit the risk that its members assumed.

At present, several clearinghouses are in the process of development in the United States and Europe. The SRR would be the obvious body to oversee such clearing houses (and indeed the Federal Reserve was already instrumental in their formation). Otherwise, some clearing houses are likely to be formed under the SEC's supervision and some under the CFTC's, thus again permitting regulatory arbitrage to develop.

A final and complex question is whether competing clearing houses are desirable or whether they should be combined into a single centralized clearing house. This issue could also be given to the SRR.

d. Authority To Mandate Writedowns for Risky Assets. A real estate bubble was the starting point for the 2008 crisis. When any class of assets appreciates meteorically, the danger arises that on the eventual collapse in that overvalued market, the equity of the financial institution will be wiped out (or at the least so eroded as to create a crisis in investor confidence that denies that institution necessary financing). This tendency was palpably evident in the failure of Bear Stearns, Lehman, Fannie Mae and Freddie Mac. If the SRR regulator relies only on debt/equity ratios to protect capital adequacy, they will do little good and possibly provide only illusory protections. Any financial institution that is forced to writedown its investment in overpriced mortgage and real estate assets by 50 percent will necessarily breach mandated debt to equity ratios. The best answer to this problem is to authorize the SRR to take a proactive and countercyclical stance by requiring writedowns in risky asset classes (at least for regulatory purposes) prior to the typically much later point at which accountants will require such a writedown.

Candidly, it is an open question whether the SRS, the Federal Reserve, or any banking regulator would have the courage and political will to order such a writedown (or impose similar restraints on further acquisitions of such assets) while the bubble was still expanding. But Congress should at least arm its regulators with sufficient power and direct them to use it with vigor.

e. Authority To Intervene To Prevent and Avert Liquidity Crises. Financial institutions often face a mismatch between their assets and liabilities. They may invest in illiquid assets or make long-term loans, but their liabilities consist of short-term debt (such as commercial paper). Thus, regulating leverage ratios is not alone adequate to avoid a financial crisis, because the institution may suddenly experience a "run" (as its depositors flee) or be unable to roll over its commercial paper or other short-term debt. This problem is not unique to banks and can be encountered by hedge funds and private equity funds (as the Long Term Capital Management crisis showed). The SRR thus needs the authority to monitor liquidity problems at large financial institutions and direct institutions in specific cases to address such imbalances (either by selling assets, raising capital, or not relying on short-term debt).

From the foregoing description, it should be obvious that the only existing agency in a position to take on this assignment and act as an SRR is the Federal Reserve Board. But it is less politically accountable than most other federal agencies, and this could give rise to some problems discussed below.

The Consumer Protection and Transparency Agency: The creation of an SSR would change little at the major Federal agencies having responsibilities for investor protection. Although it might be desirable to merge the SEC and the CFTC, this is not essential. Because no momentum has yet developed for such a merger, I will not discuss it further at this time.

Currently, there are over 5,000 broker-dealers registered with the SEC. They would remain so registered, and the SRR would concern itself only with those few whose potential insolvency could destabilize the markets. The focus of the SEC's surveillance of broker-dealers is on consumer protection and market efficiency, and this would not be within the expertise of the Federal Reserve or any other potential SRR.

The SEC is also an experienced enforcement agency, while the Federal Reserve has little, if any, experience in this area. Further, the SEC understands disclosure issues and is a champion of transparency, whereas banking regulators start from the unstated premise that disclosures of risks or problems at a financial institution is undesirable because it might provoke a "run" on the bank. The SEC and the Controller of the Currency have long disagreed about what banks should disclose in the Management Discussion and Analysis that banks file with the SEC. Necessarily, this tension will continue.

Resolving the Conflicts: The SEC and the PCAOB have continued to favor "mark to market" accounting, while major banks have sought relief from the write-downs that it necessitates. Suppose then that in the future a SRR decided that "mark to market" accounting increased systemic risk. Could it determine that financial institutions should be spared from such an accounting regime on the ground that it was pro-cyclical? This is an issue that Congress should address in any legislation authorizing a SRR or enhancing the powers of the Federal Reserve. I would recommend that Congress maintain authority in the SEC to determine appropriate accounting policies, because, put simply, transparency has been the core value underlying our system of securities regulation.

But there are other areas where a SRR might well be entitled to overrule the SEC. Take, for example, the problem of short selling the stocks of financial institutions during a period of market stress. Although the SEC did ban short selling in financial stocks briefly in 2008, one can still imagine an occasion on which the SRR and the SEC might disagree. Here, transparency would not be an issue. Short selling is pro-cyclical, and a SRR could determine that it had the potential to destabilize and increase systemic risk. If it did so, its judgment should control.

These examples are given only by way of illustration, and the inevitability of conflicts between the two agencies is not assumed. The President's Working Group on Financial Markets has generally been able to work out disagreements through consultation and negotiation. Still, in any legislation, it would be desirable to identify those core policies (such as transparency and full disclosure) that the SRR could not override.

The Failure of Quantitative Models: If one lesson should have been learned from the 2008 crisis, it is that quantitative models, based on historical data, eventually and inevitably fail. Rates of defaults on mortgages can change (and swiftly), and housing markets do not invariably rise. In the popular vernacular, "black swans" both can occur and even become predominant. This does not mean that quantitative models should not be used, but that they need to be subjected to qualitative and judgmental overrides.

The weakness in quantitative models is particularly shown by the extraordinary disparity between the value at risk estimates (VaRs) reported by underwriters to the SEC and their eventual writedowns for mortgage-backed securities. Ferrell, Bethel and Hu report that for a selected group of major financial institutions the average ratio of asset writedowns as of August 20, 2008, to VaRs reported for 2006 was 291 to 1.[96] If financial institutions cannot accurately estimate their exposure for derivatives and risky assets, this undermines many of the critical assumptions underlying the Basel II Accords, and suggests that regulators cannot defer to the institutions' own risk models. Instead, they must reach their own judgments, and Congress should so instruct them.

The Lessons of Madoff: Implications for the SEC, FINRA, and SIPC

No time need be wasted pointing out that the SEC missed red flags and overlooked credible evidence in the Madoff scandal. Unfortunately, most Ponzi schemes do not get detected until it is too late. This implies that an ounce of prevention may be worth several pounds of penalties. More must be done to discourage and deter such schemes *ex ante,* and the focus cannot be only on catching them *ex post.*

From this perspective focused on prevention, rather than detection, the most obvious lesson is that the SEC's recent strong tilt towards deregulation contributed to, and enabled, the Madoff fraud in two important respects. First, Bernard L. Madoff Investment Securities LLC (BMIS) was audited by a fly-by-night auditing firm with only one active accountant who had neither registered with the Public Company Accounting Oversight Board ("PCAOB") nor even participated in New York State's peer review program for auditors. Yet, the Sarbanes-Oxley Act required broker-dealers to use a PCAOB-registered auditor.[97] Nonetheless, until the Madoff scandal exploded, the SEC repeatedly exempted privately held broker-dealers from the obligation to use such a PCAOB-registered auditor and permitted any accountant to suffice.[98] Others also exploited this exemption. For example, in the Bayou Hedge Fund fraud, which was the last major Ponzi scheme before Madoff, the promoters simply invented a fictitious auditing firm and forged certifications in its name. Had auditors been required to have been registered with PCAOB, this would not have been feasible because careful investors would have been able to detect that the fictitious firm was not registered.

Presumably, the SEC's rationale for this overbroad exemption was that privately held broker-dealers did not have public shareholders who needed protection. True, but they did have customers who have now been repeatedly victimized. At the end of 2008, the SEC quietly closed the barn door by failing to renew this exemption—but only after $50 billion worth of horses had been stolen.

A second and even more culpable SEC mistake continues to date. Under the Investment Advisers Act, investment advisers are required to maintain client funds or securities with a "qualified custodian."[99] In principle, this requirement should protect investors from Ponzi schemes, because an independent custodian would not permit the investment adviser to have access to the investors' funds. Indeed, for exactly this reason, mutual funds appear not to have experienced Ponzi-style frauds, which have occurred only in the case of hedge funds and investment advisers. Under Section 17(f) of the Investment Company Act, mutual funds must use a separate custodian. But in the case of investment advisors, the SEC permits the investment adviser to use an affiliated broker-dealer or bank as its qualified custodian. Thus, Madoff could and did use BMIS, his broker dealer firm, to serve as custodian for his investment adviser activities. The net result is that only a very tame watchdog monitors the investment adviser. Had an independent and honest custodian held the investors' funds, Madoff could not have recycled new investors' contributions to earlier investors, and the custodian would have noticed that Madoff was not actually trading. Other recent Ponzi schemes seem to have similarly sidestepped the need for an independent custodian. At Senate Banking Committee hearings on the Madoff debacle this January, the director of the SEC's Office of Compliance, Inspection and Examinations estimated that, out of the 11,300 investment advisers currently registered with the SEC, some 1,000 to 1,500 might similarly use an affiliated broker-dealer as their custodian. For investors, the SEC's tolerance for self-custodians makes the "qualified custodian" rule an illusory protection.

At present, the Madoff scandal has so shaken investor confidence in investment advisors that even the industry trade group for investment advisers (the Investment Advisers Association) has urged the SEC to adopt a rule requiring investment advisers to use an independent custodian. Unfortunately, one cannot therefore assume that the SEC will quickly produce such a rule. The SEC's staff knows that smaller investment advisers will oppose any rule that requires them to incur additional costs. Even if a reform rule is proposed, the staff may still overwhelm such a rule

[96] See Farrell, Bethel, and Hu, *supra* note 15, at 47.

[97] See Section 17(e)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(q)(e)(1).

[98] See, *e.g.,* Securities Exch. Act Rel. No. 34-54920 (Dec. 12, 2006).

[99] See Rule 206(4)-2 ("Custody of Funds or Securities of Clients By Investment Advisers"), 17 CFR § 275.206(4)-2.

with exceptions (such as by permitting an independent custodian to use subcustodians who are affiliated with the investment adviser). Congress should therefore direct it to require an independent custodian, across the board for mutual funds, hedge funds, and investment advisers.

The Madoff scandal exposes shortcomings not only at the SEC but elsewhere in related agencies. Over the last 5 years, the number of investment advisers has grown from roughly 7,500 to 11,300—more than one third. Given this growth, it is becoming increasingly anomalous that there is no self-regulatory body (SRO) for investment advisers. Although FINRA may have overstated in its claim that it had no authority to investigate Madoff's investment adviser operations (because it could and should have examined BMIS's performance as the "qualified custodian" for Madoff's investment advisory activities), it still lacks authority to examine investment advisers. Some SRO (either FINRA or a new body) should have direct authority to oversee the investment adviser activities of an integrated broker-dealer firm.

Similarly, the Securities Investor Protection Corporation (SIPC) continues to charge all broker-dealer firms the same nominal fee for insurance without any risk-adjustment. Were it to behave like a private insurer and charge more to riskier firms for insurance, these firms would have a greater incentive to adopt better internal controls against fraud. A broker-dealer that acted as a self-custodian for a related investment adviser would, for example, pay a higher insurance commission. Also, if higher fees were charged, more insurance (which is currently capped at $500,000 per account) could be provided to investors. When all broker-dealers are charged the same insurance premium, this subsidizes the riskier firms—*i.e.,* the future Madoffs of the industry.

Finally, one of the most perplexing problems in the Madoff story is why, when the SEC finally forced Madoff to register as an investment adviser in 2006, it did not conduct an early examination of BMIS's books and records. Red flags were flying, as Madoff (1) used an unknown accountant, (2) served as his own self-custodian, (3) had apparently billions of dollars in customer accounts, (4) had long resisted registration, and (5) was the subject of plausible allegations of fraud from credible whistle-blowers. Cost constrained as the SEC may have been, the only conclusion that can be reached here is that the SEC has poor criteria for evaluating the relative risk of investment advisers. At a minimum, Congress should require a report by the SEC as to the criteria used to determine the priority of examinations and how the SEC proposes to change those criteria in light of the Madoff scandal.

Some have proposed eliminating the SEC's Office of Compliance, Inspection and Examinations and combining its activities with the Division of Investment Management. I do not see this as a panacea. Rather, it simply reshuffles the cards. The real problem is the criteria used to determine who should be examined. Credible allegations of fraud need to be directed to the compliance inspectors.

Asset-Backed Securitizations: What Failed?

Asset-backed securitizations represent a financial technology that failed. As outlined earlier, this failure seems principally attributable to a "moral hazard" problem that arose under which both loan originators and underwriters relaxed their lending standards and packaged non-creditworthy loans into portfolios, because both found that they could sell these portfolios at a high profit and on a global basis—at least so long as the debt securities carried an investment grade credit rating from an NRSRO credit rating agency.

Broad deregulatory rules contributed to this problem, and the two most important such SEC rules are Rules 3a-7 under the Investment Company Act [100] and Regulation AB. [101] Asset-backed securities (including CDOs) are typically issued by a special purpose vehicle (SPV) controlled by the promoter (which often may be an investment or commercial bank). This SPV would under ordinary circumstances be deemed an "investment company" and thus subjected to the demanding requirements of the Investment Company Act—but for Rule 3a-7. That rule exempts fixed-income securities issued by an SPV if, at the time of sale, the securities are rated in one of the four highest categories of investment quality by a "nationally recognized statistical rating organization" (NRSRO). In essence, the SEC has delegated to the NRSROs (essentially, at the time at least, Moody's, S&P and Fitch) the ability exempt SPVs from the Investment Company Act. Similarly, Regulation AB governs the disclosure requirements for "asset-backed securities" (as such term is defined in Section 1101(c) of Regulation AB) in public offerings. Some have criticized

[100] 17 CFR § 270.3a-7 ("Issuers of Asset-Backed Securities"). This exemption dates back to 1992.

[101] 17 CFR § 229.1100 *et seq.* ("Asset-Backed Securities"). Regulation AB was adopted in 2005, but reflects an earlier pattern of exemptions in no-action letters.

Regulation AB for being more permissive than the federal housing agencies with respect to the need to document and verify the loans in a portfolio.[102] Because Regulation AB requires that the issuer not be an investment company (see Item 101(c)(2)(i) of Regulation AB), its availability (and thus expedited registration) also depends on an NRSRO investment grade rating.

No suggestion is here intended that SPVs should be classified as "investment companies," but the need for the exemption given by Rule 3a-7 shows that the SEC has considerable leverage and could condition this exemption on alternative or additional factors beyond an NRSRO investment grade rating. The key point is that exemptions like Rule 3a-7 give the SEC a tool that they could use even without Congressional legislation—if the SEC was willing to take action.

What actions should be taken to respond to the deficiencies in asset-backed securitizations? I would suggest two basic steps: (1) curtail the "originate-and-distribute" model of lending that gave rise to the moral hazard problem, and (2) reintroduce due diligence into the securities offering process (both for public and Rule 144A offerings).

Restricting the "Originate-and-Distribute" Model of Lending. In a bubble, everyone expects that they can pass the assets on to the next buyer in the chain—"before the music stops." Thus, all tend to economize on due diligence and ignore signs that the assets are not creditworthy. This is because none expect to bear the costs of holding the financial assets to maturity.

Things were not always this way. When asset-backed securitizations began, the promoter usually issued various tranches of debt to finance its purchase of the mortgage assets, and these tranches differed in terms of seniority and maturity. The promoter would sell the senior most tranche in public offerings to risk averse public investors and retain some or all of the subordinated tranche, itself, as a signal of its confidence in the creditworthiness of the underlying assets. Over time, this practice of retaining the subordinated tranche withered away. In part, this was because hedge funds would take the risk of buying this riskier debt; in part, it was because the subordinated tranche could be included in more complex CDOs (where overcollateralization was the investor's principal protection), and finally it was because in a bubbly market, investors no longer looked for commitments or signals from the promoter.

Given this definition of the problem, the answer seems obvious: require the promoter to retain some portion of the subordinated tranche. This would incentivize it to buy only creditworthy financial assets and end the "moral hazard" problem.

To make this proposal truly effective, however, more must be done. The promoter would have to be denied the ability to hedge the risk on the subordinated tranche that it retained. Otherwise it might hedge that risk by buying a credit default swap on its own offering through an intermediary. But this is feasible. Even in the absence of legislation, the SEC could revise Rule 3a-7 to require, as a price of its exemption, that the promoter (either through the SPV or an affiliate) retain a specified percentage of the bottom, subordinated tranche (or, if there were no subordinated tranche, of the offering as a whole). Still, the cleaner, simpler way would be a direct legislative requirement of a minimum retention.

2. Mandating Due Diligence. One of the less noticed but more important developments associated with asset-backed securitization is the rapid decline in due diligence after 2000. Once investment banks did considerable due diligence on asset-backed securitizations, but they outsourced the work to specialized "due diligence" firms. These firms (of which Clayton Holdings, Inc. was the best known) would send squads of ten to fifteen loan reviewers to sample the loans in a securitized portfolio, checking credit scores and documentation. But the intensity of this due diligence review declined over recent years. The *Los Angeles Times* quotes the CEO of Clayton Holdings to the effect that:

> Early in the decade, a securities firm might have asked Clayton to review 25 percent to 40 percent of the sub-prime loans in a pool, compared with typically 10 percent in 2006[103]

The President of a leading rival due diligence firm, the Bohan Group, made an even more revealing comparison:

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[102] See Mendales, *supra* note 18.

[103] See E. Scott Reckard, "Sub-Prime mortgage watchdogs kept on leash; loan checkers say their warnings of risk were met with indifference," *Los Angeles Times,* March 17, 2008, at C-1.

> By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50 percent to 100 percent of the loans examined, Bohan President Mark Hughes said.[104]

In short, lenders who retained the loans checked the borrowers carefully, but the investment banks decreased their investment in due diligence, making only a cursory effort by 2006. Again, this seems the natural consequence of an originate-and-distribute model.

The actual loan reviewers employed by these firms also told the above-quoted *Los Angeles Times* reporter that supervisors in these firms would often change documentation in order to avoid "red-flagging mortgages." These employees also report regularly encountering inflated documentation and "liar's loans," but, even when they rejected loans, "loan buyers often bought the rejected mortgages anyway."[105]

In short, even when the watchdog barked, no one at the investment banks truly listened. Over the last several years, due diligence practices long followed in the industry seemed to have been relaxed, ignored, or treated as a largely optional formality. That was also the conclusion of the President's Working Group on Financial Markets, which in early 2008 identified "a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors."[106]

Still, in the case of the investments bank, this erosion in due diligence may seem surprising. At least over the long-term, it seems contrary to their own self-interest. Four factors may explain their indifference: (1) an industry-wide decline in due diligence as the result of deregulatory reforms that have induced many underwriters to treat legal liability as simply a cost of doing business; (2) heightened conflicts of interest attributable to the underwriters' position as more a principal than an agent in structured finance offerings; (3) executive compensation formulas that reward short-term performance (coupled with increased lateral mobility in investment banking so that actors have less reason to consider the long-term); and (4) competitive pressure. Each is briefly examined below, and then I suggest some proposed reforms to address these problems.

i. The Decline of Due Diligence: A Short History: The Securities Act of 1933 adopted a "gatekeeper" theory of protection, in the belief that by imposing high potential liability on underwriters (and others), this would activate them to search for fraud and thereby protect investors. As the SEC wrote in 1998:

> Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering. Congress believed that subjecting underwriters to the liability provisions would provide the necessary incentive to ensure their careful investigations of the offering."[107]

Specifically, Section 11 of the Securities Act of 1933 holds the underwriters (and certain other persons) liable for any material misrepresentation or omission in the registration statement, without requiring proof of scienter on the part of the underwriter or reliance by the plaintiff. This is a cause of action uniquely tilted in favor of the plaintiff, but then Section 11(b) creates a powerful incentive by establishing an affirmative defense under which any defendant (other than the issuer) will not be held liable if:

> he had, *after a reasonable investigation,* reasonable ground to believe and did believe, at the time such registration statement became effective, that the statements made therein were true and that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. 15 U.S.C. § 77k (b)(3)(A). (emphasis added)

Interpreting this provision, the case law has long held that an underwriter must "exercise a high degree of care in investigation and independent verification of the company's representations." *Feit v. Leasco Data Processing Equip. Corp.,* 332 F. Supp. 554, 582 (E.D.N.Y. 1971). Overall, the Second Circuit has observed that "no greater reliance in our self-regulatory system is placed on any single participant in

[104] *Id.*
[105] *Id.*
[106] See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments at 1 (March, 2008). (emphasis added). This report expressly notes that underwriters had the incentive to perform due diligence, but did not do so adequately.
[107] See SEC Release No. 7606A ("The Regulation of Securities Offerings"), 63 Fed. Reg. 67174, 67230 (Dec. 4 1998).

the issuance of securities than upon the underwriter." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.,* 480 F. 2d 341, 370 (2d Cir. 1973).

Each underwriter need not personally perform this investigation. It can be delegated to the managing underwriters and to counsel, and, more recently, the task has been outsourced to specialized experts, such as the "due diligence firms." The use of these firms was in fact strong evidence of the powerful economic incentive that Section 11(b) of the Securities Act created to exercise "due diligence."

But what then changed? Two different answers make sense and are complementary: First, many and probably most CDO debt offerings are sold pursuant to Rule 144A, and Section 11 does not apply to these exempt and unregistered offerings. Second, the SEC expedited the processing of registration statements to the point that due diligence has become infeasible. The latter development goes back nearly thirty years to the advent of "shelf registration" in the early 1980s. In order to expedite the ability of issuers to access the market and capitalize on advantageous market conditions, the SEC permitted issuers to register securities "for the shelf"—*i.e.,* to permit the securities to be sold from time to time in the future, originally over a two year period (but today extended to a three year period).[108] Under this system, "takedowns"—*i.e.*, actual sales under a shelf registration statement—can occur at any time without any need to return to the SEC for any further regulatory permission. Effectively, this telescoped a period that was often three or four months in the case of the traditional equity underwriting (*i.e.,* the period between the filing of the registration statement and its "effectiveness," while the SEC reviewed the registration statement) to a period that might be a day or two, but could be only a matter of hours.

Today, because there is no longer any delay for SEC review in the case of an issuer eligible for shelf registration, an eligible issuer could determine to make an offering of debt or equity securities and in fact do so within a day's time. The original premise of this new approach was that eligible issuers would be "reporting entities" that filed continuous periodic disclosures (known as Form 10-Ks and Form 10-Qs) under the Securities Exchange Act of 1934. Underwriters, the SEC hoped, could do "continuing due diligence" on these issuers at the time they filed their periodic quarterly reports in preparation for a later, eventual public offering. This hope was probably never fully realized, but, more importantly, this premise never truly applied to debt offerings by issuers of asset-backed securities.

For bankruptcy and related reasons, the issuers of asset-backed issuers (such as CDOs backed by a pool of residential mortgages) are almost always "special purpose vehicles" (SPVs), created for the single offering; they thus have no prior operating history and are not "reporting companies" under the Securities Exchange Act of 1934. To enable issuers of asset-backed securities to use shelf-registration and thus obtain immediate access to the capital markets, the SEC had to develop an alternative rationale. And it did! To use Form S-3 (which is a precondition for eligibility for shelf-regulation), an issuer of asset-backed securities must receive an "investment grade" rating from an "NRSRO" credit-rating agency.[109] Unfortunately, this requirement intensified the pressure that underwriters brought to bear on credit-ratings agencies, because unless the offering received an investment grade rating from at least one rating agency, the offering could not qualify for Form S-3 (and so might be delayed for an indefinite period of several months while its registration statement received full-scale SEC review). An obvious alternative to the use of an NRSRO investment grade rating as a condition for Form S-3 eligibility would be certification by "gatekeepers" to the SEC (*i.e.,* attorneys and due diligence firms) of the work they performed. Form S-3 could still require an "investment grade" rating, but that it come from an NRSRO rating agency should not be mandatory.

After 2000, developments in litigation largely convinced underwriters that it was infeasible to expect to establish their due diligence defense. The key event was the WorldCom decision in 2004.[110] In WorldCom, the court effectively required the same degree of investigation for shelf-registered offerings as for traditional offerings, despite the compressed time frame and lack of underwriter involvement in the drafting of the registration statement. The Court asserted that its reading of the rule should not be onerous for underwriters because they could still perform due diligence prior to the offering by means of "continuous due diligence" (*i.e.,* through

[108] See Rule 415 (17 C.F.R. § 230.415)(2007).

[109] See Form S-3, General Instructions, IB5 ("Transaction Requirements—Offerings of Investment Grade Asset-Backed Securities").

[110] In re WorldCom Inc. Securities Litigation, 346 F. Supp. 2d 628 (S.D.N.Y. 2004). The WorldCom decision denied the underwriters' motion for summary judgment based on their asserted due diligence defense, but never decided whether the defense could be successfully asserted at trial. The case settled before trial for approximately $6.2 billion.

participation by the underwriter in the drafting of the various Form 10-Ks and Form 10-Qs that are incorporated by reference into the shelf-registration).

For underwriters, the WorldCom decision was largely seen as a disaster. Their hopes—probably illusory in retrospect—were dashed that courts would soften Securities Act § 11's requirements in light of the near impossibility of complying with due diligence responsibilities during the shortened time frames imposed by shelf registration. Some commentators had long (and properly) observed that the industry had essentially played "ostrich," hoping unrealistically that Rule 176 would protect them.[111] In WorldCom's wake, the SEC did propose some amendments to strengthen Rule 176 that would make it something closer to a safe harbor. But the SEC ultimately withdrew and did not adopt this proposal.

As the industry now found (as of late 2004) that token or formalistic efforts to satisfy Section 11 would not work, it faced a bleak choice. It could accept the risk of liability on shelf offerings or it could seek to slow them down to engage in full scale due diligence. Of course, different law firms and different investment banks could respond differently, but I am aware of no firms attempting truly substantial due diligence on asset-backed securitizations. Particularly in the case of structured finance, the business risk of Section 11 liability seemed acceptable. After all, investment grade bonds did not typically default or result in class action litigation, and Section 11 has a short statute of limitations (one year from the date that the plaintiffs are placed on "inquiry notice"). Hence, investment banks could rationally decide to proceed with structured finance offerings knowing that they would be legally exposed if the debt defaulted, in part because the period of their exposure would be brief. In the wake of the WorldCom decision, the dichotomy widened between the still extensive due diligence conducted in IPOs, and the minimal due diligence in shelf offerings. As discussed below, important business risks may have also motivated investment banks to decide not to slow down structured finance offerings for extended due diligence.

The bottom line here then is that, at least in the case of asset-backed shelf offerings, investment banks ceased to perform the due diligence intended by Congress, but instead accepted the risk of liability as a cost of doing business in this context. But that is only the beginning of the story.

Conflicts of Interest: Traditionally, the investment bank in a public offering played a gatekeeping role, vetting the company and serving as an agent both for the prospective investors (who are also its clients) and the corporate issuer. Because it had clients on both sides of the offering, the underwriter's relationship with the issuer was somewhat adversarial, as its counsel scrutinized and tested the issuer's draft registration statement. But structured finance is different. In these offerings, there is no corporate issuer, but only a "special purpose vehicle" (SPV) typically established by the investment bank. The product—residential home mortgages—is purchased by the investment bank from loan originators and may be held in inventory by the investment bank for some period until the offering can be effected. In part for this reason, the investment bank will logically want to expedite the offering in order to minimize the period that it must hold the purchased mortgages in its own inventory and at its own risk.

Whereas in an IPO the underwriter (at least in theory) is acting as a watchdog testing the quality of the issuer's disclosures, the situation is obviously different in an assets-backed securities offering that the underwriter is structuring itself. It can hardly be its own watchdog. Thus, the quality of disclosure may suffer. Reports have circulated that some due diligence firms advised their underwriters that the majority of mortgages loans in some securitized portfolio were "exception" loans—*i.e.,* loans outside the bank's normal guidelines.[112] But the registration statement disclosed only that the portfolio included a "significant" or "substantial" number of such loans, not that it was predominantly composed of such loans. This is inferior and materially deficient disclosure, and it seems attributable to the built-in conflicts in this process.

Executive Compensation: Investment bankers are typically paid year-end bonuses that are a multiple of their salaries. These bonuses are based on successful completion of fee-generating deals during the year. But a deal that generates significant income in Year One could eventually generate significant liability in Year Two or Three. In this light, the year-end bonus system may result in a short-term focus that ignores or overly discounts longer-term risks.

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[111] See Donald Langevoort, Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment, 63 Law and Contemporary Problems, U.S. 62-63 (2000).

[112] See, *e.g.,* Vikas Bajaj and Jenny Anderson, "Inquiry Focuses on Withholding of Data on Loans," *New York Times,* January 12, 2008, at A-1.

Moreover, high lateral mobility characterizes investment banking firms, meaning that the individual investment banker may not identify with the firm's longer-term interests. In short, investment banks may face serious agency costs problems, which may partly explain their willingness to acquire risky mortgage portfolios without adequate investigation of the collateral.

Competitive Pressure: Citigroup CEO Charles Prince's now famous observation that "when the music is playing, you've got to get up and dance" is principally a recognition of the impact of competitive pressure. If investors are clamoring for "investment grade" CDOs (as they were in 2004–2006), an investment bank understands that if it does not offer a steady supply of transactions, its investors will go elsewhere—and possibly not return. Thus, to hold onto a profitable franchise, investment banks sought to maintain a steady pipeline of transactions; this in turn lead them to seek to lock in sources of supply. Accordingly, they made clear to loan originators their willingness to buy all the "product" that the latter could supply. Some investment banks even sought billion dollar promises from loan originators of a minimum amount of product. Loan originators quickly realized that due diligence was now a charade (even if it had not been in the past) because the "securitizing" investment banks were competing fiercely for supply. In a market where the demand seemed inexhaustible, the real issue was obtaining supply, and investment banks spent little time worrying about due diligence or rejecting a supply that was already too scarce for their anticipated needs.

Providing Time for Due Diligence: The business model for structured finance is today broken. Underwriters and credit rating agencies have lost much of their credibility. Until structured finance can regain credibility, housing finance in the United States will remain in scarce supply.

The first lesson to be learned is that underwriters cannot be trusted to perform serious due diligence when they are in effect selling their own inventory and are under severe time pressure. The second lesson is that because expedited shelf registration is inconsistent with meaningful due diligence, the process of underwriting structured finance offerings needs to be slowed down to permit more serious due diligence. Shelf registration and abbreviated time schedules may be appropriate for seasoned corporate issuers whose periodic filings are incorporated by reference into the registration statement, but it makes less sense in the case of a "special purpose vehicle" that has been created by the underwriter solely as a vehicle by which to sell asset-backed securities. Offerings by seasoned issuers and by special purpose entities are very different and need not march to the same drummer (or the same timetable).

An offering process for structured finance that was credible would look very different than the process we have recently observed. First, a key role would be played by the due diligence firms, but their reports would not go only to the underwriter (who appears to have at time ignored them). Instead, without editing or filtering, their reports would also go directly to the credit-rating agency. Indeed, the rating agency would specify what it would want to see covered by the due diligence firm's report. Some dialogue between the rating agency and the due diligence firm would be built into the process, and ideally their exchange would be outside the presence of the underwriter (who would still pay for the due diligence firm's services). At a minimum, the NRSRO rating agencies should require full access to such due diligence reports as a condition of providing a rating (this is a principle with which these firms agree, but may find it difficult to enforce in the absence of a binding rule).

To enable serious due diligence to take place, one approach would be to provide that structured finance offerings should not qualify for Form S-3 (or for any similar form of expedited SEC review). If the process can occur in a day, the pressures on all the participants to meet an impossible schedule will ensure that little serious investigation of the collateral's quality will occur. An alternative (or complementary approach) would be to direct the SEC to revise Regulation AB to incorporate greater verification by the underwriter (and thus its agents) of the quality of the underlying financial assets.

Does this sound unrealistic? Interestingly, the key element in this proposal—that that due diligence firm's report go to the credit rating agency—is an important element in the settlement negotiated in 2008 by New York State Attorney General Cuomo and the credit rating agencies. [113]

The second element of this proposal—*i.e.,* that the process be slowed to permit some dialogue and questioning of the due diligence firm's findings—will be more controversial. It will be argued that delay will place American underwriters at a

[113] See Aaron Lucchetti, "Big Credit-Rating Firms Agree to Reforms," *The Wall Street Journal,* June 6, 2008 at p. C-3.

competitive disadvantage to European rivals and that offerings will migrate to Europe. But today, structured finance is moribund on both sides of the Atlantic. To revive it, credibility must be restored to the due diligence process. Instantaneous due diligence is in the last analysis simply a contradiction in terms. Time and effort are necessary if the quality of the collateral is to be verified—and if investors are to perceive that a serious effort to protect their interests is occurring.

Rehabilitating the Gatekeepers

Credit rating agencies remain the critical gatekeeper whose performance must be improved if structured finance through private offerings (*i.e.,* without government guarantees) is to become viable again. As already noted, credit rating agencies face a concentrated market in which they are vulnerable to pressure from underwriters and active competition for the rating business.

At present, credit rating agencies face little liability and perform little verification. Rather, they state explicitly that they are assuming the accuracy of the issuer's representations. The only force that can feasibly induce them to conduct or obtain verification is the threat of securities law liability. Although that threat has been historically non-existent, it can be legislatively augmented. The credit rating agency does make a statement (*i.e.,* its rating) on which the purchasers of debt securities do typically rely. Thus, potential liability does exist under Rule 10b-5 to the extent that it makes a statement in connection with a purchase or sale of a security. The difficult problem is that a defendant is only liable under Rule 10b-5 if it makes a material misrepresentation or omission with scienter. In my judgment, there are few cases, if any, in which the rating agencies actually know of the fraud. But, under Rule 10b-5, a rating agency can be held liable if it acted "recklessly."

Accordingly, I would proposed that Congress expressly define the standard of "recklessness" that creates liability under Rule 10b-5 for a credit rating agency to be the issuance of a rating when the rating agency knowingly or recklessly is aware of facts indicating that reasonable efforts have not been conducted to verify the essential facts relied upon by its ratings methodology. A safe harbor could be created for circumstances in which the ratings agency receives written certification from a "due diligence" firm, independent of the promoter, indicating that it has conducted sampling procedures that lead it to believe in the accuracy of the facts or estimates asserted by the promoter. The goal of this strategy is not to impose massive liabilities on rating agencies, but to make it unavoidable that someone (either the rating agency or the due diligence firm) conduct reasonable verification. To be sure, this proposal would involve increased costs to conduct such due diligence (which either the issuer or the underwriter would be compelled to assume). But these costs are several orders of magnitude below the costs that the collapse of the structured finance market has imposed on the American taxpayer.

Conclusions

1. The current financial crisis—including the collapse of the U.S. real estate market, the insolvency of the major U.S. investment banks, and the record decline in the stock market—was not the product of investor mania or the classic demand-driven bubble, but rather was the product of the excesses of an "originate-and-distribute" business model that both loan originators and investment banks followed to the brink of disaster—and beyond. Under this business model, financial institutions abandoned discipline and knowingly made non-creditworthy loans because they did not expect to hold the resulting financial assets for long enough to matter.

2. The "moral hazard" problem that resulted was compounded by deregulatory policies at the SEC (and elsewhere) that permitted investment banks to increase their leverage rapidly between 2004 and 2006, while also reducing their level of diversification. Under the Consolidated Supervised Entity (CSE) Program, the SEC essentially deferred to self-regulation by the five largest investment banks, who woefully underestimated their exposure to risk.

3. This episode shows (if there ever was doubt) that in an environment of intense competition and under the pressure of equity-based executive compensation systems that are extraordinarily short-term oriented, self-regulation does not work.

4. As a result, all financial institutions that are "too big to fail" need to be subjected to prudential financial supervision and a common (although risk-adjusted) standard. This can only be done by the Federal Reserve Board, which should be given authority to regulate the capital adequacy, safety and soundness, and risk management practices of all large financial institutions.

5. Incident to making the Federal Reserve the systemic risk regulator for the U.S. economy, it should receive legislative authority to: (1) establish ceilings on debt/equity ratios and otherwise restrict leverage at all major financial institutions (including banks, hedge funds, money market funds, insurance companies, and pension

plans, as well as financial subsidiaries of industrial corporations); (2) supervise and restrict the design, and trading of new financial products (particularly including over-the-counter derivatives); (3) mandate the use of clearinghouses, to supervise them, and in its discretion to require their consolidation; (4) require the writedown of risky assets by financial institutions, regardless of whether required by accounting rule; and (5) to prevent liquidate crises by restricting the issuance of short-term debt.

6. Under the "twin peaks" model, the systemic risk regulatory agency would have broad powers, but not the power to override the consumer protection and transparency policies of the SEC. Too often bank regulators and banks have engaged in a conspiracy of silence to hide problems, lest they alarm investors. For that reason, some SEC responsibilities should not be subordinated to the authority of the Federal Reserve.

7. As a financial technology, asset-backed securitizations have decisively failed. To restore credibility to this marketplace, sponsors must abandon their "originate-and-distribute" business model and instead commit to retain a significant portion of the most subordinated tranche. Only if the promoter, itself, holds a share of the weakest class of debt that it is issuing (and on an unhedged basis) will there be a sufficient signal of commitment to restore credibility.

8. Credit rating agencies must be compelled either to conduct reasonable verification of the key facts that they are assuming in their ratings methodology or to obtain such verification from professionals independent of the issuer. For this obligation to be meaningful, it must be backstopped by a standard of liability specifically designed to apply to credit-rating agencies.

PREPARED STATEMENT OF T. TIMOTHY RYAN, JR.

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

MARCH 10, 2009

Chairman Dodd, Ranking Member Shelby, Members of the Committee; My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association (SIFMA).[1] Thank you for your invitation to testify at this important hearing. The purpose of my testimony is to share SIFMA's views on how we might improve investor protection as well as the regulation of our financial markets.

Overview

Our current financial crisis, which has affected nearly every American family, underscores the imperative to modernize our financial regulatory system. Our regulatory structure and the plethora of regulations applicable to financial institutions are based on historical distinctions among banks, securities firms, insurance companies, and other financial institutions—distinctions that no longer conform to the way business is conducted. Today, financial services institutions perform many similar activities without regard to their legacy charters, and often provide investors with similar products and services, yet may be subject to different rules and to the authority of different regulatory agencies because of the functions performed in a bygone era.

Regulators continue to operate under authorities largely established many decades ago. They also often operate without sufficient coordination and cooperation and without a complete picture of the market as a whole. For example, the Securities and Exchange Commission (SEC) oversees brokerdealer activity. Futures firms are regulated by the Commodity Futures Trading Commission (CFTC), while the insurance industry is regulated by 50 State insurance regulators. Thrifts are regulated by the Office of Thrift Supervision, and banks may be overseen at the Federal level by the Office of the Comptroller of the Currency, the Federal Reserve Board, or the Federal Deposit Insurance Corporation. At the same time, some financial institutions, such as hedge funds, largely escape regulation altogether.

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

As a result, our current regulatory framework is characterized by duplicative or inconsistent regulation, and in some instances insufficient or insufficiently coordinated oversight. The negative consequences to the investing public of this patchwork of regulatory oversight are real and pervasive. Investors do not have comparable protections across the same or similar financial products. Rather, the disclosures, standards of care and other key investor protections vary based on the legal status of the intermediary or the product or service being offered. For example, similar financial advisory services may be delivered to retail clients via a broker-dealer, an investment adviser, an insurance agent, or a trustee, thereby subjecting similar advisory activities to widely disparate regulatory requirements. From the perspective of financial institutions, many are subject to duplicative, costly, and unnecessary regulatory burdens, including multiple rulebooks, and multiple examinations and enforcement actions for the same activity, that provide questionable benefits to investors and the markets as a whole.

This regulatory hodgepodge unnecessarily exposes investors, market participants, and regulators alike to the potential risk of under-regulation, overregulation, or inconsistent regulation, both within the U.S. and globally. A complex and overlapping regulatory structure results in higher costs on all investors, depriving them of investment opportunities. Simply enhancing regulatory cooperation among the many different regulators will not be sufficient to address these issues.

In light of these concerns, SIFMA advocates simplifying and reforming the financial regulatory structure to maximize and enhance investor protection and market integrity and efficiency. More specifically, we believe that a reformed—and sound—regulatory structure should accomplish the following goals: First, it must minimize systemic risk. Second, through a combination of structural and substantive reforms, it must be as effective and efficient as possible, while at the same time promoting and enhancing fair dealing and investor protection. Finally, it should encourage consistent regulation across the same or similar businesses and products, from country to country, to minimize regulatory arbitrage.

Creation of a Financial Markets Stability Regulator

Systemic risk has been at the heart of the current financial crisis. While there is no single, commonly accepted definition of systemic risk, we think of "systemic risk" as the risk of a system wide financial crisis characterized by a significant risk of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the U.S. or have other serious adverse effects on economic conditions or financial stability. SIFMA has devoted considerable time and resources to thinking about systemic risk, and what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future. A regulatory reform committee of our members has met regularly in recent months to consider these issues and to develop a workable proposal to address them. We have sponsored roundtable discussions with former regulators, financial services regulatory lawyers and our members, as well as other experts, policymakers, and stakeholders to develop solutions to the issues that have been exposed by the financial crisis and the challenges facing our financial markets and, ultimately and most importantly, America's investors.

Through this process, we have identified a number of questions and tradeoffs that will confront policymakers in trying to mitigate systemic risk. Although our members continue to consider this issue, there seems to be consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. The G30, in its report on financial reform, supports a central body with the task of promoting and maintaining financial stability, and the Treasury, in its blueprint, also has supported a market stability regulator.

We are realistic in what we believe a financial markets stability regulator can accomplish. It will not be able to identify the causes or prevent the occurrence of all financial crises in the future. But at present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. We believe that a single, accountable financial markets stability regulator will improve upon the current system.

While our position on the mission of the financial markets stability regulator is still evolving, we currently believe that its mission should consist of mitigating systemic risk, maintaining financial stability and addressing any financial crisis, all of which will benefit the investing public. It should have authority over all markets and market participants, regardless of charter, functional regulator or unregulated status. In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, as applicable, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries. It should have the authority to gather information from all financial institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort. It should probably have a more direct role in supervising systemically important financial organizations, including the power to conduct examinations, take prompt corrective action and appoint or act as the receiver or conservator of all or part of a systemically important organization. These more direct powers would end if a financial group were no longer systemically important.

Other Reforms That Would Enhance Investor Protection and Improve Market Efficiency

While we believe that a financial markets stability regulator will contribute to enhancing investor protection and improving market efficiency, we also believe, as a second step, that we must work to rationalize the broader financial regulatory framework to eliminate regulatory gaps and imbalances that contribute to systemic risk. Specifically, SIFMA believes that more effective and efficient regulation of financial institutions—resulting in greater investor Protection—is likely to be achieved by regulating similar activities and firms in a similar manner and by consolidating certain financial regulators.

Core Standards Governing Business Conduct

Currently, the regulation of the financial industry is based predominantly on rules that were first established during the 1930s and 1940s, when the products and services offered by banks, broker-dealers, investment advisors and insurance companies were distinctly different. Today, however, the lines and distinctions among these companies and the products and services they offer have become largely blurred. Development of a single set of standards governing business conduct of financial institutions towards individual and institutional investors, regardless of the type of industry participant or the particular products or services being offered, would promote and enhance investor protection, and reduce potential regulatory arbitrage and inefficiencies that are inherent in the existing system of multiple regulators and multiple, overlapping rulebooks.

The core standards should be crafted so as to be flexible enough to adapt to new products and services as well as evolving market conditions, while providing sufficient direction for firms to establish enhanced compliance systems. As Federal Reserve Board Chairman Ben Bernanke once suggested, "a consistent, principles-based, and risk-focused approach that takes account of the benefits as well as the risks that accompany financial innovation" is an effective way toprotect investors while maintaining the integrity of the marketplace. [2]

This core standards approach, however, must be accompanied by outcome-oriented rules (where rules are necessary), an open dialogue between the regulator and regulated, and enforcement efforts focused on addressing misconduct and fraud and protecting the investing public.

Harmonize Investment Advisor and Broker-Dealer Regulation

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for investment advisory, brokerage and other financial services in order to promote investor protection. A 2007 RAND Corporation report commissioned by the SEC found that efforts to describe a financial service provider's duties or standard of care in legalistic terms, such as "fiduciary duty" or "suitability," contributes to—rather than resolves—investor confusion. [3] Further complicating matters, the laws that apply to many customer accounts, such as ERISA (for employer-sponsored retirement plans) or the Internal Revenue Code (for IRAs), have different definitions of fiduciaries, and prohibitions on conduct and the sale of products that differ from those under the Investment Advisers Act and state law fiduciary concepts. The RAND report makes clear that individual investors generally do not understand, appreciate, or care about such legal distinctions.

Rather than perpetuating an obsolete regulatory regime, SIFMA recommends the adoption of a "universal standard of care" that avoids the use of labels that tend

[2] See Ben S. Bernanke, Federal Reserve Board Chairman, Remarks at the Federal Reserve Bankof Atlanta's 2007 Financial Markets Conference, Sea Island, Georgia (May 15, 2007), at *http://www.federalreserve.gov/boarddocs/Speeches/2007/20070515/default.htm*

[3] Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institutefor Civil Justice, December 31, 2007, available at *http://www.sec.gov/news/press/2008/2008-1__randiabdreport.pdf*

to confuse the investing public, and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers. Such a standard could provide a uniform code of conduct applicable to all financial professionals. It would make clear to individual investors that their financial professionals are obligated to treat them fairly by employing the same core standards whether the firm is a financial planner, an investment adviser, a securities broker-dealer, a bank, an insurance agency or another type of financial services provider. A universal standard would not limit the ability of individual investors to contract for and receive a broad range of services from their financial services providers, from pure execution of customer orders to discretionary investment advice, nor would it limit the ability of clients to define or modify relationships with their financial services providers in ways they so choose.

As Congress contemplates regulatory reform, particularly in the wake of the Madoff and Stanford scandals and the recent turbulence in our financial markets, we believe that the time has come to focus on the adoption of a universal investor standard of care.

In addition, we urge Congress to pursue a regulatory framework for financial services providers that is understandable, practical and provides flexibility sufficient for these intermediaries to provide investors with both existing and future products and services. Such a framework must also avoid artificial or vague distinctions (such as those based on whether any investment advice is "solely incidental" to brokerage or whether any compensation to the financial services provider is "special"). Finally, the framework should support investor choice through appropriate relief from the SEC's rigid prohibitions against principal trading, particularly with respect to products traded in liquid and transparent markets, which has had the effect of foreclosing investors from obtaining more favorable pricing on transactions based on the requirement for transaction-by-transaction consent.

Broaden the Authority of the MSRB

The Municipal Securities Rulemaking Board (MSRB) regulates the conduct of only broker-dealers in the municipal securities market. We feel it is important to level the regulatory playing field by increasing the MSRB's authority to encompass the regulation of financial advisors, investment brokers and other intermediaries in the municipal market to create a comprehensive regulatory framework that prohibits fraudulent and manipulative practices; requires fair treatment of investors, state and local government issuers of municipal bonds and other market participants; ensures rigorous standards of professional qualifications; and promotes market efficiencies.

Merge the SEC and CFTC

The United States is the only jurisdiction that splits the oversight of securities and futures activities between two separate regulatory bodies. When the CFTC was formed, financial futures represented a very small percentage of futures activity. Now, an overwhelming majority of futures that trade today are financial futures. These products are nearly identical to SEC regulated securities options from an economic standpoint, yet they are regulated by the CFTC under a very different regulatory regime. This disparate regulatory treatment detracts from the goal of investor protection. An entity that combines the functions of both agencies could be better positioned to apply consistent rules to securities and futures.

OTC Derivatives

Although OTC derivatives transactions generally are limited to institutional participants, the use of OTC derivatives by American businesses to manage risks and reduce funding costs provides important benefits for our economy and, consequently, for individual investors as well. At the same time, problems with OTC derivatives can adversely affect the financial system and individual investors. Accordingly, we believe that steps should be taken to further develop the infrastructure that supports the OTC derivatives business and to improve the regulatory oversight of that activity.

In particular, we strongly support our members' initiative to establish a clearinghouse for credit default swaps (CDS) and we are pleased to note that ICE US Trust LLC opened its doors for clearing CDS transactions yesterday. We believe that development of a clearinghouse for credit derivatives is an effective way to reduce counterparty credit risk and, thus, promote market stability. In addition to reducing risk, the clearinghouse will facilitate regulatory oversight by providing a single access point for information about the CDS transactions it processes.

We also believe that all systemically significant participants in OTC derivatives markets should be subject to oversight by a single systemic regulator. (It is noteworthy that the AIG affiliate that was an active participant in the CDS market was not subject to meaningful regulatory supervision.) The systemic regulator should be given broad authority to promulgate rules and regulations to promote sound practices and reduce systemic risk. We recognize that effective regulation requires timely access to relevant information and we believe the systemic regulator should have the necessary authority to assure there is appropriate regulatory transparency.

Investor Protection Through International Cooperation and Coordination

Finally, the current financial crisis reminds us that markets are global in nature and so are the risks of contagion. To promote investor protection through effective regulation and the elimination of disparate regulatory treatment, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in major markets in the U.S., Europe, Asia, and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including IOSCO, the Joint Forum, the Basel Committee on Banking Supervision, and the Financial Stability Forum. Congress should support and encourage the efforts of these groups.

Conclusion

Recent challenges have highlighted the necessity of reforms to enhance investor protection. SIFMA strongly supports these efforts and commits to be a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers regulatory reform to minimize systemic risk, promote consistent and efficient regulation, eliminate regulatory arbitrage, and promote capital formation—all of which serve, directly or indirectly, the interest of investor protection. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
INVESTMENT COMPANY INSTITUTE

MARCH 10, 2009

Executive Summary

Overview: Recommendations for Financial Services Regulatory Reform

- The current financial crisis provides policymakers with the public mandate needed to take bold steps to strengthen and modernize our financial regulatory system. It is imperative to registered investment companies (also referred to as "funds"), as both issuers of securities to investors and purchasers of securities in the market, that the regulatory system ensure strong investor protection and foster competition and efficiency in the capital markets. The ultimate outcome of reform efforts will have a direct and lasting effect on the fund industry and the millions of investors who choose funds to help them save for the future.
- As detailed in a recently released white paper (attached as Appendix A), ICI recommends: (1) establishing a Systemic Risk Regulator; (2) creating a Capital Markets Regulator representing the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission; (3) considering consolidation of the bank regulatory structure and authorization of an optional federal charter for insurance companies; and (4) enhancing coordination and information sharing among federal financial regulators.
- If enacted, these reforms would improve regulators' capability to monitor and mitigate risks across the financial system, enhance regulatory efficiency, limit duplication, close regulatory gaps, and emphasize the national character of the financial services industry.

Systemic Risk Regulator

- The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting in coordination with other responsible regulators to mitigate such risks.

- Careful consideration should be given to how the Systemic Risk Regulator will be authorized to perform its functions and its relationship with other, specialized regulators.

Capital Markets Regulator

- The Capital Markets Regulator should have oversight responsibility for the capital markets, market participants, and all financial investment products. It should be the regulatory standard setter for funds, including money market funds.
- The agency's mission should focus on investor protection and law enforcement, as well as maintaining the integrity of the capital markets. Like the SEC, it should be required to consider whether proposed regulations protect investors and promote efficiency, competition, and capital formation.
- The Capital Markets Regulator should be an independent agency, with the resources to fulfill its mission and the ability to attract experienced personnel who can fully grasp the complexities of today's markets. ICI's white paper offers recommendations for organizing and managing the new agency and for how the agency can maximize its effectiveness.

Selected Other Areas for Reform

- The Capital Markets Regulator should have express authority to regulate in areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace. These areas include: (1) hedge funds; (2) derivatives; (3) municipal securities; and (4) the regulation of investment advisers and broker-dealers.

Recent Market Events and Money Market Funds

- Money market funds, stringently regulated by the SEC, are one of the most notable product innovations in American history. These funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for retail and institutional investors, and are an exceptionally important source of short-term financing in the U.S. economy.
- Until September 2008, money market funds, in some cases with support from their sponsors, largely weathered severe pressures in the fixed income markets that had been striking banks and other financial services firms since 2007. In mid-September, a series of extraordinary developments, including the failure of Lehman Brothers, roiled financial markets around the globe, affecting all market participants. In the midst of this market storm, one money market fund holding a substantial amount of Lehman commercial paper was unable to sustain its $1.00 price per share. The news of this fund "breaking the buck," combined with broader concerns about the building stresses in the money market and possible failures of other financial institutions, led to heavy redemptions in prime money market funds as investors sought safety and liquidity in Treasury securities.
- Unprecedented government initiatives—designed to provide stability and liquidity to the markets and to support money market funds—successfully bolstered investor confidence. To date, the Treasury Temporary Guarantee Program for Money Market Funds has received no claims for its guarantee, and none are anticipated. Assuming continued progress in restoring the health of the money market, there will be no need to extend the Temporary Guarantee Program beyond its current one-year maximum period.
- To capture the lessons learned from recent experience, ICI formed a Money Market Working Group of senior fund industry leaders, led by John J. Brennan of The Vanguard Group. The Working Group has conducted a thorough examination of how the money market can function better, and how all funds operating in that market, including registered money market funds, should be regulated. The Working Group intends to report its findings, conclusions, and recommendations later this month. We believe that prompt implementation of its recommendations will help assure a smooth transition away from the Temporary Guarantee Program.

Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment CompanyInstitute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $9.88 trillion and serve over

93 million shareholders. ICI is pleased to testify today about investor protection and the regulation of securities markets.

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

It is no exaggeration that the ultimate outcome of these reform efforts will have a direct and lasting impact on the future of our industry. By extension, the decisions you make will affect the millions of American investors who choose registered investment companies (also referred to as "funds") as investment vehicles to help them meet the costs of college, their retirement needs, or other financial goals. Funds themselves are among the largest investors in U.S. companies, holding about one quarter of those companies' outstanding stock. Funds also hold approximately 40 percent of U.S. commercial paper, an important source of short-term funding for corporate America, and more than one third of tax-exempt debt issued by U.S. municipalities. It is thus imperative to funds, as both issuers of securities to investors and purchasers of securities in the market, that our financial regulatory system ensure strong protections for investors and foster competition and efficiency within the capital markets.

Like other stakeholders, we have been thinking very hard about how to revamp our current system so that our nation emerges from this crisis with stronger, well-regulated institutions operating within a fair, efficient, and transparent marketplace. Last week, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of investment companies. [1] Section II of my testimony provides a summary of these recommendations.

In addition to demonstrating the need to reform our financial regulatory system, events of the past year have highlighted the need for greater protections for both investors and the marketplace in several specific areas. Section III of my testimony outlines ICI's recommendations for legislative authority to address certain regulatory gaps that have the potential to affect the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace.

Finally, as discussed in Section IV of my testimony, events of the past year have brought into sharp focus the significance of money market funds and the critical role they play as a low-cost funding vehicle for the American economy. While the regulatory regime for money market funds has proven to be flexible and resilient, lessons learned from recent events suggested the need for a thorough examination of how the money market can function better and how all funds operating in that market should be regulated. To that end, ICI last November formed a working group of senior fund industry leaders with a broad mandate to develop recommendations in these areas. The Money Market Working Group is chaired by John J. Brennan, Chairman of The Vanguard Group, and expects to issue a detailed report by the end of March. We would welcome the opportunity to discuss with this Committee the recommendations of the Money Market Working Group following the release of its report.

Financial Services Regulatory Reform

Overview of ICI Recommendations

Broadly speaking, ICI recommends changes to our regulatory structure that would create a framework to enhance regulatory efficiency, limit duplication, close regulatory gaps, and emphasize the national character of the financial services industry. To improve the government's capability to monitor and mitigate risks across the financial system, ICI supports the designation of a new or existing agency or interagency body as a "Systemic Risk Regulator." A new "Capital Markets Regulator" should encompass the combined functions of the Securities and Exchange Commis-

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

sion and the Commodity Futures Trading Commission, thus creating a single independent federal regulator responsible for oversight of U.S. capital markets, market participants, and all financial investment products. ICI further recommends that Congress consider consolidating the regulatory structure for the banking sector and authorizing an optional federal charter for insurance companies. Such a regulatory framework—with one or more dedicated regulators to oversee each major financial services sector—would maintain specialized regulatory focus and expertise, as well as avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or the allocation of resources.

To ensure the success of this new financial regulatory structure, there must be effectivecoordination and information sharing among the financial regulators, including in particular the Systemic Risk Regulator. Stronger links among these regulators should greatly assist in developing sound policies and should facilitate U.S. cooperation with the international regulatory community. In our white paper, we discuss why the President's Working Group on Financial Markets, with certain modifications, may be the most logical mechanism through which to accomplish these purposes.

Systemic Risk Regulator

The current financial crisis has exposed the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. Analyses of the causes of the current crisis suggest that systemic risks may be occasioned by, for example, excessive leveraging, lack of transparency regarding risky practices, and gaps in the regulatory framework.

ICI agrees with the growing consensus that our regulatory system needs to be better equipped to anticipate and address systemic risks affecting the financial markets. Some have called for the establishment of a "Systemic Risk Regulator." Subject to important cautions, ICI supports designating a new or existing agency or interagency body to serve in this role. We recommend that the Systemic Risk Regulator have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting in coordination with other responsible regulators to mitigate such risks.

The specifics of creating and empowering the Systemic Risk Regulator will require careful attention. By way of example, to perform its monitoring functions, this regulator likely will need information about a range of financial institutions and market sectors. The types of information that the regulator may require, and how the regulator will obtain that information, are just two of the discrete issues that will need to be fully considered.

In ICI's view, legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition, or efficiencies. For example, it has been suggested that a Systemic Risk Regulator could be given the authority to identify financial institutions that are "systemically significant" and to oversee those institutions directly. Despite its seeming appeal, such an approach could have very serious anticompetitive effects if the identified institutions were viewed as "too big to fail" and thus judged by the marketplace as safer bets than their smaller, "less significant" competitors.

Additionally, the Systemic Risk Regulator should be carefully structured so as not to simply add another layer of bureaucracy or to displace the primary regulators responsible for capital markets, banking, or insurance. Legislation establishing the Systemic Risk Regulator thus should define the nature of the relationship between this new regulator and the primary regulators for these industry sectors. The authority granted to the Systemic Risk Regulator should be subject to explicit limitations, and the specific areas in which the Systemic Risk Regulator and the primary regulators should work together will need to be identified. We believe, for example, that the primary regulators have a critical role to play as the first line of defense for detecting potential risks within their spheres of expertise.

Capital Markets Regulator

Currently, securities and futures—and their respective markets and market participants—are subject to separate regulatory regimes under different federal regulators. This system reflects historical circumstances and is out of step with the increasing convergence of these two industries. It has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. To bring a consistent policy focus to U.S. capital markets, ICI recommends the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and the CFTC. As the federal regulator responsible for overseeing the capital markets and all financial investment products, the Capital Markets Regulator—like the SEC and the CFTC—should be established as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission.

It is critically important that the Capital Markets Regulator's statutory mission focus theagency sharply on investor protection and law enforcement, as distinct from the safety and soundness of regulated entities. At the same time, the Capital Markets Regulator (like the SEC today) should be required to consider, in determining whether a proposed regulation is consistent with the public interest, both the protection of investors and whether the regulation would promote efficiency, competition, and capital formation. The Capital Markets Regulator's mission also should include maintaining the integrity of the capital markets, which will benefit both market participants and consumers. Congress should ensure that the agency is given the resources it needs to fulfill its mission. Most notably, the Capital Markets Regulator must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

ICI envisions the Capital Markets Regulator as the regulatory standard setter for registered investment companies, including money market funds (as is the case now with the SEC). In so authorizing this new agency, Congress would be continuing the important benefits that have flowed from the shared system of federal and state oversight established by the National Securities Markets Improvement Act of 1996. Under this system, federal law governs all substantive regulation of investment companies, and states have concurrent authority to protect against fraud. We believe that this approach is consistent with the national character of the market in which investment companies operate and would continue to achieve the regulatory efficiencies Congress intended, without compromising investor protection in any way.

The Capital Markets Regulator should continue to regulate registered investment companies under the Investment Company Act of 1940. While funds are not immune to problems, the substantive protections embodied in the Investment Company Act and related rules have contributed significantly to the protection of investors and the continuing integrity of funds as an investment model. Among these protections are: (1) daily pricing and redeemability of the fund's shares, with a requirement to use mark-to-market valuation; (2) separate custody of fund assets (typically with a bank custodian); (3) restrictions on complex capital structures and leveraging; (4) prohibitions or restrictions on affiliated transactions and other forms of self-dealing; and (5) diversification requirements. In addition, funds are subject to more extensive disclosure and transparency requirements than any other financial product. This regulatory framework has proven resilient through difficult market conditions, and has shielded fund investors from some of the problems associated with other financial products and services. Indeed, recent experience suggests that consideration should be given to extending the greater discipline that has worked so well in core areas of fund regulation—such as valuation,[2] independent custody, affiliated transaction prohibitions, leveraging restrictions, diversification, and transparency—to other marketplace participants.

With the establishment of a new Capital Markets Regulator, Congress has a very valuable opportunity to "get it right" in terms of how the new agency is organized and managed. Our white paper outlines several recommendations in this regard, including the need for high-level focus on management of the agency. We stress the importance, for example, of the agency's having open and effective lines of internal communication, mechanisms to facilitate internal coordination and information sharing, and a comprehensive process for setting regulatory priorities and assessing progress.

ICI's white paper also suggests ways in which the Capital Markets Regulator would be able to maximize its effectiveness in performing its responsibilities. I would like to highlight two of the most significant suggestions for the Committee. First, the Capital Markets Regulator should seek to facilitate close, cooperative interaction with the entities it regulates as a means to identify and resolve prob-

[2] From the perspective of funds as investors in corporate and fixed income securities, ICI believes that financial reporting that requires the use of mark-to-market or fair value accounting to measure the value of financial instruments serves the interests of investors and the capital markets better than alternative cost-based measures. For a more detailed discussion of our views, see Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated November 14, 2008, available at *http://www.ici.org/statements/cmltr/08_sec_mark-to-market_com.html*

lems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions. Second, the Capital Markets Regulator should establish mechanisms to stay abreast of market and industry developments. Ways to achieve this end include hiring more agency staff with significant prior industry experience and establishing by statute a multidisciplinary "Capital Markets Advisory Committee" comprised of private-sector representatives from all major sectors of the capital markets.

Expected Benefits of These Reforms

If implemented, the recommended reforms outlined above and discussed in detail in our white paper would help to establish a more effective and efficient regulatory structure for the U.S. financial services industry. Most significantly, these reforms would:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system;
- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry;
- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products;
- Preserve specialized regulatory focus and expertise while avoiding the potential for uneven attention to different industries or products;
- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern; and
- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

We recognize that some have criticized sector-based regulation because it may not provide any one regulator with a full view of a financial institution's overall business, and does not give any single regulator authority to mandate actions designed to mitigate systemic risks across financial markets as a whole. Our proposed approach would address those concerns through the establishment of the Systemic Risk Regulator to undertake this market-wide monitoring of the financial system and through specific measures to strengthen inter-agency coordination and information sharing.

We further believe that retaining some elements of the current multi-agency structure would offer advantages over a single, integrated regulator approach. Even though a single regulator could be organized with separate units or departments focusing on different financial services sectors, it is our understanding that, in practice, there can be a tendency for agency leadership or staff to gravitate to certain areas and devote insufficient attention to financial sectors perceived to be less high profile or prone to fewer problems. Such a result has the potential to stifle innovation valuable to consumers and produce regulatory disparities.

Finally, we believe that a streamlining of the current regulatory structure may be more effective and workable than an approach that assigns regulatory responsibilities to separate agencies based on broad regulatory objectives, such as market stability, safety and soundness, and business conduct. These functions often are highly interrelated. Not only could separating them prove quite challenging, but it would force regulators to view institutions in a less integrated way and to operate with a narrower, less informed knowledge base. For example, a Capital Markets Regulator is likely to be more effective in protecting investors if its responsibilities require it to maintain a thorough understanding of capital market operations and market participants. And while an objective-based structure could be one way to promote consistent regulation of similar financial products and services, it is not the only way. Under our proposed approach, minimizing regulatory disparities for like products and services would be an express purpose of enhanced inter-agency coordination and information sharing efforts.

Selected Other Areas for Reform

Recent experiences in the markets have underscored the need for the Capital Markets Regulator (or, until Congress creates such a new agency, the SEC) to have express authority to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace.[3] ICI supports reforms for these purposes in the areas discussed below.

- Hedge funds and other unregulated private pools of capital. The Capital Markets Regulator should have the power to oversee hedge funds and other unregulated pooled products with respect to, at a minimum, their potential impact on the capital markets. For example, the Capital Markets Regulator should require nonpublic reporting of information, such as investment positions and strategies, that could bear on systemic risk and adversely impact other market participants.
- Derivatives. The Capital Markets Regulator should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, while not unduly stifling innovation.
- Municipal Securities. The Capital Markets Regulator should be granted expanded authority over the municipal securities market, and should use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized, and often stale, and there are numerous disparities from the corporate issuer disclosure regime.
- Investment Advisers and Broker-Dealers. The Capital Markets Regulator should have explicit authority to harmonize the regulatory regimes governing investment advisers and broker-dealers. What once were real distinctions in the businesses of advisers and brokerdealers are no longer so clear, to the point that retail investors are largely unable to distinguish the services of an adviser from those of a broker-dealer. These two types of financial intermediaries, and their customers and clients, deserve a coherent regulatory structure that provides adequate investor protections without overlapping or unnecessary regulation. Of particular importance is devising a consistent standard of care in which investor protection must be paramount. The standard thus should be a high one. We recommend that both types of intermediaries be held to a fiduciary duty to their clients.[4]

Recent Market Events and Money Market Funds

Evolution and Current Significance of Money Market Funds

Money market funds are registered investment companies that seek to maintain a stable net asset value (NAV), typically $1.00 per share. They are comprehensively regulated under the Investment Company Act and subject to the special requirements of Rule 2a-7 under that Act that limit the funds' exposure to credit risk and market risk.

These strong regulatory protections, administered by the SEC for nearly three decades, have made money market funds an effective cash management tool for retail and institutional investors. Indeed, money market funds represent one of the most notable product innovations in our nation's history, with assets that have grown more than 2,000 percent (from about $180 billion to $3.9 trillion) since Rule 2a-7 was adopted in 1983. Money market fund assets thus represent about one third of an estimated $12 trillion U.S. "money market," the term generally used to refer to the market for debt securities with a maturity of one year or less.[5]

Money market funds also are an exceptionally important source of short-term financing in the U.S. economy. They lower the cost of borrowing to the U.S. Treasury, businesses, and banks and finance companies by investing in a wide array of money market instruments. By way of example, money market funds hold roughly 40 per-

[3] Although not necessitating legislative action, another area for reform is regulation of credit rating agencies. ICI has long supported increased regulatory oversight, disclosure, and transparency requirements for credit rating agencies. We strongly support recent regulatory initiatives that will impose additional disclosure, reporting, and recordkeeping requirements on a nationally recognized statistical ratings organization (NRSRO) for products that it rates. These requirements, which are intended to increase disclosure and transparency surrounding NRSRO policies and procedures for issuing ratings and to increase an NRSRO's accountability for its ratings, are a welcome step forward that should help to restore investor confidence in the integrity of credit ratings and, ultimately, the market as a whole. We expect to file a comment letter on the SEC's latest proposal to enhance NRSRO regulation at the end of this month.

[4] See *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 84 S. Ct. 275 (1963) (holding that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers by operation of law).

[5] Other participants in the money market include corporations, state and local governments, unregistered cash pools, commercial banks, broker-dealers, and pension funds.

cent of the commercial paper issued by U.S. corporations. In addition, tax-exempt money market funds are a significant source of funding for state and local governments. As of December 2008, these funds had $491 billion under management. Tax-exempt money market funds held more than 20 percent of all state and local government debt outstanding.

Money market funds seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost. Although there is no guarantee that money market funds can always achieve these objectives (and investors are explicitly warned of this), they have been highly successful in doing so. Since Rule 2a-7 was adopted over 25 years ago, $325 trillion has flowed in and out of money market funds. Yet only twice has a money market fund failed to repay the full principal amount of its shareholders' investments. One of these instances is directly related to recent market events and is discussed below. The other occurred in 1994, when a small institutional money market fund "broke the buck" because it had a large percentage of its assets in adjustable-rate securities that did not return to par at the time of an interest rate readjustment. Shareholders in that fund ultimately received $0.96 per share (representing a 4 percent loss of principal). In contrast, during roughly the same time period, nearly 2,400 commercial banks and savings institutions have failed in the United States.

Impact of Recent Market Events

Until September 2008, money market funds largely had weathered severe pressures in the fixed income market that had been striking banks and other financial services firms since 2007.[6] That changed as a series of extraordinary events, in rapid succession, roiled financial markets both in the United States and around the globe:

- On September 7, the U.S. Government placed Fannie Mae and Freddie Mac intoreceivership, wiping out shareholder equity;
- Long-circulated rumors about the stability of Merrill Lynch, AIG, and Lehman Brothers gained traction;
- Over the weekend of September 13-14, Merrill Lynch hastily arranged to be sold to Bank of America;
- On September 15, the federal government declined to support Lehman Brothers, despite having arranged a buyout of Bear Stearns, a smaller investment bank, earlier in the year. Unable to find a buyer, Lehman declared bankruptcy; and
- On September 16, the Federal Reserve Board announced a bailout of AIG, in which the Federal Reserve Bank of New York agreed to lend AIG up to $85 billion and to take a nearly 80 percent stake in the company.

Beginning with news of the Lehman bankruptcy on Monday, September 15, money markets in the U.S. and elsewhere began to freeze, with a severity that was unexpected. Although Lehman's viability had been questioned for several months, its failure—and that of Bear Stearns several months earlier—led to mounting concerns about the health of other financial institutions such as Wachovia, Citigroup, and many foreign banks. There was also growing uncertainty about whether and how the U.S. and foreign governments would support these institutions and their creditors.

With investors running for cover, yields on Treasury securities fell, while those on commercial paper jumped. Inter-bank rates soared with the uncertainty about financial institutions' exposure to Lehman and other failing financial institutions. Governments around the globe, attempting to calm panicked markets, injected billions of dollars of liquidity into their markets. The U.S. stock market declined nearly 5 percent on September 15 alone, reflecting broad losses to financial companies.

Certainly the Federal Reserve seems to have been surprised by the market's reaction to this chain of events. Appearing before this Committee on September 23, 2008, Federal Reserve Chairman Ben Bernanke noted:

> The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to

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[6] During the period from September 2007 to September 2008, many money market fund advisers or related persons did purchase structured investment vehicles from, or enter into credit support arrangements with, their affiliated funds to avoid any fund shareholder losses.

take precautionary measures. While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets.

Intense pressure in the money market was brought to bear, affecting all market participants. In the midst of this market storm, a further pressure point occurred for money market funds. The Lehman bankruptcy meant that securities and other instruments issued by Lehman became ineligible holdings for money market funds, in accordance with the requirements of Rule 2a-7. One such fund that held a substantial amount of Lehman Brothers commercial paper, the $62 billion Reserve Primary Fund, received $25 billion in redemption requests on September 15; the following day, September 16, its NAV dropped below $1.00 per share. News of this development, combined with investors' broader concerns about the building stresses in the money market and possible failures of other financial institutions, led to heavy redemptions in prime money market funds as investors sought safety and liquidity in Treasury securities. To meet these unprecedented redemption requests, many money market funds were forced to sell commercial paper and other assets. It should be emphasized that other market participants, including unregistered cash pools seeking to maintain a stable NAV but not subject to Rule 2a-7, and money market funds in other jurisdictions, experienced difficulties as least as great as those experienced by U.S. registered money market funds.

Actions by Federal Regulators To "Unfreeze" the Credit Markets

The Federal Reserve and U.S. Treasury Department, seeking to cope with completely illiquid short-term fixed income markets, on September 19 announced a series of unprecedented initiatives designed to provide market stability and liquidity, including programs designed to support money market funds and the commercial paper market. The Federal Reserve established the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and the Commercial Paper Funding Facility (CPFF). [7] The Treasury Department announced its Temporary Guarantee Program for Money Market Funds, which guaranteed account balances as of September 19 in money market funds that signed up for, qualified for, and paid a premium to participate in the program. According to press reports, virtually all money market funds signed up for the initial term of the Treasury Temporary Guarantee Program.

The government's programs successfully bolstered investor confidence in the money market and in money market funds. Shortly after the programs were announced, prime money market funds stabilized and, by mid-October 2008, began to see inflows once again. By February 2009, owing to renewed confidence in money market funds at both the retail and institutional levels, assets of money market funds had achieved an all-time high of just less than $3.9 trillion.

The initial three-month term of the Treasury Temporary Guarantee Program expired on December 18, 2008, but the Treasury Department extended the program until April 30, 2009. If extended again, the program will expire by its own terms no later than September 18, 2009. At the time of this hearing, an estimated $813 million has been paid in premiums. [8] There has been—and we are hopeful that there will be—no occasion for the Treasury Guarantee Program to pay any claim. Assuming continued progress in restoring the health of the money market, we would not anticipate any need to extend the Treasury Guarantee Program beyond the one-year maximum period.

Industry-Led Reform Initiative

The market events described above have brought into sharp focus the significance of money market funds and the critical role they play as a low-cost funding vehicle for the American economy. To us, these events and their impact also signaled a need to devote serious effort to capturing the lessons learned—by conducting a thorough examination of how the money market can function better, and how all funds operating in that market, including registered money market funds, should be regulated.

[7] The AMLF provided non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance purchases of high-quality asset-backed commercial paper (ABCP) from money market funds. The CPFF provided a backstop to U.S. issuers of commercial paper through a special purpose vehicle that would purchase three-month unsecured commercial paper and ABCP directly from eligible issuers. On February 3, 2009, the Federal Reserve extended these and other programs for an additional six months, until October 30, 2009.

[8] See Shefali Anand, "Treasury Pads Coffers in Bailout," The *Wall Street Journal* (February 17, 2009), available at *http://online.wsj.com/article/SB123483112001495707.html*

To that end, in November 2008 ICI formed a Money Market Working Group, led by John J. Brennan, Chairman of The Vanguard Group. The Working Group was given a broad mandate to develop recommendations to improve the functioning of the money market as a whole, and the operation and regulation of funds investing in that market. The Working Group intends to report its findings, conclusions, and recommendations later this month, and we look forward to sharing that information with the Committee at that time. We believe that prompt implementation of the Working Group's recommendations will help assure a smooth transition away from the Treasury Guarantee Program.

Conclusion

ICI applauds the Committee for its diligent efforts on the very important issues discussed above, and we thank you for the opportunity to testify. We believe our recommendations for reforming financial services regulation would have significant benefits for investors and the capital markets. We look forward to continuing to work with the Committee and its staff on these matters.

APPENDIX A

Investment Company Institute Financial Services Regulatory Reform: Discussion and Recommendations—March 3, 2009

EXECUTIVE SUMMARY

Today's financial crisis has demonstrated that the current system for oversight of U.S. financial institutions is insufficient to address modern financial markets. Yet it also affords policymakers with the public mandate necessary to take bold steps to strengthen and modernize regulatory oversight of the financial services industry. In this paper, the Investment Company Institute (ICI), the national association of U.S. investment companies, offers its recommendations on how to achieve meaningful reforms, with particular emphasis on those reforms that most directly affect the functioning of the capital markets and the regulation of investment companies (also referred to as "funds").

To improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system, ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." As the financial crisis has shown, our system is vulnerable to risks that have the potential to spread rapidly throughout the system and cause significant damage. The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators. At the same time, very careful consideration should be given to the specifics of how the Systemic Risk Regulator will be authorized to perform its functions and how it will relate to other financial regulators.

More broadly, ICI recommends changes to create a regulatory framework that enhances regulatory efficiency, limits duplication, closes regulatory gaps, and emphasizes the national character of the financial services industry. A new "Capital Markets Regulator" should encompass the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission, thus creating a single independent federal regulator responsible for oversight of U.S. capital markets, market participants, and all financial investment products. Also to achieve these goals, ICI recommends that Congress consider consolidation of the regulatory structure for the banking sector and authorization of an optional federal charter for insurance companies. Such a regulatory framework—with one or more dedicated regulators to oversee each major financial services sector—would maintain specialized regulatory focus and expertise, as well as avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or the allocation of resources.

To preserve regulatory efficiencies achieved under the National Securities Markets Improvement Act of 1996, Congress should affirm the role of the Capital Markets Regulator as the regulatory standard setter for all registered investment companies. The Capital Markets Regulator's jurisdiction should include money market funds.[1] ICI further envisions the Capital Markets Regulator as the first line of de-

[1] ICI has formed a Money Market Working Group that is developing recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. The group will identify needed improvements in market and industry practices; regulatory reforms, including improvements to SEC rules governing money market funds; and

fense with respect to risks across the capital markets. The new agency should be granted explicit authority to regulate in certain areas where there are currently gaps in regulation—in particular, with regard to hedge funds, derivatives, and municipal securities—and explicit authority to harmonize the legal standards applicable to investment advisers and broker-dealers. In performing its mission, the Capital Markets Regulator should maintain a sharp focus on investor protection and law enforcement. It also should be required to carefully consider the impact of its rulemaking activity on efficiency, competition and capital formation.

Establishing the Capital Markets Regulator presents a very valuable opportunity to "get it right" in terms of how the agency is organized and managed. It is imperative, for example, that the Capital Markets Regulator be able to keep current with market and industry developments and understand their impact on regulatory policy. Ways to achieve this end include hiring more agency staff with significant prior industry experience and establishing a multidisciplinary "Capital Markets Advisory Committee" comprised of private sector representatives from all major sectors of the capital markets. There should be a high-level focus on agency management, perhaps through the designation of a Chief Operating Officer. To perform effectively, the agency must have open and effective lines of internal communication, and mechanisms to facilitate internal coordination and information sharing. We further suggest that the agency would benefit from a comprehensive process for setting regulatory priorities and assessing progress.

Finally, if a new U.S. financial regulatory structure is to be successful in protecting the interests of our nation's savers and investors, there is a critical need for effective coordination and information sharing among the financial regulators, including in particular the Systemic Risk Regulator. Stronger links between regulators and an overriding sense of shared purpose would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community. ICI observes that the President's Working Group on Financial Markets, with certain modifications, may be the most logical mechanism through which to accomplish this purpose.

We strongly believe that the future of the fund industry depends upon the existence of strong, wellregulated financial institutions operating within a well-regulated financial marketplace that will promote investor confidence, attract global financial business, and enable our institutions to compete more effectively. ICI looks forward to working with other stakeholders and policymakers to strengthen the U.S. financial services regulatory system and to improve its ability to meet new challenges posed by the continuing evolution of the financial markets, market participants, and financial products.

Introduction

Well before mainstream Americans felt the widespread effects of the current financial crisis, many policymakers and commentators were calling for financial services regulatory reform. [2] These efforts reflected general agreement that our current organization for oversight of financial institutions is insufficient to address modern financial markets. Recent market events have served to put into much sharper focus the many weaknesses of the current system and the many important linkages that exist between and among the U.S. financial markets and the markets of other developed nations.

Yet the current financial crisis also offers an important opportunity—the chance to have a frank and robust public dialogue about what works and what does not. It further affords policymakers with the public mandate necessary to take bold steps to strengthen and modernize regulatory oversight of the financial services industry.

The debate over financial services regulatory reform will require careful consideration of a multitude of complicated and interconnected issues, and there are many stakeholders in the eventual outcomes of this debate—most importantly, the nation's savers and investors. In this paper, the Investment Company Institute (ICI),

possibly legislative proposals. The Working Group expects to report its recommendations in the first quarter of 2009.

[2] See, *e.g.,* The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (March 2008) ("Treasury Blueprint"), available at *http://www.treas.gov/press/releases/reports/Blueprint.pdf;* Report and Recommendations: Commission on the Regulation of U.S. Capital Markets in the 21st Century, U.S. Chamber of Commerce (March 2007), available at *http://www.capitalmarketscommission.com/portal/capmarkets/default.htm;* Sustaining New York's and the US' Global Financial Services Leadership (report by McKinsey & Co., Jan. 2007), at *http://www.senate.gov/schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf;* Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006), available on the Committee's Web site at *http://www.capmktsreg.org/research.html*

the national association of U.S. investment companies,[3] offers its recommendations on how to achieve meaningful reform of financial services regulation. We give particular emphasis to reforms that most directly affect the functioning of the capital markets and the regulation of investment companies (also referred to as "funds").

Investment companies have a unique perspective on our regulatory system, as both issuers of securities and investors in domestic and international securities markets. It has been our experience that, in large measure, the needs of issuers and investors are aligned—that both will benefit from broad and efficient markets, transparency of information, strong investor protections, and within that context, the elimination of unnecessary regulatory impediments to innovation.

We strongly believe that the future of our industry depends upon the existence of strong, well-regulated financial institutions operating within a well-regulated financial marketplace that will promote investor confidence, attract global financial business and enable our institutions to compete more effectively. The reforms suggested in this paper should help to build and foster such a financial system.

Our recommendations and the benefits they are designed to achieve are summarized in Section II below. We elaborate on our recommendations in Section III (Establishment of a Systemic Risk Regulator), Section IV (Formation of a New Capital Markets Regulator), Section V (Regulatory Structure Affecting Other Financial Institutions), and Section VI (Enhanced Inter-agency Coordination and Information Sharing). In Section VII, we discuss in detail the expected benefits from these reforms.

A host of different reform proposals are being advanced—by the new Administration, members of Congress, industry groups, academics, and others. ICI will closely follow these developments and participate in this debate on behalf of the fund industry. We also may refine as appropriate the views expressed in this paper.

Summary of Recommendations and Expected Benefits

Recommendations for Reform

ICI recommends that Congress:

- Designate a new or existing agency or inter-agency body to act as a Systemic Risk Regulator.
- Establish a new Capital Markets Regulator encompassing the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission. The Capital Markets Regulator should:
  - be the regulatory standard setter for all registered investment companies, including money market funds;
  - have explicit authority to regulate in certain areas where there are currently gaps in regulation and to harmonize the legal standards that apply to investment advisers and broker-dealers;
  - maintain a sharp focus on investor protection and law enforcement;
  - carefully consider as well the impact of its rulemaking activity on efficiency, competition and capital formation;
  - serve as the first line of defense with respect to risks across the capital markets as a whole; and
  - take proactive steps to maximize its continuing effectiveness, including: establishing the conditions necessary for ongoing dialogue with the regulated industry; establishing mechanisms to stay abreast of market/industry developments; and developing strong capability to conduct economic analysis to support sound rulemaking and oversight.
- Consider consolidation of the regulatory structure for the banking sector.
- Authorize an optional federal charter for insurance companies.
- Enhance inter-agency coordination and information sharing efforts, including by modernizing the Executive Order authorizing the President's Working Group on Financial Markets.

Expected Benefits of These Reforms

ICI believes the principal benefits of these reforms would be to:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system.

[3] ICI members include mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs).

- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry.
- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products.
- Preserve specialized regulatory focus and expertise and avoid potential uneven attention to different industries or products.
- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern.
- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

Establishment of a Systemic Risk Regulator

Over the past year, various policymakers and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks to the financial system as a whole. For example, in a March 2008 speech, House Financial Services Committee Chairman Barney Frank (D-MA) recommended that Congress consider establishing a "Financial Services Systemic Risk Regulator" that has the capacity and power to assess risk across financial markets and to intervene when appropriate. [4] Around the same time, then-Senator Barack Obama highlighted the need for a process that identifies systemic risks to the financial system. [5]

The deepening financial crisis has further exposed the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. It has led to a growing consensus that bold steps are needed to equip regulators to better anticipate and address such risks. Analyses of the causes of the current crisis suggest that systemic risks may be occasioned by, for example: (1) excessive leveraging by financial institutions; (2) a lack of transparency regarding risky practices; and (3) institutions or activities that fall through gaps in the regulatory framework. Systemic risks—whether they are attributable to excessive risk taking by some market participants or to other causes—can negatively impact investment companies, thereby making it more difficult for their shareholders to achieve important financial goals.

Subject to important cautions, ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." Broadly stated, the goal in establishing a Systemic Risk Regulator should be to provide greater overall stability to the financial system as a whole. The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators.

Very careful consideration must be given to the specifics of how the Systemic Risk Regulator will be authorized to perform its functions. In particular, the legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies. By way of example, it has been suggested that a Systemic Risk Regulator could be given the authority to identify financial institutions that are "systemically significant" and to oversee those institutions directly. Despite its seeming appeal, such an approach could have very serious anticompetitive effects if the identified institutions were viewed as "too big to fail" and thus judged by the marketplace as safer bets than their smaller, "less significant" competitors. [6]

Additionally, the Systemic Risk Regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance. Legislation establishing the Systemic Risk Regulator thus should define the nature of the relationship between this new regulator and the primary regulator(s) for each industry sector. This should involve plac-

[4] See Frank Calls for Significant Changes in Financial Services Regulation, Press Release (March 20, 2008), available at *http://financialservices.house.gov/press110/press0320082.shtml.* Likewise, the Treasury Blueprint issued shortly thereafter suggested that an optimal regulatory structure would include the designation of a market stability regulator responsible for overall issues of financial market stability.

[5] See Remarks of Senator Barack Obama: Renewing the American Economy, New York, NY (March 27, 2008), available at *http://www.barackobama.com/2008/03/27/remarks_of_senator_barack_obam_54.php*

[6] See, *e.g.,* Peter J. Wallison, Regulation Without Reason: The Group of Thirty Report, AEI Financial Services Outlook (Jan. 2009), available at *http://www.aei.org/publications/pubID.29285/pub_detail.asp*

ing explicit limitations on the extent of the authority granted to the Systemic Risk Regulator, as well as identifying specific areas in which the Systemic Risk Regulator and primary regulator(s) should work together. We believe, for example, that the primary regulators have a critical role to play by acting as the first line of defense with regard to detecting potential risks within their spheres of expertise.

How these issues are resolved will have a very real impact on registered investment companies, as both issuers and investors in the capital markets. Money market funds, for example, are comprehensively regulated under the Investment Company Act of 1940 and subject to special requirements that limit the fund's exposure to credit risk and market risk.[7] These strong regulatory protections, administered by the SEC for nearly three decades, have made money market funds an effective cash management tool for retail and institutional investors and an important source of short-term financing for American business and municipalities. Given the size of this industry segment[8] and its important role in our nation's money markets, money market funds are likely to be on the radar screen of the Systemic Risk Regulator as it monitors the financial markets. The type of information about money market funds that the Systemic Risk Regulator may need to perform this function, and how the regulator will obtain that information, are just two of the specific issues that will need to be carefully considered. As a threshold matter, however, ICI firmly believes that regulation and oversight of money market funds must be the province of the Capital Markets Regulator.

ICI will closely follow the debate over the establishment of a Systemic Risk Regulator, and will inform policymakers as to the fund industry's views of future proposals.

Formation of a New Capital Markets Regulator

Currently, securities and futures are subject to separate regulatory regimes under different federal regulators. This system reflects historical circumstances that have changed significantly. As recently as the mid-1970s, for example, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. In addition, as new, innovative financial instruments were developed, the lines between securities and futures often became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. With the increasing convergence of securities and futures products, markets, and market participants, the current system makes little sense. To bring a consistent policy focus to U.S. capital markets, we recommend the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and the CFTC.

As the federal regulator responsible for overseeing all financial investment products, it is imperative that the Capital Markets Regulator—like the SEC and the CFTC—be established by Congress as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission.[9] A critical part of that mission should be for the new agency to maintain a sharp focus on investor protection and law enforcement. And Congress should ensure that the agency is given the resources it needs to fulfill its mission. Most notably, the Capital Markets Regulator must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

Scope of Authority

ICI recommends that the Capital Markets Regulator assume on an integrated basis the responsibilities currently handled by the SEC and the CFTC. For the SEC, those functions include requiring public companies to disclose financial and other information to the public; overseeing various market participants, including securities exchanges, broker-dealers, investment advisers, and investment companies; and enforcing the securities laws. The SEC also oversees the setting of accounting standards for public companies. For its part, the CFTC regulates the commodity futures and option markets. It oversees various entities including exchanges, clearing facili-

[7] The term "credit risk" refers to the exposure of securities, through default or otherwise, to risks associated with the creditworthiness of the issuer. The term "market risk" refers to the exposure of securities to significant changes in value due to changes in prevailing interest rates.

[8] Money market funds had assets of approximately $3.9 trillion under management as of February 2009.

[9] Currently, regulatory oversight of both the securities and futures industries involves various self-regulatory organizations. In establishing the Capital Markets Regulator, Congress will need to determine the appropriate role for any such organization(s).

ties, and market participants such as futures commission merchants, commodity pool operators, and commodity trading advisors. Through its oversight and enforcement powers, it seeks to protect market users and the public from fraud, manipulation, and abusive practices.

Of particular importance to the fund industry is to ensure that the Capital Markets Regulator is authorized: (1) to act as the regulatory standard setter for all registered investment companies, as is the case now with the SEC; (2) to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants; and (3) to regulate broker-dealers and investment advisers in a consistent manner when they provide similar services to investors.

1. Regulation of Registered Investment Companies: In creating the new regulator, Congress should take note of the important benefits that have flowed from the shared system of federal-state oversight established by the National Securities Markets Improvement Act of 1996 (NSMIA). Under this system, federal law governs all substantive regulation of investment companies and states have concurrent authority to protect against fraud. NSMIA represented the judgment of Congress that "the system of dual federal and state securities regulation ha[d] resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, [was] redundant, costly, and ineffective." [10] In recognition of the national character of the market in which investment companies operate, and to secure the regulatory efficiencies Congress intended, Congress should affirm the role of the Capital Markets Regulator as the regulatory standard setter for registered investment companies. The Capital Markets Regulator's regulatory jurisdiction should include the authority to regulate money market funds. [11]

2. Regulatory Gaps: The Capital Markets Regulator should have express regulatory authority in the following areas:

- Hedge funds and other unregulated private pools of capital. The Capital Markets Regulator should be authorized to provide oversight over hedge funds and other unregulated pooled products with respect to, at a minimum, their potential impact on the capital markets (*e.g.,* require nonpublic reporting of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants).
- Derivatives. The Capital Markets Regulator should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, while not unduly stifling innovation.
- Municipal Securities. The Capital Markets Regulator should be granted expanded authority over the municipal securities market, and use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized and often stale, and there are numerous disparities from the corporate issuer disclosure regime.

3. Regulation of Investment Advisers and Broker-Dealers: The Capital Markets Regulator also should have explicit authority to harmonize the regulatory regimes governing investment advisers and broker-dealers. What once were real distinctions in the businesses of advisers and broker-dealers are no longer so clear, to the point that retail investors are largely unable to distinguish the services of an adviser from those of a broker-dealer. These two types of financial intermediaries, and their customers and clients, deserve a coherent regulatory structure that provides adequate investor protections—including, in particular, a consistent standard of care—without overlapping or unnecessary regulation.

Mission

The SEC describes its mission as "to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation." For its part, the CFTC states that its mission is "to protect market users and the public from fraud, manipulation

[10] Joint Explanatory Statement of the Committee of Conference, Conference Report—National Securities Markets Improvement Act of 1996, H.R. 3005, H.R. Conf. Rep. No. 104-864 (1996).

[11] ICI has formed a Money Market Working Group that is developing recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. The group will identify needed improvements in market and industry practices; regulatory reforms, including improvements to SEC rules governing money market funds; and possibly legislative proposals. The Working Group expects to report its recommendations in the first quarter of 2009.

and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and options markets.” The differing focus expressed in these two mission statements is reflective of historical distinctions in the securities and futures industries, including with regard to the purposes of their respective markets and the participants in those markets. As growing convergence within these two industries suggests the creation of a unified regulator for the capital markets, it is important to consider how the mission statement for the new regulator can best reflect this convergence.

From the perspective of the fund industry, the mission of the Capital Markets Regulator must involve maintaining a sharp focus on investor protection, supported by a comprehensive enforcement program. This core feature of the SEC’s mission has consistently distinguished the agency from the banking regulators, who are principally concerned with the safety and soundness of the financial institutions they regulate, and it has generally served investors well over the years.

At the same time, the SEC is required by NSMIA to consider, in determining whether a proposed regulation is consistent with the public interest, both the protection of investors and whether the regulation would promote efficiency, competition and capital formation. This NSMIA requirement suggests that Congress did not view investor protection and efficiency, competition, and capital formation as being competing considerations, but rather determined that each is relevant to the development of sound capital markets regulation. We strongly believe that the Capital Markets Regulator should be subject to the same requirements. [12] Investors are not well served, for example, by rulemaking actions that create significant inefficiencies or have anti-competitive effects in the marketplace, which ultimately result in increased costs for investors.

Combining the market-related missions of the SEC and CFTC should be more straightforward. Generally speaking, each agency is called upon to maintain the integrity of the markets under its jurisdiction. The same must be true for the new Capital Markets Regulator. As the ongoing financial crisis demonstrates, it is imperative that the task of maintaining market integrity be viewed broadly to include monitoring and addressing risks across the markets as a whole. Formally assigning some level of responsibility to the Capital Markets Regulator in this area makes sense. Given its expertise and its position as the primary regulator of these markets, the Capital Markets Regulator can serve as the first line of defense with regard to detecting problems in the capital markets. While this approach could result in some potential overlap with the responsibilities of the Systemic Risk Regulator, we believe that any inefficiencies may be minimized through effective coordination and information sharing.

Agency Management and Organization

It is axiomatic in the private sector that a company’s success is directly related to the soundness of its management. The same principle holds true for public sector entities. But management improvements take time and serious attention, not to mention allocation of resources. Given that they often experience frequent turnovers in leadership and strained resources, it is not surprising that government agencies can find it particularly difficult to undertake and sustain significant management reforms. Establishing a new agency presents a very valuable opportunity to “get it right” as part of that process.

There is also an opportunity to make sound decisions up-front about how to organize the new agency. In so doing, it is important not to simply use the current structure of the SEC and/or the CFTC as a starting point. In the case of the SEC, for example, its current organizational structure largely took shape in the early 1970s and reflects the operation of the securities markets of that day. Rather, the objective should be to build an organization that not only is more reflective of today’s markets, market participants and investment products, but also will be flexible enough to regulate the markets and products of tomorrow.

We offer the following thoughts with regard to management and organization of the Capital Markets Regulator:

- Ensure high-level focus on agency management. One approach would be to designate a Chief Operating Officer for this purpose.
- Implement a comprehensive process for setting regulatory priorities and assessing progress. It may be helpful to draw upon the experience of the United Kingdom’s Financial Services Authority, which seeks to follow a methodical ap-

[12] Curiously, the SEC’s description of its own mission (see *http://www.sec.gov/about/whatwedo.shtml*) omits any reference to promoting competition—notwithstanding the specific requirement under NSMIA to consider this factor.

proach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.

- Promote open and effective lines of communication among the regulator's Commissioners and between its Commissioners and staff. Such communication is critical to fostering awareness of issues and problems as they arise, thus increasing the likelihood that the regulator will be able to act promptly and effectively. A range of approaches may be appropriate to consider in meeting this goal, including whether sufficient flexibility is provided under the Government in the Sunshine Act, and whether the number of Commissioners should be greater than the current number at the SEC and at the CFTC (currently, each agency has five).
- Align the inspections and examinations functions and the policymaking divisions. This approach would have the benefit of keeping staff in the policymaking divisions updated on current market and industry developments, as well as precluding any *de facto* rulemaking by the regulator's inspections staff.
- Develop mechanisms to facilitate coordination and information sharing among the policymaking divisions. These mechanisms would help to ensure that the regulator speaks with one voice.

Additional Steps To Maximize Effectiveness

ICI believes that the following proactive steps will greatly enhance the ability of the Capital Markets Regulator to fulfill its mission successfully when carrying out its regulatory responsibilities and should be priorities for the new agency.

1. Establish the conditions necessary for constructive, ongoing dialogue with the regulated industry: The Capital Markets Regulator should seek to facilitate closer, cooperative interaction with the entities it regulates to identify and resolve problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions. The net result is that the Capital Markets Regulator would pursue its investor protection responsibilities through various means not always involving enforcement measures, although strong enforcement must remain an important weapon in the regulator's arsenal.

2. Establish mechanisms to stay abreast of market and industry developments: The Capital Markets Regulator would benefit from the establishment of one or more external mechanisms designed to help the agency stay abreast of market and industry issues and developments, including developments and practices in non-U.S. jurisdictions as appropriate. For example, several federal agencies—including both the SEC and CFTC—utilize a range of advisory committees. Such committees, which generally have significant private sector representation, may be established to provide recommendations on a discrete set of issues facing the agency (*e.g.,* the SEC's Advisory Committee on Improvements to Financial Reporting) or to provide regular information and guidance to the agency (*e.g.,* the CFTC's Agricultural Advisory Committee).

ICI believes that a multidisciplinary "Capital Markets Advisory Committee" could be a very effective mechanism for providing the Capital Markets Regulator with "real world" perspectives and insights on an ongoing basis. We recommend that such a committee be comprised primarily of private sector representatives from all major sectors of the capital markets, and include one or more members representing funds and asset managers. Additionally, the Capital Markets Advisory Committee should be specifically established in, and required by, the legislation creating the Capital Markets Regulator. Such a statutory mandate would emphasize the importance of this advisory committee to the agency's successful fulfillment of its mission.

The establishment of an advisory committee would complement other efforts by the Capital Markets Regulator to monitor developments affecting the capital markets and market participants. These efforts should include, first and foremost, hiring more staff members with significant prior industry experience. Their practical perspective would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy.

3. Apply reasonably comparable regulation to like products and services: Different investment products often are subject to different regulatory requirements, often with good reason. At times, however, heavier regulatory burdens have been placed on funds than on other investment products that share similar features and are sold to the same customer base. It does not serve investors well if the regulatory requirements placed on funds—however well-intentioned—end up discouraging investment advisers from entering or remaining in the fund business, dissuading portfolio managers from managing funds as opposed to other investment products, or creating disincentives for brokers and other intermediaries to sell fund shares. It is critically important for the Capital Markets Regulator to be sensitive to this dynamic in its rulemakings. Among other things, in analyzing potential new regulatory requirements for funds, the Capital Markets Regulator should consider whether other investment products raise similar policy concerns and thus should be subject to comparable requirements.

4. Develop strong capability to conduct economic analysis to support sound rulemaking and oversight: The Capital Markets Regulator will be best positioned to accomplish its mission if it conducts economic analysis in various aspects of the agency's work, including rulemaking, examinations, and enforcement. Building strong economic research and analytical capabilities is an important way to enhance the mix of disciplines that will inform the agency's activities. From helping the agency look at broad trends that shed light on how markets or individual firms are operating to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the agency's capability to conduct economic analysis will be well worth the long-term effort required. The agency should consider having economists resident in each division to bring additional, important perspectives to bear on regulatory challenges.

It is important that economic analysis play an integral role in the rulemaking process, because many regulatory costs ultimately are borne by investors. When new regulations are required, or existing regulations are amended, the Capital Markets Regulator should thoroughly examine all possible options and choose the alternative that reflects the best trade-off between costs to, and benefits for, investors. Effective cost-benefit analysis does not mean compromising protections for investors or the capital markets. Rather, it challenges the regulator to consider alternative proposals and think creatively to achieve appropriate protections while minimizing regulatory burdens, or to demonstrate that a proposal's costs and burdens are justified in light of the nature and extent of the benefits that will be achieved. [13]

5. Modernize regulations that no longer reflect current market structures and practices: Financial markets and related services are constantly evolving, frequently at a pace that can make the regulations governing them (or the rationale behind those regulations) become less than optimal, if not entirely obsolete. Requiring industry participants to comply with outmoded regulations imposes unnecessary costs on both firms and investors, may impede innovation, and, most troubling of all, could result in inadequate protection of investors. It is thus important that the Capital Markets Regulator engage in periodic reviews of its existing regulations to determine whether any such regulations should be modernized or eliminated.

6. Give heightened attention to investor education: During the course of their lives, investors are called upon to make a variety of investment decisions as their personal circumstances change. These decisions may involve saving to buy a home or to finance a child's education, building an adequate nest egg for retirement, or investing an inheritance, to name a few. Whether they make their investment decisions individually or with the help of a financial adviser, investors need to be able to make informed decisions based upon their individual needs.

The recent turmoil in the financial markets has underscored how important it is that investors be knowledgeable and understand their investments. Well-informed investors are more likely to develop realistic expectations, take a long-term perspective, and understand the trade-off between risk and reward. They are less likely to panic and make mistakes.

To better equip investors to make good decisions about their investments, the Capital Markets Regulator should assign a high priority to pursuing regulatory initiatives that will help educate investors. The SEC's new rule allowing mutual funds and exchange-traded funds to provide a "summary prospectus" containing key fund information to investors—while making additional information available online or by mail or e-mail upon request—is an excellent example of a forward thinking approach to better informing investors. It should serve as a model for future disclosure improvement efforts, such as reform of fund shareholder reports. Regulatory efforts

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[13] See, *e.g.,* Special Report on Regulatory Reform, Congressional Oversight Panel (submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008) (Jan. 2009) ("In tailoring regulatory responses . . . the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.").

to promote investor education also should extend beyond funds. Investors who purchase other types of investment products or services, such as separately managed accounts, likewise would benefit from clear, concise, understandable disclosure. In addition, appropriately fashioned point of sale disclosure would help investors in all types of retail investment products assess and evaluate broker recommendations.

The SEC has an Office of Investor Education and Advocacy and provides some investor education resources on its Web site. These types of efforts should be expanded, possibly in partnership with other governmental or private entities, and better publicized. Many industry participants, too, have developed materials and other tools to help educate investors; additional investor outreach efforts should be encouraged.

Process of Merging the SEC and CFTC

Legislation to merge the SEC and CFTC should outline a process by which to harmonize the very different regulatory philosophies of the two agencies, as well as to rationalize their governing statutes and current regulations. We note that there is potential peril in leaving open-ended the process of merging the two agencies. We accordingly recommend that the legislation creating the Capital Markets Regulator set forth a specific timetable, with periodic benchmarks and accountability requirements, so as to ensure that the merger of the SEC and CFTC is completed as expeditiously as possible.

The process of merging the two agencies will be lengthy, complex, and have the potential to disrupt the functioning of the SEC, CFTC, and their regulated industries. We suggest that, in anticipation of the merger, the SEC and CFTC undertake detailed consultation on all relevant issues and take all steps possible toward greater harmonization of the agencies. This work should be facilitated by the Memorandum of Understanding the two agencies signed last year regarding coordination in areas of common regulatory interest.[14] ICI believes that its recommendations with respect to the Capital Markets Regulator may provide a helpful framework for these efforts.

Regulatory Structure Affecting Other Financial Institutions

Earlier in this paper, we have recommended the establishment of a Systemic Risk Regulator, and we have discussed at length the need for a new Capital Markets Regulator to oversee markets and market participants in the securities and futures industries. In this section and the one immediately following, we comment briefly on reforms affecting the regulators overseeing other sectors of the U.S. financial system (specifically, banking and insurance) and how all regulators within the system can work together more effectively.

Regulation of the banking and insurance industries is, quite obviously, not ICI's primary area of focus. That said, regulation of these industries greatly affects the performance of the U.S. financial system as a whole and the ability of investment companies to function within that system.

ICI believes it is important, therefore, for policymakers to carefully consider how to achieve a more rational regulatory structure for the banking sector that consolidates duplicative regulatory agencies and clarifies regulatory missions. Any such analysis would no doubt need to address difficult issues concerning the future role of state banking regulators if we are to have a more rational regulatory system at the national level.

With regard to the insurance industry, ICI supports in concept the idea of creating a regulator at the federal level, a reform that has been sought by some insurance companies as a means of providing a streamlined and efficient alternative to the current system of state regulation. Authorizing an optional federal charter for insurers appears to be a logical way to bridge the gap between what exists today and the more comprehensive approach that is required for all financial institutions operating in truly national and often international markets. We also believe that a federal insurance regulator would provide an important and practical enhancement to federal inter-agency coordination and information sharing efforts, as discussed below.

Enhanced Inter-Agency Coordination and Information Sharing

A recent report examined the benefits and shortcomings of the four primary approaches to regulatory supervision currently used in jurisdictions around the

[14] See SEC, CFTC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products (SEC press release dated March 11, 2008), available at *http://www.sec.gov/news/press/2008/2008-40.htm*

world.[15] The report observed that, regardless of the type of supervisory system in place, virtually all financial supervisors emphasized the importance of inter-agency coordination and information sharing for successful oversight of the financial system as a whole and for mitigation of systemic risk.

Effective inter-agency coordination also plays a critical role when there is a need to engage on financial services regulatory issues at an international level. The variety of supervisory systems around the world and the increasing globalization of financial markets make coordination among U.S. regulatory agencies all the more important.

In the United States at present, a variety of mechanisms are used to promote coordination and information sharing within our complex regulatory system, including arrangements at both the Federal and State levels and arrangements among federal and state agencies. These arrangements may be specifically mandated by Congress, such as the inter-agency Federal Financial Institutions Examination Council, or may be initiated by the regulators themselves, such as the July 2008 Memorandum of Understanding between the Federal Reserve and the SEC to foster greater coordination and information sharing.[16] One particularly important mechanism for the past two decades has been the President's Working Group on Financial Markets, whose members are the heads of the Treasury Department, Federal Reserve, SEC and CFTC. As described in the Treasury Blueprint, the role of the PWG has evolved beyond the scope of the 1988 Executive Order creating it, so that the PWG has become a key communication and coordination mechanism for financial policy.

If efforts to streamline the U.S. financial regulatory structure are to be successful, some of these coordination mechanisms would almost certainly require modification or perhaps would no longer be necessary. There would, however, still be a very critical need for coordination and information sharing among the remaining regulatory bodies, presumably with involvement in particular by the Systemic Risk Regulator. The President's Working Group, with necessary modifications, would appear to be the easiest way to achieve this end.

ICI concurs with the recommendation in the Treasury Blueprint that the Executive Order authorizing the PWG should be modernized "to reinforce the group's mission and purpose . as an ongoing mechanism for coordination and communication on financial policy matters including systemic risk, market integrity, investor and consumer protection, and capital markets competitiveness." We suggest that any new Executive Order also discuss the following additional areas where inter-agency coordination and information sharing are critically important: (1) the regular exchange of information about the latest market and industry developments, including international trends and developments; (2) the discussion of policy initiatives that extend across jurisdictional lines; (3) the minimization of regulatory disparities for like financial products and services; and (4) the need to balance financial innovation with appropriate market and investor protection safeguards.

Equally important, in ICI's view, is the role of the PWG in fostering a culture of close consultation and dialogue among senior officials within each regulatory sector that will carry over into each regulator's dealings with one another. Stronger links between regulators and an overriding sense of shared purpose would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community.

Expected Benefits From These Reforms

If implemented, the recommended reforms outlined above would help to establish a more effective and efficient regulatory structure for the U.S. financial services industry. Most significantly, these reforms would:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system.
- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry.
- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products.
- Preserve specialized regulatory focus and expertise and avoid potential uneven attention to different industries or products.

[15] See Group of Thirty, The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace (Oct. 6, 2008), available at *http://www.deloitte.com/dtt/cda/doc/content/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf*

[16] See, *e.g.,* SEC, FRB Sign Agreement to Enhance Collaboration, Coordination, and Information Sharing (SEC press release dated July 7, 2008), available at *http://www.sec.gov/news/press/2008/2008-134.htm*

- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern.
- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

Of significant import to registered investment companies, creation of a consolidated Capital Markets Regulator would provide a single point of regulatory authority and consistent rulemaking and oversight for investment products, the capital markets, and market participants. It would create regulatory efficiencies by eliminating areas where responsibilities overlap and by ensuring against regulatory gaps and potential inconsistencies. A strong, integrated regulator for the capital markets that can see "the whole picture" will be better equipped to face the challenges of these rapidly evolving markets, and thus to protect the interests of investors.

More generally, increased consolidation of financial services regulators, combined with the establishment of a Systemic Risk Regulator and more robust inter-agency coordination and information sharing, should facilitate monitoring and mitigation of risks across the financial system. It also should result in increased regulatory efficiency, including less duplication, and help to eliminate regulatory gaps.

Consolidation of regulatory agencies also may further the competitive posture of the U.S. financial markets. It may make it easier to harmonize U.S. regulations with regulations in other jurisdictions when that is appropriate. And reducing the number of U.S. regulatory agencies, while also strengthening the culture of cooperation and dialogue among senior officials of the agencies, will likely facilitate coordinated interaction with regulators around the world.

By providing for one or more dedicated regulators to oversee each major financial services sector, the proposed structure would maintain the specialized focus and expertise that is a hallmark of effective regulation. This structure also would allow appropriate tailoring of regulation to accommodate fundamental differences in regulated entities, products and activities. Additionally, it would avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or approaches or the allocation of regulatory resources.

ICI recognizes that some have criticized sector-based regulation because it may not provide any one regulator with a full view of a financial institution's overall business, and does not give any single regulator authority to mandate actions designed to mitigate systemic risks across financial markets as a whole. Our proposed approach would address those concerns through the establishment of the Systemic Risk Regulator and specific measures to strengthen inter-agency coordination and information sharing.

We further believe that retaining some elements of the current multi-agency structure likely would offer advantages over a single, integrated regulator approach. Even though a single regulator could be organized with separate units or departments focusing on different financial services sectors, it is our understanding that, in practice, there can be a tendency for agency staff to "gravitate" to certain areas and devote insufficient attention to financial sectors perceived to be less high profile or prone to fewer problems. Such a result has the potential to stifle innovation valuable to consumers and produce regulatory disparities.

Finally, we believe that a streamlining of the current regulatory structure may be more effective and workable than an approach that assigns regulatory responsibilities to separate agencies based on broad regulatory objectives (*e.g.,* market stability, safety and soundness, and business conduct). These functions often are highly interrelated. Not only could separating them prove quite challenging, but it would force regulators to view institutions in a less integrated way and to operate with a narrower, less informed knowledge base. For example, a Capital Markets Regulator is likely to be more effective in protecting investors if its responsibilities require it to maintain a thorough understanding of capital market operations and market participants. And while an objective-based structure could be one way to promote consistent regulation of similar financial products and services, it is not the only way. Under our proposed approach, minimizing regulatory disparities for like products and services would be an express purpose of enhanced inter-agency coordination and information-sharing efforts.

PREPARED STATEMENT OF MERCER E. BULLARD

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MARCH 11, 2009

Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for the opportunity to appear before you to discuss investor protection issues. It is an honor and a privilege to appear before the Committee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Associate Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an Internet Web site for the posting of information. I also have served as a consultant and expert witnesses for plaintiffs and defendants in a variety of securities cases, including some that are discussed in this testimony.

This testimony focuses on investor protection issues related to investment management and investment advisory services. Some of these issues have arisen in connection with the current financial crisis, such as the question of prudential regulation of money market funds. This testimony begins with a discussion of different aspects of this question. But many investor protection issues reflect longstanding problems that have been left unattended by the SEC. There continue to be significant gaps in mutual fund fee disclosure rules, reform of fund distribution regulation is long overdue, and the SEC's fund governance initiative seems to have been all but forgotten. The SEC continues to allow hedge funds to offer their shares to unsophisticated investors, and brokers continue to receive undisclosed selling compensation that creates an incentive to sell the most remunerative funds even if they are not the best funds for the client.

On the whole, however, the investment management industry has fared well in the current crisis. Equity mutual funds have experienced their largest single year loss in history, yet net redemptions have remained small. Employee benefit plan participants generally have continued to make regular investors in funds. The mutual fund structure has been shown to be remarkably resilient in this time of stress. Investors seem to have faith in mutual funds' promise to convert their accounts to cash in short order at their next computed NAV, which is based on actual market values as opposed to malleable accounting principles. More money has flowed out of broker-managed accounts than mutual funds. Only one money market fund has experienced a loss of principal (compared with the failure of dozens of banks), and, with the playing field with banks temporarily leveled by the Treasury's temporary insurance program, money market funds have increased their total assets. The investment management industry's success depends, however, on its and its regulators' keeping pace with the needs of investors.

MONEY MARKET FUNDS

Money Market Fund Insurance [1]

As discussed above, mutual funds have been a singular success story in the midst of the current financial crisis. Money market funds arguably have been the best illustration of this success. As often happens when those who succeed are surrounded by failed competitors, however, some have responded to the failure of a single retail money market fund—the first in history—by demanding that money market funds be converted to and regulated as banks. A former Fed chairman explained this position as follows: "If they are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank." The problem with this argument is that money markets do not fail like banks.

Since 1980, more than 3,000 U.S. banks have failed, costing taxpayers hundreds of billions of dollars. During the same time period, two money market funds have

[1] See generally Mercer Bullard, Federally Insured Money Market Funds and Narrow Banks: The Path of Least Insurance (Mar. 2, 2009) available at *http://ssrn.com/abstract=1351987*

failed, costing taxpayers zero dollars.[2] The lesson that the Group of 30 takes from this history is that it is money market funds that should be regulated as banks. The lesson that Congress should take from this history is that banks should be regulated more like money market funds. As discussed further below, banks routinely fail because they are permitted to invest deposits that can be withdrawn at a moment's notice in illiquid, long-term, risky assets. In comparison, money market funds invest in liquid, short-term, safe assets. The Group of 30 has disparaged money market funds as "underscor[ing] the dangers of institutions with no capital, no supervision, and no safety net," yet the extraordinary stability of money market funds relative to banks makes a mockery of their argument.

It is banks that should be regulated like money market funds, with the investment of insured bank deposits being limited to liquid, short-term, safe assets. There is no longer any good policy reason to insure bank deposits backed by longterm, risky assets. The current financial crisis has demonstrated that banks no longer play a special role in this market. Many types of entities now play a significant role in the creation of liquidity through investment in long-term assets that historically was dominated by banks. And many of these entities rely on shortterm liabilities (*i.e.,* funds subject to payment on demand), including mutual funds, to fund such investments. Any regulatory regime that seeks to mitigate the systemic risk inherent in the investment of short-term funds in long-term ventures must consider the full spectrum liquidity-creation mechanisms and reject a bank-centric view of finance that distorts efficient investment and leaves unregulated large areas of financial activities.

What should be insured is cash accounts on which the stability of the payments system depends. The current crisis has demonstrated the need to ensure that the cash management vehicles that form the foundation of our payments system are absolutely secure. Deposit insurance provides this security. Its weakness, however, is that it also insures risks that are necessary to the provision of transactional services. Banks are permitted to invest insured bank deposits in longterm risky ventures, thereby destabilizing the payments system and inflicting large losses on the insurance fund and taxpayers. Money market funds have been a paragon of stability because they are permitted to invest only in a diversified pool of short-term, high-quality assets.

The answer to whether money market fund insurance should be made permanent seems obvious. Terminating the temporary insurance program could lead to another run on money market funds and require that the program immediately be restored. Even if a run does not follow termination of the program, money market funds will continue to represent a major source of transactional services the failure of which would threaten the viability of our payments system. Money market fund shareholders know this. The question of whether there is an implied federal guarantee of money market funds has been answered. The next time that a run on money market funds seems imminent, a federal entity will have to stop the run with a guarantee, except that without an insurance program in place it will not have collected any premiums that (if risk-based) might have reduced risktaking and that would have provided non-taxpayer funds with which to cover losses. Taxpayers will be left to back up this guarantee.

At the same time that federal insurance is extended to all significant sources of transaction accounts, it should be used to reduce exposure to risk from the investment of short-term deposits in long-term, risky assets. To some extent, this would be accomplished by making money market fund insurance permanent. The higher yields historically offered by money market funds would siphon even more deposits from banks reduce the attendant risk of their investment in risky assets. Federal insurance also should be extended to a new kind of bank that was required to invest deposits in the same kinds of assets as money market funds. In order to enable compete such "narrow banks" to compete effectively, they would be relieved of burdens unique to banks, such as the requirements of the Community Reinvestment Act. Narrow banks also would continued to have the advantage of access to the discount window. Without making any changes to existing deposit insurance coverage, extending coverage to money market funds and narrow banks would reduce the amount of deposits subject to long-term risk and the likelihood of failure.

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[2] Ironically, money market funds to date have provided a net positive contribution to the ongoing bailout of financial institutions. The Treasury has collected more than $800 million in money market fund insurance premiums only a small fraction of which, if any, are likely ever to be paid out in claims.

Prudential Regulation

Prudential regulation, as used herein, refers to government-imposed rules designed to ensure that adequate assets stand behind the liabilities of financial institutions. Prudential regulation is an inherently suboptimal approach to risk because free markets are far more efficient at pricing risk than governments. Governments cannot avoid injecting political considerations into the underwriting of risk, which results in inevitably inefficient risk-minimization structures. Nonetheless, short-term social instability can cause permanent damage to social, political and commercial institutions. In some cases, government intervention is necessary to mitigate potentially destabilizing fluctuations in free markets.

Under this admittedly oversimplified framework for government intervention in the capital markets, I would argue that our payments systems creates the kind of risk that should not be left to free market forces. The payments system refers to the network of providers of transactional services that enable a non-specie-based economic system of exchange to operate. The temporary collapse of our payments system could leave economic activity to be conducted on a strictly barter or specie basis until the payments system was restored. The difficulty with leaving the payments system to the mercy of free markets is that the social and political upheaval that might result from a temporary collapse of our payments system could turn the collapse into a long-term event with long-term political, social and economic consequences. On this basis, it is advisable to support the payments system with an unconditional government guarantee of cash accounts on which the payments is primarily based. Notwithstanding the likely inefficiencies of such an insurance regime, they are outweighed by the potential benefits of protecting the payments system.

One purpose that deposit insurance serves is to guarantee bank deposits and thereby stabilize an important foundation for the payments system. There are two difficulties with deposit insurance, however. First, deposit insurance covers risks that are not necessarily attendant upon the operation of cash accounts. Cash accounts can serve as an important linchpin of the payments system without being invested in long-term, high-risk assets such as the types of assets in which banks typically invest deposits. Money market funds also provide an important linchpin on the payments system, and they do so without taking such risks.

Second, deposit insurance is exclusive to bank deposits. It is not available to other types of cash accounts even if those accounts pose a similar systemic threat to the payments system. When a run on money market funds seemed imminent in late September 2008, there was no government guarantee to prevent the run from turning into a wholesale transfer of assets out of money market funds. With $4 trillion in assets, such a stampede could have shut down the payments system with potentially devastating long-term effects. The Treasury Department prudently installed a government guarantee and halted the run. With temporary money market fund insurance in place, the vast majority of assets in transaction accounts are covered by a federal guarantee.

Thus, insuring money market funds and narrow banks would promote appropriate prudential regulation that was designed to protect the stability of our payments system without transferring unnecessary risk to the government and taxpayers.

Prudential Regulator

The current financial crisis has exposed a persistent flaw in our regulatory structure. Prudential oversight should be provided through a regulatory structure that is amenable to the regulatory philosophy that prudential oversight entails. Prudential regulators are risk averse. Their purpose is to prevent loss. A regulator that is tasked with protecting investors and promoting free and efficient markets, on the other hand, will not be risk averse. The securities laws focus on full disclosure of material information is designed to promote and reward risk-taking based on the efficient flow of capital to its highest value use, even when some uses entail significant risk. Permitting such risk-taking is inimical to the essence of prudential regulation.

In more concrete terms, the SEC's roles: (1) in protecting investors and promoting free, efficient markets, and (2) as the prudential regulator of brokerdealers and money market funds, are in conflict. Similarly, banking regulators' consumer protection role has always suffered in the shadow of its primary prudential regulator role. The SEC's and banking regulators' contradictory positions on fair value accounting reflect this conflict. The SEC favors accurate pricing that reflects market values; banking regulators favor pricing that will restore investor confidence. As a prudential regulator, the SEC's failure to properly administer net capital rules has led to disappearance of the five largest investment banks as independent entities and its approach to money market funds has necessitated the intervention of a true prudential regulator, the Treasury Department, to stop a run on money market funds. Conversely, banking regulators' record of consumer protection has been abysmal, with their role more often undermining consumer protection than enhancing it.

In short, the areas of financial activity that necessitate prudential regulation should be administered by a prudential regulator. Investor protection and free markets should be handled by a different regulator. Although I support the creation of a single prudential regulator in theory, I believe it would be more realistic to shift prudential regulation to existing banking regulators and to locate consumer protection responsibility with respect to financial products and services with the SEC or FTC. If prudential regulation for insurance companies were established at the federal level, a special prudential regulator may be needed. It is not clear that the unique characteristics of insurance liabilities would be good fit for a prudential regulator that was responsible for other types of financial products. Insurance products that have predominantly investment characteristics (*e.g.,* equity-indexed annuities), however, should be regulated by the SEC as to sales practices and disclosure, and by the same federal prudential regulator that would be responsible for overseeing money market funds and banks.

Electronic Filing of Portfolios

In January 2008, my advocacy group, Fund Democracy, and the Consumer Federation of America, Consumer Action, AFL–CIO, Financial Planning Association and National Association of Personal Financial Advisors petitioned the SEC to adopt a rule requiring money market funds to file their portfolios electronically with the SEC.[3] The letter was motivated by our concern that the SEC's *ad hoc* practice of allowing fund sponsors to bail out their money market funds before they broke a dollar was inadequate in a time of market turmoil. The letter proved to be, unfortunately, prescient. Within the year, a retail money market fund broke a dollar for the first time.

Money market fund regulation, whether administered by the SEC or a true prudential regulator, should include an electronic, portfolio-filing requirement. Electronic filing would enable the regulator to monitor, among other things, the prices at which different money market funds are carrying the same securities. Although small pricing discrepancies would be inevitable and no cause for concern, large pricing discrepancies would indicate that some fund was underpricing or, more importantly, overpricing its shares. Moreover, filings would show the liquidity of the market for securities and thereby provide insight into the credibility of prevailing prices in more thinly traded issues. As stated by the SEC when it made a similar proposal 1995, money market fund portfolio filing would enhance regulators' ability: "to monitor money fund compliance with the federal securities laws, target its limited onsite examination resources, and respond in the event of a significant market event affecting money funds and their shareholders." The SEC's own justification for this proposal is far stronger today that it was twelve years ago.

Sponsor Support

The SEC has historically dealt with the risk of a money market fund's breaking a dollar by granting no-action relief to fund sponsors to purchase the problem assets at par, pump cash into the fund, extend guarantees, or take other steps to restore the fund's per share net asset value. This continues to be an appropriate tool for addressing the risk of money market fund failure, but it has become far too routine. The frequent granting of no-action relief for transactions that generally violate the affiliated transaction prohibitions of the Investment Company Act undermines the rule of law and encourages lax oversight by fund managers.

First, the SEC should amend the rule that exempts certain of these transactions to cover a broader range of sponsor support mechanisms. Sponsors should then be expected to have established written procedures that address scenarios in which their funds may need support and the mechanisms that the fund expects to use to provide it, if any.

Second, the sponsor's rescue policy should be disclosed in its Statement of Additional Information (a fund filing that investors can obtain on request or on the SEC's Web site). As indicated by Fitch's recent announcement that it intends to revise its money market fund rating system to reflect sponsors' rescue plans, these plans have become material aspects of a fund's stability. Banking regulators have previously indicated that they might not permit a bank affiliate to bail out its money market fund. This risk also should be disclosed to investors. As discussed in

[3] Petition from Fund Democracy, Consumer Federation of America, Consumer Action, AFL–CIO, Financial Planning Association and National Association of Personal Financial Advisors, to Nancy Morris, Secretary, U.S. Securities and Exchange Commission (Jan. 16, 2008) available at *http://www.funddemocracy.com/MMF%20Rulemaking%20Petition.pdf*

the consumer groups' January 2008 letter, the 11th hour negotiation of the terms of sponsor support between sponsors and SEC staff behind closed doors should not be the model by which the SEC and the fund industry manage unexpected market events.[41]

Liquidation Procedures

The haphazard liquidation of certain Reserve Funds has exposed a significant gap in the regulatory structure for money market funds. The complete liquidation of any mutual fund, even a highly liquid money market fund, cannot be accomplished overnight, but there should be no delay in the distribution of some percentage of a money market fund's assets in short order. Money market fund shareholders use these funds as the functional equivalent of bank accounts on which they often rely for daily living expenses. The SEC should require that money market fund compliance manuals include procedures that set forth the manner in which immediate redemptions can be effected in the event that circumstances cause the suspension of regular distributions. The FDIC generally is able to ensure that insured depositors receive a substantial part of their funds almost immediately following the closure of an insured bank. While it is reasonable for some money market fund assets to be withheld pending a final resolution by a receiver, there is no excuse for not releasing some percentage of shareholders' accounts in short order.

Liquidity Oversight

Many of the problems underlying the current crisis result from a failure to incorporate liquidity risk into prudential regulation. Although money market funds present less liquidity risk because of the short maturity, high quality and diversification of their assets, Rule 2a-7 should require that money market fund directors specifically consider the liquidity risk posed by the fund's portfolio. Fund directors should be required to ensure that procedures have been adopted and implemented that are reasonably designed to ensure that the pricing of portfolio securities has been tested against various market failure scenarios.

MUTUAL FUNDS

Excessive Fees

Section 36(b) of the Investment Company Act, which was passed in 1970, provides that a fund director and fund manager shall have a fiduciary duty with respect to the fees charged by the fund, and tasks the Commission with bringing actions against directors and fund managers who violate this duty. The Commission has never brought a case for excessive fees.[5] No plaintiff has ever prevailed in litigated claim under this provision although there have been some significant settlements.

Recent developments have made it unlikely that a section 36(b) claim will ever survive a motion to dismiss. Defense experts often have argued that mutual fund fees are set in a competitive marketplace and therefore are necessarily fair under section 36(b). In a Seventh Circuit decision, Judge Easterbrook adopted this theory, thereby effectively repealing the Act's private cause of action. In a split *en banc* opinion, Judge Posner rejected Judge Easterbrook's analysis, arguing that markets are not always efficient. The same Seventh Circuit also recently ruled that an Erisa fiduciary has no duty when selecting investments for a 401(k) plan not to choose funds that charge excessive fees. The court granted defendants' motion to dismiss even after accepting as true, among other things, plaintiffs' allegation that the plan sponsor had lied to plan beneficiaries about absorbing all of the costs of administering the plan (beneficiaries actually paid part of the costs). The Department of Labor filed an *amicus* brief opposing the defendants' position in that case.

The Supreme Court has granted certiorari in the Seventh Circuit's 36(b) case. Unfortunately, the Court has been quite hostile to private claims under the federal securities. I support many of the statutory limits on private claims that Congress has enacted over the last 15 years, as well as some of the interpretive restrictions im-

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[4] If money market fund insurance is made permanent, such sponsor support arrangements should be formalized and made mandatory. Sponsor support of money market funds is the functional equivalent of the equity buffer that insured banks are required to maintain under banking regulations. In this respect, it should be noted that claims that money market funds have no "capital" are misleading. Money market funds do have capital; it is the sponsor support that has, in dozens of instances prevented money market funds from breaking a dollar and resulted in a record of only two failures in almost 30 years. The problem is that the capital support is informal and voluntary.

[5] I am aware of two cases that the Commission has brought under Section 36(b), neither of which involved an excessive fees claim. See In the Matter of American Birthright Trust Management Company, Inc., Litigation Rel. No. 9266, 1980 SEC LEXIS 26 (Dec. 30, 1980); *SEC v. Fundpack, Inc.,* No. 79-859, 1979 WL 1238 (D.D.C., Aug. 10, 1979).

posed by the Court. But some decisions have gone too far and/or created absurd results. There is significant risk that the Court's decision will result in a complete evisceration of section 36(b). This will leave mutual fund investors at the mercy of opaque fee disclosure and no private claim against fund managers that charge excessive fees. It is therefore imperative that Congress strengthen the fiduciary duty standard under section 36(b) and implement long-overdue reforms in fee disclosure requirements.

Fiduciary Duty Standard

Section 36(b) applies a fiduciary duty to directors only with respect to fees paid to the fund manager. When a fund's excessive fees are attributable not to fees paid to the fund manager, but to fees paid on account of the administrative expense of operating a small fund, this fiduciary duty is not triggered. Thus, a fund director's decision to offer a fund with an 8 percent or 10 percent expense ratio may be reviewable only under the toothless state law standard that section 36(b) was designed to supplement. [6]

Congress should enact legislation that creates a fiduciary duty for fund directors that would require, for example, that directors affirmatively find that the fund could be a reasonable investment in light of its investment objective, performance history and expenses. If a fund's fees were so high so as to render the investment irrational, the directors would have to take action to cure the problem, such as by merging the fund into another fund with lower fees.

Fee Disclosure

As the Commission has recognized, fund fees "can have a dramatic effect on an investor's return. A 1 percent annual fee, for example, will reduce an ending account balance by 18 percent on an investment held for 20 years." [7] Notwithstanding the importance of fees, "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern." [8] The Department of Labor has found that employee benefit "plan participants on average pay fees that are higher than necessary by 11.3 basis points per year." [9]

In many respects, investors' lack of understanding is directly attributable to the way in which fees are disclosed. The current expense ratio is misleading because it excludes what can be a fund's single largest expense: portfolio transaction costs. 12b-1 fees are misleading because they create the impression that funds that do not charge 12b-1 fees therefore do not incur distribution expenses. Fund fees are disclosed in dollars based on hypothetical amounts, rather than a shareholder's actual costs, and the location of this disclosure makes it unlikely that investors will pay attention to this information. Nowhere are funds required to put their fees in context by comparing them to fees charged by index funds and comparable managed funds. The Commission has failed to support or actively opposed reforms designed to address each of these problems.

Portfolio Transaction Costs: The current expense ratio, which to be accurate should be referred to as the "partial expense ratio," excludes portfolio transaction costs. Portfolio transaction costs are the costs incurred by a fund when it trades its portfolio securities. Some portfolio transaction costs are easy to measure. For example, commissions paid by funds are disclosed as a dollar amount in the Statement of Additional Information, which is provided to shareholders only upon request. Other portfolio transaction costs must be measured indirectly, such as spread costs, but their existence and their substantial impact on fund expenses is no less certain.

The Commission concedes that portfolio transaction costs constitute a significant expense for fund shareholders. "[F]or many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions

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[6] A number of years ago, my research assistant was able to identify 18 funds in Morningstar's database with expense ratios in excess of 5 percent, yet the average management fee for the same funds was only 1.06 percent, and only one fund's management fee exceeded 1.29 percent.

[7] Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 25870, Part I.B (Dec. 18, 2002).

[8] *Id.* (citing a joint report of the Commission and the Office of the Comptroller of the Currency that "found that fewer than one in five fund investors could give any estimate of expenses for their largest mutual fund and fewer than one in six fund investors understood that higher expenses can lead to lower returns").

[9] See Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, Employee Benefits Security Administration, U.S. Department of Labor, 73 F.R. 43014, n.13 (July 23, 2008) ("DoL Proposal").

and spreads alone cost the average equity fund as much as 75 basis points."[10] A 2004 study commissioned by the Zero Alpha Group, a nationwide network of fee-only investment advisory firms, found that commissions and spread costs for large equity funds, the expenses and turnover of which are well below average, exceeded 43 percent of the funds' expense ratios. A 2004 survey by Lipper identified at least 86 equity funds for which the total amount paid in commissions alone exceeded the fund's total expense ratio, in some cases by more than 500 percent. The Department of Labor expressly cited, as a significant failing of the mutual fund expense ratio, its omission of portfolio transaction costs, which can equal many multiples of a fund's other expenses.[11]

Notwithstanding the significance of portfolio transaction costs, the Commission has opposed including these costs in the mutual fund expense ratio. In a June 9, 2003, memorandum, the Commission demonstrated that it had already prejudged the issue of the disclosure of portfolio transaction costs. It concluded that "it would be inappropriate to account for commissions as a fund expense" and unequivocally answered the question of "whether it is currently feasible to quantify and record spreads, market impacts, and opportunity costs as a fund expense. We believe that the answer is 'no.'"[12] Only after reaching this decision did the Commission proceed with the formality of issuing a concept release asking for comment on disclosure of portfolio transaction costs, apparently for the purpose of considering any alternative other than full inclusion in the expense ratio.[13] Six years later, the Commission has not taken any action on its proposal other than to include turnover ratios (an indirect and opaque reflection of portfolio transaction costs) with the fee table in new the summary prospectus. The expense ratio continues to be a partial expense ratio.

The Commission's position is flatly inconsistent with its responsibility to provide the information that the marketplace needs to promote price competition. By requiring funds to use the partial expense ratio, the Commission is effectively forcing the public to choose funds based on the Commission's view of the proper measure of fund costs. The Commission's decision to second-guess the market by deciding for investors which kinds of information they are capable of understanding contradicts basic market principles and is inconsistent with our capitalist system of free enterprise.

Investors logically look to the Commission to provide standardized reporting of expenses, and it is appropriate for the Commission to provide this service. But once the Commission has provided the important service of providing standardized information, it should remove itself from the market-driven determination of which information provides the best measure of a fund's true costs.

The Commission has argued that including portfolio transaction costs might distort fund managers' behavior. As noted above, this is not for the Commission to judge. The marketplace should decide which expense ratio—the partial expense ratio or a total expense that includes portfolio transaction costs—is the best measure of a fund's costs.

Furthermore, it is the partial expense ratio that distorts fund managers' and investors' behavior alike. The partial expense ratio distorts fund managers' behavior by not holding them accountable for their decisions to spend a substantial amount of fund assets on trading securities.

As illustrated in Exhibit A, for example, the Commission believes that investors should only be told that the expense ratio for the PBHG Large Cap Fund is 1.16 percent, and that they should not be told that when commissions and spread costs are included, the Fund's expense ratio for the period shown is 8.59 percent.[14] The true cost of that Fund is more than seven times the amount shown in the Commission's expense ratio. How can it be in the best interests of investors or consistent

[10] Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Investment Company Act Rel. No. 26313, at Part I (Dec. 19, 2003) ("Concept Release") (citing John M.R. Chalmers, Roger M. Edelen, Gregory B. Kadlec, Fund Returns and Trading Expenses: Evidence on the Value of Active Fund Management, at 10 (Aug. 30, 2001) (available at *http://finance.wharton.upenn.edu/edelen/PDFs/MF_tradexpenses.pdf*). "These estimates omit the effect of market impact and opportunity costs, the magnitude of which may exceed commissions and spreads." *Id.*

[11] See DoL Proposal, *supra*, at n.13.

[12] Memorandum from Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission, at 28 and 30 (June 3, 2003) (available at *http://financialservices.house.gov/media/pdf/02-14-70%20memo.pdf*) ("Donaldson Memorandum").

[13] See Concept Release, *supra*.

[14] Exhibit A also shows that, when commissions and spread are included, the expenses of the Strong Discovery Fund rise from 1.50 percent to 4.50 percent, the CGM Focus Fund from 1.20 percent to 4.48 percent, and the RS Mid Cap Opportunities Fund from 1.47 percent to 7.52 percent.

with free market economics to require, much less permit, the Fund to show its total costs of 1.16 percent? The partial expense ratio is misleading because it impliedly represents, in conjunction with other shareholder expenses listed in the fee table, the total cost of fund ownership.

The data in Exhibit A does not reflect outliers, but randomly selected examples from funds with more than $100 million in assets. If smaller funds with high turnover were considered, the differentials would be so large as to render the Commission's partial expense ratio fraudulent. For example, Lipper reports that the Rydex Telecom Fund's commissions for the fiscal year ending March 31, 2003, equaled 8.04 percent of assets. By applying the Zero Alpha Group study's methodology of estimating spread costs, we can estimate that total spread costs during that period equaled 8.75 percent of assets. Thus, whereas the Commission tells us that the Rydex Telecom Fund's is only 1.37 percent, its true costs are 18.16 percent, or 13 times higher.[15] The Commission's partial expense ratio distorts investors' behavior because investors obviously would make different investment decisions if they knew the true costs of owning certain funds.

The Commission's partial expense ratio also distorts managers' behavior because it creates an incentive for them to pay for non-execution expenses with fund commissions. Under current law, fund managers can payer higher commissions—that is, more than it would cost merely to execute the fund's trades—in return for non-execution services. By paying for these non-execution services with commissions, or what are known as soft dollars, fund managers effectively move these costs out of the expense ratio where they belong. This enables the fund that uses soft dollars to show a lower partial expense ratio than a fund that does not—even if the fund managers use identical services and have identical operating expenses. The Commission itself has conceded that "[t]he limited transparency of soft dollar commissions may provide incentives for managers to misuse soft dollar services."[16]

Furthermore, the nondisclosure of portfolio transaction costs exacerbates the conflict of interest that is inherent in the payment of soft dollars. As the Commission has recognized,

> [s]oft dollar arrangements create incentives for fund advisers to (i) direct fund brokerage based on the research provided to the adviser rather than the quality of execution provided to the fund, (ii) forego opportunities to recapture brokerage costs for the benefit of the fund, and (iii) cause the fund to overtrade its portfolio to fulfill the adviser's soft dollar commitments to brokers.[17]

The continued concealment of portfolio transaction costs permits the soft dollar conflict to operate virtually unchecked by market forces, whereas including portfolio transaction costs in a total expense ratio would, at least, permit the marketplace to judge the efficacy of soft dollar arrangements. If Congress does not take steps to eradicate soft dollars, at least it can require that these costs be disclosed so that the market can reach its own judgments regarding their efficacy.

Dollar Disclosure of Fees: Under current disclosure rules, funds are not required to disclose to investors how much they pay in fees. Many other financial services documents show investors exactly how much they are paying the service provider, including bank statements, insurance bills, credit card statements, mortgage loans and a host of other documents. But mutual funds provide only an expense ratio (and a partial one, at that, see *supra*) and the dollar amount of a hypothetical account.

Congress should require that funds provide individualized dollar disclosure of fund expenses in shareholder statements, as recommended by the Government Accounting Office[18] and proposed for employee benefit plans by the Department of Labor.[19] This requirement is necessary for two reasons. First, although the expense ratio is appropriate for providing comparability across different funds, it does not pack the same import as a dollar amount. Providing investors with the amount in

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[15] The Lipper data show that at least 31 funds' expense ratios would exceed 10 percent if they include commissions and spread costs.

[16] Concept Release at Part III.A, *supra*.

[17] Donaldson Memorandum, *supra*, at 36. Regarding directed brokerage, the Commission recently stated: "We believe that the way brokerage has been used to pay for distribution involves unmanageable conflicts of interest that may harm funds and fund shareholders." Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Rel. No. 26356 at Part II (Feb. 24, 2004).

[18] Government Accounting Office, Mutual Funds: Information On Trends In Fees and Their Related Disclosure (March 12, 2003).

[19] See DoL Proposal, *supra*.

dollars that they actually spent will give concrete form to an indefinite concept and make investors consider more fully the costs of different investment options.

Second, placing the dollar amount of expenses in the shareholder statement will direct shareholders' attention to the actual costs of fund ownership. No document is more likely to be read than a shareholder statement that shows the value of the shareholder's account and transaction activity during the period. Whereas the prospectus and shareholder report typically go directly from the mailbox to the trash can, even the most uninformed investors normally open their statements to check on the status of their accounts. There is no better way to draw shareholders' attention to the costs of investing than to require that the dollar amount of fees for the period be disclosed next to the value of the investor's account.

Some members of the fund industry have opposed informing investors about the actual costs of their fund investments on the grounds that doing so would be too costly and might mislead investors. It appears that MFS Investment Management, one of the largest mutual fund managers in America, disagrees. MFS offers to include actual dollar disclosure in investor statements, which undercuts industry arguments that providing this information is economically infeasible. The Department of Labor has proposed to require dollar disclosure of fees for plan participants and the Government Accountability has recommended that the SEC do the same.

The Commission opposes disclosure of shareholders' actual costs and opposes including dollar disclosure in shareholder statements. The Commission concluded its consideration of a proposal some years ago to require funds to disclose individualized costs in shareholder statements by expressly rejecting both concepts. Instead, the Commission decided to require disclosure of the hypothetical fees paid on a $1,000 account in the shareholder report, despite the facts that the hypothetical fees paid on a $10,000 account are already disclosed in the prospectus, and shareholders who most need to have their attention directed to the fees that they pay are least likely to read the shareholder report. In view of the Commission's, express opposition to effective disclosure of actual fees paid by shareholders, shareholders will receive disclosure of their actual fees in shareholder statements only if Congress requires funds to provide that information.

Fee Comparisons: Congress should take additional steps to promote price competition in the mutual fund industry by requiring that funds disclose fees charged by comparable funds and, for managed funds, the fees charged by index funds. Without any context, current fee disclosure provides no information about whether a fund's fees are higher or lower than its peers. Current disclosure rules also do not show the premium paid to invest in a managed funds as opposed to an index fund. Requiring comparative information in the fee table would enable investors to consider a fund's fees in context and evaluate how they compare to fees across the industry.

Distribution Fees: The Commission currently requires that 12b-1 fees be disclosed on a separate line that describes those fees as "distribution fees." It does not require that the fee table show the amount spent on distribution by the fund manager out of its management fee. This is inherently misleading, as investors often use the presence of 12b-1 fees as a negative screen that they use to avoid paying any distribution fees. In fact, investors in non-12b-1 fee funds may actually pay as much or more in distribution expenses than some investors in 12b-1 fee funds. [20]

Congress should overrule the Commission's position and require that, if distribution fees are stated separately in the fee table, they must reflect all distribution expenses paid by a fund, directly or indirectly. Alternatively, Congress should require that fund expenses be displayed in a pie chart that shows how much of a fund's fees were spent on each type of service. The Commission's current fee table is misleading and understates the amount of fund assets spent on distribution.

Disclosure of Brokers' Compensation: For virtually all securities transactions other than purchases of mutual fund shares, investors receive a transaction confirmation that shows how much the broker was paid in connection with the transaction. Permitting brokers to hide their compensation on the sale of mutual funds has spawned a Byzantine and harmful array of selling arrangements, including revenue sharing (also known as payments for shelf space), directed brokerage, and non-cash compensation. Mutual fund shareholders should be entitled to receive the same informa-

[20] In 1999, Paul Haaga, Chairman of the Investment Company Institute and Executive Vice President of the Capital Research and Management Company, stated at an SEC roundtable: "the idea that investors ought to prefer the funds that don't tell what they're spending on distribution over the ones that do is nonsense. You know, if you're spending money on distribution, say it. If you're not pending money on distribution don't say it; but don't pretend that there are no expenses there for a fund that doesn't have a 12b-1 plan." Conference on the Role of Investment Company Directors, Washington, D.C. (Feb. 23 & 24, 1999) (Haaga was not ICI Chairman at this time).

tion as other investors in securities in the form of full disclosure of their brokers' compensation on fund transaction confirmations. Such disclosure also should show how breakpoints applied to the transaction, as well as any special compensation received by brokers for selling particular funds.

Brokers also should be required to provide, at or before the time the investor places the order, an estimate of compensation to be received by the broker in connection with the transaction and the total costs of investing in the fund. When buying a house, purchasers are provided with an estimate of their total closing costs before making a final decision. As discussed immediately above, however, fund shareholders do not even receive a final statement of their actual costs, much less an up-front estimate of such costs.

In January 2004, the Commission proposed to require brokers to provide, both at the point-of-sale and in the transaction confirmation, disclosure of the costs and conflicts of interest that arise from the distribution of mutual fund shares. [21] More than 5 years later, the Commission has failed to take final action on its proposal. Congress should require that the SEC take final action on disclosure requirements that will result in brokers' customers receiving disclosure of the broker's economic incentives in the transaction.

Distribution Arrangements

12b-1 Fees

When Congress enacted the Investment Company Act of 1940, it expressly prohibited fund managers from using fund assets to finance the distribution of the fund's shares. Section 12(b) of the Act recognized the inherent conflict of interest between the manager's desire to increase fund assets in order to increase its fees on the one hand, and the fund's desire to hold down costs on the other hand. Unfortunately, the policy underlying Section 12(b) has long been abandoned, as fund assets are used for a wide range of distribution expenses that benefit fund managers at the expense of fund shareholders.

The policy of separating the product from its distribution was first abandoned by the Commission when, after a prolonged review, it adopted Rule 12b-1 in 1980. In the 1970s, mutual funds experienced periods of net redemptions that prompted fund managers to lobby the Commission to permit the use of fund assets to finance the distribution of the funds' shares. Fund managers argued that net redemptions resulted in increased costs and that the financing of distribution by the fund would help reduce or eliminate net redemptions.

The Commission initially rejected these arguments, but ultimately relented, provided that certain conditions were observed. For example, the Commission required that the fund's independent directors approve the 12b-1 plan. Among the factors that the Commission said a fund's directors should consider when evaluating whether to adopt or renew a 12b-1 plan was the plan's effectiveness in remedying the problem that it was designed to address, *i.e.,* increased costs resulting from net redemptions.

The Commission's most significant concern regarding 12b-1 fees was the conflict of interest that they created between the fund and its adviser. The Commission feared that 12b-1 fees would result in higher advisory fees and the fund's adviser would not share the benefits of asset growth. [22] Some would argue that this is precisely what has happened, with any growth-based economies of scale realized from 12b-1 fees being pocketed by fund managers and not shared with fund shareholders.

Of course, this analysis goes primarily to the use of 12b-1 fees for marketing the fund, which is what Rule 12b-1 was intended to permit. It does not address the ways in which 12b-1 are actually used today and that were wholly unanticipated by the Commission when Rule 12b-1 was adopted. According to and Investment Company Institute report, only 5 percent of 12b-1 fees are spent on advertising and

[21] Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Rel. No. 26341 (Jan. 29, 2004).

[22] See Donaldson Memorandum, *supra,* at 70-71 ("When a fund bears its own distribution expenses, the fund's investment adviser is spared the cost of bearing those expenses itself, and the adviser benefits further if the fund's distribution expenditures result in an increase in the fund's assets and a concomitant increase in the advisory fees received by the adviser.").

sales promotion, whereas 63 percent of 12b-1 fees are spent on broker compensation.[23]

The use of fund assets to compensate brokers is precisely what Section 12(b) was intended to prohibit. This practice puts the fund squarely in the position of underwriting its own securities. The fund's assets are used to incentivize brokers to recommend the fund over competing funds. The lesser the quality of the fund, the greater the pressure on the fund and its manager to pay brokers more to sell the fund.

This irreconcilable conflict is mirrored on the distribution side of the business. When brokers are paid by the funds, rather than their customers, they have an incentive to recommend the fund that offers the biggest payout, rather than the fund that will provide the best investment for their customers.[24] There is another incentive for brokers to favor arrangements whereby they are compensated by funds, and that is the fact that the compensation from the fund is not transparent. Whereas the payment of a front-end load is relatively evident to the investor, the payment of a 12b-1 fee is not. It is even less clear that the already opaque 12b-1 fee is ending up in the broker's pocket. For this reason, brokers and investors have begun to favor classes of fund shares where the broker is compensated by the fund, regardless of whether that class is in the best interests of shareholders.[25]

Thus, the Commission has created a distribution compensation structure that is directly at odds with the interests of investors and the Investment Company Act. Rather than tying brokers' compensation to their relationships with their customers, where the Investment Company Act requires that it be placed, the Commission has tied brokers' compensation to their relationships with the funds, where the Investment Company Act expressly forbade its placement.

Congress should reaffirm the supremacy of Section 12(b) and prohibit funds from compensating brokers for selling fund shares. Although this will necessarily entail the repeal of Rule 12b-1, it will in no way limit the ways in which investors can choose to pay their brokers. It will simply require that however brokers are compensated—through a front-end load, back-end load, level-load, or any combination thereof—they are compensated by their customers, not by the funds. Thus, if a customer chooses to pay his broker on an installment basis, at 0.50 percent each year, for example, that amount would be paid by the customer directly or deducted from his fund account.

One might argue that, to maintain perfect legislative coherence, Congress should also prohibit fund managers from paying for general marketing services that are not connected to specific sales. I disagree. The conflict is substantially reduced in this situation because the fund manager's and the fund's interests are generally aligned. General marketing payments do not create a direct incentive for brokers to favor one fund group over another. General marketing does what advertising for decades has been shown to do: promote competition. Indeed, by locating these payments in the management fee, the manager will be spending its own money and accordingly will have an incentive to minimize costs. With an express requirement that independent fund directors evaluate the efficacy of fund manager expenditures on marketing and determine that resulting economies have been shared with fund shareholders, expressly permitting fund managers to use the management fee to pay for marketing would be appropriate.

Revenue Sharing

Over the last two decades, a compensation practice has evolved that strikes at the heart of the principle of full disclosure of conflicts of interest. Known as "revenue sharing," this practice involves the payment of a part of fees collected by a mutual fund manager to a third party in return for administrative and/or distribution services. Notwithstanding the somewhat pejorative term "revenue sharing," there is nothing necessarily inappropriate about the practice itself. Broadside critiques of revenue sharing are off base. Revenue sharing primarily reflects a compensation structure that can be a more efficient method of compensation than direct charges by each service provider to the client. Indeed, 12b-1 fees are functionally a kind of revenue sharing that are subject to enhanced (but still inadequate, see *supra*) disclosure requirements.

[23] Use of Rule 12b-1 Fees by Mutual Funds in 1999, Investment Company Institute, 9 Fundamentals 2 (April 2000). Funds spend the other 32 percent of 12b-1 fees on administrative services. *Id.*

[24] See Laura Johannes and John Hechinger, Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds, *Wall St. J.* (Jan. 9, 2004); see also In the Matter of Morgan Stanley DW Inc., Exchange Act Rel. No. 48789 (Nov. 17, 2003).

[25] See Complaint, *Benzon v. Morgan Stanley,* No. 03-03-0159 (M.D. Tenn.). The SEC has banned the use of brokerage as compensation for fund brokerage.

That being said, the regulation and practice of revenue sharing disclosure has been abysmal. Revenue sharing payments are generally included in the total fees charged by a fund. Unlike 12b-1 fees, they are not, and are not required to be, broken out separately in the mutual fund fee table. More importantly, they are not necessarily disclosed by the service provider that receives them. Revenue sharing constitutes compensation to service provider that is not part of the fees charged directly to the client, so the client often is unaware of the service provider's economic incentive to sell the fund. When a broker recommends funds to clients, the broker does not disclose, and has not been required to disclose by the SEC or FINRA, that the broker will receive different amounts of revenue sharing payments depending on the fund purchased. The revenue sharing payments are made under the table; this blatant conflict of interest goes undisclosed.

This is a significant problem in the context of brokers' mutual fund sales. The SEC and FINRA continue to defend a suitability standard for brokers that does not require full disclosure of conflicts of interest, even when the broker is providing individualized investment advice to the client (as opposed to acting solely as a salesperson). This means that brokers can recommend funds that are "suitable" without disclosing that they are receiving higher revenue sharing payments from that fund's manager than they would receive from the manager of a more suitable fund. The fees are not trivial. One SEC settlement involving revenue sharing payments revealed that brokers were receiving payments equal to 25 percent of the fund advisory fee in revenue sharing payments on every sale of that fund's shares. It is inexcusable that brokers are not required to disclose this payment differential to their clients.

Unlike brokers subject only to a suitability standard, fiduciaries generally have been required to disclose revenue sharing to their clients. In *SEC v. Capital Gains Research Bureau,* the Supreme Court held that that an investment adviser, as a fiduciary, was required to disclose all material conflicts of interest to clients. Courts have generally applied this principle to the disclosure of revenue sharing payments on the ground that this information would be of importance to advisory clients. The Seventh Circuit recently held, however, that an Erisa fiduciary has no obligation to disclose revenue sharing payments to beneficiaries as long as the total fees being paid are disclosed. This is a truly remarkable position, especially in the wake of recent legislation that permits conflicted persons to provide investment advice to 401(k) plan participants on the condition that their compensation be the same regardless of the investment option selected. In other words, while Congress has been addressing the conflicted advice problem by flatly prohibiting differential compensation, the Seventh Circuit has decided not only that differential compensation can be received by an Erisa fiduciary, it does not even need to be disclosed.

Both the SEC and FINRA have proposed rules that, depending on their final form, would require the disclosure of differential compensation. These rules, like many important investment management initiatives, have been pending for years. While the SEC has been paralyzed with indecision, state attorneys general have sued fund managers and brokers for their failure to disclose revenue sharing arrangements in their prospectuses and to their clients. The SEC's failure to take a position one way or the other has created an unpredictable patchwork of regulation that benefits no one, especially not those who appropriately use revenue sharing in their compensation structures. And the SEC's failure to require the disclosure of revenue sharing payments has allowed the practice to flourish.

Congress should not continue to wait for regulators to recognize the obvious policy imperative of requiring full disclosure of conflicts of interest to financial services clients. In the last six years, a number of bills have been proposed that would, in one form or another, require the disclosure of revenue sharing and other forms of differential compensation. Congress should act promptly to enact some form of this legislation. The committee reports should make it clear that payments that create potential conflicts of interest must be disclosed and that the legislation is intended to overrule the Seventh Circuit's Deere decision.

Misleading Fund Share Classes

Mutual funds often offer several classes of shares that reflect different ways of paying for distribution services. Typically, Class A shares carry a front-end load, Class B shares a back-end load, and Class C shares carry a level load. An investor is usually better off buying Class A shares if he intends to hold his shares for the longterm, and Class C shares if he may sell in the short-term. When Class B shares are best option, it is for the shareholder who holds for the mid-term. In some cases, however, there is virtually no shareholder for whom Class B shares are the best option.

The Commission does not prohibit funds from offering Class B shares, even when there is no shareholder for whom Class B shares could be the best investment option. The Commission even rejected a rule amendment that would have required that funds illustrate in the prospectus the relative costs of each class of shares. Following the Commission's lead, a federal court held in January 2004 that, even assuming that there was no rational investor for whom Class B shares would be the best investment, the fund had no duty to disclose this fact in the prospectus.[26]

It is unconscionable that under current Commission positions a fund can offer a class of shares that would not be the best investment for any rational investor. Congress should require that multi-class funds illustrate, in a graphic format, the costs of investing in different classes over a 15-year period. In addition, Congress should require that the fund's independent directors find, subject to a fiduciary duty as described above, that each class of shares offered could be a reasonable investment alternative.

Fund Advertising

Throughout the late 1990s, the Commission frequently berated the fund industry for misleading investors by advertising short-term performance. Funds with short life-spans routinely advertised one-year, sometimes even 2- and 3-year annualized investment returns in excess of 100 percent. With the crash of the stock bubble in 2000, the Commission's concerns were validated, as many of these funds experienced huge losses, in some cases in excess of 70 percent of their value.

The Commission's actions have not reflected its words, however. In September 2003, the Commission adopted advertising rules that utterly failed to address the very problems that it had identified in the late 1990s.[27] The rules require funds to provide a telephone number or web address where current performance information is available, as if the problem with short-term performance was that it wasn't current enough. The Commission also required that the text in fund ads include the statement that "current performance may be higher or lower than the performance data quoted."

Fund advertisements posted following market declines in 2000–2002 demonstrate the inadequacy of the Commission's new rules. After three years of negative returns, stock funds had a banner year in 2003. Many of those funds are now advertising their stellar one-year performance without any disclosure of their poor returns in 2000, 2001, and 2002. Because they are required only to show their one-, five- and ten-year returns, the negative returns of 2000 to 2002 are hidden from view. The ads create a misleading impression by showing the outsized returns of 2003 without any mitigating disclosure of the down years that preceded them and the performance volatility that those years' returns illustrate.

For example, one ad shows SEC-mandated performance for four funds, each of which experienced superior returns in 2003, but experienced losses or substantially lower performance in each year from 2000 to 2002. As illustrated in the table below, the disclosure of each fund's annual performance in the years preceding 2003 would have presented a very different, far more accurate picture. The Commission's rulemaking has done nothing to prevent such misleading ads, which have appeared routinely in business and personal finance magazines in the first few months of this year.

Funds	Disclosed*	Not Disclosed**		
	2003	2002	2001	2000
Fund #1	51.68%	(21.27%)	(7.56%)	(18.10%)
Fund #2	42.38%	(9.37%)	(12.99%)	(8.96%)
Fund #3	23.36%	(20.44%)	(3.74%)	12.25%
Fund #4	29.96%	(17.16%)	(5.02%)	8.54%

* Source: Business 2.0 (March 2004).
** Source: Fund Prospectuses.

The Commission's rulemaking also did nothing to address the problem of the disconnect between the advertised performance of funds and the actual returns experienced by shareholders. As confirmed by a recent DALBAR study, "[i]nvestment re-

[26] See *Benzon v. Morgan Stanley,* 2004 WL 62747 (M.D. Tenn.).

[27] Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 26195 (Sep. 29, 2003).

turn is far more dependent on investment behavior than on fund performance."[28] DALBAR found that the average equity fund investor earned 2.57 percent annually over the last 19 years, in comparison with the S&P 500's 12.22 percent annual return during the same period. This translates into a cumulative return for the S&P 500 of 793.34 percent from 1984 to 2002, compared with equity fund investors' actual cumulative return of 62.11 percent during the same period.

These stunning and disheartening data illustrate, in part, a failure of investor education and individual choice. Investors have consistently chased the best performing funds just before they crashed, and dumped the worst performing funds just before they recovered. This sell-high, buy-low mentality is only encouraged by the Commission's current approach to fund performance advertising, which permits funds to present outsized returns with no meaningful caveats regarding their volatility and the likelihood that performance will soon revert to the mean.[29]

Not only do current rules fail to require meaningful disclosure about the volatility of fund returns, but they also fail to place outsized, one-year returns in the context of the market as a whole. To illustrate, the performance of the S&P 500 for 2003 was 28.68 percent, which puts the 51.68 percent return of the Fund cited above in a light very different (albeit still positive) from one in which the performance data stands alone. The Fund's advertised ten-year return of 10.58 percent would tell a different story if it were required to be juxtaposed against the S&P 500's 11.07 percent ten-year return.

The Commission also has recognized the need for investment returns to be considered in the context of fees, yet its rules do virtually nothing to benefit investors in this respect. In its proposing release, the Commission promised that its new rule would "ensure that fund advertisements remind fund shareholders about the availability of information about fund charges and expenses."[30] Yet the final rule required only that fund advertisements refer investors to the prospectus for consideration of fund expenses, among other things.[31] In contrast, the NASD has proposed that fund advertisements include a box that shows both the fund's maximum sales charge and its expense ratio.[32]

Congress should require that fund advertisements include all information necessary to make the information presented not misleading. This must include, at a minimum, investment returns for each individual year where such returns differ materially from fund's one-year performance, disclosure of the fund's total expense ratio (*i.e.,* including the fund's portfolio transaction costs) and sales charges, and the performance and expenses of a comparable index fund.

Soft Dollars

The term "soft dollars" generally refers to brokerage commissions that pay for both execution and research services. The use of soft dollars is widespread among investment advisers. For example, total third-party research purchased with soft dollars alone is estimated to have exceeded $1 billion in 1998.[33] An executive with American Century Investment Management has testified that the research component of soft dollar commissions costs six times the value of the execution component.[34]

Soft dollar arrangements raise multiple policy concerns. The payment of soft dollars by mutual funds creates a significant conflict of interest for fund advisers. Soft dollars pay for research that fund advisers would otherwise have to pay for them-

[28] DALBAR, Quantitative Analysis of Investor Behavior at 2 (2003).

[29] Notably, the Commission requires that the prospectus include a bar chart that shows a fund's return for each of the preceding ten years. If such a disclosure is necessary to make the prospectus not misleading, it is unclear why the same reasoning is not applicable in the context of a fund advertisement.

[30] Proposed Amendments to Investment Company Advertising Rules, Investment Company Rel. No. 25575, Part II.C (May 17, 2002).

[31] Amendments to Investment Company Advertising Rules, *supra.*

[32] See Disclosure of Mutual Fund Expense Ratios in Performance Advertising, National Association of Securities Dealers (Jan. 23, 2004).

[33] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998).

[34] Testimony of Harold Bradley, Senior Vice President, American Century Investment Management, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at 5 (Mar. 12, 2003).

selves. Advisers therefore have an incentive to cause their fund to engage in trades solely to increase soft dollar benefits.[35]

Soft dollar arrangements normally would be prohibited by the Investment Company Act because they involve a prohibited transaction between the fund and its adviser.[36] Section 28(e) of the Securities Exchange Act, however, provides a safe harbor from the Investment Company Act for soft dollar arrangements as long as the brokerage and research services received are reasonable in relation to the amount of the commissions paid.

The conflicts of interest inherent in soft dollar arrangements are exacerbated by current disclosure rules. The amount of fund assets spent on soft dollars is not publicly disclosed to shareholders, so they are unable to evaluate the extent, and potential cost, of the adviser's conflict.

Current disclosure rules reward advisers for using soft dollars because this practice creates the appearance that a fund is less expensive. The expense ratio does not include commissions, which gives advisers an incentive to pay for services with soft dollars, thereby enabling them to lower their management fees and the fund's expense ratio. Advisers can effectively reduce their expense ratios by spending more on soft dollars, while the fund's actual net expenses remain unchanged.

Finally, current disclosure rules may encourage excessive spending on soft dollars. Advisers would tend to spend less on soft dollars if they knew that they would be held publicly accountable for their expenditures.

The Commission has frequently recognized but declined to address the problem of soft dollars. As discussed above, the Commission is opposed to including portfolio transaction costs in funds' expense ratios, which would have the benefit of enabling the market to determine for itself the efficacy of soft dollar arrangements. The Commission previously proposed a rule that would require that soft dollars costs be quantified, but decided against adopting it.[37] When the Commission staff last evaluated soft dollar arrangements in 1998, it concluded that additional guidance was needed in a number of areas.[38] For example, the staff found that many advisers were treating basic computer hardware—and even the electrical power needed to run it—as research services qualifying under the Section 28(e) safe harbor.[39] The staff recommended that the Commission issue interpretive guidance on these and other questionable uses of soft dollars, but it has failed to do so.

In fact, the only formal action that the Commission has taken in recent years is to expand the use of soft dollars. In December 2001, the Commission took the position that the safe harbor should apply to markups and markdowns in principal transactions, although Section 28(e) expressly applies only to "commissions."[40] This position directly contradicts not only the plain text of the statute, but also the position taken by the Commission in 1995 that section 28(e) "does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions."[41] Although the Commission has, once again, suggested that intends to narrow the scope of soft dollars, its recent history suggests that Congressional action is necessary. In any case, the Commission lacks the authority to ban soft dollars.

There is no better evidence that the time has come to ban soft dollars than the recognition of the insidious nature of this practice by members of the fund industry. In addressing the fact that soft dollars enable fund managers to use the fund's money to pay for research used by the manager, the independent chairman of the Putnam Funds has stated that "[t]he best decisions get made when you buy services with your own money."[42] Similarly, MFS' chairman, Robert Pozen,

> sees the soft-dollar funnel as a lucrative one for brokers, but one that hides the true cost of such services to shareholders. "It's all camouflaged," said

[35] *Id.* at 2 (the statutory safe harbor permitting soft dollars arrangements "encourages investment managers to use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager").

[36] See Investment Company Act Section 17(e); Inspection Report at 38, *supra*.

[37] Donaldson Memorandum at 13-17, *supra*. Fidelity recently recommended that the Commission reconsider its decision not to require the quantification of soft dollar costs. Ann Davis, Fidelity Wants Trading Costs To Be Broken Down, *Wall Street Journal* (Mar. 15, 2004).

[38] Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, Securities and Exchange Commission, at text accompanying note 1 (Sep. 22, 1998) ("Section 28(e) Report").

[39] *Id.* at Section V.C.4.

[40] Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exchange Act Rel. No. 45194 (Dec. 27, 2001).

[41] Investment Advisers Act Release No. 1469 (February 14, 1995).

[42] *Id.* (quoting John Hill).

> Mr. Pozen, a former associate general counsel of the SEC. Now, he added, "If we want something, if we think it's valuable, we will pay cash."[43]

A Fidelity executive has acknowledged the pro-competitive advantage of a ban on soft dollars, stating: "[w]e don't rule out a competitive environment through which all research is acquired through cash rather than commissions."[44]

The difficulty for fund firms, however, is that without a statutory ban on soft dollars they may suffer a competitive disadvantage MFS has estimated that paying for its own research will reduce its advisory fees.[45] Fidelity has estimated that of the $1.1 billion in commission it paid in 2003, $275 million paid for soft dollar research.[46] It is unrealistic to expect these fund managers to maintain the high road at the expense of reduced advisory fees, while other fund managers continue to pay their own research expenses through soft dollars rather than out of their own pockets.

Fund Names and Investor Expectations

The recent collapse of the stock market has exposed a significant gap in the regulation of mutual fund names. The average investor will reasonably assume that funds will invest consistent with their names, but mutual fund rules do not require that funds honor these expectations.

To illustrate, one would expect a Target Date 2010 Fund to be designed to fit the needs of someone who planned to retire at age 65 in 2010. Such a fund would invest in mix of stocks and bonds. The investment of stocks carries higher risk, but this risk is necessary to provide the growth potential needed by someone who may live 30 or more years after retirement. The fixed income securities provide stability to ensure that assets that will be needed for living expenses in the near term are not exposed to risk. There is no definitive asset allocation between stocks and fixed income securities in which a Target Date 2010 Fund should invest, and one could not argue that under no circumstances would it be appropriate for a 65-year-old retiree to have an 80 percent stock / 20 percent bond mix, but such a mix would fall well outside the generally expected asset allocation of a Target Date 2010 Fund.

Mutual fund disclosure rules would allow a Target Date 2010 Fund to adopt such an 80 percent / 20 percent asset allocation. Notwithstanding that the Fund's name suggests a substantially lower stock allocation, the description of the Fund's investment objectives and style in its prospectus could correct this misimpression and investors would be expected to have read and understood such clarifying disclosure. Under current prospectus liability rules, the true nature of the Fund's aggressive asset allocation strategy could even be omitted from the summary of its investment objectives and style in the summary prospectus as long as corrective disclosure appeared elsewhere in the full prospectus. (It is likely that some courts would find that even corrective disclosure buried in the Fund's Statement of Additional Information, which is delivered to investors only upon request, would be a sufficient defense for prospectus liability purposes.) Thus, investors that expect the stock allocation suggested by the name of the Target Date 2010 Fund to be substantially lower than 80 percent and do not carefully scrutinize other fund disclosure documents will be subject to more risk than they expected. For example, a 45 percent decline in the stock market would result in a 36 percent decline in the value of their Fund shares, when they might have expected an 18 percent or 22.5 percent based on a 40 percent or 50 percent stock allocation.[47]

It is helpful to consider a recent example of this problem. A particular Target Date 2010 Fund has been criticized for declining 38 percent in value, but this decline is consistent with its aggressive asset allocation. The fourth page of the fund's prospectus (for the relatively assiduous investor) states that each retirement fund:

> is managed to the specific year of planned retirement included in its name (the 'retirement date'). The Strategies' asset mixes will become more conservative each year until reaching the year approximately fifteen years after the retirement date (the 'target year') at which time the asset allocation mix will become static.

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[43] *Id.*

[44] Landon Thomas, Jr., Mutual Fund Tells Wall Street It Wants à la Carte Commissions, *New York Times* (Mar. 16, 2004).

[45] MFS Ends 'Soft Dollar' System, *supra.*

[46] Fidelity Wants Trading Costs To Be Broken Down, *supra.*

[47] Tom Laurcella, For Retirement, 'One Size' Isn't Always a Good Fit, *Wall. St. J.* (Mar. 2, 2009) available at *http://online.wsj.com/article/SB123549381087960625.html* ("A typical fund for an investor aiming to retire 20 years from now might have at least 80 percent in stocks. By the time the retirement date approaches, most funds typically have less than 40 percent in stocks.").

At this point, the prospectus has only reinforced the expectation that the 2010 fund's asset allocation strategy will reflect a stock allocation in the range of 40 percent to 50 percent. Under current law, this disclosure by no means created an expectation on which investors could actionably rely. Indeed the same paragraph includes a state that 15 years after retirement the static allocation would be: 27 percent short-term bonds, 37.5 percent other fixed-income securities, 25 percent equities and 10 percent real estate investment trusts ("REITs"). From this, a very attentive investor could assume that the stock allocation at retirement would be fairly aggressive. The fifth page of the prospectus includes table that shows an expected allocation of approximately 77 percent 30 of the 2010 fund's assets to equities, REITS and high-yield debt in the year before retirement.

The problem is that this fund's allocation is inconsistent with what many investors will expect from a Target Date 2010 Fund. There is no reason that this fund's sponsor should not be allowed to offer a fund for retirees who wish to adopt an aggressive asset allocation. In combination with other investments the retiree might hold, the retiree's overall asset allocation might fall within the more typical 40 percent to 50 percent range. But, in the words of a Fidelity executive, something called a "target-date" fund should follow a "one size fits most" strategy, and this fund fails that test.

This problem is not limited to target-date funds. In some 529 plans, there are asset allocations designed for children expected to need the funds for college within one or two years that experienced substantial losses. These losses were inconsistent with the investment performance range one would expect from a conventionally constructed portfolio for such a short time horizon. Some of these 529 plans invested in bond funds that included "short-term" in the fund's name, but their investment returns fall well outside of the variance one would associate with short-term bond funds. Many "short-term bond" funds held outside of 529 plans have produced abnormally high losses.

To reiterate, the problem here is not that some funds have experienced substantial losses. To the extent that investors knowingly assumed the risk of large losses, criticizing these funds is somewhat unfair. For example, actively managed funds that lost 60 percent of their value while comparable markets lost only 40 percent provided their investors with returns that were within the range of variance from market returns that one assumes by accepting active management risk. One could criticize such funds for poor stock-picking, but it was the shareholder who chose to assume the active management risk that the fund would underperform the market. Similarly, the shareholder invested in a Target-Date 2050 Fund should expect to experience large losses when stock markets experience significant declines. In this case, it would be the Target-Date 2050 Fund that invested most of its assets in money market instruments that would be contradicting the asset allocation implied by its name.

The SEC has had the opportunity to address the potential of fund names to mislead investors. Pursuant to a request from consumer advocates, the SEC adopted a misleading fund names rule in 2001. The rule fell far short of providing reasonable assurances that fund names that strongly implied a particular investment objective or style would stick to it. The rule allows "stock" funds to invest 100 percent of their assets in cash in emergency situations, "short-term bond" funds to risk substantial losses, "value" funds to invest primarily in growth stocks, and "target-date 2010" funds to invest a more than 75 percent of their assets in equities. The SEC has taken the position that no matter how strongly a particular fund name implies a particular investment objective or style, the name's potential to mislead investors can be entirely corrected through narrative disclosure that is often buried in fund documents. The SEC staff went out of its way to reassure fund managers that funds the included the term "U.S. Government" in its name could nonetheless invest 100 percent of its assets in securities issued by Fannie Mae and Freddie Mac.[48] As I testified before this Committee in 2004, the term "U.S. Government" implies that the fund will invest in government-guaranteed securities, which Fannie Mae and Freddie Mac securities are not.

Although investors should read prospectuses carefully before investing, I disagree that investors whose investments in a "target-date 2010" fund, a "shortterm bond" fund or 529 plan investment option for a 16-year-old that declined more than 40 percent in one year are entirely to blame for their misfortune. Congress should enact legislation that meaningfully regulates fund names. It should require the SEC to prohibit the use of fund names that create a common expectation among investors regarding a fund's investment objectives and style unless the fund invests consistent

[48] Letter from Paul F. Roye, Director, SEC Division of Investment Management, to Craig Tyle, General Counsel, Investment Company Institute (Oct. 17, 2003).

with that style. The precise scope of the rule should be left to the SEC, but there should be no question that terms such as “target-date,” “short-term bond,” and “value” would be covered. Fund sponsors use these terms in fund names precisely to communicate something about the fund to investors. They should not be permitted to contradict the fund name’s message with qualifying disclosure in fund documents.

Some have criticized this position as requiring that the government dictate how funds invest. This argument is a red herring designed to divert attention from the real issue. The only restriction that would apply would be to the names that funds are permitted to use. The new rule would have no effect on any fund that chose a name that did not imply a particular investment objective or style. I strongly agree that free markets should determine what mutual funds invest in, not regulators. Requiring that all mutual funds invest only in a portfolio the returns of which will fall within a fairly predictable range would be inefficient, impracticable and inconsistent with basic principles of individual liberty. There are and should be mutual funds the variance of the investment returns of which essentially match the scope of the fund manager’s investment discretion.

Requiring that a fund that uses a particular name produce predictably variable returns, however, does not implicate these concerns. When Magellan Fund manager Jeff Vinik invested a large amount of the Fund’s assets in fixed income securities prior to a run-up in the stock market in the late 1990s, the opportunity lost by its shareholders was a risk that they knowingly assumed. There is nothing about the name “Magellan Fund” that implies that its investment returns will reflect the variance that is characteristic of a particular market. Indeed, the name “Magellan” aptly suits a fund that may explore any and all investment opportunities around the globe. In contrast, it is misleading that a so-named “stock” fund can, consistent with its name, invest 100 percent of its assets in cash, or that something called a “short-term bond” fund could lose 40 percent of its value in a single year.

Fund Governance

As indicated by this testimony, the breadth and depth of investor protection issues in the mutual fund industry that have been left unattended by regulators calls for new ideas on the most efficient structure for mutual fund regulation. The mutual fund scandal of 2003 also demonstrated the need for more independent boards. As described in greater detail in my March 23, 2004, testimony before this Committee, Congress should implement the following reforms to strengthen the oversight of mutual funds:

- Create a Mutual Fund Oversight Board that would have examination and enforcement authority over funds and fund boards.
- Require that a fund’s chairman be independent.
- Require that a fund’s board be 75 percent independent.
- Prohibit former directors, officers and employees of the fund manager from serving as independent directors.
- Require that independent directors stand for election at least once every 5 years.

The Commission does not have the authority to impose any of these requirements on an unconditional basis. Each of these proposals requires Congressional action.

529 PLANS

As this Committee is aware, 529 plans have become an increasingly popular means for Americans to save for higher education. These plans have enjoyed enormous appeal in part because they offer a unique combination of federal and state tax benefits, high contribution limits, matching state contributions, donor control, automatic rebalancing and, in many cases, low costs. However, 529 plans also have been subject to criticism on the grounds of excessive and inadequately disclosed fees, inconsistent state tax treatment across different plans, and questionable sales practices. The following discussion briefly sets forth some of the issues relating to 529 plans and proposes regulatory reforms.[49]

Regulatory Oversight

Permitting states to sell and regulate 529 plans has effectively added 50 new regulators for tax-deferred mutual fund wrappers (*e.g.,* 401(k) plans, IRAs, Roth IRAs,

[49] Many of these issues are discussed in greater detail at: Mercer Bullard, The Visible Hand in Government Sponsored Financial Services: Why States Should Not Sponsor 529 Plans, 74 U. Cin. L. Rev. 1265 (2006).

and 403(b) plans), which are subject to too many different regulators and sets of rules as it is. The Commission is responsible for fee disclosure for variable annuities, the Department of Labor is responsible for fee disclosure for employee benefit plans, and banking regulators and the Internal Revenue Service are responsible for fee disclosure for IRAs. Multiple disclosure regimes confuse investors and increase the costs of offering investment products, as each provider must tailor its program to the particular state's requirements. The Committee should take this opportunity to explore ways of rationalizing fee disclosure and other regulatory aspects of various tax-deferred mutual fund wrappers.

One option would be to assign exclusive oversight of 529 plans to the SEC. The SEC has greater experience and expertise in this area than any other government entity, and it would bring greater independence and objectivity to the creation and enforcement of 529 plan fee disclosure requirements. The states, as the issuers of interests in 529 plans, lack the independence and objectivity to regulate their own plans and to enforce any rules they might devise. Congress should consider specifically authorizing the Commission to establish comprehensive rules governing the 529 plan fee disclosure, and consider expanding this responsibility to all aspects of 529 plans operations.

In addition, Congress should consider amending the municipal securities exemption to exclude 529 plans or permitting private firms to offer 529 plans outside of state sponsorship. The municipal exemption under which 529 plans operate was not intended for the offering of retail financial services, but for the conduct of bona fide government activities. There is nothing state-specific about 529 plans that could not be accomplished outside of the framework of a money management structure.

Fee Disclosure

Some commentators have criticized 529 plans on the ground that the high fees charged by many plans have reduced the potential tax benefits of the plans. Indeed, one commentator decried a plan that consumed more than 10 percent of participants' balances each year for two years. Determining whether a particular fee is too high or too low, based solely on the amount of the fee, is a difficult and uncertain exercise. In my view, the best way to promote efficient pricing is through standardized, transparent disclosure of fees. It is generally accepted that standardized, transparent fee disclosure promotes competition and reduces prices. The disclosure of 529 plan fees, however, is generally incoherent and obscure, and 529 plans would likely be forced to reduce their fees if adequate fee disclosure were provided.

The lack of transparent, prominent, standardized disclosure of 529 plan fees is exacerbated by factors in the 529 plan context that make fee disclosure even more important than in other contexts. In effect, certain governmental entities have been granted an exclusive monopoly to sell a particular tax-deferred investment product in competition with private providers of other tax-deferred investment products. This intrusion of the government into the private sector may distort many functions of the financial services markets, including the setting of fees.

For example, investors may lower their guard when evaluating 529 plans on the assumption that a public-minded governmental entity would sell only a high quality, low-cost investment product. In fact, states' interests may not be aligned with plan participants' interests with respect to negotiating fees and choosing investment options, and investors' trust in states' motivations and interests may be misplaced. States may have incentives to offer plans that charge high fees. States may charge high fees as a means of increasing their general revenues, or charge higher fees to out-of-state residents as a way to subsidize services provided to instate participants. Political considerations also may influence the selection of money managers and cause states to be less diligent when negotiating fees. For example, states may favor in-state money managers or managers that have contributed to the election campaigns of state officials. State officials may even use 529 plan assets for self-promotion.

Further, participants in 529 plans have limited control over fees. Mutual funds can raise advisory and 12b-1 fees only with shareholder approval, whereas states generally can raise fees at will without notice to participants, thereby making it more important that investors understand the fees charged before making an investment decision. When a mutual fund that is a 529 plan investment option seeks to raise its fees, the state has the right to vote on the fee increase, but, as noted above, it may not have the same interests to negotiate low fees as plan participants have. Finally, federal law gives mutual fund shareholders legal recourse against a fund's directors and manager with respect to excessive fees charged by the manager, which may provide some restraint on fees. Participants in 529 plans, however, have no such rights absent a violation of the antifraud rules under the federal securities laws.

Restrictions on 529 plan investment options, participants' limited control over fees and fee increases, the costs and burdens of transferring from one plan to another, states' monopoly on state tax benefits, limited legal recourse against plan sponsors, and the divergence of state and participant interests are some of the special factors that make it especially critical that 529 plan fees be fully disclosed in an understandable, standardized, accessible format.

These special factors militate for prompt Congressional action to ensure that 529 plans are required to provide standardized, transparent, prominent fee disclosure. In short, fee disclosure for 529 plans, at a minimum, should be:

- Standardized, both in the way in which the fees are calculated and the terms used to describe the fees;
- Prominently disclosed relative to other information about the plan;
- Presented both as a percentage of assets and a dollar amount, and on an illustrative and individualized basis;
- Inclusive of a total expense ratio for each investment option that includes all fees incurred in connection with an investment in the plan, to include, among other things, portfolio transaction costs, distribution costs, operating costs and administrative fees, whether charged by the state, plan manager, investment manager, or other person;
- Inclusive of a pie chart that illustrates the components of the total expense ratio according to standardized categories of fees, such as investment management, administrative services, and marketing and distribution;
- Inclusive of information on fees charged by other 529 plans both in a disclosure document and in an easily accessible format on the Internet; and
- Inclusive of separate disclosure of all payments received by intermediaries for executing the transactions in plan interests, both as a dollar amount and percentage of assets, whether or not the payment is made directly by the participant.

As discussed above, Congress should ensure that fee disclosure requirements for 529 plans are promulgated and enforced by an independent, objective government entity.

Disparate State Tax Treatment

Most states that permit state deductions for 529 plans limit the deductions to the in-state plan. This disparate state tax treatment of 529 plans distorts the marketplace for investment products. Investors may opt for a higher-cost, in-state plan specifically in order to receive the tax benefits of the in-state plan, or may miss out on the in-state tax benefit offered by a low-cost in-state plan because brokers recommend out-of-state plans that pay higher compensation to the broker.

The disparate state tax treatment of 529 plans has the effect of reducing price competition among 529 plans because in-state plans can exploit their monopoly on in-state tax benefits to offset their higher fees. This is essentially a kind of bundling, not dissimilar to a private company that has a government-granted monopoly over one product (state tax deductions) to help it sell another, possibly inferior product (the 529 plan). States will inevitably exploit this monopoly to the detriment of investors in 529 plans. The unavailability of state tax deductions for out-of-state plans may further undermine market efficiency and create incentives to charge higher fees, as discussed in the next section. A small minority of states have extended their state tax deduction to out-of-state 529 plans, but most continue to frustrate Congress's intent in creating the plans. Congress should consider mandating that any state tax deductions for 529 plan contributions or distributions be reciprocal across all qualified 529 plans.

HEDGE FUNDS

Systemic Risk

There is no question that hedge funds are a potential source of systemic risk, that is, the kind and scope of financial risk that is systemic in the sense of posing a threat to our political, social and economic systems. Systemic risk warrants government oversight because our society might not be able to absorb an extreme contraction of free financial markets without long-term damage to political, economic and social institutions. This concern militates for appropriate prudential oversight of hedge funds, such as requirements that they report net positions and leverage ratios.

This does not mean that hedge funds or their advisers should be subject to substantive regulation, however. It is important that capital be allowed to flow to unregulated intermediaries such as hedge funds. Investment in hedge funds is limited to sophisticated investors, and these investors are presumed to be in the best position to protect their interests without costly governmental oversight. Substantive regulation of hedge funds will simply drive sophisticated capital offshore and provide little benefit to the financial markets. As discussed below, however, the SEC has permitted hedge funds to be sold to unsophisticated investors in certain circumstances.

Public Offering of Hedge Funds

In 2007, the SEC effectively decided to permit hedge funds to publicly offer their shares. These hedge funds argued that they reflected investments in hedge fund managers, not in the funds, yet the value of interests that they sold were predominantly depended on the success of their funds. The financial structure of these public companies is closer to a hedge fund than to a conventional money manager,[50] and the behavior of the stock prices of public hedge funds and conventional money managers over the last two years has reflected the significantly greater risks posed by the former. As predicted, these publicly held hedge funds are acting like hedge funds, not money managers. Much attention is being—and should be—paid to the systemic risk posed by hedge funds, but too little has been paid to the sale of hedge fund interests to unsophisticated investors. If the SEC continues to be unwilling to ensure that hedge funds are sold only to sophisticated investors, Congress should prohibit the public offering of shares of these entities.

Accredited but Unsophisticated Investors

Under current law, persons with net worth of $1 million either alone or with their spouse qualify to invest in hedge funds. The SEC has conceded that this test, which has not been adjusted since 1982, has made millions of new investors eligible to invest in hedge funds at the same time that “private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.” The Commission estimated that the minimum net worth requirement, if adjusted only for inflation and disregarding the issue of increased complexity, would have been $1.9 million as of July 1, 2006. That year, the Commission issued a modest proposal to increase the $1 million minimum to $2.5 million. That minimum would be inflation-adjusted again on July 12, 2012, and every 5 years thereafter. In 2007, the Commission requested additional comments on the proposal, but almost three years after the initial proposal, the Commission has yet to take final action.

The effect of the SEC’s position is that a newly retired couple with $700,000 investments and a $300,000 home—the SEC continues to count a person’s personal residence counts toward the $1 million net worth minimum while conceding that the “value of an individual’s primary residence may have little relevance with regard to the individual’s need for the protections of Securities Act registration”—is sophisticated enough to invest in a hedge fund. With $700,000 in investments, a retired couple’s typical withdrawal rate would be 4 or 5 percent annually, or about $31,000 per year, plus Social Security income and, in some cases, a company pension. Even assuming additional income of $20,000 per year (which would not be needed for the couple to meet the SEC standard), it is self-evident that this couple’s net worth in no way qualifies them to risk their retirement security in a hedge fund. Nearly three years after its initial proposal (and 27 years after the $1 million minimum was first established), the SEC continues to permit hedge funds to prey on unsophisticated investors. Congress should take steps to ensure that any individual net worth standard for private offerings bears a reasonable relationship to the likely financial sophistication of the purchaser.

INVESTMENT ADVISERS

Fiduciary Standard

It is hard to understand how, after years of regulatory review, the simple question of whether those who provide individualized investment advice should be subject to a fiduciary standard has not been answered. It is accepted that professionals who provide individualized, technical advice similar to investment advice—*e.g.,* lawyers and doctors—are fiduciaries. They are required to act solely in their clients’ best interests. They may charge higher fees than other advisers, but their fees must be fair. The must disclose all potential conflicts of interest to their clients. In many

[50] See After Blackstone: Should Small Investors Be Exposed to Risks of Hedge Funds? Hearing before the Subcommitee on Domestic Policy, Committee on Oversight and Government Reform (July 11, 2007) (testimony of Mercer Bullard); Mercer Bullard, Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen, 13 Stanford J. Law, Bus. & Fin. 286 (2008).

cases, doctors and lawyers are prohibited from assuming a conflicted role no matter what amount of disclosure they provide.

The Supreme Court agrees. In the Capital Gains decision, it held that investment advisers are subject to a fiduciary duty to their clients. Yet the SEC and FINRA have taken the position that when brokers provide individualized advisory services to their clients, they should not necessarily be subject to a fiduciary duty, even when they charge a separate, asset-based fee and advertise themselves as "financial consultants," "financial planners," and "wealth managers." In the narrow circumstances in which the SEC would consider a broker to be an adviser, such as when it had provided a variety of financial planning services to a client, the SEC still would allow the broker to revert to a non-fiduciary role in executing the financial plan. As a practical matter, the "financial consultant" can provide a generic financial plan subject to a fiduciary duty, and then take off its fiduciary hat when selling the client mutual funds that pay the broker higher distribution fees than other funds without disclosing the fees. As long as the funds are suitable, which they generally will be, the broker has acted consistent with FINRA's standards of conduct.

The SEC's approach to this issue has been consistently anti-investor. Ten years ago, it adopted a rule that expressly eliminated Congress's requirement that the broker exclusion apply only if the broker receives no special compensation for investment advisory services. The rule also read Congress's requirement that the advisory services also be "solely incidental" so broadly so as to be meaningless. The SEC took the position that advice was solely incidental if the advisory services were provided "in connection with and reasonably related to" brokerage services. As stated in an *amicus* brief filed by Fund Democracy and the Consumer Federation, "[t]he Commission's 'in connection with and reasonably related to' standard sets no limits on the degree of advisory services provided in relation to the brokerage services, much less in any way limit the advisory services to those that are 'minor' or otherwise 'incidental.'"

Congress needs to take action to end this debate. For over a decade, the SEC has been unable to muster the backbone to defend fiduciary standards for investment advisers, and the current SEC Chairman and one Commissioner spent years defending FINRA's self-interested position that a suitability standard is adequate,[51] notwithstanding that, for example, it does not require the disclosure of conflicts of interest. Congress should enact legislation that imposes a fiduciary duty on any persons who provide individualized investment advice or sell products pursuant to their providing of such individualized investment advice. Americans who naturally expect those providing fiduciary services to act solely in their clients' best interests are entitled to nothing less.

Madoff Scandal

It should not be necessary to include the Madoff scandal as a separate category in this testimony, but the import of the scandal for investment adviser regulation has been so distorted that some clarification is necessary. We still don't know exactly how Madoff perpetrated his fraud, except that he did so without detection for many years. Some have argued that this reflects a failure of investment adviser regulation despite the fact that he was exclusively regulated as a broker-dealer during most of the period of the fraud. These arguments may simply reflect nothing more than a short-sighted political strategy to curry favor as the preferred choice as the SRO for the adviser industry, but they nonetheless need to be addressed. I agree that an SRO for advisers would be appropriate, but if the Madoff scandal has revealed anything with respect to this issue, it is that some regulators lack a full understanding of the nature of investment adviser services and regulation and could not adequately protect investors' interests in overseeing the investment adviser industry.

During most of the period during which Madoff defrauded his clients, he was not registered as an investment adviser—he was registered as a broker. It appears that he was not registered as an investment adviser because the SEC had interpreted the broker exclusion from the definition of investment adviser for "solely incidental" investment advice to be available for discretionary accounts. The SEC has since abandoned this ill-advised position, but during most of Madoff's illegal activities he was able to rely on the exclusion and was regulated solely as a broker. Thus, while

[51] See, *e.g.,* Letter from Mary Schapiro, Vice Chairman and President, NASD, and Elisse Walter, Executive Vice President, NASD to Annette Nazareth, Director, Division of Market Regulation, and Meyer Eisenberg, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission (Apr. 4, 2005) available at *http://www.sec.gov/rules/proposed/s72599/nasd040405.pdf*

FINRA, the SRO responsible for broker oversight, has suggested that the Madoff scandal illustrates the risk of "the absence of FINRA-type oversight of the investment adviser industry," this position is belied by the undisputed fact that Madoff was subject only to broker regulation during most of the relevant period.

FINRA's position is understandable and not necessarily a negative reflection on its capacity as the broker SRO. Its leadership lacks a deep understanding of and experience with investment adviser regulation, and it has a close relationship with and is naturally protective of the brokerage industry. Its sometimes excessive exuberance for extending its jurisdiction over functionally dissimilar services is a common, unavoidable symptom of agency politics, especially in the inexperienced hands of new leadership. And one would expect that a fraud perpetrated by a man who for years served in a variety of leadership roles with FINRA's predecessor (the NASD), and who used the luster that the NASD gave his reputation to help entice unknowing victims, would put FINRA on the defensive and make its objective evaluation of the situation difficult.[52] Indeed, FINRA's precipitate response to the Madoff scandal is quite understandable, but it is also, unfortunately, evidence that it is not capable of providing effective self-regulation of the investment adviser industry.

This is not to say that the Madoff scandal tells us nothing about investment adviser regulation. As noted, it demonstrates the problem of leaving solely to broker regulation the kinds of advisory activities that are clearly in need of investment adviser oversight. The SEC has corrected the regulatory gap that allowed brokers who provided discretionary advice to avoid advisory regulation. As discussed below, the Commission should take steps to ensure that all individualized investment advice is subject to advisory regulation.

In addition, during the last stages of the scandal Madoff was registered as an investment adviser. His registration statement indicated that he had custody of $17 billion in assets under management. The Investment Advisers Act generally requires that an investment adviser maintain custody of client assets with a broker dealer or a bank, and in doing so relies on FINRA and banking regulators to ensure that the custodied assets actually exist. In view of reports that much of the Madoff related losses will be covered by SIPC, it appears that the failed custody arrangement was with a broker. It is unclear why, if the stolen assets were custodied by a broker, regular broker examinations by Madoff's SRO did not uncover the fraud. As discussed below, such prudential oversight should be assigned to a prudential regulator, not to a regulator such as FINRA with concurrent investor protection jurisdiction. A regulator such as FINRA should focus solely on what it knows and does best: regulating the sales activities of brokers.

A final word is necessary regarding the argument made by some that the Madoff scandal demonstrates the weakness of a fiduciary standard. A fiduciary duty is not designed to nor could it protect investors from those who are willing to steal their money outright. The Madoff scandal is no more a reflection on the fiduciary standard (or FINRA's lower suitability standard) than would be a bank robbery. What would have detected Madoff's fraud is adviser registration triggered by the providing of individualized investment advice and competent examinations of his custody arrangements.

Principal Trading Exemption

One of the primary reasons that brokers seek to avoid triggering investment adviser regulation is the principal trading prohibition. Section 206(3) of the Investment Advisers Act requires that investment advisers obtain written notice and consent from their clients prior to completion of the transaction in which the adviser acts in a principal capacity. Brokers chafe under the requirement to obtain client consent prior to every principal trade, and they hoped to be relieved of this restriction by the SEC's proposed rule excluding virtually all brokers managing nondiscretionary accounts from the definition of investment adviser (known as the "Merrill Rule"). When the Merrill Rule was vacated by the Court of Appeals, the SEC quickly sought to accommodate brokers' concerns by adopting an interim rule that exempted virtually all trades not conducted in a discretionary account from section 206(3).

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[52] See Susan Antilla, Investors happily handed Madoff Billions, *Business Times* (Dec. 17, 2008) (Madoff's "company Web site describes him as 'a major figure in the National Association of Securities Dealers', the regulatory agency now known as Finra. He was board chairman of the Nasdaq Stock Market; was on the board of governors of the NASD; sat on an advisory committee for the Securities and Exchange Commission (SEC); and was chairman of the trading committee of Sifma, formerly the Securities Industry Association.").

Before considering this interim rule, some history on the SEC's ill-advised Merrill Rule is in order. As with the principal trading exemption, the SEC effectively adopted the Merrill Rule without prior notice and consent. The SEC took a no-action position with respect to activity conducted within the proposal's purview, thereby circumventing Administrative Procedures Act requirements. Those who opposed the rule were left in limbo waiting for the Commission to adopt a final rule so that it could be challenged in court. Almost five years later, the Commission had yet take final action on the rule and the Financial Planning Association sued to force a final resolution of the issue. The SEC reproposed the rule in 2004, and then again in 2005. It finally adopted the rule in 2005, after it had been in operation for almost six years, and the Court of Appeals vacated the rule in its entirety in 2007.

Even before the Court's order went into effect, the SEC embarked on the same path of adopting effectively final rules without prior notice and comment. It scheduled its "interim" exemption from section 206(3) to expire more than two years after its adoption. The SEC's repeated abuse of notice and comment procedures undermines faith in the rule of law and the administrative process, especially when it abuses its authority by enacting broad exemptions from carefully crafted laws enacted by Congress specifically to protect investors against abusive transactions.

In this instance, the interim rule has created significant investor protection gaps that continue to remain unaddressed. For example, the rule does not expressly require firms to develop policies and procedures that are specifically designed to detect, deter and prevent disadvantageous principal transactions. Such procedures are necessary to ensure that the fairness of the price at which the principal trade is effected can be objectively verified. The market's current difficulty in valuing certain fixed income securities that previously were considered relatively liquid and easily valued illustrates the potential risk. Securities that are difficult to value often are more likely to be securities that an adviser may be attempting to dump on its clients. The incentive to engage in the abuses that section 206(3) is designed to prevent rises with the difficulty of determining whether the transaction was fair. Congress should insist that the SEC take prompt action to address this and other concerns relating to the principal trading exemption. [53]

Pay-To-Play Ban

In August 1999, the SEC proposed to prohibit money managers from engaging in pay-to-play. The Commission had thoroughly documented the practice among public pension officials of awarding investment management business to large political donors. [54] The retirement accounts of millions of our nation's schoolteachers, fire fighters, police officers and other public servants were being invested by money managers who qualify for the job not by earning it, but by financing the political campaigns of public pension fund officials. The SEC's proposal was elegantly simple. It would have required that money managers give up any compensation they received for managing public money for two years after the firm, its executives or agents made a campaign contribution to an elected official or candidate who could have influenced the selection of the money manager.

The pay-to-play proposal was modeled on Rule G-37, which prohibits municipal bond underwriters from contributing to the campaigns of elected officials who may influence the award of bond underwriting contracts. The rule is widely credited with cleaning up the municipal bond industry. An unfortunate byproduct of Rule G-37 has been its incidental effect on pay-to-play in the money manager arena. State treasurers and other elected fiduciaries of municipal pension funds saw campaign contributions from municipal underwriters dry up, so they turned to money managers and lawyers doing business for the pension funds to make up the difference.

Pay-to-play practices continue to plague the awarding of money management business by public pension funds at the same time that public pension underfunding has reached crisis proportions. It is imperative that managers tasked with restoring financial stability to public pension plans are not selected on the basis of political favor, but on the basis of their expertise and experience. This will not happen as long as the SEC allows investment advisers to pay-to-play in the public money man-

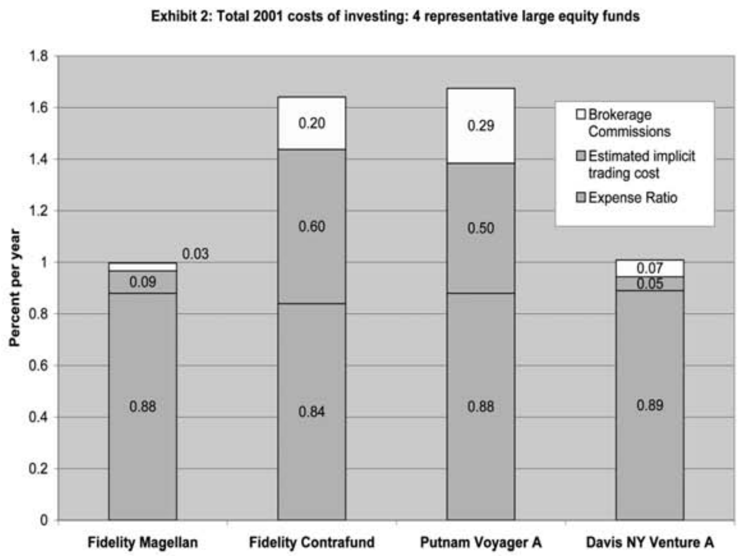
[53] See Letter from Mercer Bullard, President and Founder, Fund Democracy and Barbara Roper,Director of Investor Protection, Consumer Federation of America to Nancy Morris, Secretary, U.S. Securities and Exchange Commission (Nov. 30, 2007) available at *http://www.funddemocracy.com/principal%20trading%20ltr%2011.30.07.pdf*

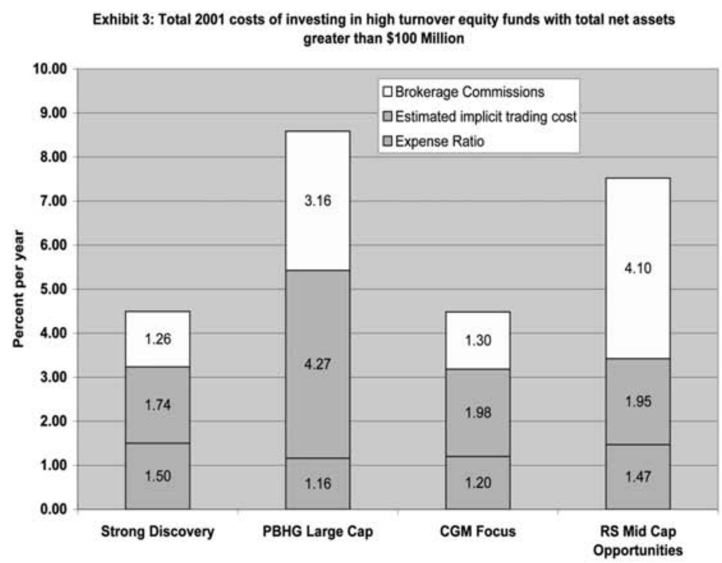
[54] These findings in a series of articles published in 2001, see Mercer Bullard, PaytoPlay in America, TheStreet.com (Apr. 26–30, 2001), available at *http://www.thestreet.com/funds/mercerbullard/1406251.html*, and a state-by-state guide to pay-to-play practices uncovered by the SEC is posted on Fund Democracy's Web site. See *http://www.funddemocracy.com/Pay-to-Play%20Page.htm*

agement arena. Congress should strongly encourage the SEC to repropose the pay-to-play rule and see it through to final adoption.

Exhibit A

from Jason Karceski, Miles Livingston & Edward O'Neal, Mutual Fund Brokerage Commissions (Jan. 2004)





PREPARED STATEMENT OF ROBERT PICKEL

EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER,
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

MARCH 10, 2009

Mr. Chairman and Members of the Committee, thank you very much for allowing ISDA to testify at this hearing. We are grateful to the Committee for the opportunity to discuss the privately negotiated derivatives business and more specifically, the credit default swaps market. This business is an important source of innovation for our financial system—it is one that employs tens of thousands of individuals in the United States and benefits thousands of American companies across a broad range of industries.

About ISDA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 850 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

In my remarks today, I would briefly like to:

- Describe how CDS contracts works and the benefits they provide;
- Clarify the level of exposure in the CDS business;
- Discuss the robust infrastructure that industry participants have developed to support the CDS business;
- Review the role of CDS in today's financial crisis; and
- Outline my views on the evolution of the regulatory framework for privately negotiated derivatives.

As I cover these topics, I hope to clarify some key misperceptions regarding the CDS business:

- The first is that, even in the face of a significant increase in defaults and the collapse of major financial institutions, the CDS business has continued to function. Credit derivatives have remained available as a means to manage risk in today's financial markets;
- Second, as recent events have proven out, the risks related to the CDS business have been widely misunderstood;
- Third, the CDS business operates within a robust infrastructure that incorporates time-tested standards, practices and principles;
- Fourth, CDS are not responsible for today's financial crisis; and
- Finally, the CDS industry continues to work with policymakers to improve and evolve how we do business.

How Credit Default Swaps Work

Credit default swaps are simple financial transactions negotiated between two counterparties. They enable firms to transfer and more effectively manage risk.

In the real world, CDS play an important role in the growth and functioning of our nation's economy:

- CDS facilitate the flow of credit to American businesses;
- CDS lower borrowing costs for American companies; and
- CDS provide vital information to the market about the creditworthiness of borrowers.

OTC derivatives exist to serve the risk management and investment needs of end-users such as the businesses that are the backbone of our economy and the investors that provide funds to those businesses. The development of OTC derivatives has followed the development of the American economy. For centuries, foreign exchange transaction have facilitated trade and helped American businesses expand; they were one of the original banking powers recognized in the National Bank Act of 1863. The first OTC derivative linked to interest rates was transacted in the early 1980s between IBM and the World Bank, helping IBM raise funds on more favorable terms. Today, over 90 percent of the Fortune 500, 50 percent of mid-sized companies and thousands of other smaller American companies, use OTC currency and interest rate derivatives. Credit derivatives first appeared in the mid-1990s as a tool to help banks diversify the credit risk in their loan portfolio, and they have grown into a vital risk management and diversification tool. In each case the need for these products was driven by the needs of end-users, and their growth was a direct function of their utility to end-users. If end-users did not want these products, they would not exist.

It might be helpful to provide an example of the needs that credit derivatives address. Imagine a bank that wants to lend more to American companies in a particular sector of the economy, or a particular geographic region, but that does not have relationships with those companies. That bank could enter into a credit derivative transaction with a bank that does have loans to those companies, whereby the first bank would sell protection to the second bank on those companies, taking on some of the second bank's credit exposure to those companies in exchange for periodic payments. This transaction benefits both banks: the first bank diversifies its loan portfolio and earns income and the second bank is able to lend more money to those companies and deepen its relationship with them. Equally importantly, this transaction also benefits the companies themselves. It expands their funding sources and thus allows them to get better rates on their borrowings.

CDS can also be used to hedge against other risks related to the potential default of a borrower. For instance, an auto parts company that is heavily reliant on one auto manufacturer as its primary customer might seek to protect itself against the risk that manufacturer will go out of business by purchasing protection in the form of a CDS on that company.

These credit derivatives, so-called single-name credit default swaps because they provide default protection on a single entity, were the foundation of the credit derivatives market and still constitute the vast majority of the market. These trades help American companies raise money more cheaply, and they help American investors diversify risk and seek out attractive investment opportunities. To that end, Warren Buffett wrote this year in his letter to Berkshire Hathaway shareholders that he has started to use single name CDS to sell protection and that he would like to enter into more such transactions. The utility of such credit derivatives to investors and to companies is what makes them so valuable to the American economy.

Growth and Size of the CDS Business

Because of the important role they play in enabling firms to more precisely manage risk, the CDS business has grown significantly in a relatively short period of time. The most common measurement of the size of the CDS business is notional amount. For CDS, this represents the face value of the bonds and loans on which participants have written protection.

While using notional amount as a measurement tool for the size of the privately negotiated derivatives business has its benefits, it also has a major drawback. Notional amount greatly overstates the actual exposure represented by the CDS business. One reason for this is because a seller of protection often seeks to hedge its risk by entering into offsetting transactions. Using the example above, if the counterparty that sold $10 million of protection wished to hedge its risk and buy protection, it too would enter into a $10 million CDS contract. Thus, there are now two CDS contracts outstanding with a total notional amount of $20 million. The reality is, however, that only $10 million is at risk.

The Depository Trust and Clearing Corporation recently began publishing market data based on information compiled for their Trade Information Warehouse. According to DTCC, the net notional amount outstanding—which represents the maximum possible net funds transfer between net sellers and net buyers of protection that could be required upon the occurrence of a credit event—is $2.6 trillion.

This may seem like a large number, and it is. But consider what it represents: the sum total of payouts if all reference entities were to default. This is, to say the least, unlikely. What's more, the average of the net notional amount across the reference entities in the DTCC warehouse is $2.6 billion. And this actually overstates the potential losses, because it excludes any recovery value that sellers of protection might receive. The point here is that the net payout on an individual reference entity basis is manageable. This was aptly demonstrated by the Lehman default, where the amounts paid on settlement were handled with no disruption to the system.

One additional point regarding the size and risks of the CDS business bears mentioning. CDS do not create new risks. They enable firms to transfer risk that already exists. This risk-shifting process is a zero-sum arrangement; what the buyer potentially gains by buying protection, the seller potentially loses by selling protection. The amount that the seller of protection loses is identical to the risk that the buyer originally held.

CDS Infrastructure

Privately negotiated derivatives are often referred to as "OTC derivatives," with the implication being that this is an unregulated business with no structure, standards or principles governing it. As someone who has been involved in building a robust infrastructure for privately negotiated derivatives for virtually my entire professional career, this misperception is perhaps the most frustrating among those that characterize the CDS business.

The truth is, there is a robust infrastructure for CDS and other swaps that has been developed over the past 25 years by ISDA, industry participants and policymakers around the world. The growth, strength, and success of the business could not have been achieved without it.

A case in point: some believe that, in the OTC derivatives business, all kinds of firms can enter into all types of CDS contracts with each other. This is simply not the case. The fact is, banks are the primary market makers in the CDS business, and firms wishing to trade CDS need to have credit lines with them. Of the trades in the DTCC warehouse, virtually all involve at least one dealer and 86 percent are between two dealers. These dealer banks, in turn, impose a variety of requirements on their counterparties (and vice versa) in terms of the maximum exposure they will take, the imposition of collateral requirements, and so on. Virtually all of the exposure in the CDS business originates within the heavily regulated banking system.

Another example of the industry's infrastructure at work: at the core of every CDS transaction is a contract negotiated and entered into between two firms. The specific terms of the contract—its amount, the premium payment, its duration, *etc.*—are determined by the counterparties and are codified in a confirmation agreement between them.

Underlying the confirmation is the widely used ISDA Master Agreement, which includes standardized language on definitions and other contract terms. The ISDA Master is widely recognized as a groundbreaking document that has enabled the growth of the risk management industry by enhancing legal certainty and reducing credit risk. It establishes key international contractual standards, and its importance to the global financial community has been described as "no less than the creation of global law by contractual consensus." Reflecting its wide acceptance, the vast majority of derivatives transactions executed annually are documented under the ISDA Master.

In addition to the standardized legal architecture governing privately negotiated derivatives, the industry has also worked to develop sound practices in other areas. These include risk management, the use and management of collateral, and the incorporation of technology into the derivatives business.

The industry's work to further strengthen and improve the infrastructure and platform upon which it operates is never-ending. The industry has, for example, greatly improved transparency through the publication of information in DTCC's trade information warehouse, and significant progress has been made to reduce operational risk in the confirming, settling, and clearing of CDS.

The Role of CDS in Today's Financial Crisis: Bear, Lehman, AIG

Over the past year, CDS have received a significant amount of attention because of concerns about their role in the current financial crisis. More specifically, issues have been raised regarding whether CDS created the financial crisis and/or played a significant part in the Bear Stearns, Lehman Brothers, and AIG situations.

It is by now clear that the roots of the current financial crisis lie in imprudent lending decisions, particularly with respect to residential housing, but also extending to other areas including consumer receivables, auto finance and commercial development. These imprudent decisions were in part the result of an "easy money" environment and a mispricing of risk. They were in turn exacerbated by distortions in ratings models that underestimated both the risk of individual securities as well as how closely correlated the risks of those securities were within portfolios.

If CDS did not cause the crisis, did they make it worse? Some industry observers cite the Bear Stearns situation in answering this question. While it may seem far longer, it was only a year ago that Bear Stearns suffered a liquidity crisis that led to its eventual purchase by JPMorgan Chase. As this drama unfolded, there were widespread concerns that Bear's failure as a derivatives counterparty would have systemic implications. The theory was the CDS and other privately negotiated derivatives supposedly created an interlinking web in which a shock from one participant could capsize others.

The fact is, Bear's problems were primarily related to a lack of confidence from its lenders and its resulting inability to secure institutional funding to run its business. It was a classic liquidity squeeze for an institution that apparently relied too much on short-term funding. The role of swaps in this situation was at best cursory.

As for the systemic risk fears related to Bear's role as a swaps counterparty, subsequent events have proven this supposition to be groundless. Lehman was larger than Bear Stearns—a bigger institution with a bigger derivatives portfolio—and its bankruptcy created no system fissures.

In fact, by the time of the Lehman default in September, the focus had shifted. No longer were market observers especially worried about the failure of a large derivatives counterparty. Concerns centered on the implications of a failure of a reference entity upon which a significant level of credit protection had been sold.

Here, too, however, the fears were overblown. Contrary to rumors, the actual payout on CDS contracts in which Lehman was a reference entity was about $5 billion—far less than some industry critics initially thought. By all accounts, the Lehman bankruptcy and default was processed well by the industry, testifying to its strength and resilience.

Moving now to AIG: Last week, this Committee heard testimony on the regulatory failures that contributed to the terrible situation at AIG. We also heard Chairman Bernanke express his frustration with AIG, stating that it acted like an unregulated hedge fund.

The truth, however, is far worse. First, it's clear that AIG was in fact regulated. Its supervisors apparently knew how much mortgage risk it was taking on in its credit protection and securities lending business. They also knew that AIG included ratings triggers and collateral requirements in its contracts in order to gain additional counterparty capacity.

In addition, a hedge fund would not have been allowed to build up such a large, uncollateralized positions with so many counterparties. In fact AIG Financial Products operated far more recklessly than most hedge funds or, for that matter, other businesses engaged in similar activities. It is worth noting these practices were contrary to the generally accepted practices advanced by ISDA for the last 20 years.

In short, the causes of the AIG situation are clear. First, AIG's Financial Products subsidiary took on too much exposure to subprime mortgage debt. As the ratings on that debt were downgraded, the company's own ratings came under pressure. Under agreements with its counterparties and customers, AIG was then forced to post ever increasing amounts of collateral with them. In short, AIG took on too much exposure to subprime debt, and failed to appropriately manage its collateral and liquidity. It was a collective risk, liquidity, and collateral management failure, facilitated by poor supervision and an overreliance on rating agency models.

The Continued Evolution of the CDS Business

As noted previously, the CDS industry is committed to further strengthening and improving how we do business. This includes working with policymakers to address areas of mutual concern.

On November 14 the PWG announced a series of policy objectives for the privately negotiated derivatives industry. The PWG broke their recommendations into four broad categories: (1) improve the transparency and integrity of the credit default swaps market; (2) enhance risk management of OTC derivatives; (3) further strengthen the OTC derivatives market infrastructure; and (4) strengthen cooperation among regulatory authorities.

ISDA agrees with these four objectives, and believes that continuing to pursue the improvements industry and regulators have worked on over the last several years is key to ensuring the OTC derivatives industry in the United States remains healthy and competitive.

Within those four broader objectives the PWG lists a number of specific recommendations. These can be separated into:

- Recommendations for policymakers (*e.g.,* "Regulators should establish consistent policy standards and risk management expectations for CCPs or other systemically important derivatives market infrastructures and apply those standards consistently");

- Recommendations for industry (*e.g.,* "Market participants should adopt best practices with respect to risk management for OTC derivatives activities, including public reporting, liquidity management, senior management oversight and counterparty credit risk management");
- Recommendations of an operational nature (*e.g.,* "Details of all credit default swaps that are not cleared through a CCP should be retained in a central contract repository").

These recommendations provide a helpful framework for policymakers and industry alike to discuss while reviewing and reforming the current regulatory structure. Of particular importance from ISDA's perspective is the PWG's statement acknowledging the continued need for bi-lateral, custom tailored risk management contracts. As the PWG states: "Participants should also be able to bilaterally negotiate customized contracts where there are benefits in doing so, subject to continued oversight by their prudential supervisors." While some have posited that all OTC derivatives contracts should be made to trade on-exchange, as the PWG notes there will continue to be the need for customized OTC transactions.

On the same day the PWG announced its policy objectives, it also released a Memorandum of Understanding among the Federal Reserve, the Commodities Futures Trading Commission and the Securities and Exchange Commission related to regulation of central counterparties. This Memorandum is an important step in ensuring that regulators do not work at cross-purposes while working to facilitate the creation of a central clearinghouse. It would be unfortunate were the creation of a CDS clearinghouse to be unnecessarily delayed because of a lack of agreement among federal regulators.

Conclusion

Both the role and effects of CDS in the current market turmoil have been greatly exaggerated. CDS were not the cause, or even a large contributor, to this turmoil. There is little dispute that ill advised mortgage lending, coupled with improperly understood securities backed by those loans, are the root cause of the present financial problems. These risk management problems have in some instances been exacerbated by a failure to appropriately manage collateral and liquidity.

CDS are valuable risk management tools. They facilitate lending and corporate finance and provide an important price discovery function that is useful not only within the CDS business itself but across a much broader spectrum. The business has remained open and liquid throughout the financial crisis, demonstrating its resiliency.

It is ISDA's hope that the facts surrounding privately negotiated derivatives, including CDS, will highlight the benefit of these risk-transfer tools and the robust, sound infrastructure that has developed around them.

At the same time, recent market events clearly demonstrate that the regulatory structure for financial services has failed. Laws and regulations written in the 20th century, in many cases designed to address markets which existed in the 18th century, need to be changed to account for 21st century markets and products. An in-depth examination of the U.S. regulatory structure is self-evidently warranted.

In summary, privately negotiated derivatives have continued to perform well during a greater period of stress than the world financial system has witnessed in decades. In the wake of failures of major market participants, both counterparties and issuers of debt, CDS participants have settled trades in an orderly way precisely according to the rules and procedures established by Congress and market participants. In this respect CDS activity has been a tremendous success. We are confident that policymakers and market participants alike will find their prudent efforts in helping build the infrastructure for derivatives over the last 25 years have been rewarded.

PREPARED STATEMENT OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL,
AFL–CIO

MARCH 10, 2009

Good morning, Chairman Dodd and Senator Shelby. My name is Damon Silvers, I am an Associate General Counsel of the AFL–CIO, and I am the Deputy Chair of the Congressional Oversight Panel created under the Emergency Economic Stabilization Act of 2008 to oversee the TARP. While I will describe the Congressional Oversight Panel's report on regulatory reform, my testimony reflects my views and the views of the AFL–CIO unless otherwise noted, and is not on behalf of the Panel, its staff or its chair, Elizabeth Warren.

The vast majority of American investors participate in the markets as a means to secure a comfortable retirement and to send their children to college. Most investors' goals are long term, and most investors rely on others to manage their money. While the boom and bust cycles of the last decade generated fees for Wall Street—in many cases astounding fees—they have turned out to have been a disaster for most investors. The 10-year nominal rate of return on the S&P 500 is now negative, and returns for most other asset classes have turned out to be more correlated with U.S. equity markets than anyone would have imagined a decade ago.

While the spectacular frauds like the Madoff ponzi scheme have generated a great deal of publicity, the bigger questions are (1) how did our financial system as a whole become so weak how did our system of corporate governance, securities regulation, and disclosure-based market discipline fail to prevent trillions of dollars from being invested in value-destroying activities—ranging from subprime mortgages and credit cards, to the stocks and bonds of financial institutions, to the credit default swaps pegged to those debt instruments; and (2) what changes must be made to make our financial system a more reasonable place to invest the hard earned savings of America's working families?

My testimony today will seek to answer the second question at three levels:

1 How should Congress strengthen the regulatory architecture to better protect investors;

2. How should Congress think about designing regulatory jurisdiction to better protect investors; and

3. What are some specific substantive steps Congress and the regulators should take to shore up our system of investor protections?

Finally, I will briefly address how to understand the challenge of investor protection in globalized markets.

Regulatory Architecture

While there has been much discussion of the need for better systemic risk regulation, the Congressional Oversight Panel, in its Special Report on Regulatory Reform issued on January 29, 2009, observed that addressing issues of systemic risk cannot be a substitute for a robust, comprehensive system of routine financial regulation.[1] There are broadly three types of routine regulation in the financial markets—(1) safety and soundness regulation for insured institutions like banks and insurance companies; (2) disclosure and fiduciary duty regulation for issuers and money managers in the public securities markets; and (3) substantive consumer protection regulation in areas like mortgages, credit cards, and insurance. These are distinct regulatory missions in significant tension with each other.

Investors, people who seek to put money at risk for the prospect of gains, really are interested in transparency, enforcement of fiduciary duties, and corporate governance. This is the investor protection mission. It is often in tension with the equally legitimate regulatory mission of protecting the safety and soundness of insured financial institutions. A safety and soundness regulator is likely to be much more sympathetic to regulated entities that want to sidestep telling the investing public bad news. At the same time, investor protection is not the same thing as consumer protection—the consumer looking for home insurance or a mortgage is seeking to purchase a financial service with minimal risk, not to take a risk in the hope of a profit.

Because these functions should not be combined, investor protection should be the focus of a single agency within the broader regulatory framework. That agency needs to have the stature and independence to protect the principles of full disclosure by market participants and compliance with fiduciary duties among market intermediaries. Any solution to the problem of systemic risk prevention should involve the agency charged with investor protection, and not supersede it.

Since the New Deal, the primary body charged with enforcing investor protections has been the Securities and Exchange Commission. Although the Commission has suffered in recent years from diminished jurisdiction and leadership failure, it remains an extraordinary government agency, whose human capital and market expertise needs to be built upon as part of a comprehensive strategy for effective re-regulation of the capital markets.

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[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 3 (Jan. 29, 2009), available at *http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf*

While I have a great deal of respect for former Treasury Secretary Paulson, there is no question that his blueprint for financial regulatory reform was profoundly deregulatory in respect to the Securities and Exchange Commission.[2] He and others, like the self-described Committee on Capital Markets Regulation led by Harvard Professor Hal Scott, sought to dismantle the Commission's culture of arms length, enforcement-oriented regulation and to replace it with something frankly more captive to the businesses it regulated.[3] While these deregulatory approaches have fortunately yet to be enacted, they contributed to an environment that weakened the Commission politically and demoralized its staff.

While there has been a great deal of attention paid to the Commission's failure to spot the Madoff ponzi scheme, there has been insufficient attention to the Commission's performance in relation to the public debt markets, where the SEC regulates more than $438.3 billion in outstanding securities related to home equity loans and manufactured housing loans, among the riskiest types of mortgages. Similarly, little attention has been paid to the oversight of disclosures by the financial and homebuilding firms investing in and trading in those securities, and perhaps most importantly, the lack of action by the Commission once the financial crisis began.[4]

But elections have consequences, and one of those consequences should be a renewed commitment by both Congress and the new Administration to revitalizing the Commission and to rebuilding the Commission's historic investor protection oriented culture and mission. The President's budget reflects that type of approach in the funding it seeks for the Commission, and the new Chair of the Commission Mary Schapiro has appeared to be focused on just this task in her recent statements.[5]

A key issue the Commission faces is how to strengthen its staff. Much of what needs to be done is in the hands of the Commission itself, where the Chair and the Commissioners set the tone for better or for worse. When Commissioners place procedural roadblocks in the way of enforcing the law, good people leave the Commission and weak staff are not held accountable. When the Chair sets a tone of vigorous enforcement of the laws and demands a genuine dedication to investor protection, the Commission both attracts and retains quality people.

Congress should work with the Commission to determine if changes are needed to personnel rules to enable the Commission to attract and retain key personnel. The Commission should look at more intensive recruiting efforts aimed at more experienced private sector lawyers who may be looking for public service opportunities—perhaps through a special fellows program. On the other hand, Congress should work with the Commission to restrict the revolving door—ideally by adopting the rule that currently applies to senior bank examiners for senior Commission staff—no employment with any firm whose matters the staffer worked on within 12 months.

Regulating the Shadow Markets and the Problem of Jurisdiction

The financial crisis is directly connected to the degeneration of the New Deal system of comprehensive financial regulation into a Swiss cheese regulatory system, where the holes, the shadow markets, grew to dominate the regulated markets. If we are going to lessen future financial boom and bust cycles, Congress must give the regulators the tools and the jurisdiction to regulate the shadow markets. In our report of January 29, the Congressional Oversight Panel specifically observed that we needed to regulate financial products and institutions, in the words of President Obama, "for what they do, not what they are."[6] We further noted in that report that shadow market products and institutions are nothing more than new names and

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[2] Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure, at 11-13, 106-126 (Mar. 2008), available at *http://www.treas.gov/press/releases/reports/Blueprint.pdf*

[3] Committee on Capital Markets Regulation, Interim Report (Nov. 30, 2006), available at *http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf;* Committee on Capital Markets Regulation, The Competitive Position of the U.S. Public Equity Market (Dec. 4, 2007), available at *http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf*

[4] Securities Industry and Financial Markets Association, Market Sector Statistics: Asset Backed Securities—Outstanding By Major Types of Credit.

[5] See, *e.g.,* Speech by SEC Chairman: Address to Practising Law Institute's "SEC Speaks in 2009" Program available at *http://sec.gov/news/speech/2009/spch020609mls.htm*

[6] Senator Barack Obama, Renewing the American Economy, Speech at Cooper Union in New York (Mar. 27, 2008) (transcript available at *http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?pagewanted=all*); Congressional Oversight Panel, Special Report on Regulatory Reform, at 29.

new legal structures for very old activities like insurance (read credit default swaps) and money management (read hedge funds and private equity/lbo funds).[7]

The Congressional Oversight Panel's report stated that shadow institutions should be regulated by the same regulators who currently have jurisdiction over their regulated counterparts.[8] So, for example, the SEC should have jurisdiction over derivatives that are written using public debt or equity securities as their underlying asset. The Congressional Oversight Panel stated that at a minimum, hedge funds should also be regulated by the SEC in their roles as money managers by being required to register as investment advisors and being subject to clear fiduciary duties, the substantive jurisdiction of U.S. law, and periodic SEC inspections.[9] To the extent a hedge fund or anyone else engages in writing insurance contracts or issuing credit, however, it should be regulated by the bodies charged with regulating that type of economic activity.

Some have suggested having such shadow market financial products as derivatives and hedge funds simply regulated by a systemic regulator. This would be a terrible mistake. Shadow market products and institutions need to be brought under the same routine regulatory umbrella as other financial actors. To take a specific case, while it is a good idea to have public clearinghouses for derivatives trading, that reform by itself is insufficient without capital requirements for the issuers of derivatives and without disclosure and the application of securities law principles, generally, to derivatives based on public securities regulations. So, for example, the SEC should require the same disclosure of short positions in public equities that it requires of long positions in equities, whether those positions are created through the securities themselves or synthetically through derivatives or futures.

The historic distinctions between broker-dealers and investment advisors have been eroding in the markets for years. In 2007, the Federal Appeals Court for the District of Columbia issued an opinion overturning Commission regulations seeking to better define the boundary between the two.[10] The Commission should look at merging the regulation of the categories while ensuring that the new regulatory framework preserves clear fiduciary duties to investors. As part of a larger examination of the duties owed by both broker-dealers and investment advisors to investors, the Commission ought to examine the fairness and the efficacy of the use of arbitration as a form of dispute resolution by broker-dealers. Finally, part of what must be done in this area is to determine whether the proper regulatory approach will require Congressional action in light of the D.C. Circuit opinion.

But there is a larger point here. Financial reregulation will be utterly ineffective if it turns into a series of rifle shots at the particular mechanisms used to evade regulatory structures in earlier boom and bust cycles. What is needed is a return to the jurisdictional philosophy that was embodied in the founding statutes of federal securities regulation—very broad, flexible jurisdiction that allowed the SEC to follow the activities. By this principle, the SEC should have jurisdiction over anyone over a certain size who manages public securities, and over any contract written that references publicly traded securities. Applying this principle would require at least shifting the CFTC's jurisdiction over financial futures to the SEC, if not merging the two agencies under the SEC's leadership.

Much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, some investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Finally, while it is not technically a shadow market, the underregulation of the credit rating agencies has turned out to have devastating consequences. The Congressional Oversight Panel called particular attention to the dysfunctional nature of the issuer pays model, and recommended a set of options for needed structural change—from the creation of PCAOB-type oversight body to the creation of a public or non-profit NRSRO.[11]

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[7] Congressional Oversight Panel, Special Report on Regulatory Reform, at 29.
[8] *Id.*
[9] *Id.*
[10] *Fin. Planning Ass'n v. SEC,* 482 F.3d 481 (D.C. Cir. 2007).
[11] *Id.* at 40-44.

Substantive Reforms

Beyond regulating the shadow markets, the Congress and the Securities and Exchange Commission need to act to shape a corporate governance and investor protection regime that is favorable to long term investors and to the channeling of capital to productive purposes. There is no way to look at the wreckage surrounding us today in the financial markets and not conclude we have had a regulatory regime that, intentionally or not, facilitated grotesquely short-term thinking and led to capital flowing in unheard of proportions to pointless or destructive ends.

This is a large task, and I will simply point out some of the most important steps that need to be taken in three areas—governance, executive pay, and litigation.

First, in the area of governance, once again the weakness of corporate boards, particularly in the financial sector, appears to be a central theme in the financial scandal. The AFL–CIO has interviewed the audit committees of a number of the major banks to better understand what happened. We found in general very weak board oversight of risk—evidenced in audit committee leadership who did not understand their companies' risk profiles, and in boards that tolerated the weakening of internal risk management.

Strong boards require meaningful accountability to investors. Short-term, leveraged investors have been the most powerful voices in corporate governance in recent years, with destructive results. The AFL–CIO urges Congress to work with the SEC to ensure that there are meaningful, useable ways for long-term investors to nominate and elect psychologically independent directors to public company boards through access to the corporate proxy. I put the stress here on long-term—there must be meaningful holding time requirements for exercising this right. Recent statements by SEC Chair Mary Schapiro suggest she is focused on this area, and we urge the Congress to support her efforts. [12]

Second, effective investor protection requires a comprehensive approach to reform in the area of executive pay. Proxy access is an important first step in this area, but we should learn from the financial crisis how destructive short-term oriented, asymmetric executive pay can be for long-term investors and for our economy. The focus of the Congressional Oversight Panel's recommendations in the area of executive pay were on ending these practices in financial institutions. [13] Here Chairman Dodd's leadership has been very helpful in the context of the TARP.

But Congress and the Administration should pursue a comprehensive approach to executive pay reform around two concepts—equity linked pay should be held beyond retirement, and pay packages as a whole should reflect a rough equality of exposure to downside risk as to upside gain. Orienting policy in this direction requires coordination between securities regulation and tax policy. But we could begin to address what has gone wrong in executive pay incentives by (1) developing measurements for both the time horizon and the symmetry of risk and reward of pay packages that could be included in pay disclosure; (2) looking more closely at mutual fund proxy voting behavior to see if it reflects the time horizons of the funds; (3) focusing FINRA inspections of broker dealer pay policies on these two issues; and (4) providing for advisory shareholder votes on pay packages. With respect to say on pay, any procedural approaches that strengthened the hand of long term investors in the process of setting executive compensation would be beneficial.

Finally, Congress needs to address the glaring hole in the fabric of investor protection created by the Central Bank of Denver and Stoneridge cases. [14] These cases effectively granted immunity from civil liability to investors for parties such as investment banks and law firms that are co-conspirators in securities frauds. It appeared for a time after Enron that the courts were going to restore some sanity in this area of the law on their own, by finding a private right of action when service providers were actually not just aiders and abetters of a fraud, but actual co-conspirators. In the Stoneridge decision, with the Enron case looming over them, the Supreme Court made clear Congress would have to act. The issue here of course is not merely fairness to the investors defrauded in a particular case—it is the incentives for financial institutions to police their own conduct. We seem to have had a shortage of such incentives in recent years.

The International Context

The Bush Administration fundamentally saw the internationalization of financial markets as a pretext for weakening U.S. investor protections. That approach has

[12] Rachelle Younglai, SEC developing proxy access plans: sources, REUTERS, Mar. 6, 2009, at *http://www.reuters.com/article/bernardMadoff/idUSTRE52609820090307*

[13] Congressional Oversight Panel, Special Report on Regulatory Reform, at 37-40.

[14] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 128 S. Ct. 761 (2008).

been discredited. It needs to be replaced by a commitment on the part of the Obama Administration to building a strong global regulatory floor in coordination with the world's other major economies. This effort is vital not only for protecting U.S. investors in global markets, but for protecting our financial sector from the consequences of a global regulatory race to the bottom that will inevitably end in the kind of financially driven economic crisis that we are living through today. Congress can play a part by seeking to strengthen its relationships with its counterpart legislative bodies in the major world markets, and should look for opportunities to coordinate setting regulatory standards on a global basis. The Administration needs to make this effort a priority, and to understand that it needs to extend beyond the narrow confines of systemic risk and the banking system to issues of transparency and investor protection.

However, Congress must not allow the need for global coordination to be an impediment or a prerequisite to vigorous action to reregulate U.S. financial markets and institutions. That task is urgent and must be addressed if the U.S. is to recover from the blow this financial crisis has delivered to our private capital markets' reputation as the gold standard for transparency and accountability.

Conclusion

The task of protecting investors by reregulating our financial system and restoring vitality to our regulators is a large one. This testimony simply sketches the outline of an approach, and notes some key substantive steps Congress and the Administration need to take. This Committee has already taken a leadership role in a number of these areas, but there is much more to be done. Even in areas where the primary responsibility must lie with regulators, there is a much needed role for Congress to oversee, encourage, and support the efforts of the Administration.

While I do not speak for the Congressional Oversight Panel, I think I am safe in saying that the Panel is honored to have been asked to assist Congress in this effort, and is prepared to assist this Committee in any manner the Committee finds useful. I can certainly make that offer on behalf of the AFL–CIO. Thank you.

SUPPLEMENT—March 10, 2009

The challenge of addressing systemic risk in the future is one, but by no means the only one, of the challenges facing Congress as Congress considers how to reregulate U.S. financial markets following the extraordinary events of the last 18 months.

Systemic crises in financial markets harm working people. Damaged credit systems destroy jobs rather than create them. Pension funds with investments in panicked markets see their assets deteriorate. And the resulting instability undermines business' ability to plan and obtain financing for new investments—undermining the long term growth and competitiveness of employers and setting the stage for future job losses. The AFL–CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL–CIO supports addressing systemic risk, but in a manner that does not substitute for strengthening the ongoing day to day regulatory framework, and that recognizes addressing systemic risk both requires regulatory powers and financial resources that can really only be wielded by a fully public body.

The concept of systemic risk is that financial market actors can create risk not just that their institutions or portfolios will fail, but risk that the failure of their enterprises will cause a broader failure of other financial institutions, and that such a chain of broader failures can jeopardize the functioning of financial markets as a whole. The mechanisms by which this broader failure can occur involve a loss of confidence in information, or a loss of confidence in market actors ability to understand the meaning of information, which leads to the withdrawal of liquidity from markets and market institutions. Because the failure of large financial institutions can have these consequence, systemic risk management generally is seen to both be about how to determine what to do when a systemically significant institution faces failure, and about how to regulated such institutions in advance to minimize the chances of systemic crises.

Historically, the United States has had three approaches to systemic risk. The first was prior to the founding of the Federal Reserve system, when there was a reluctance at the Federal level to intervene in any respect in the workings of credit markets in particular and financial markets in general. The Federal Reserve system, created after the financial collapse of 1907, ushered in an era where the Federal Government's role in addressing systemic risk largely consisted of sponsoring through the Federal Reserve system, a means of providing liquidity to member banks, and thus hopefully preventing the ultimate liquidity shortage that results from market participants losing confidence in the financial system as a whole.

But then, after the Crash of 1929 and the 4 years of Depression that followed, Congress and the Roosevelt Administration adopted a regulatory regime whose purpose was in a variety of ways to substantively regulate financial markets in an ongoing way. This new approach arose out of a sense among policymakers that the systemic financial crisis associated with the Great Depression resulted from the interaction of weakly regulated banks with largely unregulated securities markets, and that exposing depositors to these risks was a systemic problem in and of itself. Such centerpieces of our regulatory landscape as the Securities and Exchange Commission's disclosure based system of securities regulation and the Federal Deposit Insurance Corporation came into being not just as systems for protecting the economic interests of depositors or investors, but as mechanisms for ensuring systemic stability by, respectively, walling off bank depositors from broader market risks, and ensuring investors in securities markets had the information necessary to make it possible for market actors to police firm risk taking and to monitor the risks embedded in particular financial products.

In recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled. So we entered the recent period of extreme financial instability with an approach to systemic risk that looked a lot like that of the period following the creation of the Federal Reserve Board but prior to the New Deal era. And so we saw the policy response to the initial phases of the current financial crisis primarily take the form of increasing liquidity into credit markets through interest rate reductions and increasingly liberal provision of credit to banks and then to non-bank financial institutions.

However, with the collapse of Lehman Brothers and the Federal rescues of AIG, FNMA, and the FHLMC, the federal response to the perception of systemic risk turned toward much more aggressive interventions in an effort to ensure that after the collapse of Lehman Brothers, there would be no more defaults by large financial institutions. This approach was made somewhat more explicit with the passage of the Emergency Economic Stabilization Act of 2008 and the commencement of the TARP program. The reality was though that the TARP program was the creature of certain very broad passages in the bill, which generally was written with the view that the federal government would be embarking on the purchase of troubled assets, a very different approach than the direct infusions of equity capital that began with the Capital Purchase Program in October of 2008.

We can now learn some lessons from this experience for the management of systemic risk in the financial system.

First, our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely we ever will. If two administrations as different as the Bush Administration and the Obama Administration agree that the Federal Government must act when major financial institutions fail, it is hard to imagine the administration that would do differently. Since the beginning of 2008, we have used Federal dollars in various ways to rescue either the debt or the equity holders or both at the following companies—Bear Stearns, Indymac, Washington Mutual, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, Citigroup, and Bank of America. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

Second, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. We have a longstanding system of protecting small depositors in FDIC insured banks, and by the way policyholders in insurance companies through the state guarantee funds. The FDIC has a process for dealing with banks that fail—a process that does not always result in 100 percent recoveries for uninsured creditors. Then we have the steps taken by the Treasury Department and the Federal Reserve since Bear Stearns collapsed. At some companies, like Fannie Mae and Freddie Mac, those steps have guaranteed all creditors, but wiped out the equity holders. At other companies, like Bear Stearns, AIG, and Wachovia, while the equity holders survive, they have been massively diluted one way or another. At others, like Citigroup and Bank of America, the equity has been only modestly diluted when looked at on an upside basis. It is hard to understand exactly what has happened with the government's interaction with Morgan Stanley and Goldman Sachs, but again there has been very little equity dilution. And then there is poor Lehman Brothers, apparently the only non-systemic financial institution, where everybody lost. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given financial institution may be systemically significant, not every layer of its capital structure should be necessarily propped up with taxpayer funds.

Third, much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. This is not to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Fourth, financial markets are global now. Norwegian villages invest in U.S. mortgage backed securities. British bankruptcy laws govern the fate of U.S. clients of Lehman Brothers, an institution that appeared to be a U.S. institution. AIG, our largest insurance company, collapsed because of a London office that employed 300 of AIG's 500,000 employees. Chinese industrial workers riot when U.S. real estate prices fall. We increasingly live in a world where the least common denominator in financial regulation rules.

So what lessons should we take away for how to manage systemic risk in our financial system?

The Congressional Oversight Panel, in its report to Congress made the following points about addressing systemic risk:

1. There should be a body charged with monitoring sources of systemic risk in the financial system, but it could either be a new body, an existing agency, or a group of existing agencies;
2. The body charged with systemic risk managements should be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present in self-regulatory organizations;
3. We should not identify specific institutions in advance as too big to fail, but rather have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemic to fail.
4. Systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets.
5. Ironically, effective protection against systemic risk requires that the shadow capital markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commisson.
6. There are some specific problems in the regulation of financial markets, such as the issue of the incentives built into executive compensation plans and the conflict of interest inherent in the credit rating agencies' business model of issuer pays, that need to be addressed to have a larger market environment where systemic risk is well managed.
7. Finally, there will not be effective reregulation of the financial markets without a global regulatory floor.

I would like to explain some of these principles and at least the thinking I brought to them. First, on the issue of a systemic risk monitor, while the Panel made no recommendation, I have come to believe that the best approach is a body with its own staff and a board made up of the key regulators, perhaps chaired by the Chairman of the Board of Governors of the Federal Reserve. There are several reasons for this conclusion. First, this body must have as much access as possible to all information extant about the condition of the financial markets—including not just bank credit markets, but securities and commodities, and futures markets, and consumer credit markets. As long as we have the fragmented bank regulatory system we now have, this body would need access to information about the state of all deposit taking institutions. The reality of the interagency environment is that for information to flow freely, all the agencies involved need some level of involvement with the agency seeking the information. Connected with the information sharing issue is expertise. It is unlikely a systemic risk regulator would develop deep enough expertise on its own in all the possible relevant areas of financial activity. To be effective it would need to cooperate in the most serious way possible with all the routine regulators where the relevant expertise would be resident.

Second, this coordinating body must be fully public. While many have argued the need for this body to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience highlights a much more bright line problem. An effective systemic risk regulator must have the power to bail out institutions, and the experience of the last year is that liquidity provision is simply not enough in a real crisis. An organization that has the power to expend public funds to rescue private institutions must be a public organization—though it should be insulated from politics much as our other financial regulatory bodies are by independent agency structures.

Here is where the question of the role of the Federal Reserve comes in. A number of commentators and Fed officials have pointed out that the Fed has to be involved in any body with rescue powers because any rescue would be mounted with the Fed's money. However, the TARP experience suggests this is a serious oversimplification. While the Fed can offer liquidity, many actual bailouts require equity infusions, which the Fed cannot currently make, nor should it be able to, as long as the Fed continues to seek to exist as a not entirely public institution. In particular, the very bank holding companies the Fed regulates are involved in the governance of the regional Federal Reserve Banks that are responsible for carrying out the regulatory mission of the Fed, and would if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

These considerations also point out the tensions that exist between the Board of Governors of the Federal Reserve System's role as central banker, and the great importance of distance from the political process, and the necessity of political accountability and oversight once a body is charged with dispersing the public's money to private companies that are in trouble. That function must be executed publicly, and with clear oversight, or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort. One benefit of a more collective approach to systemic risk monitoring is that the Federal Reserve Board could participate in such a body while having to do much less restructuring that would likely be problematic in terms of its monetary policy activity.

On the issue of whether to identify and separately regulate systemically significant firms, another lesson of the last eighteen months is that the decision as to whether some or all of the investors and creditors of a financial firm must be rescued cannot be made in advance. In markets that are weak or panicked, a firm that was otherwise seen as not presenting a threat of systemic contagion might be seen as doing just that. Conversely, in a calm market environment, it maybe the better course of action to let a troubled firm go bankrupt even if it is fairly large. Identifying firms (ITAL)ex ante as systemically significant also makes the moral hazard problems much more intense.

An area the Congressional Oversight Panel did not address explicitly is whether effective systemic risk management in a world of diversified institutions would require some type of universal systemic risk insurance program or tax. Such a program would appear to be necessary to the extent the federal government is accepting it may be in a position of rescuing financial institutions in the future. Such a program would be necessary both to cover the costs of such interventions and to balance the moral hazard issues associated with systemic risk management. However, there are practical problems defining what such a program would look like, who would be covered and how to set premiums. One approach would be to use a financial transactions tax as an approximation. The global labor movement has indicated its interest in such a tax on a global basis, in part to help fund global reregulation of financial markets.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake. We would appear now to be in a position where we cannot wall off more risky activities from less risky liabilities like demand deposits or commercial paper that we wish to ensure. On the other hand, it seems mistaken to try and make large securities firms behave as if they were commercial banks. Those who want to maintain the current dominance of integrated bank holding companies in the securities business should have some burden of explaining how their securities businesses plan to act now that they have an implicit government guaranty.

Finally, the AFL–CIO believes very strongly that the regulation of the shadow markets, and of the capital markets as a whole cannot be shoved into the category labeled "systemic risk regulation," and then have that category be effectively a sort of night watchman effort. The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are unlikely to succeed. We even more particularly oppose this type of formulation that then hands responsibility in the area of systemic risk regulation over to self-regulatory bodies.

As Congress moves forward to address systemic risk management, one area that we believe deserves careful consideration is how much power to give to a body charged with systemic risk management to intervene in routine regulatory policies and practices. We strongly agree with Professor Coffee's testimony that a systemic risk regulator should not have the power to override investor or consumer protections. However, there are a range of options, ranging from power so broad it would amount to creating a single financial services superregulator, *e.g.,* vesting such power in staff or a board chairman acting in an executive capacity, to arrangements requiring votes or supermajorities, to a system where the systemic risk regulator is more of scout than a real regulator, limited in its power to making recommendations to the larger regulatory community. The AFL–CIO would tend to favor a choice somewhere more in the middle of that continuum, but we think this is an area where further study might help policymakers formulate a well-founded approach.

Finally, with respect to the jurisdiction and the reach of a systemic risk regulator, we believe it must not be confined to institutions *per se,* or products or markets, but must extend to all financial activity.

In conclusion, the Congressional Oversight Panel's report lays out some basic principles that as a Panel member I hope will be of use to this Committee and to Congress in thinking through the challenges involved in rebuilding a more comprehensive approach to systemic risk. The AFL–CIO is very concerned that as Congress approaches the issue of systemic risk it does so in a way that bolsters a broader reregulation of our financial markets, and does not become an excuse for not engaging in that needed broader reregulation.

AFL–CIO Executive Council Statement—Miami, Florida—March 5, 2009

Bank Bailouts

There has been a dramatic concentration of banking power since the Gramm-Leach-Bliley Act repealed New Deal bank regulation. More than 43 percent of U.S. bank assets are held by just four institutions: Citigroup, Bank of America, Wells Fargo and JPMorgan Chase. When these institutions are paralyzed, our whole economy suffers. When banks appear on the brink of collapse, as several have repeatedly since September, government steps in. The free market rules that workers live by do not apply to these banks.

Since Congress passed financial bailout legislation in October, working people have seen our tax dollars spent in increasingly secretive ways to prop up banks that we are told are healthy, until they need an urgent bailout. In some instances, institutions that were bailed out need another lifeline soon after. The Congressional Oversight Panel, charged with overseeing the bailout, recently found that the Federal Government overpaid by $78 billion in acquiring bank stock.

The AFL–CIO believes government must intervene when systemically significant financial institutions are on the brink of collapse. However, government interventions must be structured to protect the public interest, and not merely rescue executives or wealthy investors. This is an issue of both fairness and our national interest. It makes no sense for the public to borrow trillions of dollars to rescue investors who can afford the losses associated with failed banks.

The most important goal of government support must be to get banks lending again by ensuring they are properly capitalized. This requires forcing banks to acknowledge their real losses. By feeding the banks public money in fits and starts, and asking little or nothing in the way of sacrifice, we are going down the path Japan took in the 1990s—a path that leads to "zombie banks" and long-term economic stagnation.

The AFL–CIO calls on the Obama administration to get fair value for any more public money put into the banks. In the case of distressed banks, this means the government will end up with a controlling share of common stock. The government should use that stake to force a cleanup of the banks' balance sheets. The result should be banks that can either be turned over to bondholders in exchange for bondholder concessions or sold back into the public markets. We believe the debate over nationalization is delaying the inevitable bank restructuring, which is something our economy cannot afford.

A government conservatorship of the banks has been endorsed by leading economists, including Nouriel Roubini, Joseph Stiglitz, and Paul Krugman. Even Alan Greenspan has stated it will probably be necessary.

The consequences of crippled megabanks are extraordinarily serious. The resulting credit paralysis affects every segment of our economy and society and destroys jobs. We urge President Obama and his team to bring the same bold leadership to bear on this problem as they have to the problems of economic stimulus and the mortgage crisis.

AFL–CIO Executive Council Statement—Miami, Florida—March 5, 2009

Financial Regulation

Deregulated financial markets have taken a terrible toll on America's working families. Whether measured in lost jobs and homes, lower earnings, eroding retirement security, or devastated communities, workers have paid the price for Wall Street's greed. But in reality, the cost of deregulation and financial alchemy are far higher. The lasting damage is in missed opportunities and investments not made in the real economy. While money poured into exotic mortgage-backed securities and hedge funds, our pressing need for investments in clean energy, infrastructure, education, and health care went unmet.

So the challenge of reregulating our financial markets, like the challenge of restoring workers' rights in the workplace, is central to securing the economic future of our country and the world. In 2006, while the Bush administration was in the midst of plans for further deregulation, the AFL–CIO warned of the dangers of unregulated, leveraged finance. That call went unheeded as the financial catastrophe gathered momentum in 2007 and 2008, and now a different day is upon us. The costs of the deregulation illusion have become clear to all but a handful of unrepentant ideologues, and the public cast its votes in November for candidates who promised to end the era of rampant financial speculation and deregulation.

In October, when Congress authorized the $700 billion financial bailout, it also established an Oversight Panel to both monitor the bailout and make recommendations on financial regulatory reform. The panel's report lays the foundation for what Congress and the Obama administration must do.

First, we must recognize that financial regulation has three distinct purposes: (1) ensuring the safety and soundness of insured, regulated institutions; (2) promoting transparency in financial markets; and (3) guaranteeing fair dealing in financial markets, so investors and consumers are not exploited. In short, no gambling with public money, no lying and no stealing.

To achieve these goals, we need regulatory agencies with focused missions. We must have a revitalized Securities and Exchange Commission (SEC), with the jurisdiction to regulate hedge funds, derivatives, private equity, and any new investment vehicles that are developed. The Commodity Futures Trading Commission should be merged with the SEC to end regulatory arbitrage in investor protection.

Second, we must have an agency focused on protecting consumers of financial services, such as mortgages and credit cards. We have paid a terrible price for treating consumer protection as an afterthought in bank regulation.

Third, we need to reduce regulatory arbitrage in bank regulation. At a minimum, the Office of Thrift Supervision, the regulator of choice for bankrupt subprime lenders such as Washington Mutual and IndyMac, should be consolidated with other federal bank regulators.

Fourth, financial stability must be a critical goal of financial regulation. This is what is meant by creating a systemic risk regulator. Such a regulator must be a fully public agency, and it must be able to draw upon the information and expertise of the entire regulatory system. While the Federal Reserve Board of Governors must be involved in this process, it cannot undertake it on its own.

We must have routine regulation of the shadow capital markets. Hedge funds, derivatives, and private equity are nothing new—they are just devices for managing money, selling insurance and securities, and engaging in the credit markets without being subject to regulation. As President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." Shadow market institutions and products must be subject to transparency and capital requirements and fiduciary duties befitting what they are actually doing.

Reform also is required in the incentives governing key market actors around executive pay and credit rating agencies. There must be accountability for this disaster in the form of clawbacks for pay awarded during the bubble. According to Bloomberg, the five largest investment banks handed out $145 billion in bonuses in the 5 years preceding the crash, a larger amount than the GDP of Pakistan and Egypt.

Congress and the administration must make real President Obama's commitment to end short-termism and pay without regard to risk in financial institutions. The AFL–CIO recently joined with the Chamber of Commerce and the Business Roundtable in endorsing the Aspen Principles on Long-Term Value Creation that call for executives to hold stock-based pay until after retirement. Those principles must be embodied in the regulation of financial institutions. We strongly support the new

SEC chair's effort to address the role played by weak boards and CEO compensation in the financial collapse. With regard to credit rating agencies, Congress must end the model where the issuer pays.

Financial reregulation must be global to address the continuing fallout from deregulation. The AFL–CIO urges the Obama administration to make a strong and enforceable global regulatory floor a diplomatic priority, beginning with the G-20 meeting in April. The AFL–CIO has worked closely with the European Trade Union Congress and the International Trade Union Confederation in ensuring that workers are represented in this process. We commend President Obama for convening the President's Economic Recovery Advisory Board, chaired by former Federal Reserve Chair Paul Volcker, author of the G-30 report on global financial regulation, and we look forward to working with Chairman Volcker in this vital area.

Reregulation requires statutory change, regulatory change, institutional reconstruction and diplomatic efforts. The challenge is great, but it must be addressed, even as we move forward to restore workers' rights and revive the economy more broadly.

PREPARED STATEMENT OF THOMAS DOE

CHIEF EXECUTIVE OFFICER,
MUNICIPAL MARKET ADVISORS

MARCH 10, 2009

Introduction

Chairman Dodd, Senator Shelby and Committee Members: It is a distinct pleasure that I come before you today to share my perspective on the U.S. municipal bond industry. I am Thomas Doe, founder and CEO of Municipal Market Advisors, that for the past 15 years has been the leading independent research and data provider to the industry.

In addition from 2003 to 2005, I served as a public member of the Municipal Securities Rulemaking Board (MSRB), the selfregulatory organization (SRO) of the industry established by Congress in 1975.

The Market

There are nearly 65,000 issuers in the municipal market that are predominantly states and local governments. Recent figures identify an estimated $2.7 trillion in outstanding municipal debt. This is debt that aids our communities in meeting budgets and financing society's essential needs, whether it is building a hospital, constructing a school, ensuring clean drinking water, or sustaining the safety of America's infrastructure. A distinctive characteristic of the municipal market is that many of those who borrow funds, rural counties and small towns, are only infrequently engaged in the capital markets.

As a result, there are many issuers of debt who are inexperienced when entering a transaction, and unable to monitor deals that may involve the movement of interest rates or the value of derivative products.

The Growth

According to the The Bond Buyer, the industry's trade newspaper, annual municipal bond issuance was $29B in 1975 whereas in 2007 issuance peaked at $430B. In the past 10 years derivatives have proliferated as a standard liability management tool for many local governments. However, because derivatives are not regulated it is exceptionally difficult, if not impossible, to identify the degree of systemic, as well as specific, risk to small towns and counties that have engaged in complex swaps and derivative transactions.

Systemic Risk Emerges

Municipal issuers themselves sought to reduce their borrowing costs by selling bonds with a floating rate of interest, such as auction-rate securities. Because state and local governments do not themselves have revenues that vary greatly with interest rates, these issuers employed interest rate swaps to hedge their risk. Issuers used the instruments to transform their floating risk for a fixed-rate obligation.

A key factor in the growth of the leverage and derivative structures was the prolific use of bond insurance.

The Penal Rating Scale

Municipal issuers are rated along a conservative ratings scale, resulting in much lower ratings for school districts and states than for private sector financial or insurance companies. Although most state and local governments represent very little default risk to the investor, the penal ratings scale encouraged the use of insurance for both cash and derivatives to distribute products to investors and facilitate issuer borrowing.

So instead of requiring more accurate ratings, the municipal industry chose to use bond insurance to enhance an issuer's lower credit rating to that of the higher insurance company's rating.

The last 18 months have exposed the risks of this choice when insurance company downgrades, and auction-rate security failures, forced numerous leveraged investors to unwind massive amounts of debt into an illiquid secondary market. The consequence was that issuers of new debt were forced to pay extremely high interest rates and investors were confused by volatile evaluations of their investments.

Steps To Improve the Regulatory Context

The 34-year era of the municipal industry's self regulation must come to an end. Today, the market would be in a much better place if: First, the regulator were independent of the financial institutions that create the products and facilitate issuers' borrowing.

Second, the regulator were integrated into the national regime of regulation.

Third, the regulator's reach and authority were extended to all financial tools and participants of the municipal transaction: ratings agencies, insurers, evaluators, and investment and legal advisors for both the cash and swaps transactions.

Fourth, the regulator were charged with more aggressively monitoring market data with consumers' interests in mind, both investors and issuers.

The good news is that this new era of regulatory oversight can be funded by the MSRB's annual revenue $20-plus million, collected from bond transactions, and can be staffed by the current MSRB policy and administrative infrastructure.

Caution

I should be clear. The innovations of derivatives and swaps have a useful application and have been beneficial for those for which they are appropriate. However, it is also important that these instruments become transparent and regulated with the same care as the corresponding cash market.

Get This Done

It is critical to get this right. There is too much at stake.

Thank you for asking me to testify today, and I welcome your questions during this session.

Municipal Market Advisors

Founded in 1995, MMA is the leading independent strategy, research and advisory firm in the municipal bond industry. MMA's intelligent approach to timely issues and analysis of market events has proven invaluable to a wide range of clients. As conditions have become more complex and difficult, MMA's recognized ability to concisely comment on the key issues of the market is of critical importance and value. The firm's independent research, data, market coverage and insight educate and inform without bias or product agenda.

Our Clients: Investors, Dealers, Financial Advisors, Issuers and Individuals: MMA's business has been predominantly portfolio managers and dealer firms (with a focus on sales, trading and underwriting). However, in 2007, demand for our services expanded to include issuers, financial advisors, individuals and public finance professionals who have recognized the increased value of accurate and insightful coverage of current historical market conditions. MMA does not advocate on behalf of its clients, we educate on behalf of the market.

Washington, DC—Educating and Working With Decision-Makers: MMA's Washington DC office has enabled our firm to provide more direct information to policy makers, regulators, trade associations and the Federal Reserve. MMA's role is that of an educator to provide immediate uncompromised assistance to entities that are actively engaged in working on issues pertaining to the municipal industry.

Informing the Media: In 2008, more than 200 publications and media outlets have sought MMA's expertise for definitive comment on the issues confronting the industry. At no other time has accurate market coverage been more valued, and trusted resources considered indispensable. Unbiased information is important for correct representation of market conditions, policy decisions and management of portfolios.

Thomas G. Doe, Founder and CEO: Mr. Doe has been an analyst in the municipal industry for 25 years with a consistent focus on pricing data and information flows, investor and issuer behavior, and contextual investing. He has addressed all of the leading groups in the municipal industry, as Mr. Doe's insight, candor and historical context is sought to establish a clear perspective of current conditions affecting investors and issuers in the municipal cash and derivative markets. He has been a featured speaker at numerous industry conferences and has been frequently quoted in industry and national media. Mr. Doe's leadership was recognized when he was named to a 3-year term with the Municipal Securities Rulemaking Board, (MSRB) the regulatory entity of the municipal securities industry in 2002. Mr. Doe received an undergraduate degree from Colgate University in 1980 and a Masters degree from Harvard University in 1984.

Background on How the Credit Crisis Has Affected the Municipal Market

The municipal market has suffered repeated shocks from the credit crisis since August 2007. In a very primary sense, our sector was, and in many ways continues to be, exposed to the same systemic risks that collapsed the housing and securitization markets and undermined our nation's banks. The deep interconnectedness of the municipal market with the global financial and interest rate markets was unforeseen by most municipal regulators, issuers, investors, advisors, lawyers, and dealer banks; their surprise at, and misunderstanding of, the systemic risks at work has consistently exacerbated problems over the last two years. Further, there is little provision being made at present to create a more resilient and stable market in the future.

The initiation of the credit crisis in municipals, as it was elsewhere, began in 2001 and 2002, with the integration of leverage into municipal bond buying strategies. Leveraged investment vehicles, called Tender Option Bond (TOB) programs, borrowed low interest (floating-rate) cash from the tax-exempt money market funds to invest in higher yielding (fixed-rate) municipals. Not only does this strategy capture the simple difference between the high long and low short interest rates (the carry), but also TOB sponsors—which included hedge funds, dealer banks, mutual funds, liquidity providers, and many others—are placing bets on the tax-exempt market's outperformance of carefully selected taxable bonds or swaps via interest rate hedging.

However, one of the key conditions for the safe operation of a TOB was not implicit in the municipal market: liquidity. Because TOBs are subject to mark-to-market accounting, margin calls, and periodic adjustments of their leverage, they benefit from a well-traded and accurately priced bond market. A TOB invested in securities with unpredictable or volatile prices will itself provide unpredictable and volatile returns. The municipal bond market, as we have detailed elsewhere in this report, comprises 65,000 potential bond issuers and 1.5 million individual securities, most of which are rated along an overly cautious rating scale that intentionally exaggerates the risks and differences between individual issuers and bonds. Further, municipal issuers have long sold bonds in serial maturities, with a variety of interest rate coupons, call structures, security pledges, *etc.* And finally, the bulk of municipal investors are households, who either directly or indirectly though a manager, prefer to buy and hold small pieces of multiple bond offerings: these are not active securities trading operations.

This context was not conducive for TOBs, but, because their use of leverage they were permitted to purchase municipal bonds at substantially higher prices than other investors were willing to pay, so the primary market rapidly adjusted to their needs. This entailed the pervasive use of AAA-rated bond insurance and bank guaranties (creating the appearance of safe homogeneity) and the facilitation of very large, governmental-oriented bond sales carrying a standardized 5 percent coupon. For the period between 2002 and 2007, these adjustments permitted the near doubling of annual bond issuance (from about $200Bn to about $400Bn), and the amount of par volume municipal bonds outstanding swelled 77 percent from $1.5T in 2001 to $2.7T today. What's more, the rapid growth of TOB (and related strategy) investment—along with a large increase in demand from property casualty insurance companies riding post-9/11 waves of premiums and profitability—allowed municipals to be priced more and more aggressively, fulfilling the TOB investor's aim of outperformance of the taxable bond market and encouraging ever larger allocations to this strategy.

At the same time, the interest rates that tax-exempt money market funds were receiving from the TOBs were better than an investor could receive in a regular savings account, and aggressive TOB creation meant a surfeit of product in which the money funds could invest. This attracted more money fund deposits which, along with monetary policy, kept short-term interest rates low. Municipal issuers themselves sought to reduce their borrowing costs by selling long maturity, AAA-insured bonds with a floating rate of interest, including variable-rate demand obligations (VRDOs), which can be purchased by the money market funds, and auction-rate securities, which were largely bought by individuals and corporate cash managers. However, because state and local governments do not themselves receive much revenue that floats with short-term interest rates, these issuers also employed interest rate swaps with these floating-rate bonds in an attempt to exchange their floating-rate liability for a fixed one (but with the addition of increased counterparty exposure to both a bank and the a bond insurer).

By these means, issuer interest rate swaps and derivatives became a fundamental, but unregulated part of the municipal industry's standard machinery, and systemic exposure to the financial sector, the bond insurers, and, more importantly, the rating agencies' opinions of the financial sector, and the bond insurers grew rapidly. In addition, our market had become substantially vulnerable to fluctuations in the value of taxable securities: remember that much if not all of the massive investment by TOBs (estimated to have peaked near $500Bn although little was done by the municipal regulators to even tabulate this exposure) was hedged against the performance of Treasuries, LIBOR swaps, or other slightly more muni-centric derivatives.

The problems with this arrangement were exposed in August 2007 with the first surge of flight-to-safety buying of Treasury securities on news of worsening damage to the housing sector. Stronger Treasury (and LIBOR) prices created losses in TOB hedges, forcing margin calls that rapidly consumed available cash. In addition, sharp increases in the overnight lending rates pushed floating-rate product credit spreads wider: the source of TOB leverage, loans from the money funds, grew much more expensive, to the point where the money funds were demanding almost as much (or more) interest than the TOBs were receiving from their long-term, fixed-rate municipal position. Some TOBs thus began to liquidate their positions, forcing sales of their fixed-rate bonds into a municipal secondary market that quickly became oversupplied and illiquid. Keep in mind that, up until that point, the TOBs had been purchasing bonds at (and driving market clearing prices and statement evaluations to) higher levels than traditional institutional investors were reasonably willing to pay. Thus, when the TOBs needed to quickly sell their bonds to these same traditional buyers, large price concessions were required. Dealer banks helped soften the effects by acquiring bonds into their own trading inventories, but ultimately market pressures forced municipal bond yields sharply higher (while Treasury yields were moving sharply lower). Higher yields attracted enough demand to stabilize the market by the end of the month, but, through the end of the year, nervous investors repeated this pattern of fast selling/recovery, heightening volatility in prices, and encouraging a steady reduction in TOB investment. For substantially more detail on the daily and weekly evolution of our the market, please see the complete catalog of published MMA research, available to subscribers on our Web site and to Congressional staffs on request.

Importantly, market participants had by this time also become increasingly concerned about the future of the bond insurers, who had guaranteed subprime residential mortgage securitizations. Research firms such as MMA and private investors amplified former warnings about these companies. In particular, more cautious corporate cash managers began selling auction-rate securities that had been marketed to them, in part, based on the apparent safety of AAA-rated bond insurance. Once again, dealer banks managing auction-rate programs provided liquidity in the absence of incremental investor demand, but in December 2007, the rating agencies sounded formal warnings about the bond insurers. This precipitated vast selling pressure among auction-rate investors that, in January, overwhelmed dealers' risk tolerances for buying back additional auction paper, and auctions began to fail (please see Auction Rate Securities, below).

Auction-rate securities paying high penalty rates attracted investors away from other fixed- and floating-rate products, forcing both fixed and floating rates up sharply. At the end of February 2008, TOB programs were once again forced to sell bonds to pay margin calls, to unwind their leverage that had grown too expensive, and to afford investor redemptions. Extreme selling and uncertainty led to widely divergent pricing decisions across the industry; liquidity was almost completely interrupted, and state and local issuers were temporarily shut out of the capital markets.

Once again, high yields galvanized demand in March, and from that point until December 2008, the municipal market continued to face boom and bust pricing cycles of sometimes extraordinary depth. In general, these entailed yield-fueled, or media-driven demand bubbles that were ultimately pricked by yet another bond insurer downgrade that renewed fears and sometimes forced selling by leveraged bondholders. The worst of these cycles began in September, when the collapse of Lehman Brothers, plus concerns over other broker-dealer counterparties were realized in investor redemptions from municipal money markets, which put large numbers of variable rate obligations back to dealers. The flow of bonds initially overwhelmed dealer balance sheets, forcing the unwind of some proprietary positions, but was ultimately managed through dramatically higher floating rates (the municipal industry's 7-day floating rate reset from about 2 percent to 8 percent and credit spreads to that rate widened sharply, in particular for TOBs because of their reliance on multiple layers of bank support) and the temporary withdrawal of a large number of floaters from active markets onto liquidity provider balance sheets. Still, higher floating rates forced many tender option bond programs to unwind their trades for perhaps the final time, as investors now began demanding their money back in earnest.

The excess supply created by forced TOB selling in September to November, along with downgrades to the bond insurers, pushed municipal yields sharply higher, prices lower. Institutional buyers retreated from the public markets until the end of the year (although many large buyers were able to buy portfolios of highly discounted bonds in the evenings and weekends, muffling the implications of these very cheap trades on broader market pricing), causing credit spreads to widen dramatically. Spread widening and price declines hurt tax-exempt mutual fund net asset values, giving the appearance of undue credit risk to their investors and initiating perhaps the largest sequence of mutual fund investor outflows (and thus forced selling of related holdings by the funds) on record. And, as was well covered by the media, with fixed-rate yields having risen to extraordinary heights, many state and local issuers chose to table the majority of their planned primary market loans, waiting for conditions to improve. Indeed, smaller, lower-rated, and riskier credit issuers may have at least temporarily been unable to access capital at all, but large states and cities were always able to raise money; their decisions were based on price. MMA estimates that, in 2008, more than $100Bn of planned new-money infrastructure projects were delayed, the majority of that occurring in the fourth quarter.

Persistent institutional demand has not yet returned to the municipal market, but since the start of 2009, municipal fund managers and brokerages have been highly successful attracting retail investment on the back of both flight-to-safety allocations (out of equities) and, more importantly, on speculation that the stimulus will ultimately drive up municipal bond prices. In fact, yields on the kind of bonds favored by retail investors touched two-decade lows in mid-January, although they have since begun to retreat again. Lower-rated, risky credit issuers (like hospitals) still face difficulty finding cost-effective market access and even highly rated state and local governments are commonly required to downsize new bond issues or risk pushing market yields higher.

Summary of Regulation Issues

Introduction

The Municipal Securities Rule-making Board (MSRB) is a self-regulatory organization (SRO) and was formulated by Congressional statute in 1975. Please see the attached National Federation of Municipal Analysts White Paper"Federal Securities Law Relating to Municipal Securities," for background and more detail.

During Thomas Doe's tenure as a Board member from 2003 to 2005, there was rarely a Board meeting where the subject of derivatives was not discussed and the risks to the industry and investors were not addressed. However, the outdated statute limited the Board's regulatory purview to municipal cash securities and to activities of dealers and dealer banks. Proactive action was inhibited for three reasons: (1) it was exceptionally difficult, however well intended, for Board members representing security firms to advocate for change that would reduce the revenue of its firm; (2) the volunteer nature of the Board resulted in a consistent deferral of strategy, tactics and policy to staff; (3) the Chairman of the Board served only one year and dictated the Board's focus, which, in our opinion, was to sustain the status quo and could again be heavily influence by staff. Since staff, especially the Executive Director, worked for the Board, it appeared to be exceptionally difficult for innovation and proactive regulation to occur.

To be fair, there is now new leadership of the MSRB's staff. However, the negative characteristics of a: (1) short-tenured Chairman; (2) volunteer Board; and (3) the tremendous challenge to advocate for the investor or issuer interest, which could hurt an employer's revenue stream, are still present. These conditions can be inhibitive toward regulation in the best interest of the consumer—both issuers and investors.

Opportunity

In 2009, led by the catalysts of curtailed institutional demand, limited issuer access to the capital markets and the allegations revolving around municipal finance practices in New Mexico, the MSRB has suggested a review of the Congressional regulatory statute created 34 years ago. Specifically the Board has suggested an expansion of entities to be regulated swap advisors. The willingness of the Board to advocate change is applauded however, the action falls short.

Necessary Change

More entities should not alone be regulated, but rather legislative language should be expanded to be inclusive of all practices and products in which financial institutions would be involved related to municipal finance. By regulating the products, all entities involved with municipal finance—from creation to distribution—would be governed by transparency and regulations, which would advance and define a context for transactions in the municipal industry for the protection of issuer, dealer and investor. Only in this manner can responsibility and integrity be promoted and transparency ensured. The byproduct of such attention to derivatives would accomplish the disclosure required by issuers to both inform investors and those who choose to provide capital to public entities.

Action Items

1. End the MSRB as an SRO.
2. Integrate the MSRB formally and directly into a larger entity, possibly the Securities Exchange Commission, Treasury or Federal Reserve.
3. Congress expand the regulatory purview of municipal regulation to include all participants in municipal finance and all financial tools involved in a municipal finance transaction—this would include derivatives and swaps in addition to the cash market. Along with dealers: advisors, ratings agencies, and evaluation services would be included in the new regulatory scheme.
4. Ensure that the regulatory statue was adaptable and flexible to allow regulation to be proactive and timely.
5. Include the municipal industry within an organization, where its regulatory framework, data and action can be more easily coordinated with larger markets. (Too often critical regulation may not have been enacted or suggested as the industry is small relative to equities and taxable fixed-income. One might argue that the vulnerability of the eclectic resources of the 65,000 municipal issuers/borrowers of the industry demands more vigilant protection because of the critical importance of the financings to essential services and projects for town, counties and states in the US.)
6. Mandate better regulatory coordination with its consumers—specifically issuers and investors—not simply the dealer community.
7. Demand greater financial forensics to mine the vast municipal transaction data created by the Real-Time Transaction Reporting System in order to better indentify market behavior that can adversely impact (*i.e.,* volatility) issuer pricing and investor evaluations. In addition, better data analysis can better define conditions of market liquidity to assist market participants in risk management strategies and investors to better use performance data measurements, specifically indices of price performance and returns. This report highlights significant areas where more robust data collection would have helped manage and avert systemic risks exposed in the credit crisis.

Conclusion

The municipal industry has evolved outside of a confined regulatory context that is outdated and biased, and been consistently challenged by the temptation to regulate in its self-interest. The evolution resulted in detrimental practices and products that have proved penal to investors, issuers and the financial institutions. The opportunity to broaden the current regulatory framework has presented itself and in acting to take steps to protect the public entities, which require access to capital for infrastructure, the new broad regulation of the municipal industry with specific attention to both derivatives and cash financial products will provide precedence for global regulatory reform of all derivatives.

The best news is that the MSRB's current major funding mechanism, fees from municipal transactions (more than $20 million in 2008), provides a revenue stream to fund expansion and transition of the regulatory purview. In addition, the existing organizational infrastructure of the MSRB allows for experienced personnel, technology and data to be powerfully integrated in a revitalized context.

The municipal regulatory entity must be independent of those it regulates and integrated within a regular Federal entity where the industry can be included and coordinated with regulation of the larger markets.

Disclosure and Investor Protection

For a background on municipal disclosure, MMA here quotes from the National Federation of Municipal Analysts March 2008 "White Paper on Federal Securities Law Relating to Municipal Securities." The full paper is attached at the end of this report.

> The SEC promulgated Rule 15c2-12 (the "Rule" or "Rule 15c2-12") in 1989 and amended the Rule in 1994 to include continuing disclosure requirements. . . . Direct regulation of issuers would have required repeal of the Tower Amendments, so the Rule instead applies to municipal broker-dealers and generally applies to financings where the principal amount offered is $1 million or greater. The Rule applies indirectly to issuers, effectively denying their access to the market unless the Rule's requirements are satisfied. The Rule contains primary disclosure requirements and continuing disclosure requirements. With respect to continuing disclosure, the Rule prohibits the purchase and sale of municipal securities by an underwriter in a public offering unless the issuer or an "obligated person" undertakes to provide continuing disclosure. Continuing disclosure obligations include both periodic reporting of financial and operating information and disclosure of the occurrence of any of a specified list of 11 events, if material. The annual information is required to include audited financial statements when available and material financial information and operating data of the type included in the official statement for the securities. . . . Independent of contractual undertakings made by issuers and conduit borrowers and continuing disclosure obligations under Rule 15c2-12, the SEC maintains that issuers of municipal securities and conduit borrowers have continuing disclosure responsibilities under Section 10(b) of the Exchange Act and Rule 10b-5. While issuers and conduit borrowers have no affirmative duty to disclose information (unless they are engaged in the offering, purchase or sale of securities or unless disclosure is required under a continuing disclosure undertaking), if an issuer or conduit borrower chooses to disclose information to the market it is prohibited from disclosing information that is materially untrue or misleading, or that contains a material omission, "in light of the circumstances" in which such information is disclosed. There are no other limits on the issuer's or the conduit borrower's disclosure.

We also reference DPC Data's report, "The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market" that provides more information on how disclosure is disseminated. Currently disclosure occurs through a regime of several repositories (Nationally Recognized Municipal Securities Information Repositories, or NRMSIRs), but, with recent change in law, a single repository will exist: the Municipal Securities Rulemaking Board. In MMA's opinion, the state of disclosure in the municipal sector should be regarded as poor, and recent changes in the law are unlikely to make much difference here. Issuers, as detailed by DPC data's important (and accurate) study on the topic, regularly fall out of compliance with stated disclosure requirements, undermining liquidity in selected bonds and hurting smaller investors (those without credit analysts trained to track down, or mitigate the impact of, absent financial and operating data) who buy bonds, in part, based on statements in the prospectus that regular information will be disclosed.

In MMA's opinion, disclosure gaps occur because: (1) many issuer representatives are not capital markets professionals and lose track of their responsibilities, and (2) there is little penalty to be suffered by the industry for not policing compliance. A specific failing of SEC Rule 15c2-12 is its leaving the decision on whether an issuer is in disclosure compliance to the individual participants trading the issuer's securities. In our experience, firms have generally ignored this requirement and continued to trade likely safe, but disclosure-gapped bonds, albeit at a slight discount. Further, we note a pattern of smaller issuers falling out of compliance almost immediately after a new offering, remaining out of compliance for several years until, just prior to another new primary market loan, the issuer will send its past due financial information to the information repositories.

Again, MMA believes a solution to municipal disclosure problems is available:

1. We believe Congress should require that the SEC act as arbiter to determine whether each issuer is in compliance with their stated disclosure requirements. This would be a very large undertaking, potentially requiring a large staff increase by the SEC. Should the SEC subsume the MSRB, the MSRB's funds could offset at least a portion of the cost.

2. Bonds found to be not in compliance would be flagged, and registered firms would be prohibited in trading in such until either the issue's original underwriter or any other investor can succeed in getting the issuer to remedy the gap. We are reluctant to advise that the SEC be able to compel disclosure directly from the issuers for fear of abridging state autonomy.
3. The SEC would keep a database to track, for every Cusip and borrower, the number and percent of days it has been out of compliance on all of its outstanding bond issues. This statistic would be vitally important for potential buyers evaluating new purchases of the borrower's securities.
4. Additionally, all firms trading municipal bonds, regardless of their status, would need to track how many trades, and the volume of par traded, that firm had made with disclosure-flagged municipals Cusips. Again, this could be very important data for investors evaluating with which firm to invest their money.
5. MMA also believes that all tax-relevant calculations and investigations should be included in required disclosure topics. These include how tax-exempt bond proceeds are being spent, on a weekly basis, the precise formula by which bond counsel determines that a bond issue is tax exempt, and the presence and status of any SEC investigations.

The Undisclosed Risk of Bank Bonds and Swaps

MMA's principal concern for the municipal sector in 2009 is that variable-rate related problems will set off a wave of downgrades and even defaults among risky sector credits (such as hospitals and private universities), creating incremental economic loss and threatening more investor aversion to municipal bonds generally. But the risks in variable-rate demand obligations are not exclusive to hospitals; many state and local governments also issued these securities and face very similar credit challenges.

VRDOs are long maturity bonds where the interest rate is periodically (weekly, daily, *etc.*) reset by a remarketing agent—usually a dealer bank—who also attempts to make proprietary markets in these securities among a universe of the firm's clients with a strong focus on tax-exempt money market funds. VRDOs also entail some form of liquidity support (structured via a letter of credit or standby purchase agreement) from a highly rated bank. In other words, a bank is contractually obligated to become the immediate buyer of last resort for a VRDO, giving money market funds confidence in the liquidity of a VRDO investment. MMA estimates that there are about $500Bn of outstanding VRDOs at present; this number has likely increased from $400Bn since the start of 2008 reflecting numerous post-collapse ARS restructurings into VRDOs.

Yet today's financial markets entail substantially more investor caution among banks and between credits generally, and large numbers of VRDOs have been rejected by the money funds because of their reliance on a damaged or downgraded liquidity provider (most notably DEPFA and Dexia) or connection to a downgraded bond insurer. In the absence of other investors or remarketing agents' inability to bring yet more bonds onto their own balance sheets, many of these rejected bonds have triggered their liquidity features, requiring the liquidity providers to buy these securities directly. Provider-purchased VRDOs are referred to as "bank bonds," which the liquidity providers hold as available for sale for a period of time (for example, 90 days), but then convert to accelerated maturity term loans between the liquidity provider and the issuer. It is unclear whether any municipal bank bonds have actually yet converted to term loans, but their acceleration of principal and penalty interest rate would reasonably require either an immediate restructuring or a default forbearance agreement between provider and issuer. Because there is little hope for market interest in Dexia or DEPFA to improve, at some point, issuer defaults may become public. MMA estimates, based on our polling of industry sources, that there have been as many as $50Bn of rejected floaters, with perhaps $50Bn more being kept away from liquidity providers through special—and thus potentially temporary—intervention by securities dealers. MMA believes that the amount of bank bonds has fallen in 2009, as issuers are actively restructuring their bank bond obligations, although we underscore that we are unaware of any information being collected by any regulator or data provider on this topic.

Interestingly, the rejection of many VRDOs by the money funds has worsened problems elsewhere in the municipal floating-rate markets. First, it has required liquidity providers to become more cautious in writing new policies, increasing the scarcity and cost of same for municipal issuers. Second, by removing large swathes of floaters from money fund "approved" lists, and noting: (1) the near complete absence of TOB-related lending by the money funds (see "Background" section above), and (2) large, fear driven investor inflows into the money funds, has created a severe supply/demand imbalance. Approved and available securities are scarce and—because the funds' alternative is not investing their funds at all—are being bid up to extremely low yields (weekly interest rates have been close to, or well below 1 percent since November). Low benchmark floating rates, along with very strong demand for long-maturity LIBOR swap rates, an unwinding of arbitrageurs' interest rate hedges, and a dearth of new municipal issuer derivative activity, has pushed the related long-maturity municipal swap rates to very low levels. And this movement in swap rates has greatly increased issuers' cost of terminating any outstanding swap, complicating the restructuring of any distressed VRDO position. Further, higher issuer swap termination costs have produced substantial cash drains away from issuers via requirements that the issuers collateralize their potential termination liability to their counterparty. (Many issuers had purchased bond insurance AAAs to ward off credit- or rate-driven collateralization requirements. But with the insurers' losing their ratings, many issuers are no longer shielded, sometimes removing cash to the detriment of normal operations.) As not-for-profit hospitals have been particularly large users of this debt structure, and as these same hospitals also face lower private pay revenues and strained governmental reimbursements, defaults are likely in the near term. Because swap positions are only dimly disclosed, even sophisticated municipal investors remain largely without information on their own portfolios' related risks.

Once again, these municipal issuer exposures to systemic risks were accreted with little public disclosure or regulatory insight. Further, MMA is unaware of any municipal regulator or information provider systematically collecting information on the size and scope of this problem. This not only inhibits better projection of potential losses, but also prevents a more robust response from national regulators (*e.g.,* Treasury, the Federal Reserve, the SEC) who are struggling to grasp the depth of the problem and coordinate their response with those in other asset classes. Solutions are well within Federal abilities. MMA recommends that Treasury extend subsidized loans to municipal issuers to terminate difficult swap positions, with the cost of those loans recouped by Treasury via a surcharge on all future issuer swap activity. This would allow issuers to restructure their obligations into fixed rate bonds, relieving liquidity provider balance sheets of troubled exposures, and potentially encouraging future policy writing.

Auction-Rate Securities and Unchecked Systemic Risks

Auction-Rate Securities (ARS) are long maturity bonds where the interest rate is periodically reset by auction among potential investors, or failing that, set manually by a bank pursuant to an index or (typically very high) fixed rate. Because they are valued at par, ARS were typically purchased by individual investors as a higher-yielding alternative to cash deposits. However, higher yields reflected the fact that an ARS holder cannot sell their bond without an identified buyer: a sharp distinction from other "cash like" instruments that required dealer banks to periodically step in as a buyer to prevent auctions from failing. In part because of this reliance on bank intervention, ARS programs were (and still are) set up as proprietary trading exchanges by individual dealers, inhibiting the easy flow of capital and information from program to program.

The implications of the ARS structure, in the context of the municipal industry's systemic exposure to the bond insurers and the financial counterparties were little understood by issuers, investors, or the dealer banks themselves prior to 2007. It was the collapse of the bond insurers in 2007 that undermined investor confidence in ARS issuers and precipitated vast selling. (Remember that individual investors had long been sold on the AAA virtues of bond insurance; this myth was not so easy to dispel when bond insurer downgrades began). Banks were initially able to use their own cash to buy back securities, but in January 2008, bank risk tolerances prevented further purchases, and ARS auctions began to fail. Thus, current holders were left without a means to get out of their positions, and issuers were forced to pay sometimes highly punitive fixed interest rates. Since that time, MMA estimates that about two thirds of ARS issuers have restructured or refinanced their securities, although many remain unable to do so as: (1) refinances with liquidity-supported floating-rate debt require the purchase of a liquidity policy from a highly rated bank—these policies have become both scarce and expensive as U.S. banks have reduced lending; and (2) refinances with fixed-rate debt are prevented not only by the high fixed rates many lower-rated issuers must now pay, but also the sometimes staggering cost of terminating the interest rate swap most municipal issuers have connected to their bond sales (please see bank bonds section, above).

Thus, many investors still remain stuck with highly illiquid securities that are paying well-below-market, index-linked interest rates. At issue is an unwillingness to allow ARS to trade at a discount to entice potential buyers, because of the increase in potential liability and because sub-par pricing of these holdings could result in additional waves of mark-to-market losses for the already stressed banks. Although private trading venues have emerged to provide emergency assistance to distressed clients needing to liquidate their holdings at any price, we are unaware of any broker dealer making sub-par markets in any ARS. On the other hand, several of the large banks have, on the intervention of state securities regulators, settled with their individual and small institutional investors, in effect buying ARS securities back at par. Indeed, the largest current holders of ARS are likely the dealer firms themselves that are still carrying their swollen inventories from 2008 and now the bonds purchased via settlement.

ARS shows another breakdown in the municipal regulatory framework. While there are initiatives to improve ARS price discovery, no market participant (including investors, dealer banks, nor the regulators themselves) knows precisely how many ARS are outstanding (MMA's estimate was about $200Bn municipal ARS at the market's peak), how many bonds were being placed through each dealer program, how many ARS issuers were reliant on bond insurance for their marketing to investors, the extent and means by which these issuers were leveraging counterparty credit through interest rate derivatives, and how much dealer support was being directly extended to the market. The implications for systemic risk management, as now being discovered in the credit crisis, are clear in these questions, which can (and should) be extended to the still healthy, but periodically threatened, municipal VRDO market.

Municipal Bond Ratings and Bond Insurance

Most municipal bonds are rated on a different, more conservative rating scale than corporate bonds. Moody's and Standard & Poor's have shown that triple-A U.S. corporate bonds have up to 10 times the historical default rate of single-A municipals. In MMA's opinion, neither municipal issuers, nor the individual investors who own the large majority of outstanding paper or fund shares, understands this point. But instead of requiring more accurate ratings, the municipal industry (*i.e.,* issuers, investors, and underwriters) has instead chosen to make bonds appear safer and more similar through bond insurance (the insurers are rated along the more generous corporate rating scale; much of the bond insurance model distills to simple arbitrage between the two rating scales). At its peak, the municipal bond insurance industry entailed just nine companies whose ratings were applied to more than 50 percent of annual municipal bond sales. And this invited massive systemic exposure into the municipal industry as the bond insurers carried in the risk of subprime mortgage-backed securities, the insurers' and the financial sectors' leverage of ratings on securitized debt, and failed rating agency models.

Attached, please find our January 2008 report, "MMA on Corporate Equivalent Ratings," and our April 2008 report, "Second Research Note on Moody's," for more detail on the problem with how municipal bonds have been rated. In the last year, both Moody's and Fitch ratings strongly considered reforming their muni rating processes, but both have tabled these initiatives because of the recession. Standard and Poor's continues to deny the existence of separate rating scales for municipals and corporate bonds, but that agency has embarked on a plan of sweeping upgrades to selected municipal sectors. Finally, the U.S. House of Representatives considered the "Municipal Bond Ratings Fairness Act of 2008," which MMA believes would, for little cost to taxpayers, successfully remediate much of the rating problem in our sector. We strongly recommend that Congress adopt this legislation in its current form. MMA has been a leader on the topic of ratings and the municipal sector's use of bond insurance; we welcome any opportunities to continue to educate Congress and its agents on these topics.

Pricing and Evaluation Issues

The events of the past 18 months have amplified the risks and challenges associated with illiquidity and limited price discovery for municipal bond investors and issuers.

The municipal bond industry has been challenged with a troublesome irony. While municipal bonds have favorable low historical default risks, the securities can be illiquid. How can a safe investment not have liquidity? Inconsistency of primary market pricing, the eclectic composition and multitude of issuing entities, the penal and overly granular ratings scale, reduced number of liquidity providers, the diminished number of AAA bond insurers and the inability to manage interest rate and credit risk have contributed to the challenges for the markets transactions to provide evaluation services with sufficient price discovery. The result is that evaluations that represent the price that investors receive on their investment firm statements or the prices that comprise the net asset value of a mutual fund share may bear little resemblance to an execution price should an investor choose to buy or sell. In addition, the periodic illiquid market conditions and limited price can result in sharp volatility that can be misinterpreted as credit or default risk, either of which may not be valid. In this manner the data can misinform an investor and potentially prompt emotional and inappropriate investment decisions. These same characteristics can also increase the difficulty for municipal issuers to assess market conditions and accurately predict market demand to give context for the pricing of their primary market deal.

An aggressive, investigative and knowledgeable regulator with access to all transactions and who conducted each transaction, can assist consumers—both the investor and borrower—with providing a context to ensure that the data is relied upon by consumers inspires confidence and provides an objective context in which investors and issuers can make decisions from the prices of their securities.

Schedule of Additional Attachments

MMA has attached the following documents, under separate Acrobat file, in support of the arguments made herein.

- NFMA White Paper “Federal Securities Law Relating to Municipal Securities” March 2008
- DPC Data “The Consequences of Poor Disclosure Enforcement in The Municipal Securities Market” January 2009
- Municipal Market Advisors “Corporate Ratings for Munis” January 2008
- Municipal Market Advisors “Second Research Note on Moody’s” April 2008

National Federation of Municipal Analysts
White Paper on
Federal Securities Law Relating to Municipal Securities

The National Federation of Municipal Analysts (the "NFMA") was chartered in 1983. It is a not-for-profit association with the goals of promoting professionalism in municipal credit analysis and furthering the skill level of its members through educational programs and industry communication, providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities. NFMA membership includes approximately 1,000 members, primarily research analysts, who evaluate credit and other risks of municipal securities. These individuals represent, among others, mutual funds, insurance companies, broker/dealers, bond insurers, and rating agencies.

One of the primary initiatives of the NFMA is to provide educational programs and materials to its membership through its annual meeting and advanced seminars as well as through publication of educational materials useful to the membership. The NFMA's efforts have ranged from global disclosure-related issues to more detailed, sector-specific work. For further information on the NFMA's continuing work in the area of disclosure, please see the "Disclosure Guidelines" and "Position Statements" on the NFMA's web site at www.nfma.org.

This white paper includes four components: (1) a comprehensive article summarizing federal securities law relating to municipal securities, (2) a glossary containing definitions of securities terms including all such terms used elsewhere in the white paper, (3) a frequently asked questions presenting straightforward answers to analysts' concerns relating to securities laws in the municipal marketplace, and (4) a timeline showing graphically how the regulatory regime affects the municipal market at each phase of the deal, presented from both the "buy-side" and "sell-side" perspectives.

The following materials (collectively, the "Materials") are for informational purposes only and do not contain legal advice of the NFMA, any of its directors, officers, representatives or members, any of the contributors to the Materials, or the firms or other entities with which the contributors may be associated. The Materials do not represent any undertaking to advise any person or entity regarding the issues described therein or to provide any person or entity with information regarding any updates to or changes in the law with respect to such matters. The Materials do not necessarily represent the position of the NFMA or any of its directors, officers, representatives, or members, or any of the contributors or the firms or other entities with which the contributors are associated, with regard to any of the matters address therein. The NFMA is not a regulatory agency and compliance with the practices advocated herein does not constitute a "safe harbor" from any state or federal rules or regulations. Nothing in these Materials is to be construed as an offer or recommendation to buy or sell any security or class of securities.

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Federal Securities Law Relating to Municipal Securities

OVERVIEW

Federal Securities Law Generally

The federal government closely regulates disclosure in connection with the issuance of most securities. Federal securities law is aimed at concerns raised by the fact that the issuers of securities (including conduit borrowers[1]) have more information about the source of repayment of securities than potential investors, and that there may be incentives for issuers not to disclose significant information about the securities if it would preclude issuance or adversely affect pricing. The federal securities laws frequently have been adopted in response to scandals or crises and are designed to provide disincentives to bad acts, as well as to provide guidelines to those wishing to act properly.

The primary federal securities laws are the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). The basic objectives of the 1933 Act and the Exchange Act are: (1) requiring disclosure of material information about securities to allow investors to make informed decisions; and (2) prohibiting misrepresentation or other fraudulent conduct in connection with the purchase and sale of securities.

The 1933 Act governs the primary offering of securities, requires registration of the securities with the Securities and Exchange Commission (the "SEC"), and contains provisions to prevent fraud in connection with the offering of the securities. The 1933 Act and related regulations mandate very specific types of disclosure in the offering statement for registered securities, which disclosure must be reviewed and cleared by the SEC prior to being released to

[1] Conduit borrower refers to the obligor on a loan, installment sale or lease from a governmental issuer to the obligor from the proceeds of municipal securities issued by the governmental issuer.

the public. There are civil and criminal penalties for failing to do so. Certain types of securities and securities issued under particular circumstances are exempt from registration under the 1933 Act. For example, most municipal securities are exempt from registration as described below.

In addition to its registration requirements, the 1933 Act provides civil liability for participants in the issuance process who make false statements or omit certain information in the disclosure at the time of issuance, or who fail to register a security that is subject to the registration requirements. Violation of such provisions provides a right of rescission to the purchaser of the security. The issuer or conduit borrower is strictly liable for failing to register a security that is not exempt from such requirement and for any false statements or omissions made in connection with the offering, while underwriters may exercise a due diligence defense. The civil liability provisions of the 1933 Act are not applicable to municipal securities to the extent such securities are exempt from registration.

Section 17 of the 1933 Act contains provisions to prevent fraud in an offering of securities. These antifraud provisions, unlike the registration requirements and civil liability provisions, apply broadly enough to include municipal securities offerings, as discussed below.

The Exchange Act creates a regulatory scheme governing broker-dealers in the securities markets and establishes requirements for periodic, on-going disclosure in the secondary market. The Exchange Act also contains antifraud provisions related to disclosure, whether in the primary or secondary market. Since 1975, the Exchange Act applies directly to municipal broker-dealers, and the antifraud provisions therein apply expressly to municipal issuers.

Federal Securities Law Applicable to Municipal Securities

The 1933 Act and the Exchange Act did not expressly apply to municipal securities until the 1970s. The omission of municipal securities from the original versions of the federal securities laws may be attributable to the belief of Congress that the municipal market did not require federal securities regulation or that the federal Constitution prohibited such regulation as an infringement on states' rights (the Constitutional premise has been almost completely undermined by the courts).

In the early 1970s, Congress held a series of hearings concerning questionable activities of dealers that sold only municipal securities and were therefore exempt from the Exchange Act as in effect at that time (which did not include municipal securities). The hearings also addressed concerns about disclosure made in connection with offerings in the City of New York during its fiscal crisis. The Securities Acts Amendments of 1975, among other things, amended the Exchange Act to make municipal broker-dealers subject to the law and created the Municipal Securities Rulemaking Board (the "MSRB") to govern municipal broker-dealers. The 1975 law included provisions commonly referred to as the "Tower Amendments" which expressly precluded the SEC and the MSRB from requiring municipal issuers to make filings with the SEC or the MSRB prior to the sale of municipal securities and precluded the MSRB from requiring municipal issuers to deliver information to the MSRB or bond purchasers. The 1975 law, however, made municipal issuers subject to the antifraud provisions of Section 10(b) of the Exchange Act.

Following the default by the Washington Public Power Supply System on its bonds (the so-called WPPSS or "whoops" default), and in response to general concerns about the adequacy and timeliness of disclosure, the SEC promulgated Rule 15c2-12 of the Exchange Act in 1989.

Because of the limitations of the Tower Amendments municipal issuers and conduit borrowers are not directly subject to Rule 15c2-12 and the MSRB rules, but they are indirectly impacted by Rule 15c2-12 because that rule requires underwriters of most public offerings of municipal securities to obtain certain contractual agreements from municipal issuers or conduit borrowers prior to the sale of such bonds. For transactions that are not exempted from its application, Rule 15c2-12 effectively requires that the issuer or the conduit borrower agree to specified primary and continuing disclosure requirements as a condition to use of an underwriter to conduct a public offering of their securities.

The antifraud provisions of the Exchange Act (promulgated through Rule 10b-5 under the Exchange Act) are enforced via private lawsuits as well as by the SEC and federal prosecutors. Private enforcement lawsuits have been rare in the case of municipal securities. There are several hurdles to recovery in a Rule 10b-5 action, even if the falseness or omission of material information is established. The plaintiff must show that the defendant had "scienter," a state of mind consistent with an intent to deceive, manipulate or defraud. In addition, the plaintiff must sue before the statute of limitations runs out, and must prove that the false information was relied on in connection with the decision to purchase or sell, that the false information was material (discussed in detail below), and that there were damages. Furthermore, Rule 10b-5 limits liability to acts "in connection with the purchase or sale of any security." Any action for money damages must be brought by a purchaser or a seller of a security. As a result, a holder who does not sell (or a potential purchaser who does not buy) on the basis of false information does not have standing to sue under the antifraud provisions of Rule 10b-5 even if the value of the holder's security is impaired by the false information or if a potential purchase opportunity is lost by false information.[2]

Given the difficulty in bringing such private lawsuits, SEC enforcement actions are more common than private suits in the municipal market, particularly since the creation of the Office of Municipal Securities within the SEC in 1994. The SEC has broader authority to enforce Rule 10b-5 than private plaintiffs; among other distinctions, the SEC does not have to prove damages as a result of a misrepresentation or omission.

SEC enforcement actions are generally preceded by an investigation, which may be formal or informal. Formal investigation requires entry of an order by the SEC directing staff to conduct an inquiry and authorizing the staff to issue subpoenas and administer oaths. Informal investigation may be initiated by the SEC staff without specific authorization from the Commission. At the end of the investigation, staff may recommend an enforcement action under the securities laws. For example, the SEC has the power to initiate an administrative proceeding. If the target of the investigation is a person who is subject to registration or regulation by the SEC (e.g., a broker-dealer), the SEC may impose monetary penalties, remedial sanctions, a temporary cease-and-desist order, or a permanent cease-and-desist order. For any other person, such as an issuer or conduit borrower, the SEC may impose a permanent cease-and-desist order. The SEC can order an accounting and disgorgement of profits obtained illegally in either case. The SEC also may commence a civil proceeding in federal district court or make a criminal referral to the Department of Justice or to other federal, state, or self-regulatory authorities. Short of such actions, the SEC may deliver a so-called 21(a) Report which permits the SEC to make

[2] However, a bond trustee who has been expressly authorized in the indenture to enforce remedies and bring suit will have standing to sue on behalf of purchasers or sellers of securities.

statements without bringing an action. Some of the theories for liability and findings in recent SEC enforcement actions are described below, under the heading "Materiality."

MUNICIPAL SECURITIES EXEMPT FROM REGISTRATION REQUIREMENTS

As described above, all securities are subject to the registration requirements of the 1933 Act unless specifically exempt. The definition of "securities" is very broad and includes, among other things, bonds, notes, certificates of participation, and investment contracts. Also subject to registration are so-called "separate securities," a concept included in Rule 131, adopted by the SEC in the late 1960s in response to the proliferation of industrial development bonds. Rule 131 identified certain instruments in a municipal securities offering, such as loans or leases to a conduit borrower with respect to property or money used by a commercial or industrial enterprise, as "separate securities" for registration purposes.

Most municipal securities are not registered because they are "exempt securities" under the 1933 Act. The securities exemptions apply to all securities issued by the entities meeting the requirements of the exemption. Exempt securities include any security issued or guaranteed by a state or political subdivision or public instrumentality thereof. This includes all state issuers and most public authorities. Exempt securities also include securities of not-for-profit entities and most exempt facility bonds. This exemption includes most conduit borrowers. For separate securities involving a private entity as a conduit borrower, such as multi-family housing bonds, exemption from registration is based on an exception from separate security registration by virtue of a governmental agency's (e.g., the multi-family housing issuer) ownership or control of the separate security. This theory has been applied more recently in connection with the issuance of Liberty Bonds and Gulf Zone Opportunity Bonds. Even if the bond issue involves a non-exempt conduit borrower, the separate security can be made exempt by using a bank letter of credit to back the non-exempt borrower's obligations, based on a separate exemption for securities backed by a bank.

If the securities do not qualify as exempt securities under the 1933 Act, they may be offered and sold as "exempt transactions" under the 1933 Act and still not be subject to the registration requirements. The transaction exemption is based on the details of how the security is offered and who the purchasers are and is applied on a deal-by-deal basis, unlike the exempt securities exception which applies based on the type of security involved, without regard to how it is offered and sold. Distinct transactional exemptions apply separately to issuers, conduit borrowers and underwriters, i.e., each needs a transactional exemption to avoid registration. The most common exempt transaction is a private placement. There are several types of private placements provided by SEC rules: Regulation D, which applies only to issuers and conduit borrowers; Rule 144; and Rule 144A (which applies only to underwriters).[3]

Regulation D provides an issuer or conduit borrower with one of three safe harbors from the registration requirements for a transaction based upon the size of the offering and number of potential investors. Generally, issuers or conduit borrowers are limited to offering the securities to accredited investors and a limited number of non-accredited investors and the offering may not involve any form of general solicitation or advertising. The exemption is limited to the issuer or conduit borrower and requires the purchaser's certification that the purchaser is buying the security for its own account and not for distribution, which means the securities cannot be sold to an underwriter. In addition, such securities are "restricted securities" and cannot be resold

[3] The term "private placement" (or sometimes "limited offering") is sometimes used in the municipal securities market to refer to offerings that are exempt securities and therefore do not need to be structured within the strict requirements of exempt transactions. Such securities may be marketed and sold to a limited number of investors, with investor letters under which the investors contractually commit to certain terms. In such cases, the terms of the investor letter are driven by contract negotiations, not the legal requirements of a private placement within the meaning of the Securities Act. Footnote 4, below, further addresses the distinction between a "private placement" or "limited offering" and a truly rule-based, exempt offering.

without registration or an exemption from registration. In order to resell, purchasers may rely on a Rule 144 or 144A transactional exemption.

Rule 144 provides that restricted securities may be sold after a one-year holding period, provided that certain current financial information about the issuer or conduit borrower is available, the amount sold during any three-month period does not exceed certain prescribed amounts, the sale is effectuated in an unsolicited transaction or to a market maker, and, for certain sales, notice is filed with the SEC. After two years, such securities cease to be restricted and the requirement for updated disclosure required by Rule 144 is no longer applicable.

Rule 144A allows for sales or resales by a person other than the issuer to a "qualified institutional buyer," a particular type of entity listed in Rule 144A. Such list includes, in part, an investment company that is part of a family of investment companies with at least $100 million of securities, certain banks that invest at least $100 million and have an audited net worth of at lease $25 million, insurance companies, and certain broker-dealers. The seller must ensure that the subsequent purchaser is a qualified institutional buyer and is aware of the transfer restrictions. In addition, the holder of the securities and the purchaser must have the right to obtain certain financial disclosure from the issuer or conduit borrower, including a brief statement about the issuer's or conduit borrower's business, the most recent balance sheet, statement of profit and loss and retained earnings statement, and similar financial information for the two years that are "reasonably current." This means that the balance sheet must be less than 16 months old, and if older than 6 months it will be supplemented with more current information.[4]

[4] Some securities that are exempt municipal securities under the 1933 Act nevertheless include a restriction (usually on the face of the security and in the related indenture) that the securities can only be sold to a "qualified institutional buyer" or "QIB." The text of this type of restriction usually contains a reference to Rule 144A for the definition of a QIB. Such a Rule 144A reference in an otherwise exempt municipal security does not mean that the

Similar to the exemption from registration under federal securities laws, most municipal securities are exempt from state "blue sky" requirements, with certain exceptions, most notably for notice filings and for offers and sales in the state in which the issuer is located.

A VOLUNTARY DISCLOSURE MARKET

Because the registration requirements are generally inapplicable, the municipal securities market is characterized by the absence of any formal administrative framework for required content of primary offering disclosure. This is in marked contrast to the corporate securities market, where the content of registration statements is specifically prescribed by detailed regulation under the 1933 Act. In the absence of specifically described disclosure requirements, industry groups such as the NFMA, the Government Finance Officers Association (GFOA), the Healthcare Financial Management Association (HFMA), the National Association of State Auditors, Comptrollers and Treasurers (NASACT), the National Council of State Housing Agencies (NCSHA), the National Association of Local Housing Finance Agencies (NALHFA) and the Securities Industry and Financial Markets Association (or its predecessors) (SIFMA) have issued recommended guidelines to help establish market standards for the content and timing of disclosure. Furthermore, market demand has frequently mandated certain disclosures.

security relies on the transactional exemption in Rule 144A for its exemption from registration. Instead, the QIB transfer restriction is a contractual limitation, usually imposed by an issuer who wants to limit holdings to sophisticated institutions, and who uses the QIB definition in Rule 144A because it is the industry-accepted benchmark for identifying those permitted holders. In some cases the contractual restriction is time-limited, and generally the contractual restriction requires each seller to get a representation from its buyer that the buyer is a QIB.

The inclusion of contractual restrictions in exempt municipal securities complicates the determination of whether a particular security is "restricted" for purposes of many mutual funds. Whether a security is considered "restricted" for purposes of a particular fund depends in part on the provisions of the fund's prospectus and other governing documents. Many mutual funds have self-imposed limits on "restricted" securities, and the analysis of whether a particular security is restricted is done on a case-by-case basis, according to the fund's internal policies. In general, a security that actually depends on Rule 144A for an exemption from registration will be considered restricted, while a security that does not actually depend on Rule 144A may or may not be considered restricted. Many funds consider any limitation on the ability to trade a security, including purely contractual limitations, to cause the security to be restricted for internal purposes.

For example, in order to facilitate the sale and liquidity of their bonds, healthcare, housing, and student loan issuers have often agreed to provide quarterly financial statements.

Municipal securities market participants have worked together to make improvements in the dissemination of disclosure pursuant to the requirements of Rule 15c2-12 or voluntarily. The Muni Council, comprising an informal group of 18 municipal market participants including the NFMA, helped develop the central post office, www.DisclosureUSA.org, a conduit for issuers and borrowers to file secondary market disclosure more easily.

MATERIALITY

In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers is governed by the demands of market participants and the antifraud requirements. Thus, the legal test applied to the content of a disclosure document is that it contain all material information and have no material omissions. Materiality is an objective standard as described in the SEC's 1994 interpretive release on Rule 15c2-12 and the antifraud provisions (the "1994 Interpretive Release"): "an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The obligation to meet this materiality standard falls upon the direct participants in a municipal financing, calling for their active involvement and their advisors' professional judgment. Generally, counsel to one of the participants will

Materiality is a facts and circumstances test. Examples of information that the SEC has determined to be material:
- failure to disclose intended use of bond proceeds;
- failure to accurately disclose financial condition;
- failure to disclose financial interest in transaction; and
- failure to disclose potential taxability of bonds.

assume the initial responsibility of coordinating an entire disclosure document, with other participants and counsel being assigned appropriate roles respecting particular portions.

The SEC has developed a body of cases, litigation releases, Commission orders, and reports that reflect areas in which the SEC has found disclosure to be deficient. This body of decisions, releases and reports is the only formal guidance from the SEC with respect to materiality of disclosure in municipal bond offerings.

For example, in *In re Maricopa County* the SEC found that the use of bond proceeds to alleviate the issuer's cash flow deficit "was an undisclosed use of investor funds, which an investor would have considered important in deciding whether or not to purchase the Bonds."[5] Similarly, in *SEC v. Matthews & Wright Group, Inc.* the SEC brought an action related to the sale of bonds by Matthews & Wright Group in which the disclosure stated that the bonds were issued to finance the construction of various projects. Instead, substantially all of the proceeds of the offerings were intended to be used to purchase investment contracts to serve as credit enhancement instruments for the bonds and not for the projects.[6]

A number of SEC enforcement actions arose in connection with a failure to disclose financial conditions of the issuer or conduit borrower. For example, the SEC brought an enforcement action against the City of Miami, its city manager and a finance director for omissions and misstatements in the city's comprehensive annual financial report (CAFR) and in three official statements.[7] Although the city's rating was downgraded and its financial condition had steadily worsened after the close of its CAFR, the city (i) made representations that no

[5] *See Release Nos. 7345, 37748 (September 30, 1996); Release Nos. 7354, 37779 (October 3, 1996); see also, In re City of Miami, Florida, Cesar Odio and Manohar Surana, Initial Decision Release No. 185 (June 22, 2001).*
[6] *See Litigation Release No. 12072 (April 27, 1989) (settled final orders); Release No. 34-26841 (May 19, 1989); see also, SEC v. Matthews & Wright Group, Inc., Matthews & Wright Inc., George W. Benoit, Arthur Abba Goldberg, Rodger J. Burns and Bernard M. Althoff, Litigation Release Nos. 12072 (April 27, 1989) (complaint) and 12950 (August 22, 1991) (settled final order).*
[7] *In re City of Miami, Florida, Cesar Odio and Manohar Surana, Initial Decision Release No. 185 (June 22, 2001). See also In re City of Miami, Florida, Releases 8213, 47552 (March 21, 2003).*

material adverse changes occurred subsequent to the issuance of the CAFR and the related financial statements, (ii) failed to disclose that S&P downgraded the city after the close of such fiscal year, (iii) failed to disclose its cash flow crisis in the official statements in the next year, and (iv) in certain official statements, failed to disclose that bond proceeds would be used to finance operating expenditures. The administrative law judge affirmed the SEC's use of a "snapshot" methodology (i.e. where attention is focused on the financial condition of the issuer when the securities are offered, as opposed to the issuer's most recent year-end results) in determining whether the city committed securities fraud. The administrative law judge concluded the city apparently limited its disclosure because the bonds were insured. The City Manager stated in the record that "most people don't read [the Official Statement], nobody reads this. They go by what the raters, that is Moody's, Standard & Poor's, saying that these bonds are safe to buy. By rating them AAA, they're a very good buy. Therefore, they wouldn't go reading this. Nobody does." This attitude impacted the judge's decision to impose a "cease and desist" order against the city. "The city's attitude that disclosure was not important because no one reads the Official Statement when the bonds are insured, and that regardless of what the financial statements showed, 'people in the business' understood what was going on does not engender confidence in the city's future conduct." Upon appeal of the city, the SEC affirmed the administrative law judge's decision and held "it is in the public interest to order [the City] to cease and desist from committing or causing any violation or future violation of the antifraud provisions of the federal security law."

The SEC brought actions against the issuer and the underwriter based on the omission of a material fact in connection with the sale of bonds by the Dauphin County General Authority to fund the acquisition of an office building in Harrisburg, Pennsylvania. The bonds were secured solely by revenues received from office space leases and parking. While the disclosure contained information about the terms of existing leases and the fact that they expired prior to the maturity of the bonds, it was not disclosed that the largest tenant intended to vacate the building following reconstruction of another building.[8]

The SEC also brought an action based on false and misleading disclosure in a continuing disclosure annual filing. The borrower's annual financial statements and annual information disseminated pursuant to Rule 15c2-12 undertakings: (i) overstated a subsidiary's 1996 net income by approximately $40 million by failing to adjust the subsidiary's bad debt reserves to account for uncollectible accounts receivable; (ii) overstated a subsidiary's and the organization's 1997 net income through the inappropriate transfers of approximately $99.6 million in reserves that were utilized to address the bad debt reserve shortfall not addressed in 1996, as well as an additional shortfall in 1997; and (iii) overstated its 1997 net income by misclassifying certain restricted trust funds. Both the borrower and its subsidiary would have posted substantial net losses for fiscal year 1997 without the fraudulent activity. The organization declared bankruptcy in 1998, after the 1997 continuing disclosure report was disseminated.[9]

More recently (and somewhat controversially), the SEC commenced actions based on the failure to disclose potential tax risks in a transaction. For example, in connection with the financial difficulties experienced by Orange County, California, the SEC concluded that certain tax and revenue anticipation notes were not sized properly for federal tax purposes and that failure to disclose that risk was materially misleading to investors.

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[8] *In the Matter of Dauphin County General Authority, Release No. 8415 (April 26, 2004); In the Matter of Dolphin and Bradbury, Incorporated and Robert J. Bradbury, Release Nos. 8721, 54143 (July 13, 2006).*
[9] *In re Allegheny Health, Education and Research Foundation ("AHERF")*, Release Nos. *1283, 42992 (June 30, 2000) (settled final order); see related actions In re Spargo, Release Nos. 1252, 42742 (May 2, 2000) (settled final order) and SEC v. McConnell, Litigation Release No. 16534 (May 2, 2000) (settled final order).*

SEC RULE 15c2-12

The SEC promulgated Rule 15c2-12 (the "Rule" or "Rule 15c2-12") in 1989 and amended the Rule in 1994 to include continuing disclosure requirements. The Rule was initially proposed in 1988 by the SEC as part of a package accompanying release of its report on the WPPSS default. The Rule came in response to concerns that in connection with primary offerings of securities sufficient information was not always made available to potential investors in a timely manner. In 1994, the SEC adopted amendments to the Rule in response to market concerns that on-going disclosure about municipal securities was not available. Direct regulation of issuers would have required repeal of the Tower Amendments, so the Rule instead applies to municipal broker-dealers and generally applies to financings where the principal amount offered is $1 million or greater. The Rule applies indirectly to issuers, effectively denying their access to the market unless the Rule's requirements are satisfied. The Rule contains primary disclosure requirements and continuing disclosure requirements.

> ***15c2-12 Primary Disclosure***
>
> ***Does not require specific disclosure, just the inclusion of material information.***

With respect to new issue disclosure at the time of issuance of municipal securities, the Rule provides the only regulatory definition of "final official statement," setting forth certain categories of information that must be contained in the disclosure document. (However, the information is not prescribed with specificity; the Rule essentially requires the inclusion of material information.) The Rule also establishes timing constraints on the drafting and review of preliminary official statements and final official statements.

With respect to continuing disclosure, the Rule prohibits the purchase and sale of municipal securities by an underwriter in a public offering unless the issuer or an "obligated person" undertakes to provide continuing disclosure. Continuing disclosure obligations include both periodic reporting of financial and operating information and disclosure of the occurrence of any of a specified list of 11 events, if material. The annual information is required to include audited financial statements when available and material financial information and operating data of the type included in the official statement for the securities. The 11 events, which are listed to the right, are by no means a comprehensive list of those subsequently occurring events that might be material to investors. Further, the qualification that these 11 events be disclosed only if *material* leaves much room for debate. A notable example is the varying views of municipal market participants on whether a tax audit needs to be disclosed. While the Rule does not provide for a specific deadline by which the updated annual disclosure is to be provided, the 1994 Interpretive Release suggests that it be provided within 6 months of the end of the fiscal year. Furthermore, the 1994 Interpretive Release indicates that in some circumstances annual information may not be sufficient and that investors may need more frequent periodic financial information. For example, where an issuer or conduit borrower makes frequent public statements and such statements are a principal source of current information about the

15c2-12 Continuing Disclosure
11 Events to be disclosed, if material:

(1) Principal and interest payment delinquencies;

(2) Non-payment related defaults;

(3) Unscheduled draws on debt service reserves reflecting financial difficulties;

(4) Unscheduled draws on credit enhancements reflecting financial difficulties;

(5) Substitution of credit or liquidity providers, or their failure to perform;

(6) Adverse tax opinions or events affecting the tax-exempt statutes of the security;

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Release, substitution, or sale of property securing repayment of the securities; and

(11) Rating changes.

issuer or conduit borrower, ongoing disclosure provides the context for the public statements. The SEC also stated that for an issuer or conduit borrower with a primary offering document containing forward looking statements, such as projections, without updated disclosure such forward looking statements could be misleading in the event of a change in circumstances.

VOLUNTARY SECONDARY MARKET DISCLOSURE BEYOND RULE 15c2-12

Independent of contractual undertakings made by issuers and conduit borrowers and continuing disclosure obligations under Rule 15c2-12, the SEC maintains that issuers of municipal securities and conduit borrowers have continuing disclosure responsibilities under Section 10(b) of the Exchange Act and Rule 10b-5. While issuers and conduit borrowers have no affirmative duty to disclose information (unless they are engaged in the offering, purchase or sale of securities or unless disclosure is required under a continuing disclosure undertaking), if an issuer or conduit borrower chooses to disclose information to the market it is prohibited from disclosing information that is materially untrue or misleading, or that contains a material omission, "in light of the circumstances" in which such information is disclosed. There are no other limits on the issuer's or the conduit borrower's disclosure. If an issuer or conduit borrower were to limit its primary disclosure to the minimal information necessary to comply with Rule 15c2-12 and the antifraud provisions, there is no affirmative requirement to provide additional types of information in continuing disclosure filings (other than notices of certain events, if material), since the annual disclosure filings consist of audited financial statements and material financial and operating data that generally is based on the disclosure set forth in the original offering document. The only legal exception is if failure to provide additional information would make the provided information materially false and misleading. In the 1994 Interpretive Release, the SEC stated that "[a] municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions." Significantly, this refers to information reasonably *expected* to reach investors, not information *intended* for investors. That is, even if a disclosure is made other than in an offering documents or a continuing disclosure filing, it still may be subject to the federal securities laws if made in a manner reasonably likely to reach investors, such as in press release given to The Bond Buyer or information included on the investor relations portion of the issuer's or conduit borrower's web page. There has been criticism by some municipal market participants that the factors contained in Rule 15c2-12 have resulted in less disclosure in the market, so as to avoid falling within the antifraud laws and having to provide updated disclosure once expanded primary disclosure is made.

In addition to disclosure mandated by Rule 15c2-12, issuers and conduit borrowers sometimes also contractually commit to providing periodic disclosures in addition to those required by Rule 15c2-12, responding to *ad hoc* inquiries by bondholders, and providing information concerning material events in addition to those required by the Rule. As noted by the National Association of Bond Lawyers in its September 30, 2000 paper entitled "Providing Information to the Secondary Market Regarding Municipal Securities," additional secondary market disclosure beyond what is mandated by the Rule or the antifraud provisions is not required, nor is it prohibited under federal securities laws. While not required as a matter of law, such voluntary secondary market disclosure may be a good practice and policy for several reasons, including investor relations. For example, it may provide more demand and better liquidity for an issuer's or conduit borrower's securities and result in lower costs of borrowing.

Strengthened investor relations and communications also may result in more readily attainable waivers or consents, if needed from bondholders.

INSIDER TRADING ISSUES IN THE MUNICIPAL MARKET

The issue of voluntary secondary market disclosure has caused some issuers and conduit borrowers to express concern about insider trading liability for making such disclosure. Bondholders have been concerned that such worries, which they feel are unfounded, are chilling the disclosure of current, material information about issuers. Particularly where the municipal market has so little mandated disclosure, anything tending to restrict the flow of information is even more acutely felt.

Insider trading is a court-developed doctrine under which it is unlawful to purchase or sell a security while in possession of material non-public information in breach of a duty or other relationship of trust and confidence.[10]

Material

Information is material if a reasonable investor would deem the disclosure of the information to significantly alter the total mix of information available. This is the same standard applicable in the antifraud and Rule 15c2-12 area, as described above.

Non-Public

Information is non-public if it is not available to a significant number of market participants.

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[10] *Chiarella v. United States, 445 U.S. 222 (1980).*

Breach of a Duty or Other Relationships of Trust

The person providing the information must be breaching a fiduciary duty or a confidence in providing the material, non-public information. A duty of trust or confidence exists when a person agrees to maintain the information in confidence, the parties have a history of sharing confidential information such that the recipient knows, or reasonably should know, that confidentiality is expected, or the information is received from a spouse, parent, child, or sibling.

There is a line of cases related to corporate debt establishing that a corporate issuer's fiduciary duty runs to its shareholders and not to debt holders (debt holders just benefiting from contractual obligations not fiduciary ones), other than when the entity becomes insolvent. Based on this, there are theories that this element cannot be satisfied for insider trading in the municipal market where the issuer may not have "shareholders." Other theories dismiss this limitation.

Motive to Benefit Personally

The person providing the information must be seeking a personal benefit by disclosing the material, non-public information.

Insider trading is an intent-based crime. Further, it requires use of non-public information acquired in breach of a duty. Thus, where an issuer or conduit borrower official is communicating with investors in good faith, in a context that does not involve the disclosure of "market moving" information, it is highly unlikely that a duty is being breached. This is particularly the case where the issuer or conduit borrower has adopted a policy endorsing such investor communications or where the communication is required by the bond documents.

There are certain kinds of information that would tend to have a significant impact on the market price of a security, such as a plan of defeasance or an event of taxability, where selective disclosure to a single inquiring analyst is not advisable. But the cases also support the diligent analyst who tries to get "behind the financials" by asking questions about information that it reasonably believes to be generally available. While the line is admittedly not definitive, there is certainly ample room for the issuer that wishes to provide information to its investor base to do so without fear of being accused of "tipping."

Regulation FD

In the corporate market, the SEC promulgated Regulation FD, which mandates fair disclosure practices and promotes equal access to information from issuers to the market. By its terms, Regulation FD is not applicable to issuers of municipal securities and conduit borrowers. Although Regulation FD does not apply to municipal issuers or conduit borrowers, some market participants suggest it has caused municipal issuers and conduit borrowers to limit disclosure, such as by refusing to respond to direct investor inquiries, so as to avoid providing such information to all holders or potential holders of its bonds.

Glossary of Terms Used in
"Federal Securities Law Relating to Municipal Securities"

Analysts refers to professionals specializing in the credit analysis of municipal securities and includes institutional investors, bond rating agencies, bond insurance companies, portfolio managers, investment banking firms and financial advisors.

Blue sky laws are state laws regulating the offer and sale of securities to prevent fraud. Blue sky laws have been described as being designed to prevent securities schemes with no more basis than "so many feet of blue sky." Many of the blue sky legal requirements were preempted by the National Securities Markets Act of 1996, although there remain certain fee, filing and disclosure requirements.

Broker-Dealer refers to an individual or firm that is in the business of buying and selling securities for itself or others. Broker-dealers must register with the SEC, are heavily regulated by the SEC and, in the case of municipal securities, the MSRB. Broker-dealers are typically members of the National Association of Securities Dealers.

Committee or Ad Hoc Committee refers to an informal group of purchasers or holders of particular municipal securities organized to negotiate collectively.

Conduit Borrower refers to an Obligor whose obligation runs to a governmental issuer and who receives the proceeds of the municipal securities issued by the governmental issuer.

Conduit Borrowing refers to the issuance of municipal securities by a governmental issuer for the benefit of a Conduit Borrower who is the Obligor on the securities under a loan, installment sale or lease from the governmental issuer to the Obligor.

Continuing Disclosure Agreement, Rule 15c2-12 Agreement **or** ***Rule 15c2-12 Undertaking*** refers to the agreement under which the Obligor on the municipal securities undertakes to comply with the continuing disclosure requirements of Rule 15c2-12.

DisclosureUSA refers to the Internet-based electronic filing system used by issuers and other filers to upload documents for immediate transmission, together with CUSIP numbers and other information, to meet the filing requirements of Rule 15c2-12. Filing through DisclosureUSA eliminates the need to make separate filings with each NRMSIR and SID. As an outgrowth of efforts of the Muni Counsel, DisclosureUSA was created and is operated by the Municipal Advisory Council (MAC) of Texas.

Eleven Material Events are the eleven events expressly listed in Rule 15c2-12 that must be disclosed, if material, in a continuing disclosure filing with the NRMSIRs (and SIDs, where applicable). The events include principal and interest payment delinquencies; non-payment related defaults; unscheduled draws on debt service reserves reflecting financial difficulties; unscheduled draws on credit enhancements reflecting financial difficulties; substitution of credit or liquidity providers, or their failure to perform; adverse tax opinions or events affecting the tax-exempt status of the security; modifications to rights of security holders; bond calls; defeasances; release, substitution or sale of property securing repayment of the securities; and rating changes. The Eleven Material Events do not represent an exclusive list of all events that may be material for antifraud and insider trading purposes.

Final official statement is defined in Rule 15c2-12 and consists of a document or set of documents prepared by an issuer of municipal securities or its representatives that sets forth information concerning the terms of the proposed issue of securities, including financial information or operating data. The amendments to Rule 15c2-12 expanded the definition to include a requirement that a final official statement include a description of the continuing disclosure undertaking and disclosure of any failure to comply with prior undertakings in the last five years.

Exchange Act or ***1934 Act*** is the Securities Exchange Act of 1934, which created the SEC. The Exchange Act empowers the SEC with broad authority over all aspects of the securities industry, including the power to register, regulate, and oversee broker-dealers and self regulatory agencies, such as the MSRB, the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers. The Exchange Act identifies and prohibits certain types of conduct in the markets and provides the SEC with disciplinary powers over regulated entities and persons associated with them. The Exchange Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

Indenture/Trust Indenture refers to the written agreement under which municipal securities are issued and includes the terms thereof. Depending on the issuer, the indenture is sometimes calls a trust agreement, ordinance or resolution.

Insider trading refers to the illegal buying or selling of a security while having material, non-public information about the security, in breach of a fiduciary duty or other relationship of trust and confidence. Insider trading may also include "tipping" such information, securities trading by the person "tipped," and securities trading by persons who misappropriate such information. Insider trading is a felony, and the SEC also can levy large civil penalties for violations.

Interpretative Release or ***1994 Interpretive Release*** refers to a report published by the SEC in 1994 to provide guidance on Rule 15c2-12, as originally promulgated. The Interpretive Release was issued at about the same time as the release proposing the amendments to Rule 15c2-12 to provided for continuing disclosure requirements. The Interpretive Release, in part, was a response to input received by the SEC in connection with development of the Rule 15c2-12 amendments. Some of such input caused the SEC to be concerned whether Rule 15c2-12, as originally promulgated, was being complied with fully. Through the Interpretive Release, the SEC clarified certain matters related to Rule 15c2-12 and disclosure generally. Among other things, the Interpretive Release promoted voluntary disclosure and is cited for this proposition.

GFOA means the Government Finance Officers Association, a professional association of state/provincial and local finance officers in the United States and Canada. It was founded in 1906 and has over 16,800 members and full-time staff with offices in Chicago and Washington D.C. See www.gfoa.org.

"Market Moving" Information refers to information about municipal securities that is material and the dissemination of which likely would affect the pricing of the municipal securities.

Materiality or ***material*** is referred to frequently in the federal securities laws. There are violations of the antifraud rule only for "material" misstatements or omissions. Rule 15c2-12 requires disclosure of the eleven listed events, if "material." Insider trading occurs only in connection with "material" nonpublic information. Definitions of materiality are not set forth in the 1933 Act or the 1934 Act. There are multiple definitions set forth in case law, one of which is referred to in the Interpretive Release and is a good summary of the definition: "an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." There are no bright-line tests for measuring whether a fact is material.

MSRB means the Municipal Securities Rulemaking Board, established in 1975 by Congress to develop rules regulating securities firms and banks in underwriting, trading and selling municipal securities. The MSRB is a self-regulatory agency, subject to oversight by the SEC, which must approve all MSRB Rules. The MSRB is composed of members from the municipal securities dealer community and sets standard for all municipal securities dealers. See www.msrb.org.

Muni Council consisted of a group of 19 municipal market participants created in 2004 to work to improve secondary market disclosure in the municipal markets. Members included: American Bankers Association, American Bar Association - Section of State and Local Government Law, American Institute for Certified Public Accountants, Association of Investment Management and Research, Council of Infrastructure Financing Authorities, GFOA, Healthcare Financial Management Association, Investment Counsel Association of America, Investment Company Institute, Municipal Advisory Council of Texas, National Association of Bond Lawyers, National Association of Independent Public Finance Advisors, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of Health Facilities Finance Authorities, National Council of State Housing Agencies, NFMA, Regional Municipal Operations Association and The Bond Market Association.

Municipal Securities refers to debt securities issued by a governmental issuer on behalf of itself or a Conduit Borrower to fund capital projects.

NFMA refers to the National Federation of Municipal Analysts, a not-for-profit association chartered in 1983 with the goals of promoting professionalism in municipal credit analysis and furthering the skill level of its members through educational programs and industry communication, providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities. NFMA comprises six constituent societies: Boston Municipal Analysts Forum (BMAF), California Society of Municipal Analysts (CSMA), Chicago Municipal Analysts Society (CMAS), Minnesota Society of Municipal Analysts (MSMA), Municipal Analysts Group of New York (MAGNY) and Southern Municipal Finance Society (SMFS). Members of constituent societies are automatically members of the NFMA. In addition, individuals not located in proximity to a constituent society may join the NFMA as affiliated individuals.

NFMA's Disclosure Guidelines refers to papers formulated by the NFMA, including Best Practices and White Papers, intended to provide guidance to issuers of municipal securities and intermediaries in providing primary and ongoing financial and operational information to the municipal analyst community (the investors and potential investors).

NRMSIRs means Nationally Recognized Municipal Securities Information Repositories, designated by the SEC to receive the required disclosure filings under Rule 15c2-12. The SEC maintains the current list of NRMSIRs at www.sec.gov.info/municipal/nrmsir.htm. The current NRMSIRs are:

Bloomberg Municipal Repository
(www.bloomberg.com/markets/rates/municontacts.html);

DPC Data Inc.
(www.dpcdate.com);

FT Interactive Data
(www.ftid.com); and

Standard & Poor's Securities Evaluations, Inc.
(www.disclosuredirectory.standardandpoors.com).

1933 Act is the Securities Act of 1933, sometimes referred to as the "truth in securities law." The two objectives of the 1933 Act are to require that investors receive financial and other significant information concerning securities being offered for public sale, and to prohibit deceit, misrepresentations, and other fraud in the sale of securities.

Obligor means the entity primarily responsible for the repayment of debt, such as the issuer or, in a conduit offering, the Conduit Borrower.

Preliminary Official Statement or POS refers to the document or set of documents prepared prior to the pricing of municipal securities which contain the same information as the Final Official Statement, except for certain information that is determined at the time of pricing of the municipal securities. The POS is sometimes referred to as the "red herring" in reference to the disclaimer printed on the front cover of the POS, usually in red, which indicates that the POS is not the formal offer of sale of the securities. The POS often is the "deemed final official statement" as provided in Rule 15c2-12.

Qualified institutional buyer or ***QIB*** is used in Rule 144A and refers to those institutional investors who are generally perceived to possess the expertise and financial muscle to evaluate and invest in the capital markets. A QIB must be a specific type of entity listed in Rule144A, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity. The list includes without limitation, banks, savings and loans institutions, insurance companies, investment companies, employee benefit plans and entities owned entirely by qualified investors. Also included are registered broker-dealers owning and investing, on a discretionary basis, $10 million in securities of non-affiliates.

Regulation D refers to a regulation promulgated by the SEC under the 1993 Act, that provides an issuer or Conduit Borrower three different types of private placement exemptions from the registration requirements. The exemptions, set forth in Rules 504, 505 and 506 under the 1933 Act, are based on the size of the offering and the number and type of potential investors.

Regulation FD refers to the SEC's Regulation on Fair Disclosure, adopted in 2000, which prohibits selective disclosure by requiring public companies and other entities subject to the rule to disclose material, non-public information by certain means designed to achieve broad distribution. Municipal securities are not subject to Regulation FD. Nevertheless, some municipal securities market participants believe Regulation FD has chilled disclosure in the municipal market because some issuers and Obligors point to Regulation FD as a parallel disclosure standard that would not require the disclosure of certain information of interest to investors in the municipal market.

Rule 10b-5 refers to an antifraud Rule promulgated by the SEC under the Exchange Act which prohibits material misstatements or omissions in connection with the purchase or sale of a security. Municipal securities are not exempt from Rule 10b-5. Rule 10b-5 is enforced through private lawsuits for money damages. There are multiple elements of Rule 10b-5 that must be demonstrated in such a cause of action, as described in the accompanying article.

Rule 15c2-12 refers to a Rule promulgated by the SEC under the Exchange Act specifically relating to disclosure in connection with municipal securities. Given the limitations of the Tower Amendment (see definition below), the Rule governs broker-dealers of municipal securities but is applied by contract to Obligors. The Rule, originally promulgated in 1989, addressed perceived flaws in the content and timeliness of receipt of disclosure in connection with the initial offering of municipal securities. Amendments to 15c2-12 in 1994 addressed ongoing disclosure.

Rule 131 refers to a Rule promulgated by the SEC under the 1933 Act that created the concept of a "separate security." Specifically, Rule 131 specifies that any part of a security issued by a governmental unit exempt from registration under Section 3(a)(2) of the 1933 Act, which is or will be used, under a lease, sale or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate security under the 1933 Act and requires its own exemption. Rule 131 was created, in part, to specify that the loan obligation in a conduit borrowing is a security. There are a few general exceptions in Rule 131, such as if the obligation is payable from the general funds of a governmental unit or it if relates to a public project.

Rule 144 refers to a Rule promulgated by the SEC under the 1933 Act authorizing a type of private placement, which is a means of avoiding the registration requirements of the 1933 Act for a type of security that does not qualify as an exempt security. Rule 144 provides that restricted securities may be sold after a one-year holding period, provided that certain current financial information about the issuer or Conduit Borrower is available, the amount sold during any three-month period does not exceed certain prescribed amounts, the sale is effectuated in an unsolicited transaction or to a market maker, and, for certain sales, notice is filed with the SEC. After two years, such securities cease to be restricted and the requirement for updated disclosure required by Rule 144 is no longer applicable.

Rule 144A refers to a Rule promulgated by the SEC under the 1933 Act authorizing a type of private placement, which is a means of avoiding the registration requirements of the 1933 Act for a type of security that does not qualify as an exempt security. Rule 144A allows for sales or resales of a security to a "qualified institutional buyer." Rule 144A mandates the disclosure and ongoing availability of certain financial information about the Obligor.

Section 17(a) refers to Section 17(a) of the 1933 Act, the only substantive provision of the 1933 Act directly applicable to generally exempt municipal securities. Section 17(a) is an antifraud provision that prohibits false or misleading statements in connection with the offer or sale of any security.

Security is broadly defined in the 1933 Act as: "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." *See Section 2 of the 1933 Act.*

SEC is the United States Securities and Exchange Commission, established in 1934 after the market crash of 1929. The SEC is governed by five Presidential-appointed Commissioners and has four divisions: Corporation Finance, Market Regulation (which governs broker-deals and the MSRB and includes the Office of Municipal Securities), Investment Management and Enforcement.

Selective disclosure refers to an entity disclosing material, non-public information to one person or investor, or a small group of investors, without disclosing it to all investors. The SEC promulgated Regulation FD (see definition above) to address selective disclosure concerns for public companies. Regulation FD is not applicable to municipal securities.

Separate security is discussed in the above definition of Rule 131.

SIDs refers to state information depositories, of which there currently are only three, in Ohio, Texas and Michigan. For securities offerings by issuers in those states, Rule 15c2-12 disclosure filings must be made with the applicable SID in addition to the NRMSIRs.

SIFMA is the Securities Industry and Financial Markets Association, created in 2006 by merger of the Securities Industry Association and The Bond Market Association (formerly PSA). See www.sifma.org.

"Speaking to the market" refers to any disclosure by an issuer of municipal securities or a Conduit Borrower to the public that is reasonably expected to reach investors and the trading markets (whether or not such disclosure is published for the purpose of providing information to the securities markets).

Tower Amendment refers to a provision in the Securities Act Amendments of 1975 which precludes the then-created MSRB from directly regulating issuers. "The [MSRB] is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the [MSRB] or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: provided, however, that the [MSRB] may require municipal securities brokers and municipal securities dealers to furnish to the [MSRB] or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this chapter." The Tower Amendment supplemented another limitation in the Securities Act Amendments of 1975 on the ability for the SEC and MSRB to regulate issuers of municipal securities directly: "Neither the [SEC] nor the [MSRB] is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the [SEC] or the [MSRB] prior to the sale of such securities by the issuer any application, report or document in connection with the issuance, sale or distribution of such securities." *See Section 15B(d)(1) and (2) of the 1933 Act, as enacted by the Securities Act Amendments of 1975, including the so-called Tower Amendment.*

Trustee refers to a financial institution, usually a trust company or the trust department in a commercial bank, that acts on behalf of the issuer and/or Conduit Borrower and holds collateral for the benefit of the holders of municipal securities. The Trustee's obligations and responsibilities are set forth in the Indenture.

WPPSS refers to the Washington Public Power Supply System. In 1983, WPPSS defaulted on over $2 billion of municipal bonds issued to fund two nuclear power plants. The default is arguably one of the events that lead to the creation of Rule 15c2-12.

Underwriter See definition of Broker-Dealer.

Frequently-Asked Questions by Analysts About Municipal Bond Disclosure

Problems of No Information

A. If an Obligor cites one or more of the following reasons for not providing <u>any</u> information to an Analyst (perhaps on advice of counsel), how should the Analyst respond?

1. *Obligors cannot provide any information to Analysts generally.*

   This "blanket" answer reflects a misunderstanding of municipal bond disclosure regulation—or at least an aversion to trying to understand the disclosure rules. In fact, there is no general prohibition against Obligors providing information to Analysts. Obligors may try to steer clear of any hypothetical liability under Section 17(a) of the 1933 Act and Rule 10b-5 by avoiding all communications with Analysts, but this strategy is grossly overprotective and does not reflect the narrow potential for liability under those anti-fraud protections.

   Failure of an Obligor to communicate with beneficial holders of municipal bonds may result in a market disadvantage for the Obligor—investors may not price the Obligor's bonds as well as bonds of a more communicative Obligor, and more disclosure leads to better investor relations for an Obligor. Moreover, information is essential for the municipal bond market to function efficiently. For these and other reasons, the Government Finance Officers Association (GFOA) and the National Federation of Municipal Analysts (NFMA) have recommended that Obligors communicate information to beneficial owners of municipal bonds, even where there is no disclosure obligation.

2. *If an Obligor provides information to one Analyst, it must provide the same information at the same time to all Analysts.*

   The concern of "selective disclosure" in the municipal market is not nearly as widespread as the concern in the public equity market. The problem in the municipal market is more often "not enough disclosure" rather than "selective disclosure." Nevertheless, over-cautious Obligors may use the "selective disclosure" regulations, such as Regulation FD (which does not apply to municipal securities), as support-by-analogy that Obligors should not provide information on an analyst-by-analyst basis. Obligors are correct to avoid true "selective disclosure" of material information to "key" Analysts, but the solution should not be a complete shutdown of the flow of information from an Obligor to Analysts.

   It is important to distinguish between an Obligor's communications with Analysts on a one-by-one basis generally (which is permissible and often encouraged) and the "selective disclosure" of material information to certain Analysts. As a general matter, no "selective disclosure" concern will be raised simply because an Obligor takes an opportunity to explain its financial statements to a particular Analyst. Most such conversations do not involve the type of "material" information that drives "selective disclosure" concerns (that is, "market-moving" information), and avoiding "selective disclosure" is therefore not a valid reason to avoid communications with Analysts altogether.

That said, to the extent that true "selective disclosure" concerns are implicated, there are several ways for an Obligor to address those concerns without cutting off all communications with Analysts:

- The Obligor can designate a single person to be the sole route for communications between the Obligor and Analysts, following the "investor relations representative" role in public corporations. This will help mitigate some of the risks of "selective disclosure," namely, different levels of information and inconsistent information being disclosed to different Analysts.
- The Obligor can establish open-access communications periods, such as periodic conference calls, so Analysts have an equal opportunity to ask questions and hear answers.
- The Obligor can follow the NFMA's Best Practices for Disclosure in its respective sector (see www.nfma.org).
- The Obligor can provide its secondary market disclosure on the internet, free of charge, to permit Analysts open access to secondary-market information without regard to whether they have paid access to a NRMSIR.

These suggestions should help an Obligor strike a balance between concerns for "selective disclosure" and the need for appropriate disclosure in an efficient market.

3. *Insider trading laws prevent Obligors from communicating with Analysts.*

"Insider trading" is a brand of the "selective disclosure" concern.

Insider trading is the trading of securities while in possession of material non-public information acquired in breach of fiduciary duty, for the purpose of personal benefit. Because this standard is strict, it does not generally foreclose communication between an Obligor and a single Analyst. Provided that the Obligor is communicating in good faith and not disclosing "market-moving" information, the breach of fiduciary duty element of insider trading is not likely to be met, especially where the Obligor has made communication with bondholders a formal policy or is complying with the bond documents. So, for example, an Obligor should be able to answer many inquiries from an Analyst regarding publicly-disclosed financial statements without the risk of insider trading. Insider trading is a fair concern for Obligors and Analysts alike, but chilling all Obligor-to-Analyst communications is an overbroad way to address the concern.

4. *Securities laws prevent Obligors from communicating with Analysts.*

This vague statement is another example of an Obligor's fear overtaking the reality of municipal bond regulation. Usually, this statement is a reference to the anti-fraud provisions of Rule 10b-5, as applied in connection with the disclosure requirements of Rule 15c2-12.

Rule 10b-5 applies to Obligors and prohibits a material misstatement or omission regarding securities. Rule 15c2-12 indirectly applies to Obligors and requires disclosure of material information in municipal bond offering documents as well as in secondary market disclosures regarding municipal bonds.

There seems to be a myth that the materiality standards of Rule 10b-5 and Rule 15c2-12 create both a "floor" and a "ceiling" for disclosure—that is, a myth that the securities rules require a certain level of disclosure <u>and</u> prevent any disclosure beyond that level. However, beyond the prohibition against material misstatements of fact, the securities rules do not prohibit additional disclosure by Obligors. For example, although Rule 15c2-12 lists a number of material items that should be disclosed in the secondary market, that list is not an exclusive list of all material items and does not prevent the disclosure of other items that may or may not be material.

In fact, once an Obligor has "spoken to the market" by disclosing information, securities laws (Rule 10b-5) may require the Obligor to make further disclosures to keep the prior information correct, complete, and updated. Thus, while securities laws do not prevent disclosure, they may in these circumstances require disclosure.

B. If an Obligor fails to return telephone calls from an Analyst, is there anything the Analyst can do to force a response?

An Obligor should understand that the market will react negatively to a refusal to respond to Analysts, and the Obligor should therefore return an Analyst's telephone calls. Also, an Obligor is more likely to respond to an Underwriter than an Analyst, and therefore an Analyst might try to contact an incommunicative Obligor indirectly rather than directly. However, an Analyst has no legal basis for forcing an Obligor to respond to its calls or written requests for information unless the applicable bond documents provide otherwise.

C. If an Obligor or Trustee demands proof that an Analyst is a current bondholder, is the Analyst required to provide proof? Are only current bondholders entitled to receive information and participate in quarterly calls and other group calls? Are

Broker-Dealers entitled to information, even though they are not themselves bondholders?

The disclosure regulations applicable to Obligors do not differentiate between bondholders and non-bondholders. Thus, an Obligor should not demand proof that an Analyst is a current bondholder, and an Analyst should not be required to provide proof of ownership. That said, an Obligor has some latitude under the law as to whether it speaks with Analysts, and as a practical matter an Obligor is more likely to speak with an Analyst that is a current bondholder. If an Obligor refuses to provide information unless the Analysts demonstrates proof of ownership, and if an Analyst is not willing or able to do so, then the Analyst might be able to argue that the requested information is required to be disclosed by the Obligor to bondholders and non-bondholders alike. However, since the mandatory disclosure requirements for Obligors are not expansive, this argument will only succeed under limited circumstances.

If the Trustee requires proof of ownership, a different set of issues is presented. While the relationship of a bondholder or non-bondholder to the Obligor is primarily a matter of securities law, the relationship of a bondholder or non-bondholder to the Trustee is primarily a matter of contract. The applicable contract might be the Trust Indenture governing the bond issuance (in which the Trustee is the indenture trustee for *bondholders*) or might be a Rule 15c2-12 Undertaking (in which the Trustee is the dissemination agent for the Obligor with respect to *bondholders and non-bondholders*). Each of these contracts must be considered separately.

The Trust Indenture contains the rules that create and govern the relationship of the Trustee to the bondholders. The Trust Indenture has no similar import for non-bondholders. For example, the Trustee is a fiduciary for bondholders, but not for non-bondholders[11]; and the Trustee usually has contractual disclosure obligations to the bondholders, but not to non-bondholders.[12] Because the Trust Indenture does differentiate between bondholders and non-bondholders, the Trustee may request, and an Analyst should be prepared to provide, proof of ownership to the Trustee.[13] The proof required varies by Trustee according to their individual policies.

The case of a Trustee requiring proof of ownership sometimes arises where a group of bondholders has formed a committee or otherwise assembled for periodic discussions among themselves, or together with the Trustee. Such a group may not possess or discuss material non-public information from the Obligor, but it may possess the collective private thoughts of the group members. If the Trustee or the group (or any member of the

[11] It has been traditionally thought that, in the absence of a default, the Trustee acts as an agent or stakeholder for the Obligor on behalf of the bondholders. Under this view, the Trustee becomes a fiduciary for the bondholders only upon the occurrence of a default. However, in recent years courts have extended the Trustee's fiduciary duty to bondholders to non-default situations.

[12] Although this is traditionally the case, it has become more common in recent years for Trust Indentures, and sometimes related loan agreements which are binding on the Trustee as assignee of the issuer, to provide that certain information may be made available to non-bondholders either directly by the Obligor or by the Trustee.

[13] This applies also in circumstances where the Trustee is dissemination agent under a Rule 15c2-12 Undertaking but the information requested is beyond that which was provided by the Obligor.

group) has received legal advice, that advice may become part of the discussions. In order to keep these discussions confidential (and to maintain the attorney-client privilege as best as possible in respect of any legal advice), the Trustee and the bondholder group have an interest in permitting only bondholders to participate in discussions and gain access to group information.[14]

Unlike a Trust Indenture, a Rule 15c2-12 Undertaking in which the Trustee is the dissemination agent for the Obligor does not distinguish between bondholders and non-bondholders. As noted above, the Obligor should not distinguish between bondholders and non-bondholders for disclosure purposes, and therefore a Trustee acting as dissemination agent for an Obligor should not do so.[15]

Although Trust Indentures and Rule 15c2-12 Undertakings in which the Trustee is the dissemination agent contractually require certain disclosures by the Trustee, only in limited circumstances do these contracts limit disclosures by the Trustee. If a Trustee relies on a contract for declining to disclose information to an Analyst, the Analyst should make further inquiries to determine whether any such contractual limitation does in fact exist.[16]

D. If an Obligor refers an Analyst's questions to another party (e.g., a financial advisor, underwriter, or dissemination party) as the information source, responsible party, or decision-maker, should this excuse the Obligor's failure to provide information? What happens if the referral party does not provide the requested information?

An Obligor is permitted to assign responsibility to a party serving as a dissemination agent, but that agent works at the direction of the Obligor, and the Obligor remains responsible for the adequacy of the disclosure. Thus, although the assignment of disclosure responsibility creates an extra layer between an Obligor and an Analyst, it does not change the underlying set of rules regarding disclosure by Obligors. If an Analyst has

[14] Another related question is whether a Trustee or bondholder group can deny a bondholder access to group discussions or information even after the bondholder has submitted acceptable proof of ownership. For example, a group composed of par holders who have directed the Trustee to retain counsel and have regular discussions with the Trustee and its counsel may want to exclude discount purchasers from the discussions. Or a group of bondholders in which the smallest bondholder position is $1 million may want to exclude bondholders with smaller positions from such discussions. In these instances, the Trustee must maintain its dual responsibilities to the majority bondholders, who have directed the Trustee to take action, and to each individual bondholder, who may have an interest not represented by the majority. While there may be valid reasons for the Trustee to act as gatekeeper, shielding access to group information, the Trustee must also exercise caution so as not to breach its fiduciary duty to the bondholders who are not part of the group. Again, this issue is one regarding information that is not provided by the Obligor, such as independent legal or financial analysis, not an issue regarding Obligor-generated information.

[15] Some Trustees may decline to release information directly to an investor where the information has already been disseminated to the NRMSIRs and SIDs, instead directing the investor to these public repositories. If the information is already publicly available as a result of such dissemination, there is no harm in the Trustee providing it directly to the interested investor.

[16] Some Trust Indentures expressly provide that certain disclosures by the Obligor to the Trustee may not be further disclosed by the Trustee to any third party, including any bondholder. These provisions are rare and usually limited to specific types of information marked by the Obligor as proprietary or confidential.

exhausted the possibility of obtaining information from a dissemination agent, the Analyst may contact the Obligor directly. However, because the disclosure requirements for Obligors (and their agents) are limited, it may be the case that neither the Obligor nor the agent is willing—or required—to disclose the information being requested.

Problems of Not Enough Information

E. If an Obligor cites one or more of the following reasons for not providing a specific type of information to an Analyst (perhaps on advice of counsel), how should the Analyst respond?

1. The requested information is not material.

Materiality is indeed the touchstone for disclosure in both the primary and secondary markets. However, it is sometimes difficult for an Obligor and Analysts to come to a common understanding of what information is and is not "material." Much information in which an Analyst may be interested—questions about an Obligor's disclosed financial statements, for example—may nevertheless not be "material" as a legal matter. But a determination that information is not material can have a double implication. On the one hand, information that is not material is not required to be disclosed to the public generally, even where material information must be so disclosed. On the other hand, the same information that is not material does not give rise to any "selective disclosure" issues and therefore is permitted to be shared with one Analyst without being disclosed to the public generally.

If an Obligor argues that disclosure is not required because the requested information is not material, the Analyst may argue (a) that the information is in fact material and should be disclosed, (b) that the information is at least arguably material, and questions of materiality should be resolved in favor of disclosure, or (c) that the information is not material, but that the information nevertheless may and should be disclosed to the Analyst.

With respect to municipal bond disclosure, the question of whether information is material has an additional complexity because of the list of eleven specific events in Rule 15c2-12. Under Rule 15c2-12, an Underwriter may not purchase or sell municipal securities in an offering unless the Obligor has undertaken, in a written agreement or contract for the benefit of the securities holders (a "Rule 15c2-12 Undertaking"), to disclose the occurrence of any of the listed eleven events if the occurrence of such events is material. As a matter of drafting, the rule does not state that the listed eleven events are material or are not material—it only requires disclosure if they are material. Moreover, the rule does not purport to be an exhaustive list of material events. Thus, the listed events may at times be material or immaterial, and other non-listed events may be material. The bottom line under Rule 15c2-12 is that (a) only the listed events must be disclosed as part of the undertaking, and (b) the listed events must be disclosed only if they are material.

Still, an Obligor may be required (under Rule 10b-5, for example), to disclose events that are not listed at all under Rule 15c2-12.

In any case, Rule 15c2-12 does not provide an answer to the question of whether a certain type of information is material.

2. *No one else has requested this information, and it would be burdensome to disclose.*

Whether anyone else has requested the information is of no direct relevance to whether the Obligor is required disclose the information. Usually, when an Obligor says that no one else has requested the information, the Obligor means that the information is not perceived by the market to be material—that the unpopularity of a request is indirect evidence of the immateriality of the requested information. However, the judgment of whether information is material or not is an objective one, not a subjective one in the discretion of the Obligor or other Analysts. The fact that no other Analyst has requested the information does mean that the disclosure is not required or that the request is inappropriate.

Whether information is burdensome to disclose is of no relevance to whether the Obligor is required to disclose the information. If information is required to be disclosed under Rule 10b-5, Rule 15c2-12, or otherwise, it must be disclosed even if the disclosure is expensive and time-consuming. Often, when an Obligor says that disclosure would be burdensome in response to an Analyst's disclosure request, the Obligor is taking the position (a) that the information is not material and is not required to be disclosed, (b) that it might voluntarily disclose the information, despite the lack of a requirement, if the information were readily available, but (c) the information is not readily available, and it would be burdensome to disclose the information, so no voluntary disclosure will be made. If all of this is true, then the Analyst has no legal tool to force the disclosure. On the other hand, it may be untrue that disclosure is not required—and, if so, then a financial or personnel burden is no excuse for non-disclosure.

3. *This type of information has not been provided in the past.*

Whether information has been disclosed in prior issuances or at an earlier date in the same issuance is of no direct relevance to whether disclosure is required in a subsequent issuance or circumstance. For matters of disclosure, there is no waiver or estoppel—whether a potential disclosure is required in one instance is measured without reference to other instances, and an Analyst is no less entitled to disclosure now because the Analyst took no action in response to a past instance of non-disclosure.

That said, a request for information that is not typically disclosed by Obligors will, in the abstract, be less likely to be a required disclosure than information of a type that is routinely disclosed by Obligors. This is a matter of correlation, not causation. Most Obligors disclose only what is required, so precedents for what has been disclosed tend to line up with what is required to be disclosed. But information is not required to be disclosed because that type of information has been disclosed traditionally, and information is not free from disclosure because it has not been subject to disclosure traditionally.

4. *The Government Finance Officers Association (GFOA) guidelines do not require the disclosures.*

The GFOA guidelines can be helpful to Analysts (in creating a standard for voluntary disclosure by Obligors that is higher than the standard required by law) but they can also be counterproductive to Analysts (in creating the perception of a disclosure "ceiling" that need not be exceeded, even on a voluntary basis, for any reason). Some Obligors will argue that their voluntary compliance with the GFOA guidelines is a "gift" to Analysts and will act as if Analysts requesting information above and beyond that set forth in the guidelines are "greedy." This is a misperception. The GFOA guidelines are intended to set a general standard for the types of information that should be disclosed by most Obligors in most circumstances. However, just as the GFOA guidelines do not require disclosure by Obligors, they do not prevent Obligors from disclosing more information than the guidelines require. A given Obligor, or certain circumstances, may make a particular disclosure meaningful and appropriate even if it is not part of the GFOA guidelines.

Problems Specific to Secondary Market Disclosure

F. If an Obligor insists that it has complied with a Rule 15c2-12 Undertaking, but an Analyst believes that the Obligor is out of compliance, what recourse does the Analyst have?

The Rule 15c2-12 Undertaking is entered into by an Obligor for the specific benefit of the holders of the bonds issued by the Obligor. Thus, while Rule 15c2-12 does not directly obligate an Obligor to disclose information or enter into an undertaking (but instead directly regulates Underwriter action), the rule and undertakings pursuant to the rule are intended to benefit, and to be policed by, bondholder Analysts. If an Analyst believes that an Obligor has not complied with its Rule 15c2-12 Undertaking, its first recourse should be to the Obligor itself. If an Obligor is unwilling to admit non-compliance with the undertaking, or if the Obligor simply refuses to comply with the undertaking, then a bondholder usually has two options under the typical undertaking. First, the bondholder can take whatever action it deems necessary (usually court action) to enforce certain terms of the undertaking—often only the filing of the annual disclosures—on its own. Second, the bondholder can join with other bondholders who together form a majority of the bondholders (by aggregate principal amount) and take joint action to enforce the undertaking, which would include not only the filing of the annual disclosures but also to challenge the adequacy of whatever disclosure has been made. This scheme is designed to prevent one cantankerous bondholder from initiating spurious legal challenges, but nevertheless to permit bondholders to force the benefits due to them under Rule 15c2-12 Undertakings.[17]

G. If an Obligor fails or refuses to explain the details for being out of compliance with a Rule 15c2-12 Undertaking, may an Analyst demand an explanation? Is an explanation that the Obligor was unaware of the disclosure requirements a sufficient response? What about an explanation that the third-party dissemination agent was responsible for the compliance failure?

Typically, a Rule 15c2-12 Undertaking does not permit an Analyst, acting on its own, to force an explanation of any alleged non-compliance by the Obligor. Bondholders are beneficiaries under Rule 15c2-12 Undertakings, and it is likely in the best interest of the Obligor to provide bondholder Analysts with an explanation of any non-compliance by the Obligor. However, if the Obligor refuses to do so, it is usually a majority of the bondholders, not just a single non-majority bondholder, who can force an explanation under the terms of the undertaking (see question and answer F and footnote 4 above).

Ignorance is no defense under a Rule 15c2-12 Undertaking, and an explanation by the Obligor that it was unaware of a disclosure requirement is not likely to succeed as a legal matter. A defense of ignorance is also unlikely to be genuine, because of the Obligor's execution of the Rule 15c2-12 Undertaking and the general familiarity of Obligors with continuing disclosure requirements.

Likewise, while an Obligor is permitted to assign responsibility to a party serving as a dissemination agent, that agent works at the direction of the Obligor, and the Obligor remains responsible for the adequacy of the disclosure. Thus, an explanation that a third-party dissemination agent, and not the Obligor, is to blame for disclosure non-compliance is not an explanation that exculpates the Obligor or mandates forgiveness of the non-compliance.

That said, the remedy for violation of a Rule 15c2-12 Undertaking is usually only specific performance—that is, forced disclosure of what should have been disclosed in the first place—so the validity of the explanation is often not relevant to the purpose of the undertaking and its enforcement.

H. Is an Obligor required to disclose a prior failure to comply with a Rule 15c2-12 Undertaking?

The definition of "final official statement" in Rule 15c2-12(f)(3) includes a requirement that such a statement include any instances in the past five years in which an Obligor (or agent) failed to comply, in all material respects, with any previous undertakings in a Rule 15c2-12 Undertaking. While this requirement does not (like the other parts of the rule) apply to Obligors directly, its application to underwriters will effectively result in the

[17] Although Rule 15c2-12 Undertakings are generally standardized in this regard, bondholders should obtain a copy of the Rule 15c2-12 Undertaking applicable to their issuance and review its particular terms before reaching any conclusion regarding enforcement mechanics for the undertaking.

disclosure of any past disclosure non-compliance. It should be noted, however, that this disclosure of non-compliance is not a continuing disclosure requirement, but rather a disclosure requirement for future final official statements. Thus, if an Obligor is non-compliant in the period between issuances, no disclosure of that non-compliance is required.

I. If the disclosure commitment language is incorrect in a preliminary official statement and the Obligor or Bond Counsel resists correcting the language in time for a competitive bid, how should the Analyst respond? Is it sufficient if the Obligor or Bond Counsel orally assures the Analyst that the language will be corrected in the final official statement? Should the Analyst insist on receiving in writing the proposed corrected language?

The better course is to obtain the new language in writing. However, Bond Counsel is likely to resist providing the language in writing for a variety of reasons. First, providing the language to one Analyst can cause a selective disclosure problem. Second, providing the language before the final official statement is drafted can reduce Bond Counsel's flexibility in choice of language when the final official statement is drafted. Of course, the best course is for Bond Counsel to correct the preliminary offering statement in time for the competitive bid. But if that fails, an oral assurance from Bond Counsel may be the best that an Analyst can achieve as a practical matter.

J. How can an Analyst obtain current contact names and telephone numbers for an Obligor, to assist with secondary market inquiries for current information regarding an Obligor's credit quality?

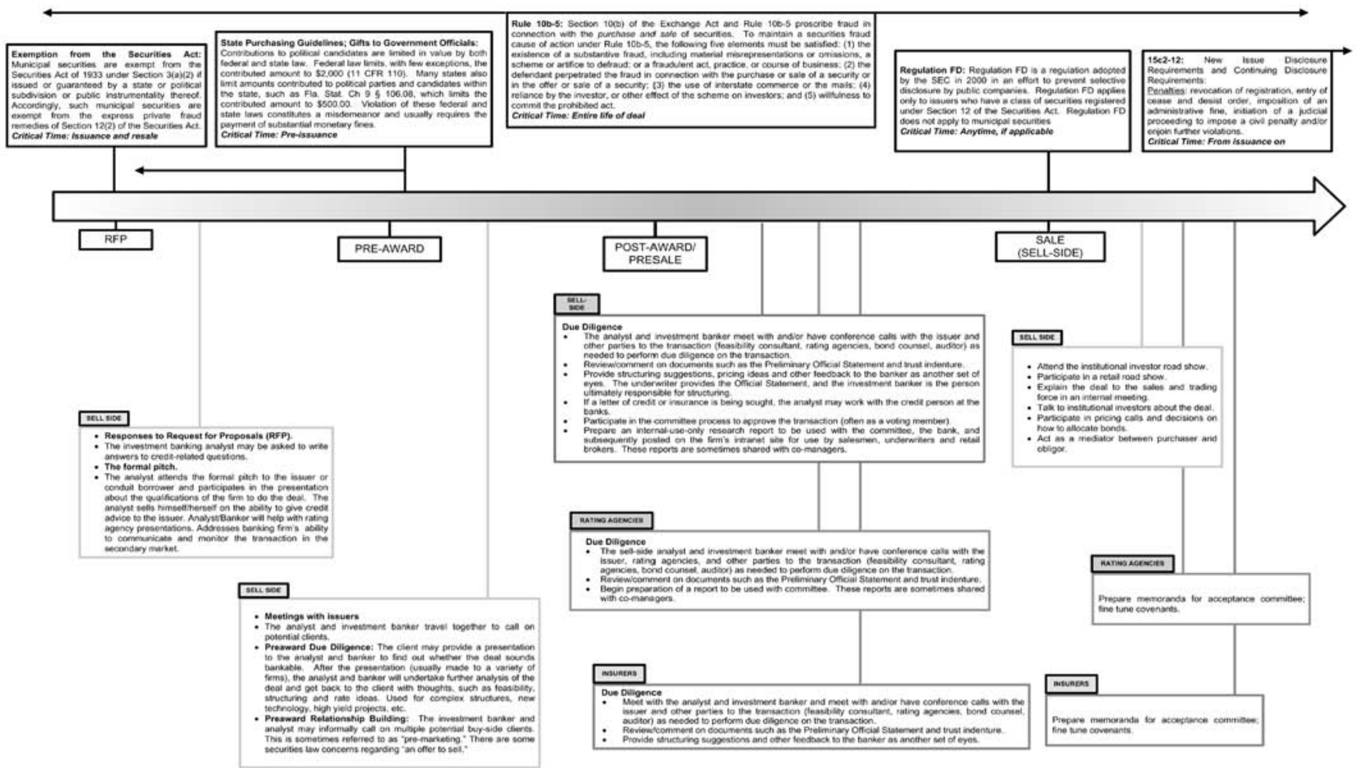
There is no one best path for an Analyst to follow in obtaining current contact information for an Obligor. In many cases, an Analyst must make use of whatever information is available and place telephone calls with many different people before finding the best contact for an Obligor.

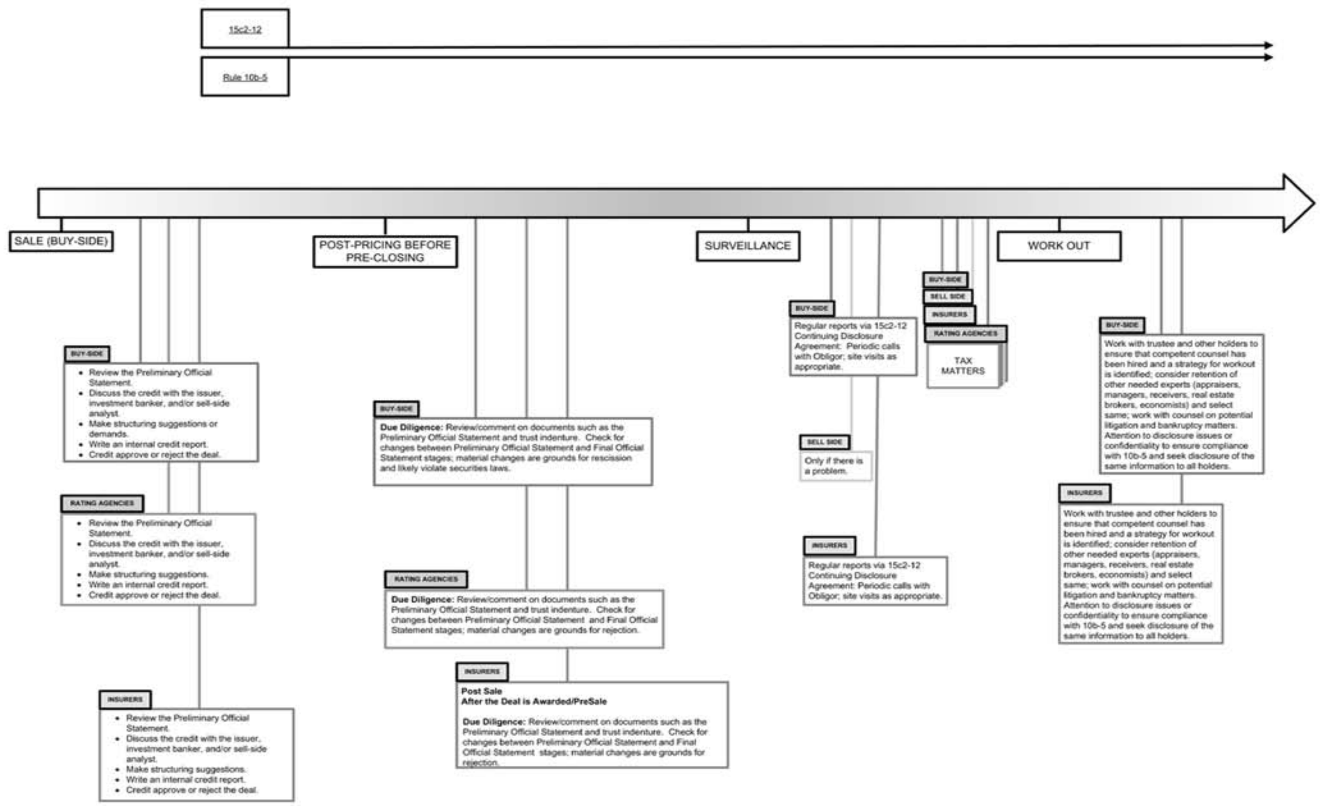
K. May an Obligor provide uneven disclosure, for example, more information (quarterly) to large bondholders who request information in writing and less information (annually) to Nationally Recognized Municipal Securities Information Repositories (NRMSIRs)?

The problem of uneven or "selective" disclosure is addressed above. The bottom line is that uneven disclosure is highly problematic, especially in a manner that would provide an entire set of quarterly numbers to certain preferred Analysts. Of course, nothing prevents an Obligor from making quarterly information available to the market at large, through NRMSIRs or otherwise, on a voluntary basis. Healthcare issuers have frequently agreed to do so, for example, in order to increase the liquidity of their bonds. Moreover, the SEC's 1994 interpretive release regarding antifraud protections indicates that in some circumstances annual information will not suffice and more frequent information disclosure is required. Still, whether on a voluntary or mandatory basis, quarterly financial information made available to one Analyst should in most circumstances be made available to all Analysts.

L. By sending information to the NRMSIR, has an Obligor satisfied all obligations and requirements to provide information in the secondary market?

No. By complying with a Rule 15c2-12 Undertaking, the Obligor has satisfied that undertaking, but no other requirement. For example, the Obligor may have continuing disclosure requirements under Rule 10b-5, and, even if an Obligor has no continuing obligation to disclose information under Rule 10b-5, any information that an Obligor does disclose (including any information disclosed under a Rule 15c2-12 Undertaking) is subject to antifraud regulation that might require a broader disclosure than that which was made. Moreover, the Obligor may have contractual disclosure obligations, for example in the bond documents.


Exemption from the Securities Act: Municipal securities are exempt from the Securities Act of 1933 under Section 3(a)(2) if issued or guaranteed by a state or political subdivision or public instrumentality thereof. Accordingly, such municipal securities are exempt from the express private fraud remedies of Section 12(2) of the Securities Act.
Critical Time: Issuance and resale
State Purchasing Guidelines; Gifts to Government Officials: Contributions to political candidates are limited in value by both federal and state law. Federal law limits, with few exceptions, the contributed amount to $2,000 (11 CFR 110). Many states also limit amounts contributed to political parties and candidates within the state, such as Fla. Stat. Ch 9 § 106.08, which limits the contributed amount to $500.00. Violation of these federal and state laws constitutes a misdemeanor and usually requires the payment of substantial monetary fines.
Critical Time: Pre-issuance
Rule 10b-5: Section 10(b) of the Exchange Act and Rule 10b-5 proscribe fraud in connection with the purchase and sale of securities. To maintain a securities fraud cause of action under Rule 10b-5, the following five elements must be satisfied: (1) the existence of a substantive fraud, including material misrepresentations or omissions, a scheme or artifice to defraud; or a fraudulent act, practice, or course of business; (2) the defendant perpetrated the fraud in connection with the purchase or sale of a security or in the offer or sale of a security; (3) the use of interstate commerce or the mails; (4) reliance by the investor, or other effect of the scheme on investors; and (5) willfulness to commit the prohibited act.
Critical Time: Entire life of deal
Regulation FD: Regulation FD is a regulation adopted by the SEC in 2000 in an effort to prevent selective disclosure by public companies. Regulation FD applies only to issuers who have a class of securities registered under Section 12 of the Securities Act. Regulation FD does not apply to municipal securities.
Critical Time: Anytime, if applicable
15c2-12: New Issue Disclosure Requirements and Continuing Disclosure Requirements:
Penalties: revocation of registration, entry of cease and desist order, imposition of an administrative fine, initiation of a judicial proceeding to impose a civil penalty and/or enjoin further violations.
Critical Time: From issuance on
RFP
PRE-AWARD
POST-AWARD/ PRESALE
SALE (SELL-SIDE)
SELL SIDE
• Responses to Request for Proposals (RFP).
• The investment banking analyst may be asked to write answers to credit-related questions.
• The formal pitch.
• The analyst attends the formal pitch to the issuer or conduit borrower and participates in the presentation about the qualifications of the firm to do the deal. The analyst sells himself/herself on the ability to give credit advice to the issuer. Analyst/Banker will help with rating agency presentations. Addresses banking firm's ability to communicate and monitor the transaction in the secondary market.
SELL SIDE
• Meetings with issuers
• The analyst and investment banker travel together to call on potential clients.
• Preaward Due Diligence: The client may provide a presentation to the analyst and banker to find out whether the deal sounds bankable. After the presentation (usually made to a variety of firms), the analyst and banker will undertake further analysis of the deal and get back to the client with thoughts, such as feasibility, structuring and rate ideas. Used for complex structures, new technology, high yield projects, etc.
• Preaward Relationship Building: The investment banker and analyst may informally call on multiple potential buy-side clients. This is sometimes referred to as "pre-marketing." There are some securities law concerns regarding "an offer to sell."
SELL-SIDE
Due Diligence
• The analyst and investment banker meet with and/or have conference calls with the issuer and other parties to the transaction (feasibility consultant, rating agencies, bond counsel, auditor) as needed to perform due diligence on the transaction.
• Review/comment on documents such as the Preliminary Official Statement and trust indenture.
• Provide structuring suggestions, pricing ideas and other feedback to the banker as another set of eyes. The underwriter provides the Official Statement, and the investment banker is the person ultimately responsible for structuring.
• If a letter of credit or insurance is being sought, the analyst may work with the credit person at the banks.
• Participate in the committee process to approve the transaction (often as a voting member).
• Prepare an internal-use-only research report to be used with the committee, the bank, and subsequently posted on the firm's intranet site for use by salesmen, underwriters and retail brokers. These reports are sometimes shared with co-managers.
RATING AGENCIES
Due Diligence
• The sell-side analyst and investment banker meet with and/or have conference calls with the issuer, rating agencies, and other parties to the transaction (feasibility consultant, rating agencies, bond counsel, auditor) as needed to perform due diligence on the transaction.
• Review/comment on documents such as the Preliminary Official Statement and trust indenture.
• Begin preparation of a report to be used with committee. These reports are sometimes shared with co-managers.
INSURERS
Due Diligence
• Meet with the analyst and investment banker and meet with and/or have conference calls with the issuer and other parties to the transaction (feasibility consultant, rating agencies, bond counsel, auditor) as needed to perform due diligence on the transaction.
• Review/comment on documents such as the Preliminary Official Statement and trust indenture.
• Provide structuring suggestions and other feedback to the banker as another set of eyes.
SELL SIDE
• Attend the institutional investor road show.
• Participate in a retail road show.
• Explain the deal to the sales and trading force in an internal meeting.
• Talk to institutional investors about the deal.
• Participate in pricing calls and decisions on how to allocate bonds.
• Act as a mediator between purchaser and obligor.
RATING AGENCIES
Prepare memoranda for acceptance committee; fine tune covenants.
INSURERS
Prepare memoranda for acceptance committee; fine tune covenants.


15c2-12
Rule 10b-5
SALE (BUY-SIDE)
BUY-SIDE
• Review the Preliminary Official Statement.
• Discuss the credit with the issuer, investment banker, and/or sell-side analyst.
• Make structuring suggestions or demands.
• Write an internal credit report.
• Credit approve or reject the deal.
RATING AGENCIES
• Review the Preliminary Official Statement.
• Discuss the credit with the issuer, investment banker, and/or sell-side analyst.
• Make structuring suggestions.
• Write an internal credit report.
• Credit approve or reject the deal.
INSURERS
• Review the Preliminary Official Statement.
• Discuss the credit with the issuer, investment banker, and/or sell-side analyst.
• Make structuring suggestions.
• Write an internal credit report.
• Credit approve or reject the deal.
POST-PRICING BEFORE PRE-CLOSING
BUY-SIDE
Due Diligence: Review/comment on documents such as the Preliminary Official Statement and trust indenture. Check for changes between Preliminary Official Statement and Final Official Statement stages; material changes are grounds for rescission and likely violate securities laws.
RATING AGENCIES
Due Diligence: Review/comment on documents such as the Preliminary Official Statement and trust indenture. Check for changes between Preliminary Official Statement and Final Official Statement stages; material changes are grounds for rejection.
INSURERS
Post Sale
After the Deal is Awarded/PreSale
Due Diligence: Review/comment on documents such as the Preliminary Official Statement and trust indenture. Check for changes between Preliminary Official Statement and Final Official Statement stages; material changes are grounds for rejection.
SURVEILLANCE
BUY-SIDE
Regular reports via 15c2-12 Continuing Disclosure Agreement: Periodic calls with Obligor; site visits as appropriate.
SELL SIDE
Only if there is a problem.
INSURERS
Regular reports via 15c2-12 Continuing Disclosure Agreement: Periodic calls with Obligor; site visits as appropriate.
BUY-SIDE
SELL SIDE
INSURERS
RATING AGENCIES
TAX MATTERS
WORK OUT
BUY-SIDE
Work with trustee and other holders to ensure that competent counsel has been hired and a strategy for workout is identified; consider retention of other needed experts (appraisers, managers, receivers, real estate brokers, economists) and select same; work with counsel on potential litigation and bankruptcy matters. Attention to disclosure issues or confidentiality to ensure compliance with 10b-5 and seek disclosure of the same information to all holders.
INSURERS
Work with trustee and other holders to ensure that competent counsel has been hired and a strategy for workout is identified; consider retention of other needed experts (appraisers, managers, receivers, real estate brokers, economists) and select same; work with counsel on potential litigation and bankruptcy matters. Attention to disclosure issues or confidentiality to ensure compliance with 10b-5 and seek disclosure of the same information to all holders.

The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market

A Study of Questionable Trading Practices Based on Publicly Available Information Held by the NRMSIRs and the MSRB

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Abstract

This report summarizes a study of the effectiveness of the market-wide regulatory apparatus for the domestic municipal securities market in preventing certain types of abusive or predatory practices toward investors. This apparatus consists of the Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB), which the SEC controls through its rule making authority.

The study found a measurable segment of apparent bad practices. These practices were characterized by an intersection of poor disclosure by issuers and obligors on the one hand, and on the other hand, poor use of available disclosure information by the buy and sell sides of the municipal market. The result could be termed the worst of both worlds. That is, trades in impaired credits were transacted at prices of par or above, despite the prior availability of default or other similar event notices in the official disclosure system.

Two important issues related to market safety emerged from this study. First, it appears that crucial disclosure information that is available to the market at large is sometimes either disregarded by dealers or withheld from buyers. If so, existing rules pertaining to fair dealing, suitability, and fair pricing are being violated, particularly in the extreme cases which surfaced in this study. These rules have been on the books of the MSRB for many, many years and explicitly reference the disclosure requirements of SEC Rule 15c2-12.[1] To the best of our knowledge, the MSRB has never initiated enforcement actions for failure to inform investors of prejudicial continuing disclosure information in the course of a transaction.

Second, the lack of any continuing disclosure information at all in many cases creates even more risk for the buyers of these bonds. Due to issuer/obligor non-compliance with disclosure covenants[2], one-half of the buyers of these distressed bonds had no means of defending themselves against putative predatory dealer practices, because there were no filings in the previous two years.

Prior to these trades, neither the dealers nor the buyers of one-half of these distressed bonds could have known from officially filed disclosures what the condition of the underlying distressed credits was. Thus, the first official evidence other than the fact that they were distressed was the material event notices stating so. As the burden of fair dealing, determining suitability, and fair pricing is borne by the dealers, according to

[1] There are several MSRB rules related to ethical dealing that directly or indirectly reference the requirements of SEC Rule 15c2-12, the continuing disclosure regulation that established the Nationally Recognized Municipal Securities Information Repositories (NRMSIR) to make disclosure information available to dealers and investors for this purpose. These MSRB rules include G-17 (Fair Dealing) http://www.msrb.org/MSRB1/Rules/notg17.HTM; G-19 (Suitability) http://www.msrb.org/MSRB1/Rules/interpg19.HTM and its embedded reference to G-21 (Advertising); and G-30 (Prices and Commissions) http://msrb.org/MSRB1/Rules/Notg30.htm (particularly End Note #7 to the section subtitled "Inter-Dealer and Brokers' Brokers Transactions."

[2] For background on the larger issue of municipal bond issuer/obligor disclosure filing behavior, see "Estimating Municipal Securities Disclosure Compliance: A Litmus Test Approach"; DPC DATA Inc., 2008. This is available at http://www.dpcdata.com/html/about-researchpapers.html.

MSRB regulations related to ethical trading, as well as the intent of SEC Rule 15c2-12, it is difficult to see how the dealers involved in these trades could have viewed these bonds as suitable at prices of par or above.

From publicly available data filed with the NRMSIR operated by DPC DATA and the MSRB's Real-time Transaction Reporting System (RTRS), this study found that the incidence of questionable trades increased dramatically in 2008 over previous years, as the stresses of the financial markets intensified.

On the highest level, this study found that, despite SEC and MSRB regulations related to disclosures, the concept of *caveat emptor* still reigns in the municipal market, whether or not crucial disclosure information is readily available.

Key Findings

In the context of the dealer's obligation to ensure suitability and fair pricing of municipal securities sold to investors, highlights of this study include the following findings:

- In 2008, 667 trades that were dealer-to-customer sales were executed at par or higher after a default or other stress notice was filed by the issuer or obligor in the official disclosure system.

- The majority of these trades occurred during the tumultuous months of September through November when credit markets were imploding.

- More than 40 percent of the trades were in par amounts of $50,000 or less, which suggests sales to retail (rather than institutional) buyers.

- In half of all sales of these distressed bonds, no financial statements had been officially filed during the 2007 or 2008 calendar years.

The Municipal Bond Market of 2008

Very few informed market observers and economists foresaw the turmoil and dislocation that befell all of the world's capital markets during 2008. In the municipal bond market new issuance activity declined[3] as underwriters faced loss of credit facilities[4] supporting their capital commitments, and large traditional buyers of these instruments pulled back from the market[5] or reduced their holdings[6] in the midst of a massive liquidity crunch. Along the way, the market experienced the total collapse of most auction rate securities as the loss of liquidity prevented the remarketing of most of these deals.[7]

The collapse of Bear Stearns and Lehman Brothers, the absorption of Merrill Lynch into Bank of America, and the withdrawal of UBS from the municipal securities market all impacted the situation significantly. The problem of looming insolvency on the part of the nation's largest commercial banks also had serious impact. Federal government intervention in the form of the hastily conceived and implemented Troubled Asset Relief Program (TARP) drove other leading municipal bond market participants, such as Goldman Sachs, Morgan Stanley and Raymond James, to reorganize themselves as bank holding companies.[8]

Many state and local governments made numerous announcements of dire liquidity and credit circumstances, suspended infrastructure projects, lack of funds to meet ordinary expenses and payrolls, and severe cutbacks on current spending and public employment.[9] Some municipalities even sought refuge in bankruptcy court or began preparations for it.[10]

During the year, the increase in material event notices filed with the DPC DATA NRMSIR also was notable[11], while at the same time the number of financial statements

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[3] *The BondBuyer*; "A Decade of Municipal Bond Finance;" p.22; January 8, 2009.
[4] *The BondBuyer*; "Fed Moves to Provide Extra Liquidity Through TSLF;" p.4; September 16, 2008. "New Issuance Slows to A Crawl in September;" p.1; October 1, 2008.
[5] *The BondBuyer*; "Several New Deals in Limbo After Market's Turbulent Week;" p.6; September 22, 2008. "Funding Infrastructure Remains a Challenge;" p.4; October 20, 2008. "Market Finds Problems In Primary, Secondary;" p.1; December 9, 2008.
[6] *The BondBuyer*; "Funds See Slight Recovery;" p.1; September 26, 2008.
[7] *The BondBuyer;* "Issuers: Variable-Rate Liquidity Drying Up;" p.1; August 1, 2008. "Short-Term Market Dries Up;" p.1; October 7, 2008.
[8] *The BondBuyer*; "Goldman, Morgan Stanley Enter New Era;" p.1; September 23, 2008. "Raymond James Financial Will Apply For Bank Holding Company Status", p.5; September 29, 2008.
[9] *The BondBuyer*; "Wisconsin Gov. Revises Budget Bill;" p.1; May 19, 2008. "Economy Starts to Pinch Largest Texas Cities;" p.1; June 3, 2008. "New York Faces $47 Billion Shortfall Over Four Fiscal Years;" p.4; October 29, 2008. "NYC's Bloomberg Calls for Cuts Rescinding Property Tax Breaks;" p.36; November 6, 2008. "California in Crisis Mode As Deficit Passes $11B;" p.1; November 7, 2008.
[10] *The BondBuyer*; "Vallejo Files for Chapter 9;" p.1; May 27, 2008. "Is Vallejo Really Broke? Its Unions Want to Know;" p.1; July 25, 2008. "Vallejo, Union Bank of California Far From Deal to Restructure Debt;" p.36; July 28, 2008. "Chapter 9 Urged for Jefferson County;" p.1; August 18, 2008.
[11] Municipal bond material event notice filings totaled 94,589 in 2008, as compared to 54,515 for all of 2007. The demise of the bond insurance industry caused an increase by nearly 25,000 in the number of

officially filed increased only slightly. The market as a whole took greater interest in basic credit information just as the insured bond ratings evaporated[12] and the rating agencies came under severe criticism by Congress and the SEC for the way they conducted their business and subverted their own credibility.[13]

In short, it was a bad year during which all market participants were put to the test.

General Trading Activity

In concert with the well-publicized credit and liquidity dislocations in the municipal market, new long-term municipal bond issuance volume declined by 9% for the year and the number of new issues declined by 16% from the 2007 levels.[14] Despite all of these factors, however, total reported trading activity for the market actually increased by about 22% during 2008. *Table 1* and *Table 2* show how both the trend in trading volume and the composition of these trades changed recently.

	2005	2006	2007	2008
Total # Reported Municipal Trades	7,244,731	7,603,192	9,004,886	11,022,192
Sales to Customers	3,734,552	3,555,909	4,218,572	5,563,233
Sales to Customers as % of Total Reported Trades	52%	47%	47%	50%

Table 1. Source: MSRB's RTRS Data Feed.

Table 1 shows the rise in overall municipal trading activity from 2005 to 2008, and the spike in sales from dealers to customers in 2008. The difference between these two figures in each year is accounted for in dealer-to-dealer trades and dealer purchases from customers, which are not a focus of this study. When dealers sell securities to investors, the ethical standards spelled out in the MSRB rules pertaining to investor protection are most significant.

rating changes that were officially filed as material event notices. Over the same period, bond redemption notices rose by 18%.

[12] *The BondBuyer*; "S&P Takes Action on Five Bond Insurers;" p.1; February 26, 2008. "Credit Crunch Hits Variable Rate Market;" p.1; February 29, 2008.

[13] *The BondBuyer*; "Raters Look to Curb Conflicts of Interest;" p.1; February 8, 2008. "SEC Votes to Remove NRSRO From 38 Rules;" p.1; June 26, 2008. "Poll Finds Dim View of Rating Agencies;" p.1; July 8, 2008. "SEC: Conflicts of Interest Not Well-Managed;" p.4; July 9, 2008. "Congressional Flak;" p.1; October 23, 2008. See also *The Wall Street Journal*; "SEC Chief Pledges Effort To Bolster Enforcement;" p. B1; February 7-8, 2009.

[14] *The BondBuyer*; "A Decade of Municipal Bond Finance;" p.22; January 8, 2009.

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2008 Municipal Bond Market Number of Trades by Month (Millions)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Total # Municipal Trades	0.9	1.0	1.1	1.0	0.8	1.0	0.8	0.8	0.8	1.1	0.8	1.0
Total # Municipal Trades That Were Sales to Customers	0.4	0.4	0.5	0.5	0.4	0.5	0.4	0.4	0.4	0.6	0.4	0.5
Customer Sales as % of Total	46%	44%	51%	42%	49%	51%	51%	51%	51%	55%	53%	55%

Table 2. Source: MSRB's RTRS Data Feed.

Just how important sales to customers, including retail, became over the course of 2008 is broken out in *Table 2*. While monthly reported trades stayed in the 800,000 to 1,100,000 trade per month range, an ever increasing number and proportion of trades left the Street for investor portfolios. As the crisis worsened for the entire market around mid-year, the collapse of credit and liquidity sources pressured the dealer firms to liquidate proprietary trading positions. The only place for trading positions to go is into customer portfolios, including retail. It is probable that individual investors continued to view the otherwise 'stable' municipal bond market as a safe haven in the global financial storm and increased net purchases at the same time.

A Time of Credit Stress

Default and other types of severe stress on municipal bond credits is a small but constant part of the fabric of the market. In more normal times, defaults and other forms of stress are usually confined to marginal credits that occupy the riskiest parts of the market. During 2008, however, the dislocations caused by reduced access to traditional sources of credit and liquidity during 2008 broadened across the market. Table 3 compares distressed bond notices filed officially over the past four calendar years.[15]

	2005	2006	2007	2008
# of Distressed Bond Notices Filed	404	235	187	348
# Associated CUSIP9s	18	15	10	647

Table 3. Source: DPC DATA NRMSIR.

For purposes of this study, 'distressed bond' refers to any bond for which there was filed with the DPC DATA NRMSIR a material event notice for any of the following notice types: Payment Delinquencies, Non-Payment Related Defaults, Unscheduled Draws on Debt Service Reserves, and Unscheduled Draws on Credit Enhancements.

Over the period 2005 to 2007, the annual number of new distressed bond event notice filings declined, as did the breadth of related new defaults indicated by the number of affected CUSIP numbers. The reported defaults in 2008 almost doubled the number for 2007, and the number of affected CUSIPs exploded, which is consistent with the widespread decline in credit among municipal issuers and obligors that has been reported throughout 2008 in the nation's press.

As the US economy slips deeper into recession and tax receipts and user fees continue to decline, it should be expected that the number of bonds declaring distress will continue to increase. As evidence that municipal credit erosion continues, the trend in new distress notice filings with the DPC DATA NRMSIR continues at an accelerated rate. For the period January 1, 2009 through February 15, 2009, sixty-six new distressed bond filings have been made. This compares with only twenty-seven for the same period in 2008.

[15] This study does not tabulate or report on all municipal bonds that are in default. Instead, it focuses more narrowly on the distress notices that were filed in each discrete year covered by the study as a means of isolating the year-over-year incidence of declared distress situations. If a bond encountered distress as defined in this study but the obligor for those bonds or its agent filed no material event notice with the DPC DATA NRMSIR declaring it, then it is not covered in this report.

Trading Activity in Distressed Bonds

Tables 4, 5, 6 and *7* look at a particular cross-section of bond trading activity over the period 2005 through 2008 that includes only the trades in bonds that filed distress notices during each discrete year. *Table 4* tabulates the number of trades that took place in the market during the calendar year of notice at any time before and after a distressed bond notice was filed where the trades were defined as sales from dealers to customers.[16] These trades are of particular interest because they contain the elements of the fundamental themes related to investor protection that investors ordinarily take for granted: (a) The availability of critical information that an investor would reasonably require in advance to be informed about the advisability of a given bond purchase, (b) the inclusion of this information in the pricing of the transaction, (c) the ethical application of this information at the time of trade, and (d) the extent to which market regulatory bodies ensure a level playing field for investors in the municipal securities market.

This study focuses on these specific trades. It examines the availability of critical information in the official disclosure system,[17] and how that information or lack of it may have factored into the transactions. Though extrapolation from the available trade data provides only circumstantial evidence, it does suggest there were ethical and regulatory lapses that make a large number of these trades appear questionable at best.

	# Distress Notices Filed	# Related Trades During Year Notice Was Filed	# Related Trades During Year Notice Was Filed That Were Sales to Customers	# Related Trades During Year Notice Was Filed That Were Sales to Customers at a Price of Par or Higher
2005	404	744	329	18
2006	235	401	87	10
2007	187	126	41	23
2008	348	27,919	9,643	5,798

Table 4. Source: DPC DATA NRMSIR and MSRB's RTRS data feed.

Municipal bond credit determinants, unlike their analogs in other securities asset classes, usually don't manifest in sudden shifts that lead immediately to distress. This is because

[16] The identification of these trades comes from the MSRB RTRS data feed, which describes trades as either dealer-to-dealer, purchase from customer, or sale to customer.

[17] Under the current disclosure system defined by SEC Rule 15c2-12, issuers and other obligated persons who are not exempt from the requirements of 15c2-12 must file their continuing disclosure materials at least annually with all NRMSIRs simultaneously either directly or through the Central Post Office (CPO) at www.DisclosureUSA.org. Obligated persons are also required to file notices of material events either (i) with all NRMSIRs simultaneously, or (ii) with the Municipal Securities Rulemaking Board (MSRB). Material event notices can be filed with the NRMSIRs via www.DisclosureUSA.org.

municipal debt obligors are overwhelmingly governments and government-sponsored enterprises that operate on a more stable economic platform than pure for-profit entities that operate in highly competitive markets.

To be sure, there are sudden events that can and do negatively affect credits that are small and undiversified, such as adverse court judgments, plant closings, and *force majeure* events, to name a few, that eventually affect sales tax receipts, user fees and property tax base. But typically, if disclosures are filed regularly according to existing regulations, there is warning of disintegrating financial condition in the materials filed in the official disclosure system. The official disclosures are available to both dealers and customers through the NRMSIR system.

Under the current disclosure regime embodied in the combined SEC and MSRB rules, dealers must have access to this official disclosure information, because they are responsible for determining fairness, suitability and fair pricing in any transactions with customers. Through these filings, credit trends can be identified and informed judgments can be made so that investors can take rational steps to protect their interests.

If regular continuing disclosures indicated that the credit worth of a bond was deteriorating, or if an official stress notice had already been filed by the bond issuer or obligor, it seems unlikely that an investor would willingly purchase such bonds at par or premium prices. If the trades could be deemed suitable at all for a given investor according to MSRB rules, they would be transacted at discount prices. These would likely be trades with sophisticated investors looking for distressed bonds. The fact that such 'going-away' trades took place at all at par and premium levels raises questions. Was the minimum standard of conduct abrogated somewhere in the process?

Bad Things That Flourish in the Dark

In the absence of regular and close scrutiny of disclosure practices and related dealer practices in the municipal market by the two main regulatory bodies over the years, the stage was set for the worst possible predatory behavior to take place in distressed bonds as the market imploded. *Table 5* and *Table 6* illustrate the worsening scenario of this behavior.

Table 5 shows the number of bonds sold to investors at prices of par or higher after the issuer or obligor had already made public announcements through the official disclosure system that their bonds were in serious stress. It is noteworthy that most of these trades occurred in the months of the most dramatic market meltdown, as shown in *Table 6*.

Rational and informed buyers would not have agreed to these trades at these prices. We can only conjecture about how these trades may have occurred. There are at least two obvious possibilities. Either the dealers who sold the bonds were remiss in actually checking with the NRMSIRs, which SEC Rule 15c2-12 requires them to have access to,

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	# Bond Sales to Customers (During the Calendar Year the Distress Notice Was Filed) At Any Price After the Distress Notice Was Filed	# Bond Sales to Customers (During the Calendar Year the Distress Notice Was Filed) At a Price of Par or Higher After the Distress Notice Was Filed
2005	283	7
2006	29	4
2007	26	9
2008	1,782	667

Table 5. Source: DPC DATA NRMSIR and MSRB's RTRS data feed.

about the existence of default or other stress related notices. Alternatively, they did have knowledge of these notices and concealed it from the customer at the point of trade.

2008 Monthly Distribution of Distressed Bond Sales to Customers at a Price of Par or Higher After the Distress Notice Was Filed												
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	TOTAL
0	3	21	61	85	77	21	41	52	207	99	0	667
								------54%------				

Table 6. Source: DPC DATA NRMSIR and MSRB's RTRS data feed.

While it is hard to imagine that any dealer subject to MSRB rules pertaining to suitability and fair pricing would reasonably allow trades in defaulted or otherwise severely stressed bonds to execute at prices of par or above, it is also hard to imagine that a dealer would feel much at risk in doing so. Neither the SEC nor the MSRB have monitored disclosure compliance in the NRMSIR archives. Nor have these regulatory bodies specifically enforced disclosure-related rules, except in a handful of secondary charges by the SEC.

The data in *Table 7* points out that 41% of the worst trades were transacted in the under-$50,000 par amount range, suggesting probable retail accounts on the receiving end.

Breakdown of Trade Size by Par Amount for the 667 Distressed Bond Trades During 2008 That Were Sold to Investors at Prices of Par or Higher After the Distress Notice Was Filed					
Par Amount of Trade	>$100K	≥ $75K ≤$100K	≥ $50K <$75K	≥ $25K <$50K	<$25K
# of Trades	233	97	66	114	157
				------41%------	

Table 7. Source: DPC DATA NRMSIR and MSRB's RTRS data feed.

For the Investors Involved, Was Self-defense a Reasonable Possibility?

Continuing disclosure information, as defined in SEC Rule 15c2-12, is deemed public when it is deposited with the designated repositories and thereby made simultaneously available to the general public. While large or sophisticated investors, such as mutual funds, may have taken responsibility for their own due diligence in municipal investments, retail investors usually depend on advice from dealers and personal financial advisors. However, universal access to NRMSIR archives has been available through the internet for nearly a dozen years at www.MuniFILINGS.com, operated by DPC DATA.

Access by brokers or investors to publicly filed disclosures is not the primary problem facing municipal market participants. Far more serious is the failure of many issuers and obligors to file disclosures. There are also well documented problems with the content of continuing disclosure materials that do find their way into the official disclosure system, but that is not a focus of this study.[18]

The lack of SEC enforcement of Rule 15c2-12 over the past fourteen years has bred a general indifference to continuing disclosure on the part of both issuers/obligors[19] and, apparently, some portion of the dealer community. How was this indifference allowed to take root?

A recent study released in 2008 by this author documented the extent to which issuers/obligors in general ignore their own affirmative covenants to make regular continuing disclosure filings for as long as their bonds are deemed to be outstanding.[20] That study identified the lack of enforcement actions involving continuing disclosure pursuant to SEC Rule 15c2-12 since the requirements went into effect in 1994 as a probable cause for the general level of issuer/obligor non-compliance with their own disclosure covenants.

It also appears that there are virtually no effective negative consequences for dealers under MSRB rules for not disclosing pertinent continuing disclosure and material event information to clients in the context of securities sales. It appears that the lack of rigorous enforcement of MSRB Rules G-17, G-19 and G-30 as they pertain to the use of continuing disclosure information by dealers has created a parallel sense of laxness that manifested in the highly questionable trades examined in this study.

Not only has the SEC not enforced the key municipal continuing disclosure rule in the secondary market, it has caused confusion through public statements about whether issuers/obligors really have to make official filings pursuant to their own covenants to

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[18] "Issues in Municipal Bond Disclosure," by Peter J. Schmitt, DPC DATA Inc.; presentation to the California Municipal Treasurers Association; May 1, 2003, Miramonte Resort, Indian Wells, CA. See also *The BondBuyer*; "ICI: Improve Disclosure;" p.1; January 30, 2009.

[19] Schmitt, *Op.cit*.

[20] Schmitt, *Op. cit*.

disclose.[21] For whatever reason, the SEC has consistently declined to act on the myriad instances of issuer/obligor filing deficiencies, and also in monitoring dealer trades that evidence disregard for the materials that should figure into minimum standards of conduct when selling bonds to investors.

The MSRB shares in this broad regulatory failure, despite explicitly acknowledging the materiality of SEC Rule 15c2-12 continuing disclosure requirements in its own rules pertaining to fair dealing, suitability, and fair pricing. Together, the SEC and the MSRB have shown no serious intent of enforcing the continuing disclosure regime that protects investors in the municipal securities market. Whatever steps these two related regulatory bodies[22] are now taking to increase the MSRB's regulatory span[23] and revise the physical structure through which disclosure materials will be filed and made available to the public[24], neither is taking any steps to strengthen compliance and make substantive improvements on behalf of investors.

So, could the buyers involved in these most questionable 667 trades during 2008 have protected their personal interests by studying continuing disclosure materials in the SEC-designated disclosure system prior to making their ill-advised purchases? The answer is 'maybe.'

Table 8 identifies an interesting dynamic that took place in the bonds for which the official distress notices were filed during 2008. Among the trades that took place at par or higher in these bonds both prior to and after the filing date of the distress notices, about one-third of the traded issues had no official filings of financial disclosures in the current or prior year.[25] Taking a different view of the data, the trades that took place in this category of bond at any price after the distress notice was filed, we note that 40% hadn't filed financials in the current or prior year.

But when we isolate the post-distress notice trades at par or higher, the proportion for which no financials were filed or available in new public offering documents during 2008

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[21] For example, see speech by Martha Mahan Haines presented to the Michigan Municipal Finance Officers Association, Thomsonville, Michigan, September 19, 2000, under the section subtitled "Selective Disclosure;" posted at http://www.sec.gov/news/speech/spch400.htm. For additional insight, see also comments of Ward Marsh in *The Bond Buyer*, January 16, 2001, "Issuers Leave Muni Players In Info Lurch," p. 44. Mr. Marsh acknowledges that market practitioners routinely use information that has not been filed with the NRMSIRs and SIDs and thereby deemed public. Also see Martha Mahan Haines' comments in *The BondBuyer*, February 1, 2001, "Commonsense Solutions," particularly on p.40. Ms. Haines encouraged issuers to post continuing disclosure information on their own Web sites, apparently without affirming the requirement to file those materials with the NRMSIRs and/or SIDs.

[22] The MSRB was created by Act of Congress in 1975, and placed under the rule-making authority of the SEC.

[23] *The BondBuyer*; "MSRB Calls For Fed Action;" p.1; January 12, 2009.

[24] *The BondBuyer*; "MSRB to Talk EMMA Development at Board Meeting;" p.28; April 2, 2008. "MSRB Eyes Jan. EMMA Start in Secondary;" p.1; August 6, 2008. "SEC OKs EMMA as NRMSIR;" p.1; December 8, 2008.

[25] According to SEC Rule 15c2-12, a continuing disclosure is deemed to have been made if (i) the covenanted materials are deposited with the designated repositories, or (ii) if the obligor comes to market during the prescribed time with a new public offering for which the official statement contains the previously covenanted information. This study evaluated both sources of information.

or 2007 rose to 49%. Among these 667 most questionable trades, the chances were only about one in two that either the dealer or the investor could have had a clear picture of the financial condition of the underlying obligor prior to the trade, even though the distress notice had already been officially filed. This data strongly suggests that some process of adverse selection against investors took place. The burden, of course, was on the dealer, not the investor.

Trades in Distressed Bonds During 2008 For Which Distress Notices Were Filed During 2008 and Where No Financial Statements Were Filed With the DPC DATA NRMSIR and No Bond Issues for the Underlying Obligors Came to Market During 2007 or 2008 Calendar Years

	Distressed Bond Sales to Investors at Par or Higher Prior to and After Distress Notice Was Filed	Distressed Bond Sales to Investors at Any Price After Distress Notice Was Filed	Distressed Bond Sales to Investors at Par or Higher After Distress Notice Was Filed
# Trades	5,798	1,782	667
# With No 2007 or 2008 Financial Statements Available	1,902	715	327
%	32.8%	40.1%	49.0%

Table 8. Source: DPC DATA NRMSIR and MSRB's RTRS data feed.

Conclusion

This study leads to several important conclusions that are meaningful to all participants in the municipal securities markets.

First, the SEC's and the MSRB's failure to enforce their continuing disclosure-related rules over the years has created a no-penalty environment that leaves gaping holes in the disclosure fabric of the market, leaves investors defenseless against questionable practices by dealers, and does nothing to ensure investors' ability to independently assess every municipal issue subject to the SEC disclosure rules. Routine and consistent enforcement of existing rules pertaining to municipal bond disclosure over the years would have produced a much healthier environment for investors in this market, particularly now that the entire system is so stressed and credit failures are on the rise.

Second, despite repeated public statements by the SEC and the MSRB over the past two years to condition the market into believing that the current disclosure framework does not provide the information necessary for investor protection, this study is evidence that it does exist and has existed as long as the SEC-designated official archives have been in operation. The sad fact is that neither of these two regulatory bodies has taken any interest in monitoring disclosure compliance in the NRMSIR archives, much to the detriment of investors. The resulting failure to enforce disclosure-related rules at any level was not due to the unavailability of necessary data.

Third, while claiming to 'improve' disclosures by irrelevant and possibly counter-productive changes to the disclosure regime, the SEC and the MSRB are deliberately and irresponsibly continuing to divert attention from these issues. In their zeal to discredit the current NRMSIR system and place all clearinghouse responsibilities in the hands of the MSRB, both regulatory bodies have avoided addressing their dangerous failures to monitor current disclosure practices or enforce their own regulations. Instead, they have focused on superficial changes that have been promoted as helpful to the investor. In fact, these changes place control of the official disclosure archives in the hands of the same regulatory body that has willfully chosen not to use them for enforcement purposes in furtherance of investor protection up to this point.

Investors and federal lawmakers should question whose interests are served by the recent rule changes that place the municipal disclosure system into the hands of the MSRB. <u>There is no change except the will to enforce these rules that translates into better investor protection.</u> In addition, there is still the looming issue of the Tower Amendment to the Securities Exchange Act of 1934 which delineates the role the MSRB can legally play in municipal securities disclosure. Both investors and lawmakers should be concerned whether MSRB-controlled archives will ever be used for enforcement of disclosure regulations.

As an industry self-regulatory organization, the MSRB itself has an inherent conflict in its structure that raises questions of moral hazard. Analogous to the credit rating agencies that collect fees from the entities they rate, thereby casting doubt on the independence of their judgments, the MSRB is governed by a board of directors two-thirds of which come from the dealer and bank dealer community. It also derives virtually all of its revenues from that same dealer community that it was established to oversee. Its own rules pertaining to the disclosure matter have been on the books for many years, without any apparent effort to enforce them. What incentive will the MSRB have to suddenly take an aggressive stance against apparent predatory dealer practice in the realm of disclosure, or to increase the burden of due diligence on the dealers for the protection of investors?

In the broader discussions centered on regulatory reform, the question must be raised as to the probity of industry self-regulation in the financial markets. This question becomes

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particularly pointed when that self-regulating body oversees the only regulations addressing disclosure in the municipal securities market.

Meanwhile, when it comes to municipal bond continuing disclosure practices, *caveat emptor* reigns in this marketplace.

Municipal Market Advisors

CORPORATE RATINGS FOR MUNIS

The Trusted Name in Municipal Market Strategy

January 17, 2008

Rating Categories	Cumulative Historic Default Rates			
	Moody's		S&P	
	Munis	Corps	Munis	Corps
Aaa/AAA	0.00%	0.52%	0.00%	0.60%
Aa/AA	0.06%	0.52%	0.00%	1.50%
A/A	0.03%	1.29%	0.23%	2.91%
Baa/BBB	0.13%	4.64%	0.32%	10.29%
Ba/BB	2.65%	19.12%	1.74%	29.93%
B/B	11.86%	43.34%	8.48%	53.72%
Caa-C/CCC-C	16.58%	69.18%	44.81%	69.19%
Investment Grade	0.07%	2.09%	0.20%	4.14%
Non-Invest Grade	4.29%	31.37%	7.37%	42.35%
All	0.10%	9.70%	0.29%	12.98%

Figure 1. Historically, all investment grade munis have defaulted less frequently than AAA corporations.

Sector	Muni Defaults By Sector	
	Sector	Cumulative
Corporate-Backed IDBs	31.9%	31.9%
Housing	25.1%	57.0%
Long Term Care	19.1%	76.1%
Land Secured	10.2%	86.3%
Hospitals	5.5%	91.8%
Utilities	3.5%	95.3%
GO & Lease	1.8%	97.1%
Public Facilities	1.2%	98.2%
Transportation	1.0%	99.2%
Education	0.8%	100.0%

Figure 2. Fitch study of defaults between '79 and '02; the implication is that even the default statistics shown in Fig. 1 dramatically understate the real risk in safe sector bonds like GOs.

Mapping Muni to Global Scale Ratings					
Muni Scale Ratings	Corporate Scale Equivalents, by Sector				
	State GO	Local GO, State Lease, Wtr/Swr	COPs; Sp Tax; Pub. Higher Ed; Airports	Private Higher Ed, Hospitals	Start-up TIFs and toll roads, CCRC, Multifam
Aaa	Aaa	Aaa	Aaa	Aaa	Aaa
Aa	Aaa	Aaa	Aa-Aaa	Aa-Aaa	Aa
A	Aa-Aaa	Aa	Aa	A-Aa	A-Aa
Baa	Aa	A-Aa	A	A	Baa-A
Ba	A-Aa	A	Baa-A	Baa	Ba-Baa
B	Baa-A	Baa	Ba-Baa	B-Ba	B-Ba
Caa	Baa	Ba-Baa	B-Ba	Caa-B	Caa-B

Figure 3. From Moody's 3/07 report showing how muni scale ratings (at left) map to the global scale. For example, all local GOs with an investment grade rating on the muni scale would be a Aa or better on the corporate scale.

OVERVIEW AND PROS/CONS

OVERVIEW: Most municipal bonds are rated on a different, more conservative rating scale than corporate bonds. Triple-A US corporate bonds have up to 10x the historical default rate of single-A munis (**Fig. 1**). Neither municipal issuers, nor the individual investors who own the large majority of outstanding paper or fund shares, understand this point. As a result of the "muni rating scale," taxpayers likely pay a large premium to access the capital markets (via insurance and rating fees and higher interest rates). We recommend that state and local issuers, or their federal regulators, consider requiring rating scale equivalency either directly or by policy alternative.

THE PROBLEM: The muni scale increases issuers' costs by:

1. Creating the appearance of increased default risk and credit opacity, warding off potential investors;
2. Exaggerating rating (and thus bond price and investor) volatility, encouraging buyers to seek higher returns to compensate for the risk;
3. Requiring a costly interim step—bond insurance—in order for municipal credit to be translated to the corporate rating scale; and
4. Creating an opportunity cost for issuers forced to manage financial and capital operations to overly-conservative rating standards.

BENEFITS AND SUPPORTERS: A transition to corporate scale ratings on munis would broaden investor demand for tax-exempt bonds, and likely reduce both benchmark and credit-related yields. This could well affect the income of many traditional investors, yet there is still growing support for corporate scale ratings on munis, specifically:

1. Tender option bond programs (encompassing hedge funds, dealer proprietary desks, and third party sponsors), which are almost universally facing liquidity risks and mark-to-market costs on fears of a bond insurer downgrade below AA;
2. Dealers and investors, who are transacting in a de-commoditized

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OPPOSITION AND RATING THEORY

muni market with higher costs of both buying and selling a loan; corporate AAAs could re-establish some uniformity and broaden investor participation in both cash bonds and related derivative products;

3. Smaller secondary trading interests, for whom today's more granular secondary market may be causing price discovery and transparency difficulties;
4. Corporate risk managers, who are seeking to better compare asset class exposures on an apples-to-apples basis;
5. The muni ETF market, because a reduction in rating-specific dynamics supports index-oriented return performance;
6. The muni credit default swap (CDS) market, where better apples-to-apples comparisons with corporate risks, along with more direct exposure to the muni issuers themselves, could stoke both buyer and seller demand and facilitate growth; and
7. State and local taxpayers, who are facing difficult budget conditions, would benefit from any related cost reductions.

RISKS AND OPPONENTS: By contrast, opposition to corporate scale ratings comes from:

1. Traditional investors, who by their expertise have long benefitted from confusion created by the current rating dichotomy (although any diminution in bond insurance could help muffle related losses);
2. The bond insurers, for whom corporate scale ratings would represent a permanent, structural contraction in their profits (municipal issuers and taxpayers have given the insurers as much as $2.3B per year in premiums according to S&P);
3. The rating agencies themselves, in particular S&P, which continues to publicly insist that municipal ratings are already on a global scale. By contrast, Moody's work in this area implies that they would be more amenable to change;
4. Current AAA (either corporate- or muni scale) issuers, who would see demand dilution for their offerings; and possibly
5. Muni investment bankers and financial advisors, who, in the interest of easier and thus cheaper distribution of immediate primary market offerings, will likely be biased against dramatic market innovation.

Other risks entail unfavorable press coverage, as the current editorial bias favors more conservative underwriting; a shift to corporate scale ratings could easily, but incorrectly, be portrayed as a loosening of credit standards. Further, the muni market may have some difficulty adjusting to a major rating standard change: many traditional investors could choose to "look through" the corporate scale rating. The benefits of a change may not outweigh the costs until the medium-term (3-5 years).

COMPARING RATING SCALES: To illustrate rating scale differences, we note the relative default studies prepared by all three rating agencies—starting with the Fitch paper in 1999—that point to dramatically lower default rates for municipal bonds versus comparably rated corporate obligations (**Fig. 1, page 1**). The ten year cumulative default rate for *all* Moody's-rated muni bonds (0.10%) is less than one-fifth of the rate for Aaa-rated corporate bonds (0.56%), and, again by Moody's, a Aaa-rated corporate security, like that of a bond insurer, has more than ten-times the default risk of a single-A muni.

After Moody's published their default study in 2002, the agency began selectively assigning corporate scale ratings, called "global scale ratings" by them, to muni issuers selling taxable debt specifically to investor segments (e.g. foreign banks, etc.) with little traditional understanding of US municipal ratings. These corporate scale ratings underscored—while, in our opinion, still understating—the relative default protection of municipals. For example, the City of Detroit's taxable COPs are currently rated Baa2 on the municipal scale and Aa2 on the corporate scale. The State of California is rated A1 on the municipal scale, Aaa on the corporate scale. Moody's has also provided a ratings map or matrix that shows the likely global scale equivalent for any given muni rating (**Fig. 3, page 1**); note how the sector to which a bond belongs is highly important—consistent with the Fitch study of how historical muni defaults cluster tightly by sector (**Fig. 2, page 1**). MMA, along with many other muni market participants, uses the Moody's map to better understand muni risk in its broader market context.

A technical distinction here is that, while muni ratings are one dimensional, depicting default risk only[1], corporate scale rat-

[1] *Actually, S&P defines muni ratings as predicting default while for Moody's they show proximity to distress (meaning, the point at which the obligor would need to access extraordinary means or capital to keep payments current). The muni market has largely disregarded these differences, as, it appears, have the rating agencies, which still rate many securities the same regardless of their scales' differing perspectives. In theory at least, Moody's muni ratings should be several notches lower than those of S&P as distress is typically closer than default.*

BOND INSURANCE AND CONCLUSION

ings are two dimensional, incorporating both probability of default (PD) and projected default-related losses. Moody's matrix applies this two dimensional framework to munis; using their example, a local GO A3 rating has a PD of 0.66% and a loss given default rate of 10%. Multiplying those together gives a 10-year expected loss of 0.066%, equivalent to the loss history of Aa1-rated corporate bonds. Within this matrix, a B1 municipal airport rating maps to a corporate scale Baa2, while an A3 rating on a not-for-profit hospital equates to a Moody's corporate A1.

THE BOND INSURERS: Regarding munis, the insurers largely avoid the four sectors that have accounted for 86% of all historical muni defaults. Thus, based on statistics, the insurers themselves are substantially more likely to default than the vast majority of the muni credits they protect, even as US muni issuers pay the insurers to "guaranty" up to 50% of all new issuance. In effect, the bond insurers—which have been able to maintain very limited collateral rates (1-1.5 cents per dollar of net exposure)—engage in rating scale arbitrage, translating high quality muni credits onto the corporate scale. In MMA's opinion, if the insurers' muni risks were not already eligible for AA or better corporate scale ratings, there is little chance the insurers would themselves be able to garner corporate AAA financial guaranty ratings under their current business model.

CONCLUSION: Noting the tremendous potential benefits to taxpayers and the growing incentives for investors and dealers, we see greater rating scale integration as inevitable. Faltering market confidence in the bond insurers has created an opportunity for interested parties to press this issue, both locally and at the federal levels. A federal or even state policy choice could be to restrict the use of tax exempt bond proceeds to ratings that are comparable with other US taxable market obligations like Treasuries and corporate bonds. There is also a fledgling movement among the alternative investors to encourage rating agency action, perhaps by allowing the synthetic floating rate securities issued by a TOB (i.e., the TOB's trust equity) to be rated on the global scale, regardless of how the underlying muni bond is rated. This would cut the relevancy of bond insurance in the primary market, lead to lower insured penetration, and increase the industry-wide interest in corporate equivalent ratings. However, the traditional investment community should be expected to continue to discourage any change, and issuers do not have the full support of their financial representatives. With at least $2B of annual taxpayer savings possible, we urge issuers to act.

Municipal Market Advisors

RESPONSE TO MOODY'S PROPOSAL FOR GLOBAL SCALE RATINGS FOR ALL ISSUERS

The Trusted Name in Municipal Market Strategy

April 14, 2008

RESPONSE

Municipal Market Advisors generally supports Moody's proposal to provide Global Scale Ratings (GSRs) for all municipal issuers, regardless of tax status. However, we believe the following improvements are essential to more permanently resolve the problems the municipal scale has created for issuers, investors, and regulators. These improvements are:

1. GSR assignments should be automatic for any municipal issuer.
2. Moody's should also provide either GSRs—or approximations of GSRs—for all outstanding municipal bond ratings by the end of 2008. This would speed investors' understanding of the new scale and would more quickly reduce our sector's systemic reliance on the bond insurers for pricing and credit quality.
3. The relevance of maintaining the municipal scale at all is debatable; however, its withdrawal would meet strong investor backlash that could undermine Moody's credibility and muffle the net impact of GSRs. Thus we agree with keeping both scales for at least the medium term.
4. That being said, the rating agencies' use of identical rating symbols for both municipal and corporate scales is confusing. This is particularly true for non-specialist retail investors and issuers to whom the municipal scale is most costly. We strongly encourage Moody's and the other rating agencies make substantive changes to the municipal rating scale's lettered system (perhaps to a purely numerical scheme) to make clear its difference from any corporate ratings. Yet any new method of illustrating municipal ratings should also preserve the same number of gradations or notches as at present to minimize difficulties for issuers and investors.
5. Importantly, "municipal scale" ratings should be clarified to contain *only* municipal scale assessments—corporate scale counterparty ratings like bond insurer or bank guaranties should either be moved to the issuer's GSR or converted to a municipal scale assessment. The current, muddy mix included within issuers' "municipal" ratings permits unacceptable ratings scale arbitrage by the insurers and should be changed.
6. To address "cliff risk" concerns (discussed below) associated with a transition to GSRs, Moody's should provide some comfort to investors that the new rating scale will be accompanied by a rigorous rating analyst training program and perhaps enhanced credit surveillance for the future.

BASIS FOR OUR OPINION

We continue to support Moody's leadership in our sector's ultimate transition to rating parity. We also recognize and support the statements and needed actions taken by the State of California and other issuers, the US House Financial Services Committee, and industry participants who have spoken out in favor of change. MMA's perspective remains that the industry as a whole is best served by credit transparency via corporate equivalent ratings, enhanced issuer disclosure, and improved investor access to issuers. Further, any change that reduces our sector's systemic risk to the bond insurers is welcome; an earlier adoption of corporate equivalent ratings for municipals would likely have prevented at least a share of the recent turmoil in the ARS, VRDO, TOB, and fixed rate markets.

Briefly, corporate equivalent ratings for municipal bonds would bring the following benefits or changes:

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BASIS FOR OUR OPINION

1. **Improve credit transparency**. One of Moody's failings in prior discussions of GSRs is the statement that "crossover investors" were historically rare in the municipal sector, and their recent increase now requires apples-to-apples credit comparisons between asset classes. This is true; more than ever, municipals are bought and sold by global banks, hedge funds, and investment houses that weigh their relative risk and reward versus hundreds of alternative instruments. Yet this point still does not go far enough. Individuals—who own 34% of outstanding municipals directly (versus only 8% of corporates) and substantially more via managed accounts—allocate to munis versus stocks, taxable bonds, and other instruments. They base investing decisions on relative income production, safety, and growth potential. Individuals are thus fundamental crossover investors who, without the support or sophistication of institutions, have no ability to look through an opaque municipal rating scale to discern actual default risk.
2. **Better align municipal ratings with regulatory requirements.** Rating parity would help alleviate the current mismatch between the municipal scale's sector-specific focus and regulatory requirements that assume all rating scales show the same thing. The most pressing example is of course money markets' Rule 2a-7 requirement that they purchase only AA or better rated securities, and most munis are simply not eligible for those ratings, regardless of default risk. A switch to GSRs now would give the muni money markets much better flexibility in their investment decisions and reduce the ongoing risk of VRDOs losing their liquidity provider on a bond insurer downgrade. Further, more issuer-based AAA ratings implies better fundamentals for tender option bond programs and thus lower yields and tighter spreads across the curve. Other regulatory mismatch examples include Basel-related regulatory capital requirements, where lower rated assets require more collateralization regardless of actual default risk. And also risk adjusted return standards for bank-type investors, where a AAA-rated bond is accounted as more profitable than an A-rated bond even if the physical returns are identical.
3. **Reduce taxpayers' cost of capital.** In our opinion, the municipal rating scale both exaggerates default risk and heightens valuation risk, limiting the investor base for muni bonds and, perhaps, keeping tax-exempt bond yields unnaturally high. However, more definitively avoidable costs to taxpayers are: 1) bond insurance premiums that, in recent years at least, approximated $2-2.5 billion annually according to S&P; 2) recently high short term funding rates because of the bond insurers' troubles; and 3) onerous rating standards. The last is the converse of the "moral hazard" risk noted below and does not apply to all issuers. We believe that the municipal scale's more conservative criteria may require the over-protection of investors through excessive reserves, higher tax rates, etc., creating undue political and financial pressure on some safe-sector state and local issuers. Easier lending standards for safer issuers could free up extra dollars for much needed capital improvements and social subsidy programs. We also note, however, that a transition to GSRs will reasonably lead to higher disclosure-related costs for issuers since investors' understanding of local credit quality will become more relevant to bond pricing and valuation. Credit analysts' role in the industry would likely grow with GSRs.
4. **Reduce rating volatility**. Because: 1) most investment grade, safe sector muni bonds would carry GSRs of either AA or AAA; and 2) municipal default risk is driven more by structure than by month-to-month financial condition, municipal rating volatility should fall with GSRs. Again, reduced rating risk, and thus event-driven valuation risks, should improve investor demand for municipal paper.
5. **Limit systemic risk from the bond insurers**. The apparently easier standards for getting a corporate scale Aaa versus a municipal scale Aaa has permitted widespread rating scale arbitrage by the bond insurers and massive industry exposure to these companies. A transition to GSRs should reasonably lead to much lower insured penetration in municipals and help prevent similar collapses as seen in the first quarter. We do see an ongoing role for the insurers after corporate equivalent ratings, albeit a more limited one that is focused on risky sector credits, project finance, and securitization.
6. **Better compare muni bonds across sectors.** Another problem with the municipal scale is its internal inconsistency. Single project, unenhanced apartment buildings can carry ratings as high or higher than some state GOs; water revenue bonds are sometimes rated below tax increment finance districts. We assume that, using the same criteria for all muni bonds (i.e., risk of default and loss given default) would, for the first time, regularize ratings of all muni issuers versus each other.

Noteworthy

The municipal rating scale exacerbates issuers' and individual investors' lack of specialization and limits sector transparency

RISKS IN A CHANGE OF RATING POLICY

While we strongly believe that GSRs are overdue, we also agree with some institutional buyers that there is value in the municipal scale. And, as a data company ourselves, we believe it would be heedless to discard any historical information. Below, we have cataloged a list of reasons for retaining the municipal scale and our opinions on the relevance of each.

1. **Munis ratings need granularity**. Muni bonds have thousands of issuers, highly individual credit and structural features, poor disclosure, and weak and often biased communication between borrowers and investors. As with structured finance, (where ratings are an essential shorthand for the majority of investors not sophisticated enough to model the underlying assets themselves) the municipal industry's heterogeneity forces large holders to outsource some or all of their credit work to the raters. That service is devalued by rating compression. This is a credible reason for maintaining the municipal scale, but not a good one for not ALSO mapping munis onto a less detailed, but more accurate GSR system. We also point out that the transition to GSRs would improve top line rating granularity in a market now flooded with insured AAAs.
2. **The buyers need a more conservative scale.** This argument goes that our sector's majority holders—individuals—are long-term holders better served by more "careful" ratings. This might be a valid reason to maintain the muni scale, if in fact the rating agencies also view it as a longer-term assessment than are GSRs. They don't; note the persistent, cyclical change in muni ratings based on cash/budget fluctuations and the long-term secular upgrade trends at all companies.
3. **Higher ratings create a moral hazard**. Here, the idea is that more generous rating conditions would induce issuers to trim pledged security, putting bondholders at risk. We agree that GSRs will allow some issuers, in particular safe sector credits, to reduce collateral without notable financial penalty. However, in theory at least, corporate scale ratings should be much more important to primary and secondary transaction pricing, and issuers should face much higher penalties for lower ratings than is now the case. For example, the spread penalty for falling from a GSR of AA to A may be seen as tantamount to falling from a muni scale AA to BBB. Further, risky sector credits most at risk from moral hazard-related security dilution, would, according to Moody's GSR/Muni scale map, not see as much inflation from muni to GSR ratings.
4. **Higher ratings increase "cliff risk"**. At issue are valid investor fears that the rating agencies do not remain current enough on each issuer's credit quality to give investors sufficient warning of a crisis or collapse. A transition to GSRs amplifies these fears by raising the stakes of a rating "miss". In a similar way, a tightrope is scarier at 20ft above the ground than at 10ft. To address these concerns, the rating agencies should make some effort to ensure an improved level of review for each credit, acknowledging the changed analytic context for institutional investors.
5. **The current system is not broken**. It is.
6. **Munis are already on the corporate scale**. They're not.
7. **Munis are riskier than the statistics imply.** This follows: 1) the nation has just had a long economic expansion with abnormally few defaults; and 2) munis carry less predictable but highly potent political risk. Both points may be true; however: 1) corporate issuers are emerging from the same economic period and are headed into the same hypothetical dark days yet have a substantially higher rating baseline than their muni peers. Should munis begin to show more default risk as an asset class, we agree they would then warrant lower ratings. But not until. And 2) we argue that, while corporations are generally not run by purely political leadership, they also face a much more complicated capital structure, where equity and debt investors' interests are often at odds and where a company's existence can be actively shorted in a public exchange. In the past, this exposure to conflicting investors has greatly disrupted the predictive power of corporate ratings.

PREPARED STATEMENT OF LYNN E. TURNER

FORMER CHIEF ACCOUNTANT,
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MARCH 10, 2009

Thank you Chairman Dodd and Ranking Member Shelby for holding this hearing on an issue important to not only investors in America's capital markets, but to all who are being impacted by the current economic devastation.

Before I start with my personal perspective on the issues surrounding the current economic crisis and securities regulation, it might be worthwhile to provide some background on my experience. I serve as a trustee of a mutual fund and a public pension fund. I have served as an executive of an international semiconductor manufacturer as well as on the board of directors of both Fortune 500 and small cap public companies. In the past, I served as chief accountant of the U.S. Securities and Exchange Commission (SEC) and as a partner in one of the major international auditing firms, where I was involved with audits and restructurings of troubled or failed institutions. I also was the managing director of research at a financial and proxy advisory firm. In addition, I have also been a professor of accounting at a major U.S. public university and an investor representative on the Public Companies Accounting Oversight Board (PCAOB) Standards Advisory Group and the Financial Accounting Standards Board's (FASB) Investor Technical Advisory Committee (ITAC).

The Crisis—Bad Loans, Bad Gatekeepers, and Bad Regulation

The economic crisis of 2007–2009 has three root causes; the making of bad loans with other peoples money, gatekeepers who sold out, and a lack of regulation. In order to prevent a repeat of this debacle it is of paramount importance that policy makers understand what will cure the "disease" before they remedy the cause. To that end, I would urge the committee to take the same approach it did some seven decades ago when the Senate Banking Committee, with experienced investigators using its subpoena powers, investigated the banking and security markets, stock exchanges, and conduct of their participants. A similar approach in the midst of the current crisis would give Americans and investors hope and confidence that their interests will be served, and adequate protections restored. Unfortunately, if the public perceives the remedy is off target, as it has with other recent legislation, I fear the markets will continue their downward spiral resulting in a lengthening of the recession, or potentially worse outcome.

From my perspective, those most responsible for the current crisis are the banks, mortgage bankers, and finance companies who took money from depositors and investors and loaned it out to people who simply could not, or did not repay it. In some instances predatory practices occurred. In other instances, people borrowed more than they should have as Americans in general "leveraged" their personal and corporate balance sheets to the max. Speculators also took out loans expecting that real estate values would continue to rise, allowing them to profit from flipping their investments. But who can dispute that when "liar," "no doc," and "Ninja loans" are being made while banking regulators are watching, there is something seriously wrong.

In addition to the financiers, a second problem was the gatekeepers—the credit rating agencies and underwriters—who are suppose to protect investors. They did anything but that. Instead they became the facilitators of this fraud on the American public, rather than holding up a stop sign and putting the brakes on what was occurring. They became blinded by the dollars they were billing rather than providing insight to the public into the perfect storm that was forming. Recent testimony before the House of Representatives that the rating agencies knew their models did not work, but did not fix them was stunning. But perhaps not as stunning as the report of the SEC in which employees of an agency stated they would rate a product even if it had been created by a cow.

And while lenders were making bad loans in exchange for up-front fees, and gatekeepers were falling down on the job, Federal Government agencies were failing to supervise or regulate those under their oversight, as well as failing to enforce laws. It is a huge public concern that a systemic failure of financial and securities market regulation in this country occurred. Some of this was due to the lack of regulation of new products and institutions, such as credit default swaps and hedge funds, but more importantly, the fundamental problem was the lack of Federal Government regulators doing their jobs, or lacking the resources to do so.

For example, for 13 years, as abuses of subprime lending occurred, the Federal Reserve refused to issue regulations as mandated by the Homeownership Equity Protection Act of 1994 (HOPEA). That legislation specifically stated:

> PROHIBITIONS—The Board, by regulation or order, shall prohibit acts or practices in connection with— "(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.".
>
> Not less than once during the 3-year period beginning on the date of enactment of this Act , and regularly thereafter, the Board of Governors of the Federal Reserve System, in consultation with the Consumer Advisory Council of the Board, shall conduct a public hearing to examine the home equity loan market and the adequacy of existing regulatory and legislative provisions and the provisions of this subtitle in protecting the interests of consumers, and low-income consumers in particular . . .

Yet the Federal Reserve Board (Federal Reserve or Fed), which had examiners in the very banks who were making mortgage loans, did nothing. Had the Federal Reserve acted, much of the subprime disaster might have been averted. Instead, ignoring the clarion calls of one of its own Governors for action, the late Edward Gramlich, it was not until 2007 that the Federal Reserve acted. But by then, much of the damage to the American economy and capital markets had been done.

Indeed, even the Comptroller of the Currency spoke in 2006 of 3 years of lowering of lending standards. In a press release in 2006, the Comptroller stated:

> "What the Underwriting Survey says this year should give us pause," Mr. Dugan said. "*Loan standards have now eased for* three consecutive years." The Comptroller reported "slippage" in commercial lending involving leverage lending and large corporate loans as well as in retail lending *with significant easing in residential mortgage lending standards including home equity loans.* [Emphasis supplied]

Unfortunately, armed with this information and legislative authority to fix the problem, the Comptroller of the Currency (OCC) failed to act in earlier years. Rather than reining in these abusive practices, the OCC permitted them to continue, with the most toxic of the subprime loans being originated in 2006 or 2007. And today, we have Inspector General reports that have cited the lack of action by the OCC and Office of Thrift Supervision, leaving taxpayers and investors exposed to losses totaling trillions of dollars.

What is equally troubling about this lack of action by the banking regulators, is that it comes after similar problems occurred with the crisis in the savings and loan and banking industries in the 1980s and early 1990s. I was at the SEC at that time and watched as the Federal Reserve who had oversight over an undercapitalized CitiBank, worked to keep it afloat. It seems that we are seeing a repeat performance of this situation and rather than having learned from history, we are again repeating it. After having two swings at the bat, I wonder why some want to make the same regulators the risk regulator for the entire financial system in the United States. These are regulators who all too often have been captured by the regulated.

Once again, as with Enron, a lack of transparency has also been a contributing factor to the current crisis. Investors have time and time again—from Bear Stearns to Lehman to Wachovia to Citigroup and Bank of America—questioned the validity of the financial numbers they are being provided. The prices of their stocks have reflected this lack of credibility driven by transactions hidden off the balance sheets and values of investments and loans that fail to reflect their real values.

Unfortunately, millions of bad loans were made that are not going to be repaid. While financial institutions argue they will hold the loans to maturity and be repaid, that just isn't true for loans subject to foreclosures or short sales. And for many mortgages, they prepay and once again are not held to maturity. At the same time, collateral values of the underlying assets securing the loans have taken a tremendous tumble in values. Almost 5 million Americans have lost their jobs since this recession began impacting their ability to make their mortgage payments. There is a years worth of inventory of unsold homes on the market even further depressing home prices. Asset backed securities are being sold in actual transactions at pennies on the dollar. Yet the financial institutions continue to act like an ostrich with their head in the sand and ignore these facts when valuing their assets. At the same time however, the markets are looking through these numbers and revaluing the stocks in what is an inefficient approach, driving stocks of some of the largest financial institutions in this country to a price that is lower than what you can buy a Happy Meal for at McDonalds.

In 1991 the General Accounting Office (GAO) published a report titled "Failed Banks—Accounting and Auditing Reforms Urgently Needed." In their report, the GAO noted how during the savings and loan crisis, the failure of banks and savings and loans to promptly reflect their loans and assets at their market values drove up the cost to the taxpayer. I hope Congress will not allow this mistake to be repeated by allowing banks to avoid marking their assets to market.

Managing the assets held by a financial institution and the positions taken has also been lacking. One large institution that was failing and required a bailout through a buyer did not even have a chief risk officer in place as the risks that caused their demise were entered into. This could have been avoided in if the recommendations of the 2001 Shipley Working Group on Public Disclosure had been adopted by the banking and securities regulators that had convened the group. Instead, consistent with a deregulatory approach, the type of risk disclosures the group called remained nonexistent, hiding the buildup of risks in the financial system.

There has also been a lack of regulation of new products and institutions. Credit rating agencies were not subject to regulation by the SEC until after many of the subprime loans had been made. Credit default swaps and derivatives were specifically exempted by Congress from regulation, despite a plea for regulation from the CFTC chairman, creating grave systemic risks for the financial system. These markets grew to over $60 trillion, a multiple of many times the actual debt subject to these swaps. In essence, a betting system had been established whereby people were wagering on whether others would pay their debt. But while we regulate betting in Las Vegas, congress chose to specifically not regulate such weapons of mass destruction in the capital markets. This has directly led to the more than $160 billion bailout of the bets AIG placed, and those to whom it is indebted on those on those bets.

Likewise, there has been a rise in a shadow banking system that includes hedge funds and private equity firms. These funds have under management money from many public sources, such as public pension funds and their members and the endowments of colleges and universities. Yet they remain largely opaque and these unregulated entities have been allowed to co-exist alongside the regulated firms as a push was made for less regulation. That push was advanced by an argument the markets can regulate themselves, a perspective that has been proven to totally lack any credibility during this decade of one scandal after another. Others said that without regulation, these unregulated entities could innovate and create great wealth. Unfortunately, their innovation has not always created wealth and in other instances has been quite destructive.

The subprime crisis, and our economic free fall, is the showcase for what can happen without adequate regulation and enforcement. Those who made the loans including mortgage bankers, the credit rating agencies who put their stamp of approval on the Ninja, no doc and liar loans, and the investment bankers who packaged them up and sold them to an unsuspecting public were all unregulated or regulated only in a token fashion.

Unfortunately, the deregulation of the U.S. capital markets that many not so long ago called for, has not resulted in increased competitiveness of the markets. Rather it has left the preeminence and credibility of our capital markets shattered. Instead of making the allocation of capital more efficient, it has resulted in a lack of transparency and mispricing and misallocation of capital. Investors have watched as over ten trillion in wealth has disappeared. And instead of fueling a growth in our economy, we have seen it fall into a decline the likes that haven't been seen since the great depression. Indeed, some have now called our situation the "Not So Great Depression" and one commentator, Stephen Roach of Morgan Stanley has warned of a Japanese style economy that continues to this day to sputter along.

Reforms—The Long Road Back

On a bipartisan basis, we have dug the hole we find ourselves in over an extended period of time. During much of that time we have enjoyed economic prosperity that in recent years contributed to the "suspended disbelief" that the good times would never end. All too often people spoke of the "New Economy" and those who doubted it or warned of dangers were treated as outcasts. But as with many a bubble in the past, this one too has burst.

The capital markets have always been the crown jewel of our economy—the engine that powered it. And it can once again achieve that status, firing on all cylinders, but only if care is taken in structuring reforms that protect the investing public.

Basic Principles

In creating regulator reform, I believe there are some critical fundamental principles that should be established. They include:

1. Independence
2. Transparency
3. Accountability
4. Enforcement of the law
5. Adequate Resources

Independence

Those responsible for oversight, including regulators and gatekeepers, must be independent and free of conflicts and bias when doing their jobs. And it is not just enough that they are independent on paper, they must be perceived by investors to be free of conflicts avoiding arrangements that cause investors to question their independence. They need to be free of political pressures that unduly influence their ability to carry out their mandates to protect the American consumer and investor. They must avoid capture by the regulated. And their ability to get resources should not be contingent on whether they reach a favorable decision for one special interest group or political affiliation.

This is especially true of regulators such as the SEC and CFTC. These agencies must avoid becoming political footballs thrown between opposing benches. Unfortunately, that has not always been the case as we saw recently at the SEC or with the CFTC when it asked for regulation of credit derivatives.

Similarly, the credit rating agencies have suffered from some of the same lack of independence the auditors did before Enron, WorldCom, and the enactment of the Sarbanes-Oxley Act of 2002 (SOX). They became captured by the desire to increase revenues at just about any cost, while ignoring their gatekeeper role.

Independence also means there is a lack of conflicts that can impact one's independent thinking. For example, when a bank originates a subprime loan it may will ask its investment banking arm to securitize it. But if it is a no doc, liar loan or Ninja loan, will the investment banker perform sufficient due diligence and ensure full and fair disclosure is made to the investors clearly delineating in plain English what they are being sold? I doubt that has really occurred.

Unfortunately, when the Gramm-Leach-Bliley Act was passed, allowing the creation of giant financial supermarkets, it failed to legislate and adequately address such conflicts. In fact, it did not address them at all leaving us with huge conflicts that have now given rise to investments that are not suitable for the vast majority of investors. Given this Act gave an implicit blessing to the creation of institutions that are "Too Big To Fail" and knowing that after the failure of Long Term Capital management the creation of such institutions brings with it the backing of taxpayers money, this serious deficiency in the laws governing regulation of conflicts of interests in these institutions needs to be addressed in a robust fashion.

Transparency

Transparency is the life blood of the markets. Investors allocate their capital to those markets where they get higher returns. Investors need the best possible financial information on which to base their decisions as to which capital markets they will invest in, and which companies, in order to generate the maximum possible returns. Maximizing those returns is critical to investors, and institutions who manage their investments, as it determines how much they will have for retirement, or spending.

Investors will allocate their capital to those markets where returns are maximized. While economic growth in a particular country has a significant impact on returns for a capital market, the quality of the information provided to those who allocate capital also significant impacts it. In general, the better the information, the better the decisions made, and the more efficiently capital is allocated and returns maximized.

The U.S. capital markets have maintained their lead in transparency, albeit our pride in that respect has been tarnished by off balance sheeting financings, a lack of disclosures regarding the quality of securities being sold, and credit ratings that were at best poorly done, if not outright misleading. Nonetheless, even in today's markets, the U.S. markets have continued to outperform foreign markets.

Accountability

Accountability clearly places the responsibility for decisions made and actions taken. People act differently when they know they will be held accountable. When people know there is a state trooper ahead on the highway, they typically drive accordingly. When they know there is no trooper, a portion of the population will hit the accelerator and speed ahead.

There needs to be greater accountability built into the system. The executives and boards of directors of the financial institutions that have made the bad loans bringing our economy to its knees, causing Americans to lose their jobs, students to have to forgo their education, all at a great cost to the taxpayer should be held accountable. The American public will demand nothing less.

The banking, insurance, commodities and securities regulators all need to have greater accountability. We need to know that we have a real cop on the beat, not just one in uniform standing on a corner.

Likewise, gatekeepers must be held accountable for the product they provide the capital markets. Their product is critical to ensuring the credibility of financial information needed for capital allocation.

Enforcement

We are a Nation of laws. The laws governing the capital markets and banking in this country have been developed to provide protections for investors and consumers alike. They provide confidence that the money they have worked hard for, when invested, is safe from abusive, misleading and fraudulent practices. Without such laws, people would be much more reluctant to provide capital to banks and public companies that can be put to work creating new plants and products and jobs.

But laws aren't worth the paper they are written on if they are not properly enforced. An unleveled playing field in the markets brought on by a lack of enforcement of laws providing consumer and investor protections can have the devastating effect we are now seeing. For example, the Financial Accounting Standards Board Chairman has written members of this committee citing how some institutions were not properly following the standards hiding transactions off balance sheet. Yet to date, enforcement agencies have not brought any cases in that regard.

And laws are not just enforced by the law enforcement agencies, but also through private rights of actions of investors and consumers. This is critically important as law enforcement agencies have lacked the adequate resources to get the job done alone.

Unfortunately, in recent years we have seen an erosion of investor and consumer rights to enforce the laws. Court cases setting up huge hurdles to these attempts to enforce the laws have made it much more costly taking significant time and resources to get justice. For example, one such court decision has now made it in essence legal for someone to knowingly aid another party in the commission of a fraud on investors, yet be protected by the courts from legal liability. It is akin to saying that if one drives a getaway car for a bank robber, they can go to jail. But if one wears a white collar and provides assistance to such a fraud in the securities market, they get a pass. Something is just simply wrong when that is allowed to occur in our Nation. Congress needs to remedy this promptly with legislation Senator Shelby introduced 7 years ago in 2002.

Likewise we have seen passage of laws such as the Commodities Modernization Act of 2000 which also put handcuffs on our enforcement and regulatory agencies. This Act passed in the waning moments of that Congress at the requests of special interests. Supported by government officials, the Act specifically prevented the SEC and CFTC from regulating the derivatives market now totaling hundreds of trillions of dollars. These handcuffs need to be promptly removed. The securities and commodities laws need to be clarified to give the CFTC the authority to regulate commodities and any derivative thereof such as carbon trading, and the SEC the authority to regulate securities and any derivative thereof such as credit derivatives.

Adequate Resources

No one can do their job if they are not provided the proper tools, sufficient staffing and other resources necessary for the job. This includes being provided the necessary authority through legislation to do the job. It means Congress has to provide a budget to these agencies to hire sufficient number of staff. But it is not just the numbers that count, the agencies must also be given enough money to hire staff with sufficient experience. For example, while I was at the SEC, the budget you provided to the agency did not give the Office of Compliance Inspections and Examination a sufficient number of staff. And it certainly did not provide the office with enough money to hire senior experienced examiners who had the type of depth and breadth of expertise in the industry that was necessary to do the job right. Whose fault is it then when that agency fails to detects frauds through their examinations? I would say a good part of the blame lies at the feet of Congress.

I would urge you to take a look at how these agencies that are so critical to the proper functioning of our markets are funded. In the case of the SEC, it collects sufficient fees to pay for an adequate budget. Yet each year it must go hat in hand to ask for a portion of those fees in an amount that has not met its needs. Instead, the SEC should be removed from the annual budget process and established as an independently funded agency; free to keep the fees it collects to fund its budgets.

Necessary Reforms

Once again, before legislating reforms, I would urge this committee to undertake "Pecora" hearings to ensure it gets the job done right. Some of the reforms that I believe are necessary, and which could be examined in such hearings include the following;

Regulatory Structure: Arbitrage among banking regulators should be eliminated, and accountability for examination and regulation of banks centralized in one agency. To accomplish that, Congress should once again consider the legislation offered in 1994 by the former Chairman of this Committee, Donald Reigle. That legislation would combine the examination function into one new agency, while having the FDIC remain in its role as an insurer and the Federal Reserve as the central banker. Careful consideration needs to be given to the conflicts that arise when the central banker both sets monetary policy, such as when it created low interest rates earlier this decade, and then regulates the very banks such as Citigroup and Country Wide that exploit that policy, and at the same time fails to put in place safeguards as the Fed had been asked to do by Congress in 1994. And the mission of the new agency, as well as the missions of the FDIC and Fed with respect to consumer and investor protection needs to be made much more explicit. All too often these regulators have been captured by industry, much to the detriment of consumers and investors and in the name of safety and soundness. Yet we have learned that what is good for consumers and investors alike, is also good for safety and soundness, but not necessarily the reverse.

I believe the roles of the CFTC and SEC should be clarified. I do not support the merger of the two agencies as I don't believe the synergies some believe exist will be achieved. I also believe commodities and securities are fundamentally two different markets, with significantly differing risks, and the regulator needs significantly differing skill sets to regulate them. Accordingly, as I have previously mentioned, I would clarify the roles of these two agencies by giving all commodities and derivatives thereof to the CFTC to regulate, and all securities and derivatives thereof to the SEC.

Some have argued for the creation of new agencies. To date; I have yet to see the need for that. For example, some have argued that a separate investor and consumer protection agency should be created. However, when it comes to the securities markets, I believe the SEC should continue in that role, and given the resources to do so.

Over the years, the SEC has shown it can be a strong investor protection agency. It has only been in recent years, when quite frankly people who did not believe in regulation were appointed to the Commission, that it fell down on the job. By appointing investor minded individuals to the Commission, who have a demonstrated track record of serving and protecting the public, this problem can be fixed. Likewise however, if a separate agency is created, but the wrong people put in place to run it, we will see a repeat performance of what has occurred at the SEC.

Gaps in Regulation: There are certain gaps in regulation that are in need of fixing. Credit derivatives should become subject to regulation by the SEC as former SEC Chairman Cox urged this committee to do some time ago. While the establishment of a clearing house is a positive development, in and of itself it is insufficient.

I understand the securities laws generally exclude over-the-counter swaps from SEC regulation. This improperly limits the SEC's ability to provide for appropriate investor protection and market quality. The OTC derivatives market is enormous, and proper regulation is in the public interest. The SEC would be in a better position to provide that regulation if the following changes were made:

- Repeal the exclusion of security-based swap agreements from the definition of "security" under the Securities Act of 1933 and Securities Exchange Act of 1934.
- Include within the definition of "security" financial products that are economic derivatives for securities. It is important to consolidate the regulatory authority at the SEC because of its investor protection and capital markets mandate. While the SEC has a mandate to protect investors and consumers, other regulators may lose sight of that mission. Based on my business and agricultural background, I have found derivatives in agriculture and other physical commod-

ities have a different purpose than financial derivatives as they permit risk management and secure supplies for users and producers of goods.

- Require all transactions in securities to be executed on a registered securities exchange and cleared through a registered clearing agency.

There needs to be much greater transparency for this market. The recent reluctance of the FED to disclose the counter parties receiving the bailout in connection with AIG is alarming but not surprising. Even the current Fed Chairman has stated this is an agency that has been all too opaque in the past.

There needs to be greater disclosure to the public of the trading, pricing and positions of these arrangements. There also needs to be disclosure identifying the counterparties when the impact of the contracts could have a material effect on their operations, performance or liquidity. Given the deficiencies that have existed in some contracts, there also needs to be more transparency provided around the nature, terms, and amounts of such contracts when they are material.

There is also a legitimate question as to whether one party should be able to bet on whether another party will pay their debt, when the bettor has no underlying direct interest in the debt. Certainly as we have seen at AIG and elsewhere, these contracts can have devastating effect. Quite frankly, they do not serve a useful purpose for investors as a whole in the capital markets. As such, I would like to see them prohibited.

There is also a gap in regulation of the municipal securities market as a result of what is known as the Tower Amendment. Recent SEC enforcement actions such as with the City of San Diego, the problems in the auction rate securities, and the lurking problems with pension obligation bonds, all cry out for greater regulation and transparency in these markets. These token regulated municipal market now amount to trillions of dollars and poses very real and significant risks. Accordingly, as former Chairman Cox recommended, I believe Section 15B(d)—Issuance of Municipal Securities—of the Securities Act of 1934 should be deleted.

The SEC should be given authority to regulate hedge and private equity funds that directly or indirectly take public capital including from retail investors. They should be subject to the same type of regulation as their counter parts in the mutual fund market. This regulation should give the SEC the (i) authority to require the funds to register with the SEC, (ii) give the SEC the authority to inspect these firms, (iii) require greater transparency through public quarterly filings of their positions and their financial statements and (iv) give the SEC appropriate enforcement capabilities when their conduct causes damage to investors or the financial markets and system.

As testimony before this committee in the past has demonstrated, the SEC has insufficient authority over the credit ratings agencies despite the roles those firms played in Enron and now the subprime crisis. This deficiency needs to be remedied by giving the SEC the authority to inspect credit ratings, just as Congress gave the PCAOB the ability to inspect independent audits. In addition, the SEC should be given the authority to fine the agencies or their employees who fail to adequately protect investors. Greater transparency should be provided to credit ratings themselves. And disclosure should be required, similar to that for independent auditors of potential conflicts of interests.

The SEC, CFTC and Banking Regulators should also be given powers to regulate new financial products issued by those whom they regulate. This should be accomplished through disclosure. The agencies should have to make a determination that adequate disclosures have been made to consumers and investors regarding the risks, terms conditions of new products before they can be marketed. If a new product is determined by an agency to present great risk to the financial system or investors, the regulating agency should be empowered to prevent it from coming to market, just as is done with new drugs.

In addition, there needs to be greater regulation of mortgage brokers. Some States have already made progress in this regards. However, the Federal banking regulators should be given power to provide consumers necessary protections, if they find that state regulators have failed to do so.

Greater Accountability Through Improved Governance and Investor Rights: Legislation equivalent to an investor's Bill of Rights should be adopted. Investors own the company and should have some basic fundamental rights with respect to their ownership and investments. It is well known that investors in the U.S. lack some of the fundamental rights they have in foreign countries such as the United Kingdom, the Netherlands and Australia. Yet while some argue for regulation and regulators similar to those in foreign countries, these very same people often oppose importing investor rights from those same countries into our system of governance.

The excesses of executive compensation have been well documented and need no further discussion. Some have argued investors have an ability to directly address this by voting for or against directors on the compensation committee of corporate boards. But that is a fallacy. First of all, investors can only vote for, not against a director in the system we have today. Second, some institutional investors have direct conflicts when voting as a result of receiving fees for managing corporate pension funds of the management they are voting on. At times this seems to unduly and improperly influence their votes.

To remedy these shortcomings, Congress should move to adopt legislation that would:

- Require majority voting for directors and those who can't get a majority of the votes of investors they are to represent should be required to step down.
- Require public issuers to annually submit their compensation arrangements to a vote of their investors—commonly referred to as "say on pay."
- Give investors who own 3 to 4 percent of the company, the same equal access to the proxy as management currently has. While some argue this will give special interests an ability to railroad corporate elections, that simply has proven not to be the case. When special interests have tried to mobilize votes based on their interests and not those of investors, they have ALWAYS failed miserably.
- Investors who own 5 percent or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all investors. They should also be given the right to do so to call for a vote on reincorporation when management and corporate boards unduly use state laws detrimental to shareholder interests to entrench themselves further.
- Strengthen the fiduciary requirements of institutional investors when voting on behalf of those whose money they manage. This should extend to all such institutional investors including mutual funds, hedge funds, public and corporate pension funds as well as the labor pension funds.

Since voting is an integral part of and critically important to governance, greater oversight should be put in place with respect to those entities who advise institutions on how they should vote. Recently a paper from the Milstein Center for Governance and Performance at Yale has made recommendations in this regard as well. As a former managing director of one such entity, I would support legislation that would:

- Require these entities to register with the SEC as investment advisors, subject to inspection by the SEC. While some have registered, others have chosen not to.
- Require these entities to improve their transparency by disclosing their voting recommendations within a reasonable time period after the vote.
- Require all institutional investors, including public, corporate, hedge and labor pension funds to disclose their votes, just as mutual funds are currently required to disclose their votes.
- Require that only the legal owner of a share of stock can vote it, prohibiting those who borrow stock to unduly influence an election by voting borrowed stock they don't even own, and eliminating broker votes.

It should also be made explicit that the SEC has authority to set governance standards for the mutual funds. For example, the SEC should have the authority, and act on that authority, to require a majority of independent directors for mutual funds, as well as an independent chair.

Investor's rights of private actions have also been seriously eroded in the past decade. Certainly we should not return to the abuses of the court system that existed before the Private Securities Law Reform Act (PSLRA) was passed. But at the same time, investors should not have to suffer the type of conduct that contributed to Enron and other scandals. And the SEC does not, and will not have the resources to enforce the securities laws in all instances.

The SEC should continue to be supportive of investors' private right of action. The SEC should also continue to support court rulings that permit private investors to bring suits in the event of aiding and abetting and scheme liability. In 2004, the SEC filed an *amicus* brief in *Simpson v. Homestore.com, Inc.,* upholding liability against an individual regardless of whether or not the person made false or misleading statements. In 2007, a request from SEC Commissioners to the Solicitor General to submit a brief in favor of upholding scheme liability in the case of *Stoneridge v. Scientific-Atlanta* was denied by the White House, despite the urging of Senate Banking Committee Chairman Christopher Dodd (D-CT) and House Financial Services Committee Chairman Barney Frank (D-MA). The SEC needs to reclaim the SEC's role of providing strong support for the right of investors to seek a private remedy.

Investors in securities fraud cases have always had the burden of proving that defendants' fraud caused the investors' losses. Congress continued this policy in PSLRA. However, recent lower-court interpretations of a 2005 Supreme Court case have improperly transformed loss causation into an almost impossible barrier for investors in serious cases of fraud. Congress, with the support of the SEC, should act to fix the law in this area.

Taking advantage of the loophole in the law the courts have now created, public companies have begun gaming the system. Specifically, corporations may now simultaneously disclose other information—positive and negative—in order to make their adverse disclosures "noisy," so that attorneys representing shareholders will find it more difficult, if not impossible, to satisfy loss causation requirements. Other corporations may leak information related to the fraud, so that the share price declines at an early date, before they formally reveal the adverse news.

In sum, narrow lower-court standards of loss causation are allowing dishonest conduct to avoid liability for fraudulent statements by disclosing that the corporation's financial results have deteriorated without specifically disclosing the truth about their prior misrepresentations that caused the disappointing results. Insisting on a "fact-for-fact" "corrective disclosure" allows fraudsters to escape liability simply by not confessing.

Transparency: The lack of credible financial information has done great damage to the capital markets. This has ranged from a lack of information on off balance sheet transactions as was the case with Enron, to a lack of information on the quality of assets on the balance sheets of financial institutions, to a lack of information on risk management at public entities, to a lack of transparency at regulators.

The lack of transparency begins with accounting standards that yet again have failed to provide the markets and investors with timely, comparable and relevant information. The off balance sheet transactions that expose great risk to the markets, have once again been permitted to be hid from view by the accounting standard setters. What is more disturbing about this is that the standard setters were aware of these risks and failed to act.

To remedy this serious shortcoming, and ensure the standard setters provide a quality product to investors and the markets, I believe Section 108 of SOX should be amended. It should require that before the SEC recognizes an accounting standard setter for the capital markets, either from the U.S. or internationally, that its board of trustees and voting board members must have preferably a majority of representatives from the investor community and certainly no less than 40 percent of their membership should be investors with adequate skills and a demonstrated ability to serve the public. In addition, any standard setter should be required to have an independent funding source before their standards are used. And finally, each standard setter should be required to periodically reevaluate the standards they have issued, and publicly report on the quality of their implementation. For too long accounting standard setters have disavowed any responsibility for their standards once they have been issued, a practice that should come to an immediate halt.

The SEC also needs to closely monitor the current efforts of the FASB and International Accounting Standards Board (IASB) to ensure appropriate transactions are brought on balance sheet when a sponsoring company controls, or effectively controls the economics of the transaction. I fear based on developments to date, these efforts may yet once again fail investors.

Transparency of the regulators needs to be enhanced as well so as to establish greater accountability. For example, the regulators should be required in their annual reports to Congress to:

- Identify key risks that could affect the financial markets and participants they regulate, and discuss the actions they are taking to mitigate those risks. For example, the OCC and SEC have had risk management offices for some time, yet their reports have failed to adequately alert Congress to the impending disaster that has now occurred. Unfortunately the SEC risk management office was reduced to a staff of one.
- They should have to provide greater detail as to their enforcement actions including the aggregate number and nature of the actions initiated, the number of actions in the pipeline and average age of those cases, the number and nature of the cases resolved and how those cases were resolved (*e.g.,* litigation, settlement, case dismissed).

- Banking and securities regulators should be required to make public their examination reports. The public should be able to see in a transparent fashion what the regulator has found. Regulators who have found problems have all too often failed to disclose their findings of problems to the unsuspecting public or Congress. In some instances, the problems identified have not been promptly addressed by the regulator and have resulted in the need for taxpayer bailouts amounting to hundreds of billions of dollars. That simply should not be allowed to occur. And while some in the industry and banking regulators have indicated such disclosure could harm a financial institution, I believe any such harm is questionable and certainly of much less significance than the damage now being wrought on our economy and society.

The securities and banking regulators should also be required to adopt greater disclosures of risks that can impact the liquidity and capital of financial institutions. The Shipley Working Group encouraged such disclosures. These disclosures should include greater information regarding the internal ratings, risks and delinquencies with respect to loans held by financial institutions. In addition, greater disclosures should be required regarding how a company identifies and manages risk, and changing trends in those risks, with an eye to the future.

Improve Independence and Oversight of Self Regulatory Organizations: FINRA has been a useful participant in the capital markets. It has provided resources that otherwise would not have been available to regulate and police the markets. Yet serious questions have arisen that need to be considered when improving the effectiveness and efficiency of self regulation.

Currently the Board of FINRA includes representatives from those who are being regulated. This is an inherent conflict and raises the question of whose interest the Board of FINRA serves. To address this concern, consideration should be given to establishing an independent board, much like what Congress did when it established the PCAOB.

In addition, the arbitration system at FINRA has been shown to favor the industry, much to the detriment of investors. While arbitration in some instances can be a benefit, in other situations it has been shown to be costly, time consuming, and biased towards those who are constantly involved with it. Accordingly, FINRA's system of arbitration should be made optional, and investors given the opportunity to pursue their case in a court of law if they so desire to do so.

Finally careful consideration should be given to whether or not FINRA should be given expanded powers over investment advisors as well as broker dealers. FINRA's drop in fines and penalties in recent years, and lack of transparency in their annual report to the public, raises questions about its effectiveness as an enforcement agency and regulator. And with broker dealers involved in providing investment advice, it is important that all who do so are governed by the same set of regulations, ensuring adequate protection for the investing public.

Enforcement: With respect to enforcement of the securities laws, there are a number of steps Congress should take. After all, if laws are not adequately enforced, then in effect there is no law.

Enforcement by the SEC would be enhanced if it were granted the power to bring civil and administrative proceedings for violations of 18 U.S.C. 1001, and seek civil money penalties therein. 18 U.S.C. 1001 is a criminal statute that provides, in pertinent part:

> in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully—(1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry;
>
> shall be fined under this title, imprisoned not more than 5 years or, if the offense involves international or domestic terrorism (as defined in section 2331), imprisoned not more than 8 years, or both.

The SEC should be authorized to prosecute criminal violations of the Federal securities laws where the Department of Justice declines to bring an action. When I was at the Commission, it made a number of criminal referrals, including such cases as the Sunbeam matter, which DOJ declined to advance because of resource constraints. Finally the SEC should be provided an ability to take actions for aiding and abetting liability under the Securities Act of 1933. The Commission can bring actions for aiding and abetting violations under the Securities Exchange Act of 1934.

The SEC has been chronically underfunded. A dedicated, independent financing arrangement, such as that enjoyed by the Federal Reserve, would be useful, and is long overdue.

Finally, we have seen serious problems arise for those who have blown the whistle on corporate fraud. Despite the provisions of SOX designed to protect such individuals, regulatory interpretations of that law have rendered it meaningless all too often. Congress should fix these shortcomings, in part by giving jurisdiction over the law as it is applicable to the securities markets, to the SEC rather than the Department of Labor.

Conclusion

Improvements to the securities laws and regulations that will once again ensure investors can have confidence they are playing on a level playing field are critical to recovery of our capital markets and economy. Such legislative changes are necessary if a recovery is to occur, but it is equally important that when they are made, they are changes and improvements investors perceive as being credible and worthwhile.

Thank you and I would be happy to answer any questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM JOHN C. COFFEE, JR.

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets?

Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. Very simply, my answer is yes. In the case of financial institutions, recent experience has shown that, despite the Enron-era reforms, the major banks underwriting asset-backed securitizations entered into "liquidity puts" with preferred customers under which they agreed to repurchase those offerings if liquidity was lost in the secondary market—and they did not disclose these obligations on the face of their balance sheets. This was the same use of off balance sheet financing as Enron employed—all over again. Accounting regulators acquiesced to pressure from banks, and once again the result endangered the financial well being of the entire economy.

Credit rating agencies should disclose their methodologies and assumptions (more or less as Senator Reed's bill (S. 1073) would require).

In general, financial institutions do need to provide better and more timely disclosure of risk management practices on a continuing basis. Here, rather than listing specific disclosures that should be made, I would suggest that Congress instruct the SEC to study the recent failures and tighten its disclosure requirements in light of such study.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. In particular, conflicts of interest have affected the practices of the credit rating agencies, as they both "consult" with issuers and rate them, and only a thin (and possibly permeable) Chinese Wall separates the two functions and staffs. In addition, there is the problem of forum-shopping, as the issuer pays an initial fee to several agencies, but only uses the higher or highest ratings (after paying a second fee).

Proxy advisors (including Risk Metrics) are similarly subject to the same conflicts of interest, as they also advise both their client base of institutional investors and issuers who specially hire them. At a minimum, such conflicts should be disclosed to investors along with all fees received by the proxy advisor from the issuer.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. The best response is to mandate the use of clearinghouses in the trading of over-the-counter derivatives. Such clearinghouses would in turn specify margin and mark-to-market procedures for such instruments, subject to the general oversight of the Fed or the SEC/CFTC (depending on the instrument). The industry will respond to this proposal by saying such a rule should only apply to "standardized" derivatives. But there is no clear line between "standardized" and "customized" derivatives, and good lawyers can make any derivative customized in about 10 minutes if it will enable the issuer to escape additional regulatory costs. Thus, Congress or the SEC must draw a careful line so as not to permit the clearinghouse requirement to be trivialized.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. I support the SEC's proposals on access to the proxy statement and would require "say on pay" (*i.e.,* an advisory shareholder vote on compensation) by legislation. I would urge Congress to expressly authorize the SEC to adopt its proposals on shareholder access to the proxy litigation, as otherwise there is certain to be litigation about the SEC's authority. Nor is the outcome of this litigation free from doubt. With respect to majority voting, I do not think it is necessary to overrule state law by mandating majority voting on directors, as the majority of the Fortune 1000 already follow this practice.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. I favor the provisions set forth in the Reed Bill (S. 1073) and in the more recent proposals made by the Bipartisan Policy Counsel's Credit Rating Agency Task Force. I agree that the rating agencies face a conflict when they perform consulting services for companies that they rate. Liability for "recklessness" makes sense, but should be accompanied by a safe harbor that establishes clear standards that will enable the rating agency to avoid liability (as the Reed Bill does). Although Congress cannot resolve the First Amendment issues that the rating agencies raise in their defense, Congress can make legislative findings of fact (to which most courts do give deference) that find that credit ratings (particularly those on structured finance products) do not relate to matters of public concern and so do not merit constitutional protection beyond that normally accorded "commercial speech." Finally, I would urge a statutory ceiling on the liability of a credit rating agency for any one rating or transaction, which ceiling would apply in both Federal and State court actions.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. I agree with the MFA's position. Systemic risk should be delegated to a different agency than the agency charged with consumer protection, as there are potential conflicts between these two roles. In short, a "twin peaks" model should be followed. Hedge funds are not inherently different than AIG in that any large financial institution could potentially fail in a manner that endangered counterparties and could therefore pose a systemic risk to the financial system.

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. Principally, I believe that pre-dispute arbitration agreements should be limited, as the process is often unfair to investors. Beyond that, the position of investment advisers, who have no SRO, is anomalous and should be re-examined. I express no view on whether they should form their own SRO or be brought under FINRA.

In overview, the SROs did not cause (but did little to prevent) the 2008 financial crisis. Conceivably, they could have discovered Mr. Madoff's fraud (but the SEC bears the greater responsibility). The SRO structure has some value, particularly because SROs are self-funding and can tax the industry. Also, they enforce "fair and equitable" rules that are far broader than the SEC's typically narrower anti-fraud rules.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. I do not believe that merging the SEC with another regulator is sensible or politically feasible in the short run. Nor do I think that the SEC should (at least over the short-run) assume any of the duties of other regulators. However, the SEC's "Consolidated Supervised Entity" Program, which was begun in 2004, clearly failed in 2008 and should not in any form be re-created. Large financial institutions (such as Goldman, Sachs or Morgan Stanley) are better monitored by the Federal Reserve as Tier One Bank Holding Companies, and the capital markets have greater confidence in the Fed's monitoring ability.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. The SEC needs more funds and more staff. This is best accomplished by making the SEC at least partially "self-funding," specifically by allowing the SEC to keep the fees and other charges that it levies on issuers, brokers and other regulated entities. I would not, however, recommend that the SEC keep civil penalties and fines, as this would raise both due process and "appearance of justice" issues that are best avoided.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN C. COFFEE, JR.

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.1. *Bernanke's Comments:* I would strongly agree with Chairman Bernanke's above quoted remarks, and I believe that his final question about the desirability of a systemic risk regulator must be answered in the affirmative (although the identity of that regulators can be reasonably debated). The term "too big to fail" is a misnomer. In reality, a systemic risk regulator must have the authority to identify financial institutions that are "too interconnected to fail" and to regulate their capital structure and leverage so that they do not fail and thereby set off a chain reaction.

SEC/CFTC Merger: Although a merger of the SEC and the CFTC would be desirable, it is not an essential reform that must be accomplished to respond effectively to the current financial crisis (and it would be a divisive issue that might stall broader reform legislation). At most, I would suggest that jurisdiction over financial futures be transferred from the CFTC to the SEC. An even narrower transfer would be to give the SEC jurisdiction over single stock futures and narrow-based stock indexes. Over the counter derivatives might be divided between the two in terms of whether the derivative related to a security or a stock index (in which case the SEC would receive jurisdiction) or to something else (in which case the CFTC should have jurisdiction).

The AIG Failure: AIG's failure perfectly illustrates the systemic risk problem (because its failure could have caused a parade of falling financial dominoes). It also illustrates the multiple causes of such a failure. AIG Financial Products, Inc., the key subsidiary, was principally based in London and was the subsidiary of the parent of the insurance company. As a non-insurance subsidiary of an insurance holding company, it was beyond the effective oversight of the New York State Insurance Commissioner, and there is no Federal insurance regulator. Although AIG also owned a small thrift, the Office of Thrift Supervision (OTS) could not really supervise an unrelated subsidiary operating in London. Thus, this was a case of a financial institution that fell between the regulatory cracks.

But it was also a case of a private governance failure caused by excessive and short-term executive compensation. The CEO of AIG Financial Products (Mr. Cassano) received well over a $100 million in compensation during a several year period between 2002 and 2006. This gave him a strong bias toward short-term profit maximization and incentivized him to continue to write credit default swaps for their short term income, while ignoring the long term risk to AIG of a default (for which no reserves were established). Thus, there were both private and public failures underlying the AIG collapse.

Procedures for Failure of a "Systematically Critical Firm": The Lehman bankruptcy will remain in the courts for a decade or more, with considerable uncertainty overhanging the various outcomes. In contrast, the FDIC can resolve a bank failure over a weekend. This suggests the superiority of a resolution-like procedure following the FDIC model, given the uncertainty and resulting potential for panic in the case of a failure of any major financial institution. Both the Bush and Obama Administrations have endorsed such a FDIC-like model to reduce the prospect of a financial panic. I note, however, that one need not bail out all counterparties at the level of 100 percent, as a lesser level of protection would avert any panic, while also leaving the counterparties with a strong incentive to monitor the solvency of their counterparty.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM JOHN C. COFFEE, JR.

Q.1. Are you concerned that too much reliance on investor protection through private right of action against the credit ratings agencies will dramatically increase both the number of law suits the companies will have to deal with as well as their cost of doing business? Have you thought about alternative ways to ensure adequate investor protections that will not result in driving capital from the U.S. in the same way that the fear of litigation and costs created by Sarbanes-Oxley has resulted in a decline in new listings in American capital markets?

A.1. I have two independent responses: First, authorizing a cause of action along the lines that Senator Reed's bill (S. 1073—"The Rating Accountability and Transparency Enhancement Act of 2009") does should not increase the number or aggregate recoveries in securities litigation to any significant degree. This is because the Reed bill's proposed cause of action against credit rating agencies contains an important safe harbor under which a credit rating agency that conducts due diligence or hires an independent due diligence firm will be protected against suit. In this light, I believe the real impact of this provision will be *ex ante,* rather than *ex post,* meaning that it will change the rating agency's behavior so as to avert litigation, rather than affecting the overall incidence or outcome of suits against it.

Secondly, I have elsewhere proposed that all securities litigation against secondary defendants (*i.e.,* persons other than the issuer or underwriter) be subject to a ceiling on damages to protect against such litigation causing their insolvency. So limited, securities litigation against secondary participants could deter, but not destroy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM T. TIMOTHY RYAN, JR.

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets?

Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. We do not believe that there are "additional types of disclosures" that should be required regarding participants in the capital markets. The disclosures currently required in financial statements have increased substantially over the last decade and in particular over the last year, and have led some commentators to observe that re-organizing current mandated disclosures might result in a more concise but more intelligible set of disclosures for readers of financial statements. We think that such an approach would be more beneficial than simply increasing the amount of data required.

Both FASB and the SEC have recognized the need for additional disclosure regarding off-balance sheet exposures. Those requirements will be phasing in over the course of this year and we believe will meaningfully increase the amount of information in the marketplace regarding off-balance sheet assets and liabilities.

Last year, SIFMA formed a global, investor-led task force to identify and examine key issues related to the credit ratings paradigm. SIFMA's Credit Rating Agency Task Force issued its recommendations last July. These recommendations included the following related to disclosure:

- CRAs should provide enhanced, clear, concise, and standardized disclosure of CRA rating methodologies;
- CRAs should disclose results of due diligence and examination of underlying asset data examinations, and limitations on available data, as well as certain other information relied upon by the CRAs in the ratings process;
- CRAs should provide disclosure of CRA surveillance procedures; this will foster transparency, and allow market users of ratings to understand their bases and limitations;
- CRAs should provide access to data regarding CRA performance; this will allow investors to assess how CRAs differ both in the performance of their initial ratings, and in their ongoing surveillance of existing ratings; and
- CRA fee structures, and identities of top payors, should be disclosed by CRAs to their regulators.

The report discusses these recommendations in detail. A copy of the report is attached and can also be found at *http://www.sifma.org/capital_markets/docs/SIFMA-CRARecommendations.pdf*

Municipal issuers are already required to provide annual financial statements and material event notice disclosures to investors pursuant to SEC Rule 15(c)2-12, and plans are underway for this information to be more easily accessed under the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (EMMA). As of July 1, 2009, EMMA will be the new central filing repository for municipal issuer annual financial statements and material events notices as well as a free Internet-based transparency vehicle for retail investors seeking this information.

The current disclosure requirements already encompass a great deal of information on the risk management policies/practices of banks and securities firms, particularly in the MD&A of financial statements. While improvements in the presentation and intelligibility of such disclosures may occur as a result of preparer interaction with investors, analysts, and other users of financial statements, we do not believe that at this point additional requirements *per se* are warranted.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. SIFMA agrees that effective management of conflicts of interest by market intermediaries builds confidence in the integrity of financial markets and promotes investor protection. We generally support initiatives to identify and manage conflicts and we believe the industry has made significant steps over the past several years to develop best practices in this area. For example, our members have developed an "Investor's Bill of Rights" which states that each investor has the right "to be apprised of significant conflicts of interest identified in a financial relationship between an investor and his or her broker-dealer or account representative." This resource is available at *http://www.sifma.org/private_client/pdf/SIFMA_InvestorRights.pdf.* In another example, our members have also developed "Principles for Managing the Distributor-Individual Relationship" for structured products that includes guidance on managing potential conflicts. This resource is available at *http://www.sifma.org/private_client/pdf/GlobalRSPDistributor-PrinciplesFinal.pdf.* Similarly, our proposed universal standard of care for retail investors, would also require financial professionals to provide full and fair disclosure of all material facts, including material conflicts of interest.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. Credit default swaps are important financial tools that allow companies across America access to capital at lower cost by allowing banks to efficiently hedge exposure to debt of these companies. We believe there is wide agreement that steps should be taken to address issues that have arisen in connection with CDS and other derivatives, but care should be taken not to impair the usefulness of these products. In particular, as recognized by the President's Working Group, market participants should be allowed to enter into customized bilateral contracts in order to accomplish their risk management objectives. We believe that Congress should consider subjecting all systemically significant participants in derivatives markets, whether they are investors or dealers, to oversight by a single Federal regulator with broad authority to identify who is systemically significant, to consult with industry and develop principles for prudent management of risk, to promulgate appropriate rules based on those principles, and to access information necessary to carry out its oversight responsibilities. Among other things, we believe the principles adopted by the systemic regulator should encourage submission of standardized credit default swaps to clearing houses that are subject to Federal regulatory oversight. This will help assure adequate collateral posting and decrease aggregate leverage in the financial system, both of which will reduce overall levels of risk. Because financial markets and the activities of major market participants are global, it is important that the Federal systemic risk regulator consult and coordinate with regulators in major markets outside of the United States.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. While requiring a majority shareholder vote for directors to be elected in uncontested elections may promote selection of well-qualified directors, SIFMA would note that for some issuers, this could be a difficult requirement to meet. The SEC is likely to prohibit brokerdealers from voting the uninstructed shares of clients in director elections in a current rulemaking project. SIFMA is concerned about protecting the privacy of those clients who object to direct contact with issuers. This will also increase costs for issuers who will need to spend significant sums to get out the vote. Finally, small issuers would likely be disadvantaged because their shares are more often held by retail investors rather than large, institutional investors.

SIFMA does not have a position on this proposal but notes that the thresholds for when a shareholder or group of shareholders would be granted access to an issuer's proxy should be high enough so that the process isn't abused. The process for allowing shareholders to submit amendments to proxy statements would need to be clear and to minimize costs, uniform. It is very important that shareholders have the right to vote; the submission of amendments should not inhibit today's efficient and timely process for the arrival of proxy statements. Building in time for amendments could further delay the transmission of proxy material, this and other practical issues presented by the proposal warrant careful consideration.

As the Committee knows, a number of SIFMA members are subject to the TARP requirement to conduct an advisory shareowner vote on compensation. Several firms have either implemented this requirement or are working toward meeting it. We caution that the results of this year's advisory votes may not be emblematic of potential future advisory votes. This year many of the TARP companies did not pay senior management any bonuses and it is quite possible that this factored heavily in the votes in favor. Also, many

TARP companies that implemented the advisory vote were required to do so in a hasty manner and as a result included the "boilerplate" proposal language without thinking through what language made sense for their particular company. SIFMA has yet to take a position on whether annual advisory shareowner votes should be mandated for all public issuers as suggested by the Council of Institutional Investors or whether other mechanisms, such as issuer-specific surveys, would be more helpful to enhance communications between Boards and shareowners.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. Last year, SIFMA formed a global, investor-led task force to identify and examine key issues related to the credit ratings paradigm. SIFMA's Credit Rating Agency Task Force issued its recommendations last July. A copy of the report is attached and can also be found at *http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf.*

SIFMA's CRA Task Force found that there is a perception by some that the degree and nature of interaction between CRAs and issuers during the ratings process may result in conflicts of interest. This perception undermines investor confidence in the accuracy and reliability of ratings. These perceived conflicts can arise both from the interaction between CRAs and issuers in the course of a CRA assigning a rating to a particular security, and from the CRAs' provision of consulting or advisory services.

The Task Force noted that each of five major CRAs (A.M. Best, DBRS, Fitch, Moody's, and Standard & Poor's) committed in their Joint Response to the IOSCO Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets to "plainly indicate" that it does "not and will not provide consulting or advisory services to the issuers the [CRA] rates."

In order to provide clarity to market participants, the Task Force recommended that "core" rating services be clearly defined by the CRAs and distinguished from such "consulting or advisory" services. The Task Force further recommended that CRAs clarify that "consulting or advisory" services exclude other "ancillary" services provided to issuers and intermediaries in the ordinary course of business.

The Task Force viewed the CRAs' permissible "core" services as including:

1. the assignment and monitoring of public, private, and private placement ratings;
2. issuance of credit estimates and hypothetical ratings, including requested Rating Evaluation Service and Rating Advisory Service (RES/RAS) services regarding issuer-proposed structures of hypothetical securities, indicative, or preliminary ratings, and impact assessments;
3. hybrid securities assessment services;
4. internal assessments;
5. ratings coverage of project and infrastructure finance transactions and hybrid securities;
6. dissemination of press releases and rating reports (that include the rating opinion);
7. research reports and other publications, including methodologies, models, newsletters, commentaries, and industry studies;
8. regular oral and written dialogue with issuers, intermediaries, investors, sponsors,regulators, legislators, trade organizations, and the media; and
9. conducting and participating in conferences, speaking engagements, and educational seminars.

In particular, the Task Force believes that these "core" services include the iterative process that occurs between an issuer, arranger, underwriter, and CRA during the rating of structured finance, project and infrastructure finance, and hybrid securities.

The Task Force believes there is a misperception by some that this type of "core" interaction is essentially a consultation service by CRAs that gives rise to an insuperable conflict of interest, and which undermines the integrity and reliability of the resulting rating. As described above, however, the process of rating structured finance, project and infrastructure finance, and hybrid securities necessarily involves an iterative give-and-take between the issuer, arranger, underwriter, and CRA as part of the "core" services performed by the CRA.

In light of this, the Task Force did not recommend placing limitations on this iterative process. Rather, the Task Force recommended that CRAs maintain an adequate governance structure that includes policies, procedures, mechanisms, and firewalls designed to minimize the likelihood that conflicts of interest will arise, and to manage the conflicts of interest that do arise.

Similarly, "ancillary" services, in the view of the Task Force, are permissible rating-related services that are generally segregated by the CRA into separate business groups. The Task Force views examples of "ancillary" services as including, among others, market implied ratings (MIRS), KMV credit risk management, data services, credit risk solutions, and indices.

SIFMA has not taken a position on legal liability for NRSROs.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. We support giving the financial markets stability regulator the authority to gather information from all U.S. financial institutions and markets in order to identify systemic risk and maintain financial stability. We believe this authority should apply to all financial institutions, regardless of charter, and regardless of whether they are currently functionally regulated or not, including hedge funds or private equity funds. One of the lessons learned from recent experience is that sectors of the market can be systemically important, even though no single institution in that sector is a significant player. The financial markets stability regulator will need information necessary to form and maintain a picture of the overall systemic risks in the U.S. financial system. The financial markets stability regulator should also have the authority, in consultation with any relevant Federal regulator, to make uniform rules to the extent necessary to reduce systemic risk and promote financial stability.

As noted above, we have proposed that the financial markets stability regulator should probably have a more direct role in supervising systemically important financial institutions or groups. Such systemically important financial institutions or groups could include currently unregulated institutions, such as hedge funds or private equity funds, although we do not believe the financial markets stability regulator should become the functional regulator for such unregulated institutions. We agree with others that hedge funds should be regulated by a merged SEC and CFTC.

Because we believe the financial markets stability regulator should have the authority to address a financial crisis, we believe such a regulator should have certain resolution powers, including the authority to appoint itself or another Federal regulatory agency as the conservator or receiver of any systemically important financial institution or group.

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. The SRO structure remains a viable regulatory framework. Supplemented by government oversight, this tiered regulatory system can provide a greater level of investor protection than the government alone might be able to achieve. Self-policing by professionals who have the requisite working knowledge and expertise about both marketplace intricacies and the technical aspects of regulation creates a self-regulatory system with valuable checks and balances. SRO performance may be improved by eliminating duplicative regulation, filling regulatory gaps, and harmonizing standards that are appropriately applicable to all investment services providers. In harmonizing standards, however, we note that just as one size does not fit all broker-dealers, it also does not fit all market users. There is a world of difference between an individual investor seeking to invest his/her retirement savings and a multi-billion dollar hedge fund implementing a sophisticated trading strategy. Indeed, there is a similar difference between a high net worth individual managing substantial assets and retail market participants seeking to save for college. While all participants must be protected from fraud, we need a flexible regulatory structure that can differentiate between the various types of market participants when it comes to mandatory prophylactic rules and requirements.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. We have testified that we are in support of a merger of the SEC and the CFTC. The longstanding focus of the SEC has been investor protection, and we believe that this should continue to be so with any regulatory reform. We do not see a systemic risk regulator taking over any of the SEC's duties; rather, such a regulator would work with existing Federal functional regulators such as the SEC. For example, we agree with others that hedge funds should be regulated by a merged SEC and CFTC.

The SEC's investor protection mandate could be expanded to other areas or products, and so we do not see the need for a separate financial services consumer protection agency for that purpose. On the other end of the spectrum, we do not see support for moving to an FSA-type model of a single prudential financial services regulator. Certain inefficiencies that result from the regulation of activities by the states and the SEC could be eliminated by vesting the regulatory authority for those activities in the SEC.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5

clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. If the SEC is to take on a greater responsibility with respect to the regulation of hedge funds and other private equity vehicles, we believe that current staffing levels are inadequate. The SEC is currently unable to examine investment advisers in a timely manner, and with enhanced responsibilities their resources will be even more stretched. As a result, we believe additional funding of the SEC will be necessary. We would also support an internal reorganization of the SEC such that the examination functions, such as broker-dealer and investment adviser examinations, are combined with, and reporting into, the policy making units, so that the SEC speaks and acts consistently on policy issues.

SIFMA®
Securities Industry and
Financial Markets Association

Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force

July 2008

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Preamble

The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force (the Task Force) is a global, investor-led, industry task force formed to examine key issues related to credit ratings and credit rating agencies (CRAs).

The 37-person Task Force is comprised of members drawn from a cross-section of the financial services industry, including asset managers, underwriters, and issuers. It includes senior-level experts in structured finance, corporate bonds, municipal bonds, and risk. The Task Force is also global, with members from the US, Europe, and Asia.[1] In addition to providing industry input to lawmakers and regulators in Europe and Asia, the Task Force has been designated by the U.S. President's Working Group on Financial Markets (the PWG) as the private-sector group to provide the PWG with industry recommendations on credit rating matters.

To determine priority areas of focus, the Task Force first sought to identify what—in the view of its industry experts—were the credit-rating-related causal variables that played a significant role in triggering the current crisis. Sixteen key issues were identified, and then stack-ranked in order of importance by the Task Force members. Those issues that headed the list are the issues that the Task Force has addressed in its below recommendations.[2]

The Task Force engaged in discussions with, and solicited input from, a number of lawmakers, regulators, and CRAs across the globe. The below recommendations have been crafted with the dual goals of: a) avoiding a repetition of the credit-rating-related turmoil of the past year; and b) strengthening the investor confidence that is vital to robust and liquid global financial markets.

The Task Force recognizes the important role played by CRAs and the ratings they provide in the overall functioning of our financial markets. In light of recent market turmoil, however, particularly in markets relating to residential mortgage-backed securities (RMBS) collateralized by subprime mortgages and collateralized debt obligations (CDOs), questions have arisen regarding the quality of CRA ratings and the integrity of the rating process. The resulting decline in investor confidence has been a key factor among those that have led to investor reluctance to invest in RMBS and CDOs, and to liquidity issues generally in our global markets.

The Task Force believes that if the recommendations are followed, we will enhance the ability of market participants to understand credit ratings and to incorporate ratings properly into their own independent risk assessments. While some of the recommendations relate to issues particular to the rating of structured products, the recommendations often apply to the ratings process generally.

1 *A roster of Task Force members can be found in Appendix A.*

2 *A summary of the stack-ranking results can be found at http://www.sifma.org/capital_markets/cra-taskforce-issues.shtml*

The recommendations include the following:

- *CRAs should provide enhanced, clear, concise, and standardized disclosure of CRA rating methodologies* (see *p. 3);*
- *CRAs should disclose results of due diligence and examination of underlying asset data examinations, and limitations on available data, as well as certain other information relied upon by the CRAs in the ratings process* (see *p. 5);*
- *CRAs should provide disclosure of CRA surveillance procedures; this will foster transparency, and allow market users of ratings to understand their bases and limitations* (see *p. 8);*
- *CRAs should provide access to data regarding CRA performance; this will allow investors to assess how CRAs differ both in the performance of their initial ratings, and in their ongoing surveillance of existing ratings* (see *p. 9);*
- *Conflicts of interest should be addressed with a sensitivity towards the difference between "core" CRA services and CRA consulting and advisory services* (see *p. 10);*
- *A global SIFMA advisory board of industry participants should be established to advise regulators and lawmakers on ratings issues; this will give regulators access to industry expertise, and encourage the more fully harmonized global regulatory framework the Task Force views as essential* (see *p. 11);*
- *Lawmakers, regulators, and law enforcers across the globe should coordinate more closely in addressing this global problem, in order to avoid counter-productive, piecemeal, inconsistent attempts at remediation* (see *p. 12);*
- *CRA fee structures, and identities of top payors, should be disclosed by CRAs to their regulators* (see *p. 12);*
- *CRAs should ensure that ratings performance of structured products is consistently in line with ratings performance of other asset classes; this will increase investor confidence in the reliability of ratings* (see *p. 13);*
- *Rating "modifiers" should not be the means adopted to create transparency; they would lead to significant unnecessary costs, while at the same time likely triggering unintended negative consequences* (see *p. 14);*
- *Investors should understand the limits of ratings, and use them as just one of many inputs and considerations as they conduct their own independent analyses* (see *p. 16); and*
- *All members of the financial industry involved in the generation and use of ratings, including issuers and underwriters, should examine their processes with an eye towards improvement, including working towards standardizing reporting and disclosure on underlying assets* (see *p. 17).*

1. Enhanced Disclosure of CRA Rating Methodologies

Ratings of structured securities have been a particular source of controversy during the past year's market turmoil. The Task Force found that ratings of structured securities were generally based largely on CRA statistical models that predicted future performance of the assets that collateralized the rated securities, based on the past performance of apparently similar assets.

The Task Force determined that these quantitative, model-driven analyses assisted arrangers, underwriters, and securitization issuers by facilitating pricing consistency and predictability between the primary/origination market and the secondary/securitization market. Certain models, particularly many relating to RMBS, proved to be based on overly optimistic assumptions about asset performance, however. This was likely due to their reliance on a data set of past performance that looked back only to the relatively recent years for which performance data was available, without sufficiently accounting for the possibility of shifts in the economy and significantly changed market conditions, and which analogized the future performance of new assets to past assets, without sufficiently accounting for qualitative differences between the assets.

The Task Force found that CRAs publish general descriptions of their structured security rating methodologies, and in some instances license their statistical models to paying subscribers. The Task Force determined, however, that even when CRAs licensed these models, this information was generally insufficient for investors to understand CRA rating methodology with respect to particular structured securities. For example, even if an investor licensed the CRAs' models and obtained all the data inputs to run the model for a particular security, the investor still could not determine what assumptions and adjustments the CRAs employed in determining their final assigned rating. Therefore, investors generally did not understand the method by which CRAs determined ratings for particular structured securities, could not on their own determine any potential flaws in the CRAs' analyses, and were unable to monitor the performance of the securities (some of which proved to be more susceptible to ratings volatility than traditional rated corporate debt) in comparison to the assumptions underlying the CRAs' ratings.

The Task Force finds that, prior to the recent subprime mortgage crisis, investors were generally not sufficiently aware of the particular limitations associated with the CRAs' statistical models, when the CRAs deviated from those models in rating securities (particularly structured products), the key assumptions underlying those ratings, and the potential impact of changes in such assumptions.

The Task Force recognizes that ratings are not solely model-driven, and that other factors impact ratings. Models are, however, clearly an integral part of the ratings process.

The Task Force believes that this limited transparency in the ratings process, and the resulting inability of the market to understand clearly the bases of ratings of certain structured products, were primary causes of misunderstandings of the ratings. These misunderstandings, in turn, were central to the ratings-related market turmoil of the past year.

The Task Force finds that greater disclosure by CRAs with regard to aspects of the rating process, including statistical models, would enhance transparency in the structured products market by providing market participants with greater understanding of the ratings analysis.

The Task Force therefore recommends that CRAs provide greater disclosure with regard to the method by which they determine ratings for securities, and mortgage- and asset-backed structured securities in particular. This will enable investors to better understand and evaluate the CRA analysis, and monitor the performance of the rated securities in comparison to the rating analysis over time.

The Task Force concluded that it would be preferable for CRAs to adopt the practice of providing clear and concise disclosure, preferably in the form of a "pre-sale report," rather than disclose additional large quantities of raw information pertaining to the model. This disclosure, above and beyond current practice and sufficient to enable the market to understand what a rating means and how it was derived, should include:

a. A description of the CRA model and model outputs (including cumulative collateral loss assumptions and assumptions relative to the pre-securitized assets and loss curve over time, timing of losses, default frequency and severity expectations, the amount of loss coverage required at each rating level, and credit enhancement requirements);

b. Inasmuch as ratings are not purely model-driven, and deviations from the model are common, a description of any material deviations from the rating or credit enhancement analysis called for by the CRA model, any material adjustments to the model for the purpose of the subject rating, and the reasons for such deviations/adjustments;

c. A description of qualitative factors relied upon by the CRA in its analysis; and

d. A description of the key risks and sensitivities of the rating to key variables (as well as compensating factors) considered by the CRA in determining its rating, such as external changes that could cause a rating to change (*e.g.*, a decline in home prices), including any stress test results.

Each rating should be developed from a general model or criteria that have been published by the CRA. To the extent that general model information is already published by a CRA, the CRA should, in its pre-sale report for a rated security or in such other place as is reasonable, reference such information and indicate where this information can be found.

The provision of this kind of additional specific information by CRAs could be used by investors for investment decision analytics and for enhanced, better-informed risk control decisions. In addition, such greater disclosure would highlight the key distinctions between, and different risk characteristics of, certain structured products and corporate bonds. This additional transparency would at the same time obviate the need for rating "modifiers" to distinguish between broad categories of issue types.

While this disclosure should be appropriately concise, a level of helpful detail is called for. Simply sharing numerical scores that weigh and aggregate information, such as "volatility scores" or "stress test scores," would by itself be of limited use to investors conducting their own risk analyses.

In order to ensure the provision of this information on a clear and comparable basis, the Task Force recommends that CRAs consider developing guidelines for pre-sale reports that would encompass the disclosures recommended in (a)-(d) above, and that would appropriately reflect the differences among different types of securities. These guidelines would serve as a framework for disclosure, without mandating a strict homogeneity across the CRAs to the detriment of each CRA's unique methodologies.

This increased transparency, adopted as a permanent ongoing practice of the CRAs, would enhance the ability of investors and other market participants to understand and use a rating as just one of many inputs and considerations in their own independent risk analyses, with a clear understanding of the basis and limitations of the rating.

2. Enhanced Disclosure of Due Diligence Information, and Other Information Relied upon by CRAs in the Rating Process

A. Disclosure of Due Diligence/Reviews of Data Accuracy. The Task Force finds that CRAs have in recent periods generally performed only limited (and, in some instances, did not perform any) independent review or due diligence to confirm the accuracy of data provided to them in connection with the assets underlying structured securities, and performed limited independent confirmation of asset origination standards. Instead, perhaps in part because some CRAs have not seen it as their role to do more, they have substantially relied on publicly available information and/or the representations of other parties to the transaction with regard to the reliability of the data presented to the CRAs.

The post-mortems of the recent subprime mortgage crisis suggests that this reliance by CRAs on other parties to verify the quality of assets underlying certain structured securities being rated by the CRAs, which was combined with only a limited understanding by some market participants as to the level of this reliance, may have led to ratings that were inaccurate reflections of the default risk of such structured securities (for example, some such ratings neglected to take into account the higher incidence of mortgage fraud). In addition, there are indications that some CRAs at times relied on information that may have been questionable or suspect on its face, taking into account market changes at the time.

The Task Force therefore recommends that CRAs disclose in their pre-sale reports, at a minimum:

a. Whether and to what extent the CRA has conducted or reviewed any independent examination and/or review to confirm the accuracy of underlying data and asset origination standards relating to a security;

b. If the CRA relied on the due diligence or examination of another (such as an issuer, underwriter, or third party) with respect to the rating of a security: who conducted the due diligence or examination, what their relation is to the transaction, and the extent to which such due diligence or examination was relied upon;

c. What the due diligence analysis entailed (*e.g.*, data accuracy, origination standards and processes, loan level due diligence, credit, or value);

d. With regard to asset-backed securities, what due diligence was conducted on the individual securities or assets in the collateral pool underlying the structured deal, and what if any individual components did not receive any due diligence review; and

e. The results of the due diligence review, including the exceptions that were noted.

If a CRA does not undertake an independent examination of the underlying data and asset origination standards, the Task Force believes the CRA should satisfy itself that some reasonable minimum level of examination has been undertaken by other parties to the transaction to ensure that the information underlying each CRA rating and opinion is of sufficient quality to support a credible rating. For example, CRAs should question issuers to satisfy themselves that thorough underwriting due diligence, including data verification, has been performed by reputable parties.

Where the diligence disclosure reflects that a given security has a limited amount of historical data upon which to base a rating, as may be the case with newer structured finance securities, the CRA should prominently disclose the limitations on available data and the resulting rating's limitations and augmented risks. The Task Force anticipates that such limitations would be reflected in higher credit enhancement requirements.

The Task Force does not, however, recommend a blanket prohibition on the issuance of a rating on a structured product where there is limited information available on the underlying assets. In the instance of new structured products, for example, there may be little or no historical information relating to the underlying assets, but the underlying assets may be comparable to, or a variation on, assets previously incorporated into structured products as to which there is an adequate amount of data available. A broad prohibition on the ability of CRAs to rate new kinds of issues would stifle innovation, both in the creation of new kinds of issues and in the ratings process. To ensure transparency of the unique considerations and risks related to the rating of a new kind of security, the Task Force recommends that CRAs prominently and with an appropriate level of detail disclose: (i) that there is limited information available regarding the assets underlying the security being rated; (ii) the methodology used by the CRA to rate the new structured product in the absence of extensive information; and (iii) the attendant risks involved.

This disclosure would not only provide additional information to investors regarding the level of examination underlying a given rating, but also serve as an impetus to CRAs to make substantive improvements to their examination processes.

B. Disclosure of Other Information Relied upon by the CRA in the Rating Process. The SEC has suggested disclosure of not only the due diligence and model information described above, which the Task Force views as the most important disclosure, but also of all other information used by a CRA to determine credit ratings of structured finance issues. This could, for example, include asset tapes representing the composition of the asset pool, representations and warranties provided by the securitization sponsor, originator, or seller, and selection criteria for asset pools.

The Task Force recognizes that, as the SEC suggests, this disclosure may also enable CRAs to provide "unsolicited" ratings by CRAs that were not engaged to rate the issues. The primary goal of the SEC in making this proposal is to promote greater competition among CRAs.

If such disclosures can be made in a manner that is sensitive to the following important issues, the Task Force recognizes that this further disclosure and enhanced transparency may be beneficial. One important issue is that some information is proprietary and/or confidential (*e.g.*, information regarding underlying obligors in the context of asset-backed commercial paper); and limitations on the ability to disclose such information would have to be addressed. Also, it is important that such disclosure requirement not chill appropriate business communications (for example, by requiring that all oral communications between an issuer and CRA be reflected in writing) or stifle innovation. In addition, the Task Force's view is that such disclosure should not serve to expand the liability of an issuer or underwriter.

Finally, the Task Force cautions that if unsolicited ratings are published, they should be published in a manner that makes quite clear to the market the unsolicited nature of the ratings. That is because unsolicited ratings will necessarily be issued on the basis of less information, and lack the robust iterative communications with the issuer's management and onsite visits that attend solicited ratings. Investors should therefore be made aware of the unsolicited nature of the ratings, so that they can properly consider the weight that they wish to give such ratings.

C. Comprehensive Disclosure; CRAs Best-Positioned to be Comprehensive Disclosing Party. The Task Force strongly supports enhanced ratings transparency, and views it as essential to restoring confidence in ratings and their quality.

As to the question of who should disclose due diligence and examination information, and other information, that the CRA relied upon in issuing its rating, the Task Force recognizes that there are various views. The Task Force understands that a number of the CRAs are of the view that they should not be the parties tasked with disclosing such information. Rather, they suggest, others, as the "owners" of much of the information, should take on that responsibility.

The Task Force believes, however, that the CRA is the party best suited to disclose the due diligence and examination information that the CRA used in issuing its rating. This is for three primary reasons. First, the CRA is the party that actually relied upon the information, and determined that the information was both used by the CRA in arriving at its rating and of sufficient quality to support the CRA's rating. Second, the CRA's view as to what information is necessary to determine an initial credit rating or to maintain surveillance on an existing credit rating can be applied in a consistent manner by the CRA across various issues rated by the CRA. Finally, while such information may come from multiple sources (including the issuer, underwriter, sponsor, depositor, and trustee), the CRA is the centrally situated repository of all information relied upon by the CRA (in the formation of its opinion leading to the CRA's rating), and therefore uniquely situated to provide "one-stop-shopping" and disclose the information most efficiently.

3. Disclosure of CRA Surveillance Procedures

The Task Force finds that more timely and diligent CRA surveillance of rated structured securities would decrease the incidence of significant delays between deteriorating asset performance and related ratings downgrades, alleviate uncertainty regarding potentially impending downgrades, and contribute to stabilization of the credit markets. Uncertainty regarding the continued accuracy and reliability of ratings of certain structured securities has, the Task Force believes, been a primary factor leading to investors' increased reluctance to invest in structured securities. This, in turn, has exacerbated the recent liquidity crunch experienced by the markets.

The Task Force therefore recommends that CRAs disclose in their pre-sale reports how a rating will be handled on a going-forward basis following issuance of the rating, and the nature and extent of surveillance that will be performed by the CRAs to ensure that the rating remains current and reliable. CRAs should also regularly disclose when this process has been completed with regard to individual transactions and ratings. The Task Force anticipates that this increased disclosure will incentivize CRAs to implement improved targeted procedures, and allocate sufficient resources to surveillance of existing ratings.

This disclosure should at a minimum include:

a. How frequently the CRA will review the rated security (*e.g.*, on a certain periodic or event-driven basis), and how often the rating will be updated, if the circumstances warrant an update;

b. Whether the timing and nature of a surveillance review will depend on external factors (*e.g.*, the frequency and quality of updated data received from the issuer or servicer of the security);

c. How soon after the CRA receives updated data it will review the data and, if appropriate, act upon the new information by updating or confirming a rating;

d. The extent of the surveillance review (*e.g.*, review of a particular security, a particular sector, or a type of transaction);

e. What the surveillance review will entail (*e.g.*, a quarterly assessment comparison of security performance to initial collateral loss expectations and assumptions; periodic or event-driven sector analyses);

f. If the issue is a structured finance security, whether its rating will be periodically updated based on a re-analysis of the underlying assets or securities; if so, how often this re-analysis will be conducted; and how this will affect the surveillance of the structured finance security;

g. Whether the team or analyst conducting the surveillance is different from the party who was involved in assigning the initial rating, and if so why;

h. Whether different models are used for rating surveillance than for initial ratings, and whether changes made to rating models and methodologies, including their criteria and assumptions, are retroactively applied to existing ratings; and

i. The status of current surveillance for each rating.

Surveillance should be conducted with sufficient frequency to allow market participants to take into account on a real-time basis the underlying market changes and issue- or issuer-specific events having an effect on rated securities. This ongoing analytical process should also work to incorporate qualitative marketplace factors into the ratings (*e.g.*, shifts in the housing market).

In instances in which the frequency and quality of surveillance is dependent on information received from issuers of securities, or servicers of the assets underlying such securities, CRAs should disclose that they lack the information necessary to update a rating, or may not be able to update a rating in a timely fashion. Similarly, if the frequency and quality of surveillance for the rating of a CDO or RMBS depends on the CRA's re-analysis of the underlying assets or updating of the rating of the underlying ABS, the CRA should disclose this factor and describe in detail the potential effects and delays on surveillance of the structured product.

The Task Force believes that increased surveillance, and investor awareness of the nature and extent of the surveillance being conducted, is central to investor confidence in the reliability of ratings over time.

4. Disclosure of Comparable CRA Performance

The Task Force finds that CRAs have not routinely published historical performance data regarding their ratings that is easily verifiable and comparable. Consequently, performance data that has been disclosed has been of limited utility to market participants seeking to compare the performance of different CRAs.

The Task Force recommends that CRAs publish verifiable, quantifiable historical information about the performance of their ratings in a format that facilitates the ability of investors and others to compare the performance of different CRAs directly. The Task Force has encouraged the CRAs to contribute their thoughts and suggestions for specific common performance metrics. For example, one such potential performance metric for structured products might be a comparison of the collateral loss curve used to determine an initial rating, and the actual performance of the collateral over time for the relevant sector. The global Credit Ratings Advisory Board described below may facilitate the creation of such a common metric, thereby promoting competition and superior performance.

Specifically, CRAs should disclose a minimum level of transparent historical ratings migration and default performance by asset class on a directly comparable basis (*i.e.*, a common approach regarding cohort treatment, treatment of withdrawn ratings, and structured finance sector definitions, etc.).

The common performance metrics chosen should not interfere with the unique rating process of each individual CRA. They should, however, encourage increased surveillance by the CRAs and allow for ease of comparability by investors and other market participants.

5. Differentiation between CRA Core Services and CRA Consulting Services

The Task Force finds that there is a perception by some that the degree and nature of interaction between CRAs and issuers during the ratings process may result in conflicts of interest. This perception undermines investor confidence in the accuracy and reliability of ratings. These perceived conflicts can arise both from the interaction between CRAs and issuers in the course of a CRA assigning a rating to a particular security, and from the CRAs' provision of consulting or advisory services.

The Task Force notes that each of five major CRAs (A.M. Best, DBRS, Fitch, Moody's, and Standard & Poor's) committed in their Joint Response to the IOSCO Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets to "plainly indicate" that it does "not and will not provide consulting or advisory services to the issuers the [CRA] rates."

In order to provide clarity to market participants, the Task Force recommends that "core" rating services be clearly defined by the CRAs and distinguished from such "consulting or advisory" services. The Task Force further recommends that CRAs clarify that "consulting or advisory" services exclude other "ancillary" services provided to issuers and intermediaries in the ordinary course of business.

The Task Force views the CRAs' permissible "core" services as including:

a. the assignment and monitoring of public, private, and private placement ratings;

b. issuance of credit estimates and hypothetical ratings, including requested Rating Evaluation Service and Rating Advisory Service (RES/RAS) services regarding issuer-proposed structures of hypothetical securities, indicative, or preliminary ratings, and impact assessments;

c. hybrid securities assessment services;

d. internal assessments;

e. ratings coverage of project and infrastructure finance transactions and hybrid securities;

f. dissemination of press releases and rating reports (that include the rating opinion);

g. research reports and other publications, including methodologies, models, newsletters, commentaries, and industry studies;

h. regular oral and written dialogue with issuers, intermediaries, investors, sponsors, regulators, legislators, trade organizations, and the media; and

i. conducting and participating in conferences, speaking engagements, and educational seminars.

In particular, the Task Force believes that these "core" services include the iterative process that occurs between an issuer, arranger, underwriter, and CRA during the rating of structured finance, project and infrastructure finance, and hybrid securities.

The Task Force believes there is a misperception by some that this type of "core" interaction is essentially a consultation service by CRAs that gives rise to an insuperable conflict of interest, and which undermines the integrity and reliability of the resulting rating. As described above, however, the process of rating structured finance, project and infrastructure finance, and hybrid securities necessarily involves an iterative give-and-take between the issuer, arranger, underwriter, and CRA as part of the "core" services performed by the CRA.

In light of this, the Task Force does not recommend placing limitations on this iterative process. Rather, the Task Force recommends that CRAs maintain an adequate governance structure that includes policies, procedures, mechanisms, and firewalls designed to minimize the likelihood that conflicts of interest will arise, and to manage the conflicts of interest that do arise.

Similarly, "ancillary" services, in the view of the Task Force, are permissible rating-related services that are generally segregated by the CRA into separate business groups. The Task Force views examples of "ancillary" services as including, among others, market implied ratings (MIRS), KMV credit risk management, data services, credit risk solutions, and indices.

6. Creation of SIFMA Global Credit Ratings Advisory Board

The Task Force finds that there is a need for market participants globally to, in a direct, impactful, and coordinated fashion, provide expert input and advice on issues related to credit ratings to relevant regulators, lawmakers, and market participants globally. This would foster a globally consistent and convergent approach to ratings issues.

The Task Force therefore recommends the creation of a global, independent, industry Credit Ratings Advisory Board, under the auspices of SIFMA.

The Advisory Board would perform strictly advisory functions, and serve as a consultative resource. The Advisory Board would not engage in any regulatory oversight of CRAs. Furthermore, the Advisory Board would not have any regulatory, quasi-regulatory, judiciary, enforcement, or auditing powers.

The Advisory Board would be composed of a broad representation of investors, underwriters, and issuers. Inasmuch as the Advisory Board would largely be continuing the efforts of this Task Force, the initial Advisory Board members would be drawn primarily from the membership of the SIFMA CRA Task Force. In performing its activities, the Advisory Board would confer with the CRAs from time to time.

More specifically, the Advisory Board would:

a. Serve as a resource on issues relating to credit ratings, both by: (i) identifying and exploring potential issues; and (ii) advising, providing informed input to, and responding to specific requests for expert consultation from regulators (such as the European Commission, the SEC, and IOSCO), lawmakers, and market participants;

b. Facilitate the global convergence of regulatory approaches by seeking regular dialogue with local, national, and global regulatory and lawmaking bodies working in this area;

c. Promote the development of objective performance criteria, guidelines, and best practices for CRAs across a spectrum of areas, including CRA rating performance, surveillance, disclosure, and transparency; and

d. Disclose on a public website, and through other public media, CRA performance information made available to the Advisory Board by the CRAs themselves and by governmental bodies, though the Advisory Board would not itself make any independent performance assessments.

7. Convergent Global Regulatory Framework

The Task Force is highly sensitive to the fact that the credit rating issues are global in nature. The Task Force believes, therefore, that it is essential that solutions to the issues raised by ratings be globally coordinated to a greater extent than is the case today. This is necessary for the solutions to be effective, and also to avoid adverse complications that can otherwise be caused by the application of inconsistent prescriptive solutions.

The Task Force therefore recommends that all governmental and regulatory bodies that contemplate addressing the roles and activities of CRAs, and the issues that arise from the credit ratings CRAs publish, recognize and act in accordance with the need for a more fully harmonized and convergent global regulatory framework. Our goal is to avoid piecemeal, fragmented, non-coordinated regulatory or other remedial actions.

A more fully harmonized, convergent global approach is particularly essential in the instance of laws, regulations, best practices, and settlement agreements and other legal requirements that set forth responsibilities and divisions of responsibilities among CRAs, investors, issuers, underwriters, and others, in order to maintain an orderly, transparent, properly functioning global financial marketplace.

8. Disclosure of CRA Fees

The Task Force finds that there is a perception among some that an inherent conflict of interest exists in the credit rating process because many CRAs receive the majority of their revenue from the issuers they rate. This perception is particularly acute in the structured finance area, given that in recent years an increasing amount of the CRAs' revenue stream has been related to structured finance ratings. This, it is suggested, increases the incentive of CRAs to maintain the transaction flow leading to this revenue. With regard to complex structured finance transactions, concerns have been voiced about client dependency and the risk that CRAs may overrate structured products to ensure continued client relationships.

The Task Force therefore recommends that CRAs be required to submit disclosure regarding their fee structures to the applicable regulators for review of the overall fees received by each CRA from issuers, investors, and other parties in the ratings process. The Task Force also recommends that CRAs disclose to the applicable regulators on an annual basis: (a) the percent of fees each CRA receives from issuers versus investors; (b) fees by sector; and (c) the identities of the payors of the largest fees that the CRA has received (on both a sector and a total basis).

The Task Force further recommends that CRAs and issuers of structured securities agree that rating fees associated with surveillance be paid to CRAs directly from the related transaction structures on a periodic basis, in order to align the rating fee structure and timing with the timing of the services the market understands to be, and desires to be, provided. The Task Force recognizes that this may have to be addressed differently in situations in which surveillance fees are not deal-specific, as in revolving master trusts.

As to a related issue, that of who pays the fees to the CRAs, the Task Force recognizes that in today's marketplace CRA services are offered based on both investor-pay and issuer-pay models, and that this affords market participants the ability to choose freely whichever model they prefer.

9. Consistent Ratings

The Task Force finds that the confidence of market participants in ratings of structured products has been undermined in part by the recent pace, precipitousness, and extent of rating downgrades of certain structured products (primarily subprime RMBS, and CDOs backed by subprime RMBS), and by the inconsistency between these rating migration levels and the migration levels of other classes of structured securities and other asset classes, such as standard corporate bonds. The Task Force believes that each rating symbol should be clearly defined and consistently applied for all types of products to which that symbol is assigned.

In order to obtain this consistency, the Task Force recommends that each CRA undertake a review of its ratings process with regard to structured products to ensure that going forward the ratings performance of structured products will be consistently in line with the ratings performance of ratings in other asset classes. This would include consistency in the projected probability of default and/or expected loss for a given rating category, depending on the policy of the respective CRA. In certain cases, if permissible under off-balance sheet rules and regulatory recourse rules, this may mean that credit enhancement levels on certain structured products may need to be raised in order to reduce differences in potential ratings volatility between various structured products and corporate issues of the same ratings category.

While the Task Force does not believe that blunt "volatility" ratings by themselves would enhance clarity as to the nature of the risks associated with particular issues, the Task Force is supportive of CRAs enhancing transparency by disclosing in pre-sale reports information regarding the historical performance, data adequacy, complexity, and market value and change in loss rate (on the collateral backing a pool) sensitivity of a transaction, governance, and sensitivity to change in the expected loss rate on the collateral that might in turn impact the volatility of a particular issue. Similarly, the Task Force does not believe that summary "stress testing" scores would by themselves increase transparency, but the Task Force is supportive of disclosure with regard to the results of stress test "what if" analyses on structured products issues.

This recommendation dovetails with the increased disclosure and transparency recommendations included herein, in that both are intended to restore investor confidence in the reliability of structured product ratings and increase the level of investor understanding of the meaning and appropriate use of these ratings.

10. Rating Modifiers

Certain regulators and organizations, including IOSCO and the SEC, have recently raised the possibility of appending a suffix or credit rating "modifier" to ratings of certain issues, such as structured finance issues, to better identify the nature of those issues. Thus, a "AAA" structured finance issue would now be designated "AAA.SF." The goal, as we understand it, is greater transparency.

The Task Force strongly supports enhanced transparency and disclosure, but suggests that the transparency goal here can be best met instead by adoption of the transparency recommendations that the Task Force proposes elsewhere in these recommendations.

The Task Force is concerned that this proposed change could further damage our already unsettled capital markets, impair capital raising (for student loans, auto loans, credit cards, mortgages, and the like), and lead to the sudden sale of structured finance securities at fire-sale prices, into an already highly illiquid market, at a time when our financial markets can ill afford such an unnecessary shock to their system. The Task Force recommends therefore that CRAs not use ratings modifiers, but instead provide greater transparency and disclosure regarding the models, inputs, and assumptions underlying any given rating, as described elsewhere in these recommendations.

The Task Force believes that the use of credit rating modifiers to distinguish structured finance securities would at best be a cosmetic solution to the credit rating problems. Given that most investors in structured finance issues are highly sophisticated Qualified Institutional Buyers, with $100 million or more of assets under management, they are unlikely to gain any new information from an appended "SF."

In addition, the Task Force believes that this proposal could have several negative unintended consequences.

First, the existing rating categories are embedded in investment guidelines for asset managers. Under the modifier approach, those same "AAA" securities would now be referred to by a new symbol (*e.g.*, AAA.SF) that does not explicitly appear in any existing guidelines.

The addition of a modifier to existing ratings might force asset managers working within existing carefully worded investment guidelines that mandate that purchases consist of particularly rated securities, such as "AAA" securities, to sell off structured finance securities now rated under a new symbol into an already illiquid market (depending, of course, on the specific wording of the guidelines). It may well also restrict future purchases of such securities, while the asset manager undertakes a lengthy guideline-revision process.

This problem is not restricted to investment guidelines. Asset managers and other parties would face also considerable difficulties given what the Task Force believes are easily tens of thousands of laws, regulations, corporate documents, and bilateral contracts embedded with existing rating symbols. They include state insurance and other regulations, pension legislation, SEC rules, ERISA, Basel II, compliance programs, board of directors minutes, and other US and non-US laws and regulations.

The time it can take to change even State laws in the 50 States of the US is considerable. For example, while the investor-protection Uniform Securities Act has enjoyed widespread consensus support by the National Conference of Commissioners on Uniform State Laws and others, only 14 of the States in the US have adopted it since it was introduced 6 years ago. Similarly, it took the better part of a decade for all 50 of the States in the US to adopt the broadly supported revisions to Article 8 of the Uniform Commercial Code. In light of this, it is unlikely that this problem would be addressed during even a reasonably lengthy "burn-in" period for implementation of the modifier proposal, if the proposal were adopted.

Second, attaching a modifier to all structured products ratings might lead to the impairment of structured products that have thus far performed well and avoided the precipitous rating downgrades experienced by sub-prime RMBS and CDOs of asset-backed securities, such as credit card, auto loan, and prime mortgage asset-backed debt. By applying a blanket modifier to securities with a variety of types of underlying collateral, the proposal would hinder the ability of investors to differentiate between such structured finance securities, and might even increase the possibility that investment boards of institutions such as pension plans and foundations might group these types of securities together as "problem" securities, and react by instituting a blanket policy to not own any securities with an SF modifier. The result could be a substantial reduction in liquidity for credit card, auto loan, prime mortgage, and other asset-backed debt–resulting in higher borrowing rates to consumers.

Third, the modifier proposal raises systems and cost issues. Financial firms rely on extensive compliance and other systems that have been set up to handle the existing ratings. The firms' computer fields can accommodate the current ratings. Firms involved in securities issuance, underwriting, investment, and custody may, however, not have systems capable of accepting and interpreting the new ratings that are being considered, with fields wide enough to handle the extra characters that such a new, expanded rating scheme would require. Similar major industry systems concerns, such as Y2K systems disruptions, have of course been averted, but only at considerable expense.

To quantify the cost of the modifier proposal, in terms of the otherwise unnecessary refitting of current systems that implementation of the proposal would require, SIFMA polled industry firms of various sizes. SIFMA found that the cost to engage in such refitting to avoid systems disruptions would be significant, and in a number of instances would be millions of dollars per financial firm.

Given that there is little benefit to be realized from this proposal, and that we can anticipate significant negative consequences and needless costs, the Task Force strongly suggests that the modifier proposal not be adopted – even in the alternative.

11. Independent Risk Analysis by Investors

The Task Force recognizes that as we have seen increased complexity in structured finance products, and ever-increasing embedded regulatory dependence on ratings, certain investors have come to rely on credit ratings to the detriment of a more complete independent risk analysis. The complexity of structured products, due to complex legal structures and financial devices, and the multitude of individual underlying assets for which little or no information is publicly available, creates great difficulties for investors seeking to analyze risk. This, in turn, encourages increased reliance on the ratings of CRAs. This increased reliance on CRAs' ratings, to the detriment of investors' own valuations, risk analyses, and continuing review of structured products, has resulted in credit ratings having an inordinate impact on the valuation and liquidity of, in particular, RMBSs and CDOs of ABS.

The Task Force believes that market participants should understand and use credit ratings as just one of many inputs and considerations in their own independent risk analyses of different classes of instruments. Investors should augment their use of CRA risk assessments by conducting their own analysis of the risks involved. As discussed elsewhere in these recommendations, the Task Force believes that investors would be best aided in performing such analysis by the provision of additional transparency in the credit rating process, the data review and due diligence conducted in the ratings process, and the surveillance procedures undertaken by CRAs to foster a better understanding of and scrutiny of the basis of the ratings.

In addition, to encourage investors to conduct an independent determination of security credit quality, the Task Force recommends that CRAs prominently disclose and emphasize on each rating pre-sale report that: (a) a credit rating is a CRA's opinion of the loss characteristics of a given security, not a seal of approval or a recommendation to buy, sell, or hold a given security; (b) investors should read the entire report issued with a rating as one element of their own risk assessment process; and (c) investors should not rely solely on the credit rating itself.

Also, CRAs should assist investors in developing a greater understanding of the nature and limitations of a credit rating in particular asset classes. The Task Force believes investor education by CRAs is integral to preventing investor over-reliance on ratings.

Although the Task Force recognizes that the use of credit ratings embedded in regulation may foster reliance on ratings, the Task Force has not found that this suggests that we should delete all references to, and use of, credit ratings in regulation. The incorporation of credit ratings in securities regulation in many cases continues to provide an appropriate minimum, though not sufficient, threshold, and is an important data point that should be part of a larger analysis. The Task Force believes that investor over-reliance is less a regulatory issue, and more one of best practices within the marketplace.

12. Disclosure by Issuers & Underwriters

The Task Force believes that it is important for all members of the financial industry involved in the generation or use of ratings, including not only CRAs and investors – but also issuers and underwriters – to examine what measures they can take to improve their processes so as to enhance ratings and the proper understanding and use of ratings.

The Task Force recommends that issuers and underwriters work towards improving transparency and disclosure with regard to structured finance issues by standardizing reporting and disclosure on underlying assets. At the same time, the Task Force recognizes that it is important to be sensitive to the differences between private and public issues, and to the fact that information may at times be proprietary or confidential.

The Task Force notes that SIFMA and two of its affiliates (the American Securitization Forum and the European Securitisation Forum) have formed a global, joint working group that will work towards developing and publishing actionable industry-developed recommendations with regard to, among other things, disclosure practices of issuers and securitization sponsors, underwriter due diligence practices and reporting standardization, and similar issues. The Task Force endorses this effort and recognizes it as an important natural progression from this Task Force's initiative, one that will further detail what can be done by parties other than the CRAs to re-start our markets, and that can help revitalize the securitization and structured credit markets and bolster investor and public confidence in those markets.

The Task Force recommends that consideration be given in this effort to greater disclosure to investors from issuers and underwriters, which may include the following (subject to appropriate legal analysis in the relevant jurisdictions):

a. Standardization of disclosure of the due diligence process undertaken by the issuer, underwriter, and/or third party due diligence provider on each securitization, including:

   i. Who performed the due diligence;

   ii. What the due diligence analysis entailed (*e.g.*, with respect to RMBS, rules defining the sample selection, sample size as a percentage of the pool, percentage of sample loans removed from the securitization for non-conformity to stated characteristics in offering documents, and the reasons for removal from the pool); and

   iii. The results of this due diligence, including what exceptions were noted;

b. Standardization of initial or periodic disclosure of collateral characteristics, on an asset-class basis, in line with SIFMA/ASF/ESF-generated templates;

c. Historical performance of similarly underwritten pools, if relevant;

d. Disclosure of additional data elements in standardized periodic remittance reports (such as FICO or other consumer credit scores, loan to value ratios, and others), to enhance transparency and risk assessment of structured finance securities on an ongoing basis;

e. Standardization of remittance reports by asset class, to facilitate greater transparency in the market; and

f. Standardization of commonly used definitions, to the extent feasible.

Deborah A. Cunningham
Chief Investment Officer
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Boyce I. Greer
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Appendix A: Roster of SIFMA Credit Rating Agency Task Force Members

CO-CHAIRS

Deborah A. Cunningham
Chief Investment Officer
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Boyce I. Greer
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MEMBERS

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Chris Blum
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David Brownstein
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Citigroup

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JPMorgan Chase

Robert Ehudin
Managing Director
Goldman Sachs

Craig Fitt
Managing Director
UBS

Brad Gewehr
Managing Director;
Manager of Municipal Research
UBS Securities

Mark C. Gossett, CFA
Chief Operating Officer
Northern Trust Global Investments

Chris Hamel
Head of Municipal Finance
RBC Capital Markets

Richard Johns
Vice President; Head of Securitization
Capital One Financial Corporation

Brian Keegan
Managing Director
JPMorgan Chase

Warren Lee
Managing Director; Head of Securitisation Asia
Standard Chartered Bank Limited (China)

Daniel T. McIsaac
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UBS

Barbara A. McKenzie
COO; Chief Compliance Officer
Principal Global Investors

Joanne Medero
Global Head of Government Relations & Public Policy
Barclays Capital

Michele Mirabella
Liquidity Team; Structured Products
Western Asset Management Company

Kevin Murphy
Managing Director; Investment Grade Corporates & Emerging Market Debt
Putnam Investments

Casey Neilson
Principal
Banc of America Securities

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Dan Pakenham
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Jeremy Reifsnyder
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Randy Snook
Executive Vice President &
Senior Managing Director
Securities Industry &
Financial Markets Association

Jack R. Wiener
Managing Director &
Associate General Counsel
Securities Industry &
Financial Markets Association

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM T. TIMOTHY RYAN, JR.

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

A.1. We agree with Chairman Bernanke's remarks and support the proposal to establish a financial markets stability regulator. At present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information systemwide or to use that information to take corrective action across all financial institutions and markets regardless of charter. The financial markets stability regulator will help fill these gaps.

We have proposed that the financial markets stability regulator should have authority over all financial institutions and markets, regardless of charter, functional regulator or unregulated status, including the authority to gather information from all financial institutions and markets, and to make uniform regulations related to systemic risk. This could include review of regulatory policies and rules to ensure that they do not induce excessive procyclicality.

We have proposed that the financial markets stability regulator should probably have a more direct role in supervising systemically important financial institutions or groups. This would address the risks associated with financial institutions that may be deemed "too big to fail." Such systemically important financial institutions or groups could also include primary dealers, securities clearing agencies, derivatives clearing organizations and payment system operators, which would help strengthen the financial infrastructure, another key element of Chairman Bernanke's proposal for regulatory reform.

Q.2. Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

A.2. We have testified that we are in support of a merger of the SEC and the CFTC. The U.S. is the only jurisdiction that splits the oversight of securities and futures activities between two separate regulatory bodies. When the CFTC was formed, financial futures represented a very small percentage of futures activity. Now, an overwhelming majority of futures that trade today are financial futures. These products are nearly identical to SEC regulated securities options from an economic standpoint, yet they are regulated by the CFTC under a very different regulatory regime. This disparate regulatory treatment detracts from the goal of investor protection. An entity that combines the functions of both agencies could be better positioned to apply consistent rules to securities and futures. We would support legislation to accomplish such a merger.

Q.3. How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

A.3. We believe the problems at AIG resulted from a combination of several factors. Its affiliate, AIG Financial Products, sold large amounts of credit protection in the form of credit default swaps on collateralized debt obligations with exposure to subprime mortgages, without hedging the risk it was taking on. At the same time, AIG's top credit rating gave many of its counterparties a false sense of security. Accordingly, many of the CDS agreements it negotiated provided that AIG would not be required to post collateral so long as it maintained a specified credit rating. AIG apparently believed its credit rating would never be downgraded, which enabled it to ignore the risk it would ever have to post collateral. Moreover, AIG appears to have under-estimated the default risk of the CDOs on which it sold credit protection, thus underestimating the size of its obligation to post large amounts of collateral in the event of its credit rating downgrade. While others might have made similar errors, it seems AIG in particular did not adequately account for the correlation of default risk among the different geographic areas where the mortgage assets underlying the CDOs originated. The market value of those CDOs fell by much more than AIG anticipated, leading to much greater collateral demands than it could possibly meet. It also appears that AIG Financial Products was not subject to adequate, effective regulatory oversight. All these factors are specific to AIG; its problems did not result from an inherent defect in CDS as a product.

Q.4. How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.4. One of the most important gaps exposed during the current financial crisis was the lack of Federal resolution powers for systemically important financial groups. We believe that the proposed financial stability regulator should have the authority to appoint itself or another Federal regulatory agency as the conservator or receiver of any systemically important financial institution and all of its affiliates. Such conservator or receiver should have resolution powers similar to those contained in Sections 11 and 13 of the Federal Deposit Insurance Act. But because the avoidance powers, priorities and distribution schemes of the FDIA are very different from those in the Bankruptcy Code or other specialized insolvency laws that would otherwise apply to various companies in a systemically important financial group, the proposed resolution authority needs to be harmonized with the Bankruptcy Code and such other laws to avoid disrupting the reasonable expectations of creditors, counterparties and other stakeholders. Otherwise, the new resolution authority itself could create legal uncertainty and systemic risk.

The Treasury's proposed resolution authority for systemically significant financial companies is a good first start, but its scope needs to be expanded to apply to all of the companies that comprise a systemically important financial group while the gap between its substantive provisions and those in the Bankruptcy Code and other specialized insolvency codes that would otherwise apply needs to be reduced in order to protect the reasonable expectations of creditors, counterparties and other stakeholders.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM PAUL SCHOTT STEVENS

Q.1. Transparency: Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets? Also, would you recommend more transparency for investors:

- By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
- By credit rating agencies of their ratings methodologies or other matters?
- By municipal issuers of their periodic financial statements or other data?
- By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. Investment companies provide extensive disclosures and are highly transparent, especially as compared to many other investment products. As investors, investment companies generally favor efforts to increase transparency in the securities markets, unless countervailing policy objectives dictate otherwise or the information would not be meaningful to investors.

Two specific areas in which ICI believes additional disclosure should be required are credit rating agencies and municipal securities. We strongly supported the Securities and Exchange Commission's recent credit rating agency proposals—which would impose additional disclosure, reporting, and recordkeeping requirements on rating agencies for rating structured finance products—as an important first step to restoring investor confidence in the integrity of credit ratings and, ultimately, the market as a whole. We believe, however, that more must be done to increase disclosure and transparency not only in the area of structured finance products but also with respect to other debt securities, particularly municipal securities. We have urged the SEC to expand many of its proposed requirements for credit rating agencies to include these additional categories of securities, and to support legislation that would extend increased disclosure requirements to the issuers of these instruments. We also have recommended a number of additional disclosures to be made by rating agencies and issuers that should enhance disclosure for investors in a meaningful way.[1] We believe the SEC currently has authority to implement many of our recommendations. Others (such as the repeal of the Tower Amendment and certain changes to improve municipal securities disclosure, discussed below) would require Congressional action.

[1] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated March 26, 2009.

Rating Agency Disclosure: ICI recommends the following additional disclosures, which go beyond the SEC's recent proposals, to improve the transparency of ratings and the rating process:

- Rating agencies should be required to provide public disclosure of any material deviations between the credit rating implied by a rating model and the final credit rating issued.
- Rating agencies should make more timely disclosure of their rating actions.
- Rating agencies should disclose additional information regarding staffing issues, including personnel turnover and resource levels.
- Rating agencies should disclose certain information about the ongoing review of their ratings.
- Rating agencies should disclose additional information regarding rating stability, including when and how downgrades are conducted and the severity of potential downgrades.
- Rating agencies should disclose additional information regarding conflicts of interest.
- Rating agencies should be required to use standardized performance measurement statistics to facilitate comparability of these statistics.
- Rating agencies should be required to conduct due diligence on the information they review to issue ratings and to provide related disclosure.

We also recommend that the SEC apply these suggested disclosure requirements in a consistent manner to all types of rating agencies. In addition, to realize the full potential of a meaningful and effective disclosure regime, we recommend that the SEC require the standardized presentation of disclosure information in a presale report issued by the rating agencies.

Municipal Securities Issuer Disclosure: ICI strongly urges Congress and the SEC to improve the content and timing of required disclosures regarding municipal securities. The Tower Amendment, adopted by Congress in 1975, prohibits the SEC and the Municipal Securities Rulemaking Board from directly or indirectly requiring issuers of municipal securities to file documents with them before the securities are sold. As we have stated numerous times, because of these restrictions, the disclosure regime for municipal securities is woefully inadequate, and the regulatory framework is insufficient for investors in today's complex marketplace. [2]

Legislative action regarding the Tower Amendment will be necessary to fully develop an adequate disclosure regime for municipal securities, including imposing certain disclosure requirements directly on municipal issuers. We would strongly support such action. We also recommend that Congress clarify the legal responsibilities of officials of municipal issuers for the disclosure documents that they authorize. In particular, Congress should spell out the responsibilities of underwriters with respect to municipal securities offer-

[2] See, *e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated September 22, 2008.

ing statements and the responsibilities of bond counsel and other participants in municipal offerings.

In the meantime, important steps can be taken to improve municipal securities disclosure without legislative action. In particular, ICI recommends that the SEC expand the list of information that is required to be disclosed under current SEC rules.[3] For example, the rule provision concerning notice of material events should be modified to more fully reflect the types of events that are material to today's investors. These events should include, among others, material litigation or regulatory action, pending or threatened, or failure to meet any financial covenants contained in the bond documents (especially the failure to make any monthly/quarterly payments due under the bond documents).

We also recommend changes to ensure that issuer financial information is provided to the public on a timely basis.[4] Specifically, the SEC should establish meaningful timeframes for the delivery of information required pursuant to the undertakings in an issuer's continuing disclosure agreement. For example, issuers should be required to file financial reports within 180 days of the end of the fiscal year, instead of the more common practice of 270 days after fiscal year end. Also, if audited financial statements are not available within the recommended timeframe, issuers should be required to issue unaudited financials in the interim, as appropriate, in accordance with guidelines established by the National Federation of Municipal Analysts. Timely reporting would enhance the usefulness of the information reported, including by alerting investors to those issuers that may be experiencing problems that could affect the credit quality or other characteristics of their securities.

Other Matters: In response to the question posed, ICI has no specific recommendations to offer regarding disclosure by publicly held banks or other financial institutions of off-balance sheet liabilities or other data. As a general matter, however, we would support additional transparency of off-balance sheet entities and activities. Such transparency should provide investment companies and other investors with important information about potential risk exposures faced by the companies in which they invest and should help avoid the market inefficiencies and other adverse consequences that the current lack of transparency has engendered.[5] We understand that the Financial Accounting Standards Board is working on revisions to two of its standards (FAS 140 and FIN 46) that are intended to address deficiencies in the accounting and disclosure of risks associated with off-balance sheet entities (*e.g.,* structured investment vehicles) that were revealed during the current financial

[3] ICI is not advocating a wholesale replication of the corporate disclosure framework for municipal securities. Instead, we are recommending a regulatory regime designed expressly for the needs of the municipal securities market.

[4] Rule 15c2-12 under the Securities Exchange Act of 1934 currently requires information about municipal securities issuers to be provided only annually. In contrast, corporate issuers are subject to quarterly reporting requirements. Moreover, the rule does not provide any outside deadline for the disclosure of financial information, thus leaving the timing completely to the discretion of the issuer. As a result, investors often receive financial information anywhere from three months to twelve months, or even longer, following the end of a fiscal year.

[5] See Written Testimony of Elizabeth F. Mooney, CFA, CPA, Accounting Analyst, Capital Group Companies, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, Hearing on "Transparency in Accounting: Proposed Changes in Accounting for Off-Balance Sheet Entities" (September 18, 2008).

crisis. We look forward to the implementation of these improvements.

ICI likewise has no formal position on whether publicly held banks, securities firms, and GSEs should be required to disclose their risk management policies and practices. We would caution, however, that "risk management" means different things to different people and can also have varying connotations depending on the context. General disclosure would be of little value, and specific disclosure could create opportunities for exploitation. Disclosure describing policies and practices also would not convey how effective (or ineffective) any particular set of policies and practices are likely to be. Such disclosure therefore might create a false sense of security about an entity's ability to cope with various risks. We do not intend to suggest that sound risk management policies and practices are not important; we merely question the usefulness of required public disclosure concerning such policies and practices.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. Conflicts of interest that are unknown or not properly managed can have a negative impact on financial markets and market participants. ICI agrees, therefore, that it is important to identify conflicts or potential conflicts and determine how they can best be addressed, including through regulation. The appropriate solution may vary depending on the nature and extent of the conflict as well as the context in which it arises. For example, sometimes disclosure can be an effective tool for addressing conflicts, by putting investors and the marketplace on notice and allowing them to evaluate the significance and impact of the conflict. In other circumstances, different measures may be called for, such as restricting or prohibiting conduct or transactions that present conflicts.

The laws governing investment advisers and investment companies have employed both of these approaches. Under the Investment Advisers Act of 1940, an investment adviser must disclose conflicts to clients, and often must seek their consent to proceed with a transaction notwithstanding a conflict. By contrast, the Investment Company Act of 1940 addresses potential conflicts of interest in the context of investment company (fund) operations by prohibiting certain transactions between a fund and fund insiders or affiliated organizations (such as the corporate parent of the fund's adviser). The Investment Company Act authorizes the Securities and Exchange Commission (SEC) to grant exemptions by rule or order to the extent such exemptions are consistent with the underlying objectives of the statute. Pursuant to this authority, the SEC has issued exemptive rules and orders containing conditions designed to ensure that the interests of fund investors are amply protected.

The restrictions on affiliated transactions under the Investment Company Act are widely viewed as a core investor protection and one that has served funds and their investors very well over nearly 70 years. Congress may wish to consider whether it would be appropriate and beneficial to apply similar restrictions to other financial market participants or activities, coupled with exemptive authority similar to that granted to the SEC. At the same time, as noted above, ICI recognizes that this approach does not fit every situation that involves conflicts of interest.[6]

While ICI does not have any specific legislative recommendations at this time regarding conflicts of interest that may affect the integrity of the markets or investor protection, we have commented extensively in the debate over possible regulatory actions to address conflicts of interest involving credit rating agencies—one of the issues mentioned in the question above.[7] We provide our comments on that topic below.

The SEC has recently increased the list of conflicts of interest that must be disclosed and managed by rating agencies or, alternatively, that are prohibited. ICI supported these amendments but we believe that more should be done in this area.[8] We recommend that the SEC require additional disclosures by rating agencies regarding their conflicts of interest including, for example, the number of other products rated by a rating agency for a particular issuer. In addition, the SEC recently adopted a requirement that rating agencies disclose information regarding the conflict of being paid by certain parties to rate structured finance products. The targeted conflict of interest, however, is not confined to the ratings of these instruments. The disclosure requirement therefore should be extended to ratings of municipal securities.

Public disclosure of conflict of interest information should improve transparency surrounding the information and processes used by rating agencies for rating products. It will provide users of ratings with a more complete picture of a rating agency's rating process and expose that process to greater scrutiny. This exposure, in turn, should promote the issuance of more accurate, high-quality ratings, and could prevent rating agencies from being unduly influenced to produce higher than warranted ratings. It should also assist investors and other market professionals in performing an independent assessment of these products. To achieve these goals, it is critical that the SEC's rules governing conflicts of interest be actively enforced and that rating agencies be held accountable for

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[6] Likewise, a disclosure and consent model would be impracticable in the context of a pooled investment vehicle if each investor in the pooled vehicle were required to provide consent.

[7] ICI believes that the SEC currently has authority under the Credit Rating Agency Reform Act of 2006 to implement the necessary regulatory reforms to address rating agency conflicts of interest.

[8] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated March 26, 2009.

any failures to comply with the rules and their policies and procedures adopted under the rules.

Moreover, to fully and properly address concerns about conflicts of interest, ICI believes the government should ensure that regulatory reforms for rating agencies are applied in a uniform and consistent manner equally to all types of credit rating agencies. Each type of rating agency business model—be it issuer-paid, subscriber-paid, or other [9]—poses concerns and harbors conflicts of interest. Indeed, it is not clear that one model poses fewer risks of conflicts or invariably produces higher quality ratings.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. As we stated in our testimony, we believe that a single independent Federal regulator should be responsible for oversight of U.S. capital markets, market participants, and all financial investment products. We envision this "Capital Markets Regulator" as a new regulator that would encompass the combined functions of the Securities and Exchange Commission (SEC) and those of the Commodity Futures Trading Commission that are not agriculture-related. The Capital Markets Regulator should have express authority to regulate derivatives, including credit default swaps (CDS), including clear authority to adopt measures to increase transparency and reduce counterparty risk, while not unduly stifling innovation. [10]

The current initiatives toward centralized clearing for CDS are a positive step in this regard. Central clearing of CDS should help reduce counterparty risk and bring transparency to trading in the types of CDS that can be standardized. We support these initiatives.

Not all CDS are sufficiently standardized to be centrally cleared, however, and institutional investors will continue to need to conduct over-the-counter transactions in CDS. Accordingly, we do not support efforts to require the mandatory clearing of all CDS. We do support, however, reasonable reporting requirements for these CDS transactions in order to allow the Capital Markets Regulator to have enough data on the CDS market to provide effective oversight.

Institutional market participants should also be required to make periodic public disclosure of their CDS positions. SEC registered investment companies currently make these types of periodic public disclosures. To the extent that registered funds buy or sell CDS, they provide extensive quarterly financial statement disclosures that typically include both textual note disclosure on the

[9] While the focus of the current debate has been on issuer-paid versus subscriber-paid models, we recognize that there may be other compensation models worthy of consideration that may better incentivize rating agencies to produce high quality ratings. For example, payment for public ratings could be linked to "quality provided" as determined by the end user—the investors. We believe these or other models should be subject to the same regulatory oversight as the more common issuer-paid and subscriber-paid models.

[10] To the extent that no Capital Markets Regulator is formed, we believe that the SEC is the regulator best suited to provide effective oversight of financial derivatives, including CDS.

nature and operation of CDS and tabular disclosure describing the terms of outstanding CDS at the report date. Textual note disclosures typically include: objectives, strategies, risks, cash flows, and credit events requiring performance. Tabular disclosures typically include: the reference entity, the counterparty, the pay/receive fixed rate, the expiration date, the notional amount, and the unrealized appreciation/depreciation (*i.e.,* the fair value of the position). The Financial Accounting Standards Board (FASB) has recently taken steps to improve disclosures by the sellers of credit derivatives.[11] We fully supported that effort, and will continue to support similar initiatives that we believe will improve marketplace transparency in derivatives.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include" Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. Investment companies (funds) are major shareholders in public companies and support strong governance and effective management of all companies whose shares they own. Funds typically are charged with seeking to maximize returns on behalf of fund investors, and they use a variety of methods to influence corporate conduct to this end. These methods include deciding whether to invest in a company, or to continue to hold shares; engaging directly with company management; and voting proxies for the shares they own.

Since 2004, funds—alone among all institutional investors—have been required to publicly disclose their proxy votes. As a result of this unique disclosure requirement, the manner in which fund firms vote proxies has been intensely scrutinized, and critics have sought to politicize fund portfolio management.

While critics have mischaracterized the data, the availability of fund voting records demonstrates how funds use the corporate franchise to promote the interests of their shareholders. ICI published a report last year on a study we conducted of more than 3.5 million votes cast by funds in the 12-month period ended June 30, 2007. Our report, Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders, made numerous important findings including, among others, that: (1) funds de-

[11] See FASB Staff Position No. 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161 (Sept. 12, 2008), available at *http://fasb.org/pdf/fsp_fas133-1&fin45-4.pdf*

vote substantial resources to proxy voting; (2) funds vote proxies in accordance with their board-approved guidelines; and (3) funds do not reflexively vote "with management," as some critics claim, but rather make nuanced judgments in determining how to vote on both management and shareholder proposals.[12]

ICI has recommended that Congress extend proxy vote disclosure requirements to other institutional investors, and we reiterate that recommendation here. Greater transparency around proxy voting by institutional investors should enhance the quality of the debate concerning how the corporate franchise is used.

We are not the only proponents for increased transparency about the proxy votes of other institutional investors. Senator Edward M. Kennedy (D-MA) commissioned a 2004 GAO study entitled "Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting," which concluded, among other things, that workers and retirees would benefit from increased transparency in proxy voting by pension plans. Similarly, in his testimony for the March 10, 2009, Senate Banking Committee hearing, former Securities and Exchange Commission Chief Accountant Lynn Turner expressed support for legislation to "require all institutional investors, including public, corporate and labor pension funds to disclose their votes, just as mutual funds currently are required to disclose their votes."[13] House Financial Services Committee Chairman Barney Frank (D-MA) also has expressed interest in considering this issue.[14] If disclosure of proxy votes promotes important public policy objectives, then similar requirements should apply to all institutional investors.

Below we provide our views on shareholder access to company proxy materials for director-related bylaw amendments and shareholder advisory votes on executive pay.

Proxy Access: In their dual role as major, long-term investors in securities of public companies and as issuers with their own shareholders and boards of directors, funds have a valuable perspective to offer on the topic of shareholder access to company proxy materials and the need to appropriately balance the interests of shareholders with those of company management. ICI generally supports affording certain shareholders direct access to a company's proxy materials for director-related bylaw amendments.[15] We agree that long-term shareholders with a significant stake in a company have a legitimate interest in having a voice in the company's corporate governance. We believe that the ability to submit bylaw amendments concerning director nomination procedures could be an effec-

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[12] The report is available at *http://www.ici.org/stats/res/per14-01.pdf*

[13] See Statement of Lynn E. Turner Before the Senate Committee on Banking, Housing, and Urban Affairs on Enhancing Investor Protection and the Regulation of the Securities Markets (March 10, 2009) at 13.

[14] See Siobhan Hughes, Rep. Frank Plans Hearing on Disclosure of Proxy Votes, Dow Jones News Service, March 22, 2007.

[15] ICI has presented its views on this matter in Congressional testimony and in a comment letter to the SEC. See Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the Committee on Financial Services, United States House of Representatives on "SEC Proxy Access Proposals: Implications for Investors" (September 27, 2007); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated October 2, 2007, available at *http://www.ici.org/statements/cmltr/07_sec_proxy_access_com.html#TopOfPage*

tive additional tool for use by funds and others to enhance shareholder value.

At the same time, the privilege of proxy access should not be granted lightly. The Federal securities laws should not facilitate efforts to use a company's proxy machinery—at company expense—to advance parochial or short-term interests not shared by the company's other shareholders. Instead, the regulatory scheme should be crafted to afford access to a company's proxy only when the interests of shareholder proponents are demonstrably aligned with those of long-term shareholders.

To achieve this objective, appropriate limits on the ability to use company resources to propose changes to a company's governing documents are critically important. In our view, these limits should include:

- Restricting the privilege of proxy access to shareholders who do not acquire or hold the securities for the purpose of changing or influencing control of the company. Shareholders seeking to change or influence control of the company should be required to follow the regulatory framework for proxy contests and bear the related costs.
- Requiring shareholder proponents to demonstrate that they are long-term stakeholders with a significant ownership interest. We recommend that there be a meaningful required holding period, such as two years, to provide assurance that shareholder proponents are committed to the long-term mission of the company, rather than seeking the opportunity for personal gain and quick profits or advancement of parochial interests at the expense of the company and other shareholders. Similarly, we support establishing a relative high minimum ownership threshold that would encourage shareholders to come together to effect change. We believe a five percent ownership threshold may not be sufficiently high to assure that the company's proxy machinery would be used to advance the common interests of many shareholders in addressing legitimate concerns about the management and operation of the company. Consideration should be given to varying the required ownership threshold based on factors such as the company's market capitalization. The Securities and Exchange Commission (SEC) should study share ownership and holding period information to arrive at well-reasoned criteria that will encourage would-be shareholder proponents to work together to achieve goals that benefit all shareholders.
- Excluding borrowed shares from the determination of ownership level and holding period. Beneficial ownership of shares should be required to assure that the proponents' interests truly are aligned with those of long-term shareholders.

Another important element of proxy access is disclosure. Shareholder proponents should be required to provide disclosure for inclusion in proxy materials that would allow a company's other shareholders to make informed voting decisions (*e.g.,* information about their background, intentions, and course of dealing with the company). SEC rules also should hold shareholder proponents—and not companies—responsible for the disclosure those shareholders provide.

SEC Chairman Mary Schapiro recently indicated that the SEC will soon consider a proposal "to ensure that a company's owners have a meaningful opportunity to nominate directors."[16] We look forward to reviewing and commenting on the SEC's proposal.

Say on Pay: As noted above, funds are significant holders of public companies. When deciding whether to invest in a company or to continue to hold its stock, funds consider many factors, including how the company compensates its top executives. This information is important because it allows funds to decide whether (1) there is an alignment of interests between the executives running the company and the shareholders who own the company and (2) executives have incentives to maximize value for shareholders. ICI has supported SEC efforts to ensure that investors receive clear and complete disclosure regarding executive pay packages.

The financial crisis has fanned the flames of public outrage over executive compensation, particularly where such compensation appears to be grossly excessive in light of a company's performance or where the compensation seems to promote the short-term interests of managers over the longer-term interests of shareholders. Funds are deeply mindful of these issues. ICI would not oppose requiring public companies to put the compensation packages of their key executive officers to a non-binding advisory vote of shareholders as an additional way to encourage sound decision-making by companies regarding the composition of executive pay packages.

We strongly urge, however, that any such requirement be coupled with requiring other institutional investors to disclose their proxy votes, as we recommend above. Otherwise, the votes of funds on executive compensation, but not those of any other institutional investor, would be subject to scrutiny and, often we feel, unfair second-guessing. Moreover, the potential benefits of greater transparency of the proxy voting process would seem to be particularly evident here, where the public disclosure of executive compensation votes would maximize their influence over management.

Q.5. *Credit Rating Agencies:* A. Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies. In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness

[16] See SEC Speech: Address to the Council of Institutional Investors, by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission (May 6, 2009), available at *http://www.sec.gov/news/speech/2009/spch040609mls.htm*

when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. *Measures To Improve the Oversight of Rating Agencies:* ICI is committed to the objective of improving the rating process to make ratings more accurate and useful to investors and to promote the sound functioning of our capital markets.[17] We recommend several regulatory measures to enhance the oversight of credit rating agencies and thereby improve the quality, accuracy, and integrity of ratings and the rating process.[18] Generally speaking, our recommendations would enhance disclosure, address conflicts of interest, and hold rating agencies accountable for their ratings.[19]

Specifically, we recommend that the Securities and Exchange Commission (SEC) improve disclosure about credit ratings and the rating process for structured finance securities and other debt securities. Public disclosure of information about a credit rating agency's policies, procedures, and other practices relating to rating decisions will allow investors to evaluate more effectively a rating agency's independence, objectivity, capability, and operations. Disclosure will serve as a powerful additional mechanism for ensuring the integrity and quality of the credit ratings themselves. To realize the full potential of such a disclosure regime, the SEC should require the standardized presentation of this information in a presale report issued by the rating agencies.

The SEC also should take steps to strengthen the incentives to produce quality ratings, because such incentives are clearly insufficient in the current system. To this end, the SEC should require rating agencies to conduct "due diligence" assessments of the information they review to issue ratings. This should help build investor confidence in ratings and the rating process over time, by enabling users of ratings to gauge both the accuracy of the information being analyzed by the rating agency and the rating agency's ability to assess the creditworthiness of the underlying security. We also recommend that rating agencies have greater legal accountability to investors for their ratings. Both of these recommendations should encourage rating agencies to improve the quality of their ratings.

Today's rating system is hampered by deep concerns about conflicts of interest, poor disclosure, and lack of accountability. To address these concerns effectively, the SEC should apply necessary regulatory reforms in a consistent manner to all types of credit rating agencies. A consistent approach is not only critical to improving ratings quality and allowing investors to identify and assess poten-

[17] ICI recently participated in the SEC's Roundtable on the oversight of credit rating agencies in an effort to further the discussion on ways in which to improve ratings and the ratings process. See Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009, available at *http://www.ici.org/home/09_oversight_stevens_stmt.html#TopOfPage.* See also Statements of Paul Schott Stevens, President, Investment Company Institute, on the "Credit Rating Agency Duopoly Relief Act of 2005," before the Committee on Financial Services, U.S. House of Representatives (November 29, 2005) and on "Assessing the Current Oversight and Operation of Credit Rating Agencies," before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (March 7, 2006).

[18] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated March 26, 2009.

[19] We believe the SEC currently has authority to implement many of our recommendations. Others (such as certain changes to improve municipal securities disclosure, discussed below) would require Congressional action.

tial conflicts of interest, but also to increasing competition among rating agencies. The SEC must also employ a consistent and active approach to enforcement of the oversight regime, holding rating agencies accountable for any failures to comply with the SEC's rules and the rating agency's own policies and procedures adopted under the rules. Finally, we recommend that the SEC address the need for better disclosure by certain issuers (*e.g.,* expand issuer disclosure for structured finance products, expand and standardize issuer disclosure for asset-backed securities, and require that disclosure for asset-backed securities be ongoing). In addition, we recommend that the SEC improve issuer disclosure for municipal securities.[20] Better disclosure will assist investors in making their own risk assessments and should foster better quality ratings.

Controlling Conflicts of Interest—Limiting or Prohibiting Consulting Activities: Addressing conflicts of interest at rating agencies is particularly important given the role that ratings play in today's capital markets. For this reason, ICI has recommended that the SEC require rating agencies to disclose information, including: (1) any material ancillary business relationships between a rating agency and an issuer and (2) information regarding the separation of a rating agency's consulting and rating activities.[21] If such information is available, we believe that it is unnecessary to prohibit rating agencies from performing any consulting activities for the firms they rate. The SEC already has prohibited rating agencies from rating a product in which the rating agency has been consulted on the structure of the product. We believe that this measure, in combination with the disclosure we have recommended, should curtail opportunities for questionable conduct. In addition, it should put investors on notice regarding potential conflicts of interest arising from a rating agency's consulting business and provide investors with the information needed to assess the ability and effectiveness of a rating agency to manage those conflicts of interest.

Enhancing Accountability, Due Diligence, and Legal Liability of Rating Agencies: Given the role of ratings in the investment process and the use of ratings by investors, ICI agrees with the recommendation in the G30 Report and by Professor Coffee: credit rating agencies should have greater legal accountability for their ratings. Currently, investors do not have sufficient legal recourse against rating agencies if, for example, a rating agency issues an erroneous rating.

We believe that the exemption for nationally recognized statistical rating organizations (NRSROs) from Section 11 of the Securities Act of 1933 should be reconsidered.[22] Under current regulations, the SEC exempts NRSROs, but not other rating agencies, from treatment as experts subject to liability under Section 11 and, thus, allows NRSRO ratings in prospectuses and financial reports.

[20] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated September 22, 2008.

[21] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008.

[22] Section 11 under the Securities Act creates liability for issuers and certain professionals who prepared or certified any part of a registration statement for any materially false statements or omissions in the registration statement.

Although the SEC has stated that NRSROs remain subject to antifraud rules, the NRSROs have steadfastly maintained that, under the First Amendment, they cannot be held liable for erroneous ratings absent a finding of malice.

While it may be argued that rating agencies should not be liable for an erroneous rating as such, they should, at a minimum, have some accountability for ratings issued in contravention of their own disclosed procedures and standards. As we have stated in the past, even if the First Amendment applies to credit ratings, it should not immunize rating agencies for false or misleading disclosures to the SEC and to the investing public. Quite simply, if a rating agency obtains an NRSRO designation based on, for example, a specific ratings process, it should be held accountable to the SEC and to investors if it fails to follow that process.

A rating agency's ability to continue to claim First Amendment rights also has been questioned based on the business decisions and the roles undertaken by rating agencies over the last decade. Rating agencies have abandoned their former practice of rating most or all securities whether or not hired to do so, and rating agencies have become deeply involved in the structuring of complex securities, which are normally not sold to retail investors. These changes warrant serious attention when considering whether rating agencies still merit the protection that the First Amendment may have provided to them in their more traditional role.[23]

In addition to increasing legal accountability for rating agencies, we believe that rating agencies would have greater ability to produce high quality and more reliable ratings if they were required to conduct better due diligence and verification. Under current SEC rules, it is difficult for a user of a rating to gauge the accuracy of the information being analyzed by the rating agency and, thus, evaluate the rating agency's ability to assess the creditworthiness of a structured finance product.[24] Rating agencies are required neither to verify the information underlying a structured finance product received from an issuer nor to compel issuers to perform due diligence or to obtain reports concerning the level of due diligence performed by issuers of structured finance products.

To address these concerns, we recommend that credit rating agencies be required to conduct due diligence on the information they review to issue ratings. In addition, to raise investor confidence in the quality of ratings and the rating process as a whole, the due diligence requirements should apply (as appropriate) to all rated debt securities, not only structured finance products. Specifically, we recommend that:

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[23] Rating agencies have cited the First Amendment in statements to Congress, the courts, and the investing public, stating that their ratings are opinions only—not "recommendations or commentary on the suitability of a particular investment." See, *e.g.,* Statement of Deven Sharma, President, Standard & Poor's, on "Credit Rating Agencies and the Financial Crisis," before the Committee on Oversight and Government Reform, U.S. House of Representatives (October 22, 2008). See also Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield Rating Agencies From Liability for Over-Rating CDOs, David J. Grais and Kostas D. Katsiris, Grais & Ellsworth, Bloomberg Law Reports (November 2007).

[24] Current rules only require that rating agencies provide a description of: (1) the public and nonpublic sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; (2) whether and how information about verification performed on assets underlying structured finance securities is relied upon in determining credit ratings; and (3) whether and how assessments of the quality of originators of structured finance securities factor into the determination of credit ratings.

- Rating agencies be required to have policies and procedures in place reasonably sufficient to assess the credibility of the information they receive from issuers and underwriters.
- Rating agencies disclose these policies and procedures, the specific steps taken to verify information about the assets underlying a security, and the results of the verification process.
- Rating agencies disclose the limitations of the available information or data, any actions they take to compensate for any missing information or data, and any risks involved with the assumptions and methodologies they use in providing a rating.
- Rating agencies be required to certify that the rating agency has satisfied its stated policies and procedures for performing due diligence on the security being rated.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. *Systemic Risk Regulation:* Over the past year, various policymakers and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks to the financial system as a whole. ICI concurs with those commentators and with the Managed Funds Association (MFA) that creation of such a mechanism is necessary. The ongoing financial crisis has highlighted the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. A mechanism that will allow Federal regulators to look across the system should equip them to better anticipate and address such risks.

Generally speaking, MFA's statement about a "single central systemic risk regulator" touches on some of the same themes that ICI addressed in its March 3, 2009, white paper, *Financial Services Regulatory Reform: Discussion and Recommendations.*[25] In our white paper, we endorsed the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." Broadly stated, the goal in establishing a Systemic Risk Regulator should be to provide greater overall stability to the financial system as a whole. The Systemic Risk Regulator should have responsibility for:

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[25] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

(1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators.

In ICI's view, Congress should determine the composition and authority of the Systemic Risk Regulator with two important cautions in mind. First, the legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies. By way of example, it has been suggested that a Systemic Risk Regulator could be given the authority to identify financial institutions that are "systemically significant" and to oversee those institutions directly. Such an approach could have very serious anticompetitive effects if the identified institutions were viewed as "too big to fail" and thus judged by the marketplace as safer bets than their smaller, "less significant" competitors.[26]

Second, the Systemic Risk Regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance. We strongly concur with MFA that the Systemic Risk Regulator should focus principally on protecting the financial system—as discussed in detail in our white paper, we believe that a strong and independent Capital Markets Regulator (or, until such agency is established by Congress, the Securities and Exchange Commission) should focus principally on the equally important mandates of protecting investors and maintaining market integrity. Legislation establishing the Systemic Risk Regulator should define the nature of the relationship between this new regulator and the primary regulator(s) for each industry sector. This should involve carefully defining the extent of the authority granted to the Systemic Risk Regulator, as well as identifying circumstances under which the Systemic Risk Regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators have a critical role to play by acting as the first line of defense with regard to detecting potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI believes that the Systemic Risk Regulator would be best structured as a statutory council comprised of senior Federal regulators. Membership should include, at a minimum, the Secretary of the Treasury, Chairman of the Federal Reserve Board of Governors, and the heads of the Federal bank and capital markets regulators (and insurance regulator, if one emerges at the Federal level).

Regulation of the Hedge Fund Industry—Appropriate Focus of Regulatory Oversight: In 2004, the Securities and Exchange Commission (SEC) adopted a rule to require hedge fund advisers to register with the SEC as investment advisers. ICI supported this registration requirement as a way to provide the SEC with reliable,

[26] See, *e.g.,* Peter J. Wallison, Regulation Without Reason: The Group of Thirty Report, AEI Financial Services Outlook (Jan. 2009), available at *http://www.aei.org/publications/pubID.29285/pub_detail.asp*

current, and meaningful information about this significant segment of the capital markets without adversely impacting the legitimate operations of hedge fund advisers. Many ICI member firms—all of whom are registered with the SEC—currently operate hedge funds and have found that registration is not overly burdensome and does not interfere with their investment activities.

In June 2006, the SEC's hedge fund adviser registration rule was struck down by the U.S. Court of Appeals for the D.C. Circuit. The following month, in testimony before this Committee, then SEC Chairman Christopher Cox commented that the rule's invalidation had forced the SEC "back to the drawing board to devise a workable means of acquiring even basic census data that would be necessary to monitor hedge fund activity in a way that could mitigate systemic risk." [27]

In our white paper, we call for this regulatory gap to be closed. Specifically, ICI recommends that the Capital Markets Regulator (or SEC) have express regulatory authority to provide oversight over hedge funds (through their advisers) with respect to, at a minimum, their potential impact on the capital markets. [28] For example, similar to MFA's recommendation, we state that the regulator could require nonpublic reporting of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants.

We continue to believe that hedge fund adviser registration is an appropriate response to address the risks that hedge funds can pose to the capital markets and other market participants. In this regard, the Capital Markets Regulator (or SEC) may wish to consider the adoption of specific rules under the Investment Advisers Act of 1940 that are tailored to the specific business practices of, and market risks posed by, hedge funds. Areas of focus for such rulemaking should include, for example, disclosure regarding valuation practices and the calculation of investment performance; both of these areas have been criticized as lacking transparency and presenting the potential for abuse.

ICI does not support, however, requiring the registration of individual hedge funds with the SEC. Rather, as discussed in detail below, ICI believes there must continue to be a strict dividing line between registered, highly regulated investment companies and unregistered, lightly regulated hedge funds. A registration requirement for hedge funds would blur this line, invariably causing confusion for both investors and the marketplace. This confusion would likely exacerbate already imprecise uses of the term "fund" to refer to investment pools, whether registered or not. Further, we believe it is imperative to keep any problems in the hedge fund area from bleeding over in the public's mind to include mutual funds, which are owned by almost half of all U.S. households.

Maintaining the distinctions between investment companies and hedge funds—Compared to registered investment companies, which are subject to the comprehensive and rigorous regulatory regime

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[27] See Written Testimony of SEC Chairman Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 25, 2006) (concerning the regulation of hedge funds), available at *http://www.sec.gov/news/testimony/2006/ts072506cc.htm*

[28] It is imperative, of course, that the Capital Markets Regulator (or SEC) be organized and staffed, and have sufficient resources, to effectively perform this oversight function.

set forth in the Investment Company Act of 1940 and related rules, hedge funds are lightly regulated investment products. Hedge funds are effectively outside the purview of the Investment Company Act by reason of Sections 3(c)(1) and 3(c)(7), which require that the hedge fund is not making or proposing to make a public offer of its securities and that those securities be sold only to certain specific groups of investors. These provisions thus place express statutory limits on both the offer and the sale of securities issued by a hedge fund. ICI firmly believes that these limits must be preserved and should be reconfirmed in any legislation enacted to regulate hedge funds or their advisers.

No general solicitation or public advertising by hedge funds—Despite clear statutory language precluding a hedge fund from "making or proposing to make a public offer of its securities," there have been several occasions in the recent past where the hedge fund industry has argued that it should be able to advertise through the public media, while remaining free from the regulatory restrictions and shareholder protections imposed by the Investment Company Act. Additionally, in 2003, the SEC staff recommended that the SEC consider eliminating the prohibition on general solicitation in offerings by certain hedge funds. ICI emphatically opposes any such efforts, because allowing hedge funds organized pursuant to Sections 3(c)(1) and 3(c)(7) to engage in any form of general solicitation or public advertising is fundamentally inconsistent with hedge funds' exclusion from regulation under the Investment Company Act.

Section 3(c)(7) was added to the Investment Company Act in 1996, in apparent recognition that the full panoply of investment company regulation is not necessary for hedge funds (and other private investment pools) offered and sold only to financially sophisticated investors able to bear the risk of loss associated with their investment. The "no public offering" language used by Congress in Section 3(c)(7) generally tracks the language in Section 4(2) of the Securities Act of 1933. For almost five decades, the SEC has taken the position that public advertising is inconsistent with a nonpublic offering of securities under Section 4(2).[29]

In its rulemaking to implement Section 3(c)(7) and related provisions, the SEC observed that "while the legislative history . . . does not explicitly discuss Section 3(c)(7)'s limitation on public offerings by Section 3(c)(7) funds, the limitation appears to reflect Congress's concerns that unsophisticated individuals not be inadvertently drawn into [such] funds."[30] A member of Congress intimately involved in this debate later concurred with the SEC's interpretation in a letter to then SEC Chairman Arthur Levitt. His letter further explained:

> In 1996, as part of the National Securities Markets Improvement Act, Congress reaffirmed that hedge funds should not be publicly marketed, specifically adding

[29] See Non-Public Offering Exemption, SEC Rel. No. 33-4552 (Nov. 6, 1962) at text preceding n.2, text preceding n.3 ("Consideration must be given not only to the identity of the actual purchasers but also to the offerees. Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers . . . . Public advertising of the offerings would, of course, be incompatible with a claim of a private offering.").

[30] See Privately Offered Investment Companies, SEC Rel. No. IC-22597 (April 3, 1997), at n.5.

> this restriction to a modernized hedge fund exemption that was included in the final bill. As you will recall, I was one of the authors of this provision . . . I believe that the Congress has appropriately drawn the lines regarding hedge fund marketing, and intend to strongly oppose any effort to liberalize them.[31]

Any form of general solicitation or public advertising of unregistered hedge funds would surely cause investors to confuse such funds with registered, highly regulated investment companies. It also would present greater opportunities for perpetrators of securities fraud to identify and target unsophisticated investors. This potential for investor confusion and fraudulent activity would be compounded by the fact that the SEC simply would not have the resources to monitor advertisements by hedge funds—whether legitimate or fraudulent—in any meaningful way.

For all of these reasons, ICI firmly believes that there must continue to be a strict prohibition on any form of general solicitation or public advertising in connection with hedge fund offerings.

Limitations on who may invest in hedge funds—No less critical is the need to ensure that interests in hedge funds are sold only to financially sophisticated investors able to bear the economic risk of their investment. To this end, ICI believes that the accredited investor standards in Regulation D under the Securities Act of 1933 (which determine investor eligibility to participate in unregistered securities offerings by hedge funds and other issuers) should be immediately adjusted to correct for the substantial erosion in those standards since their adoption in 1982. This one-time adjustment should be coupled with periodic future adjustments to keep pace with inflation. Specifically, ICI has recommended that the SEC's Office of Economic Analysis be required to reset the accredited investor thresholds every 5 years, so that the percentage of the population qualifying as accredited investors would remain stable over time. This would entail a straightforward economic analysis that could be performed using widely available government databases.[32]

Also in this regard, ICI continues to support the SEC's 2006 proposal to raise the eligibility threshold for individuals wishing to invest in hedge funds (and other private investment pools) organized under Section 3(c)(1) of the Investment Company Act. Specifically, an individual would need to be an "accredited investor" based upon specified net worth or income levels, as is now required, and own at least $2.5 million in investments. According to the SEC, this new two-step approach would mirror the existing eligibility requirements that Congress determined were appropriate for investors in hedge funds organized under Section 3(c)(7).

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

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[31] See Letter from Rep. Edward J. Markey (D-Mass.) to SEC Chairman Arthur Levitt, dated Dec. 18, 2000.

[32] For a detailed discussion of the Institute's views on these issues, see Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated Oct. 9, 2007, available at *http://www.sec.gov/comments/s7-18-07/s71807-37.pdf*

A.7. Self-regulatory organizations (SROs) form an integral part of the current system of securities markets oversight. ICI has had a longstanding interest in the effective and efficient operation of SROs, and we support an examination of their role and operations. We believe there may be several ways to improve SROs' performance and operations, particularly through enhancements to their rules and rulemaking processes, and their governance structure.

SRO rules should be crafted both to protect investors and to promote efficiency, competition and capital formation. To achieve these objectives, it is critically important that SROs consider the relative costs and benefits of their rules. We have recommended on several occasions that Congress by law, or the SEC by rule, require that all SROs evaluate the costs and benefits of their rule proposals prior to submission to the SEC and establish a process for reexamining certain existing rules. [33] This process should be designed to determine whether the rules are working as intended, whether there are satisfactory alternatives of a less burdensome nature, and whether changes should be made.

The SRO rulemaking process itself serves important policy goals, including, among other things, assuring that interested persons have an opportunity to provide input regarding SRO actions that could have a significant effect on the market and market participants. ICI has supported amendments that would improve the ability of interested persons to submit comments on SRO actions. In particular, we have recommended extending the length of the comment period for any significant SRO proposal. [34]

Finally, ICI supports efforts to strengthen SRO governance processes. [35] For example, to ensure that the views of investors are adequately represented, we have recommended that SROs be required to have sufficient representation from funds and other institutional investors in their governance structures. In addition, to address concerns that SROs are inherently subject to conflicts of interest, consideration should be given to requiring SRO boards to have an appropriate balance between public members and members with industry expertise. [36]

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;

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[33] See Statement of the Investment Company Institute on the Review of the U.S. Financial Markets and Global Markets Competitiveness, Submitted to the Senate Republican Capital Markets Task Force, U.S. Senate (February 25, 2008) and Submission of the Investment Company Institute to the Department of the Treasury, Review of the Regulatory Structure Associated with Financial Institutions (December 7, 2007).

[34] See Letters from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated April 6, 2001, and Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated June 4, 2004.

[35] See, *e.g.,* Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated March 8, 2005.

[36] See Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?, Speech by SEC Commissioner Elisse B. Walter Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 5, 2009), available at *http://www.sec.gov/news/speech/2009/spch050509ebw.htm*

2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. Investment companies (funds) are both major holders of securities issued by public companies and issuers of securities (fund shares) held by almost half of all U.S. households. As such, they have a vested interest in the effective regulation of the capital markets by a strong and independent regulator. Funds and their shareholders stand to benefit if that regulator has the tools it needs to fulfill important policy objectives, such as: preserving the integrity of the capital markets; ensuring the adequacy and accuracy of periodic disclosures by public issuers; and promoting fund regulation that protects investors, encourages innovation, and does not hinder market competition.

As discussed in its March 3, 2009, white paper, *Financial Services Regulatory Reform: Discussion and Recommendations,*[37] ICI supports the creation of a new Capital Markets Regulator that would encompass the combined functions of the Securities and Exchange Commission (SEC) and those of the Commodity Futures Trading Commission (CFTC) that are not agriculture-related. In our response below to part A of the question, we briefly discuss this recommendation and our suggestions relating to the Capital Markets Regulator's responsibilities and structure. Pending, or in the absence of, Congressional action to create a Capital Markets Regulator, most of our recommendations just as appropriately could be applied to the SEC. Where appropriate for ease of discussion, we use the term "agency" to refer equally to the SEC or a new Capital Markets Regulator.

We then address the issues outlined in part B of the question in the context of a discussion about how the SEC or a new Capital Markets Regulator should fit within the broader financial services regulatory framework.

Reforming the Responsibilities and Structure of the SEC: To bring a consistent policy focus to U.S. capital markets, ICI strongly recommends the creation of a new Capital Markets Regulator. Currently, securities and futures are subject to separate regulatory regimes under different Federal regulators. This system reflects historical circumstances that have changed significantly. As recently as the mid-1970s, for example, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. In addition, as new, innovative financial instruments were developed, the lines between securities and futures often became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes between the SEC and the CFTC, regulatory inefficiency, and gaps in investor protection and market oversight. With the increasing conver-

[37] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

gence of securities and futures products, markets, and market participants, the current system simply makes no sense.

As envisioned by ICI, the Capital Markets Regulator would be a single, independent Federal regulator responsible for oversight of U.S. capital markets, market participants, and all financial investment products. It would have an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission. [38] From the perspective of the fund industry, the mission of the Capital Markets Regulator must involve maintaining a sharp focus on investor protection, supported by a comprehensive enforcement program. This core feature of the SEC's mission has consistently distinguished the SEC from the banking regulators, who are principally concerned with the safety and soundness of the financial institutions they regulate, and it has generally served investors well over the years.

Examination of the recent financial crisis has prompted calls for Congress to close regulatory gaps to ensure appropriate oversight of all market participants and investment products. In our white paper, we recommend that the Capital Markets Regulator (or SEC) have express regulatory authority to provide oversight with regard to hedge funds, derivatives, and municipal securities. We further recommend that the agency be given explicit authority to harmonize the legal standards applicable to investment advisers and broker-dealers.

How a regulatory agency is managed, and the details of its organizational structure, can have significant implications for the agency's effectiveness. In our white paper, we offer the following suggestions with regard to management and organization of the Capital Markets Regulator (or SEC).

- Ensure high-level focus on agency management. One approach would be to designate a Chief Operating Officer for this purpose.
- Implement a comprehensive process for setting regulatory priorities and assessing progress. It may be helpful to draw upon the experience of the United Kingdom's Financial Services Authority, which seeks to follow a methodical approach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.
- Promote open and effective lines of communication among the Commissioners and between the Commissioners and staff. Such communication is critical to fostering awareness of issues and problems as they arise, thus increasing the likelihood that the agency will be able to act promptly and effectively. A range of approaches may be appropriate to consider in meeting this goal, including whether sufficient flexibility is provided under the Government in the Sunshine Act, and whether the number of Commissioners should be greater than the current number at the SEC (five).

[38] Currently, regulatory oversight of both the securities and futures industries involves various self-regulatory organizations. In establishing a Capital Markets Regulator, Congress would need to determine the appropriate role for any such organization(s).

- Align the inspections and examinations functions and the policymaking divisions. This approach would have the benefit of keeping staff in the policymaking divisions updated on current market and industry developments, as well as precluding any *de facto* rulemaking by the agency's inspections staff.
- Develop mechanisms to facilitate coordination and information sharing among the policymaking divisions. These mechanisms would help to ensure that the agency speaks with one voice.

How the SEC (or a New Capital Markets Regulator) Fits Within the Broader Financial Services Regulatory Framework: Today's financial crisis has demonstrated that the current system for oversight of U.S. financial institutions is insufficient to address modern financial markets. In its white paper, ICI recommends changes to create a regulatory framework that enhances regulatory efficiency, limits duplication, closes regulatory gaps, and emphasizes the national character of the financial services industry. In brief, ICI supports:

- Creating a consolidated Capital Markets Regulator, as discussed above;
- Establishing a "Systemic Risk Regulator" that would identify, monitor and manage risks to the financial system as a whole;
- Considering consolidation of the regulatory structure for the banking sector;
- Authorizing an optional Federal charter for insurance companies; and
- Promoting effective coordination and information sharing among the various financial regulators, including in particular the new Systemic Risk Regulator.

Increased consolidation of financial services regulators, combined with the establishment of a Systemic Risk Regulator and more robust inter-agency coordination and information sharing, should facilitate monitoring and mitigation of risks across the financial system. We believe that consolidation of regulatory agencies also may further the competitive posture of the U.S. financial markets and could make it easier, when appropriate, to harmonize U.S. regulations with regulations in other jurisdictions. Reducing the number of U.S. regulatory agencies, while also strengthening the culture of cooperation and dialogue among senior officials of the agencies, will likely facilitate coordinated interaction with regulators around the world.

By providing for one or more dedicated regulators to oversee each major financial services sector, this proposed structure would maintain the specialized focus and expertise that is a hallmark of effective regulation. This structure also would allow appropriate tailoring of regulation to accommodate fundamental differences in regulated entities, products and activities. Additionally, it would avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or approaches or the allocation of regulatory resources.

In particular, the regulatory structure favored by ICI would preserve the important distinctions between the mission of the Capital Markets Regulator (or SEC), which is sharply focused on investor protection, and that of the banking regulators, which is principally concerned with the safety and soundness of the banking system. Both regulatory approaches have a critical role to play in ensuring a successful and vibrant financial system, but neither should be allowed to trump the other. For this reason, we believe it would be inappropriate to combine the SEC into a larger "prudential" financial services regulator, a move that could result in diminished investor protections.

Preserving regulatory balance, and bringing to bear different perspectives, is a theme that has influenced ICI's thinking on how to structure a Systemic Risk Regulator. In our white paper, we suggested that very careful consideration must be given to the specifics of how a Systemic Risk Regulator would be authorized to perform its functions. We offered two important cautions in that regard. First, we recommended that the legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies. Second, we recommended that the Systemic Risk Regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking, or insurance.

Legislation establishing the Systemic Risk Regulator thus should define the nature of the relationship between this new regulator and the primary regulator(s) for each industry sector. This should involve carefully defining the extent of the authority granted to the Systemic Risk Regulator, as well as identifying circumstances under which the Systemic Risk Regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators have a critical role to play by acting as the first line of defense with regard to detecting potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI believes that the Systemic Risk Regulator would be best structured as a statutory council comprised of senior Federal regulators. Membership should include, at a minimum, the Secretary of the Treasury, Chairman of the Federal Reserve Board of Governors, and the heads of the Federal bank and capital markets regulators (and insurance regulator, if one emerges at the Federal level).

Finally, we note that the question requests comment on whether some of the SEC's duties should be given to a financial services consumer protection agency. As a general matter, we observe that Federal regulators must improve their ability to keep up with new market developments. This will require both nimbleness at the regulatory level and Congressional willingness to close regulatory gaps, provide new authority where appropriate, and even provide additional resources. ICI does not believe, however, that it would be helpful to create a new "financial products safety commission" or "financial services consumer protection agency." Financial products and services arise and exist in the context of a larger marketplace, and they need to be understood in that context. The primary regulator is best positioned to perform this function.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. Investment companies (funds) are both major holders of securities issued by public companies and issuers of securities (fund shares) that are held by almost half of all U.S. households. As such, they have a vested interest in effective regulation of the capital markets by a strong and independent regulator. Funds, and therefore their shareholders, stand to benefit if that regulator has the tools it needs to fulfill important policy objectives, such as: preserving the integrity of the capital markets; ensuring the adequacy and accuracy of periodic disclosures by public issuers; and promoting fund regulation that protects our investors, encourages innovation, and does not hinder market competition.

As discussed in our March 3, 2009, white paper, *Financial Services Regulatory Reform: Discussion and Recommendations,*[39] ICI supports the creation of a new Capital Markets Regulator that would encompass the combined functions of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The white paper makes a series of recommendations—including several concerning the staffing, funding, and management of the Capital Markets Regulator—aimed at maximizing this regulator's ability to perform its mission effectively. Pending, or in the absence of, Congressional action to create a Capital Markets Regulator, most of our recommendations just as appropriately could be applied to the SEC. An outline of those recommendations is included in the response below. Where appropriate for ease of discussion, we use the term "agency" to refer equally to the SEC or a new Capital Markets Regulator.

Agency Funding, and Staffing: ICI consistently has called for adequate funding for the SEC in order to support its critical regulatory functions. We note that, in testimony before the House Financial Services Committee in March of this year, SEC Commissioner Elisse Walter stated that the SEC's examination and enforcement resources are inadequate to keep pace with the growth and innovation in the securities markets.[40] We believe that Congress must seriously consider any suggestion from senior SEC officials that additional resources are required. We were pleased, therefore, to hear about the recent bipartisan effort, led by Sen-

[39] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

[40] See Testimony of Elisse B. Walter, Commissioner, U.S. Securities and Exchange Commission, Before the House Committee on Financial Services, Concerning Securities Law Enforcement in the Current Financial Crisis (March 20, 2009) at 30-31.

ators Charles Schumer (D-NY) and Richard Shelby (R-AL) and endorsed by SEC Chairman Mary Schapiro, to increase the SEC's budget by $20 million for fiscal years 2010 and 2011 in order to add enforcement staff and fund needed technology upgrades.

ICI believes that the agency also must have greater ability (and resources) to attract and retain professional staff having significant prior industry experience. Their practical perspectives would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy. The SEC's announcement of a new Industry and Market Fellows Program is an encouraging step in the right direction.[41] As discussed further below, the agency also should build strong economic research and analytical capabilities and should consider having economists resident in each division.

Examination of the recent financial crisis has prompted calls for Congress to close regulatory gaps to ensure appropriate oversight of all market participants and investment products. In our white paper, we recommend that the Capital Markets Regulator (or SEC) have express regulatory authority to provide oversight with regard to hedge funds, derivatives, and municipal securities. To the extent that the scope of the agency's responsibilities is expanded, it will be imperative that it have sufficient staffing and resources to effectively perform all of its oversight functions.

Agency Management and Organization: How a regulatory agency is managed, and the details of its organizational structure, can have significant implications for the agency's effectiveness. In our white paper, we offer the following suggestions with regard to agency management and organization.

- Ensure high-level focus on agency management. One approach would be to designate a Chief Operating Officer for this purpose.
- Implement a comprehensive process for setting regulatory priorities and assessing progress. It may be helpful to draw upon the experience of the United Kingdom's Financial Services Authority, which seeks to follow a methodical approach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.
- Promote open and effective lines of communication among the Commissioners and between the Commissioners and staff. Such communication is critical to fostering awareness of issues and problems as they arise, thus increasing the likelihood that the agency will be able to act promptly and effectively. A range of approaches may be appropriate to consider in meeting this goal, including whether sufficient flexibility is provided under the Government in the Sunshine Act, and whether the number of Commissioners should be greater than the current number at the SEC (five).
- Align the inspections and examinations functions and the policymaking divisions. This approach would have the benefit of

[41] See SEC Announces New Initiative to Identify and Assess Risks in Financial Markets (April 30, 2009), available at *http://www.sec.gov/news/press/2009/2009-98.htm*

keeping staff in the policymaking divisions updated on current market and industry developments, as well as precluding any *de facto* rulemaking by the agency's inspections staff.

- Develop mechanisms to facilitate coordination and information sharing among the policymaking divisions. These mechanisms would help to ensure that the agency speaks with one voice.

Improving Agency Effectiveness: Our white paper recommends the following additional ways to enhance the agency's ability to fulfill its mission successfully when carrying out its regulatory responsibilities:

1. *Establish the conditions necessary for constructive, ongoing dialogue with the regulated industry:* The agency should seek to facilitate closer, cooperative interaction with the entities it regulates to identify and resolve problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions. The net result is that the agency would pursue its investor protection responsibilities through various means not always involving enforcement measures, although strong enforcement must remain an important weapon in the agency's arsenal.
2. *Establish mechanisms to stay abreast of market and industry developments:* The agency would benefit from the establishment of one or more external mechanisms designed to help it stay abreast of market and industry issues and developments, including developments and practices in non-U.S. jurisdictions as appropriate. For example, several Federal agencies—including both the SEC and CFTC—utilize a range of advisory committees. Such committees, which generally have significant private sector representation, may be established to provide recommendations on a discrete set of issues facing the agency (*e.g.,* the SEC's Advisory Committee on Improvements to Financial Reporting) or to provide regular information and guidance to the agency (*e.g.,* the CFTC's Agricultural Advisory Committee).

   ICI believes that a multidisciplinary "Capital Markets Advisory Committee" could be a very effective mechanism for providing the agency with "real world" perspectives and insights on an ongoing basis. We recommend that such a committee be comprised primarily of private sector representatives from all major sectors of the capital markets, and include one or more members representing funds and asset managers. Additionally, the Capital Markets Advisory Committee should be specifically established in, and required by, legislation. Such a statutory mandate would emphasize the importance of this advisory committee to the agency's successful fulfillment of its mission.

   The establishment of an advisory committee would complement other efforts by the agency to monitor developments affecting the capital markets and market participants. These efforts should include, first and foremost, hiring more staff members with significant prior industry experience. As indicated above, their practical perspectives would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy.

3. *Apply reasonably comparable regulation to like products and services:* Different investment products often are subject to different regulatory requirements, often with good reason. At times, however, heavier regulatory burdens have been placed on some investment products or services than on others, even where they share similar features and are sold to the same customer base. It does not serve investors well if the regulatory requirements placed on funds—which serve over 93 million investors—end up discouraging investment advisers from entering or remaining in the fund business, dissuading portfolio managers from managing funds as opposed to other investment products, or creating disincentives for brokers and other intermediaries to sell fund shares. It is critically important for the agency to be sensitive to this dynamic in its rulemakings.

   Among other things, in analyzing potential new regulatory requirements for funds or in other situations as appropriate, the agency should consider whether other investment products raise similar policy concerns and thus should be subject to comparable requirements. In this regard, we note that separately managed accounts sometimes are operated much like mutual funds and other investment companies and yet do not offer the same level of investor protection. For example, as the fallout from the Ponzi scheme perpetrated by Bernard Madoff has highlighted, separately managed accounts are not subject to all of the restrictions on custody arrangements that serve to protect fund assets, and existing rules leave room for abuse. [42]

4. *Develop strong capability to conduct economic analysis to support sound rulemaking and oversight:* The agency will be best positioned to accomplish its mission if it conducts economic analysis in various aspects of the agency's work, including rulemaking, examinations, and enforcement. Building strong economic research and analytical capabilities is an important way to enhance the mix of disciplines that will inform the agency's activities. From helping the agency look at broad trends that shed light on how markets or individual firms are operating to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the agency's capability to conduct economic analysis will be well worth the long-term effort required. The agency should consider having economists

[42] The SEC has scheduled an open meeting on May 14, 2009, at which it will consider proposed rule amendments designed to enhance the protections provided to advisory clients when they entrust their funds and securities to an investment adviser. The SEC's meeting announcement indicates that if adopted, the amendments would require investment advisers having custody of client funds and securities to obtain a surprise examination by an independent public accountant, and, unless the client assets are maintained with an independent custodian, obtain a review of custodial controls from an independent public accountant. See SEC News Digest (May 7, 2009), available at *http://www.sec.gov/news/digest/2009/dig050709.htm*

resident in each division to bring additional, important perspectives to bear on regulatory challenges.

It is important that economic analysis play an integral role in the rulemaking process, because many regulatory costs ultimately are borne by investors. When new regulations are required, or existing regulations are amended, the agency should thoroughly examine all possible options and choose the alternative that reflects the best trade-off between costs to, and benefits for, investors. Effective cost benefit analysis does not mean compromising protections for investors or the capital markets. Rather, it challenges the regulator to consider alternative proposals and think creatively to achieve appropriate protections while minimizing regulatory burdens, or to demonstrate that a proposal's costs and burdens are justified in light of the nature and extent of the benefits that will be achieved.[43]

5. *Modernize regulations that no longer reflect current market structures and practices:* Financial markets and related services are constantly evolving, frequently at a pace that can make the regulations governing them (or the rationale behind those regulations) become less than optimal, if not entirely obsolete. Requiring industry participants to comply with outmoded regulations imposes unnecessary costs on both firms and investors, may impede innovation, and, most troubling of all, could result in inadequate protection of investors. It is thus important that the agency engage in periodic reviews of its existing regulations to determine whether any such regulations should be modernized or eliminated.

6. *Give heightened attention to investor education:* The recent turmoil in the financial markets has underscored how important it is that investors be knowledgeable and understand their investments. Well-informed investors are more likely to develop realistic expectations, take a long-term perspective, and understand the trade-off between risk and reward. They are less likely to panic and make mistakes.

   To better equip investors to make good decisions about their investments, the agency should assign a high priority to pursuing regulatory initiatives that will help educate investors. The SEC has an Office of Investor Education and Advocacy and provides some investor education resources on its Web site. These types of efforts should be expanded, possibly in partnership with other governmental or private entities, and better publicized. Many industry participants, too, have developed materials and other tools to help educate investors; additional investor outreach efforts should be encouraged.

Q.10. *Systemic Risk Regulatory Structure:* You have put forth the idea of a systemic risk regulator that is organized as a committee

[43] See, *e.g.,* Special Report on Regulatory Reform, Congressional Oversight Panel (submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008) (Jan. 2009) ("In tailoring regulatory responses . . . the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats-especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.").

of financial regulatory heads. Could you please elaborate on the structure and organization of such a systemic risk regulatory you are suggesting? Also, please describe the positives and negatives of such an arrangement and the reasons why it would be superior to other possibilities.

A.10. In light of the financial crisis, it is imperative that Congress establish in statute responsibility to address risks to the financial system at large. For certain specific and identifiable purposes, such as assuring effective consolidated global supervision of the largest bank holding companies and overseeing the robust functioning of the payment and settlement system as appropriate, this systemic risk management responsibility might be lodged with the Federal Reserve Board. Beyond this context, however, I recommend that systemic risk management responsibility should be assigned to a statutory council comprised of senior Federal regulators.

In concept, such a council would be similar to the National Security Council (NSC), which was established by the National Security Act of 1947. In the aftermath of World War II, Congress recognized the need to assure better coordination and integration of "domestic, foreign, and military policies relating to the national security" and the ongoing assessment of "policies, objectives, and risks." The 1947 Act established the NSC under the President as a Cabinet-level council with a dedicated staff. In succeeding years, the NSC has proved to be a key mechanism utilized by Presidents to address the increasingly complex and multi-faceted challenges of national security policy. It was my honor from 1987–89 to serve as statutory head (*i.e.,* Executive Secretary) of the NSC.

As with national security, addressing risks to the financial system at large requires, in my view, diverse inputs and perspectives. Membership of such a council accordingly should draw upon a broad base of expertise, and should include at a minimum the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and the heads of the Federal bank and capital markets regulators (and insurance regulator, if one emerges at the Federal level). As with the NSC, flexibility should exist to enlist other regulators into the work of the council on specific issues as required—including, for example, State insurance regulators and self-regulatory organizations.

By statute, the council should have a mandate to monitor conditions and developments in the domestic and international financial markets, to assess their implications for the health of the financial system at large, to identify regulatory actions to be taken to address systemic risks as they emerge, to assess the effectiveness of these actions, and to advise the President and the Congress on emerging risks and necessary legislative or regulatory responses. The council would be responsible for coordinating and integrating the national response to systemic financial risks, but it would not have a direct operating role (much as the NSC coordinates and integrates military and foreign policy that is implemented by the Defense or State Department and not by the NSC itself). Rather, responsibility for addressing identified risks would lie with the existing functional regulators, who would act pursuant to their normal statutory authorities but under the council's direction.

The Secretary of the Treasury, as the senior-most member of the council, should be designated chairman. An executive director, appointed by the President, should run the day-to-day operations of the council and serve as head of the council's staff. The council should meet on a regular basis, with an interagency process coordinated through the council's staff to support and follow through on its ongoing deliberations.

To accomplish its mission, the council should have the support of a dedicated, highly-experienced staff. The staff should represent a mix of disciplines (*e.g.,* economics, finance and law) and should consist of individuals seconded from government departments and agencies (Federal and state), as well as recruited from the private sector with a business, professional or academic background. As with the NSC, the staff's focus would be to support the work of the council as such, and thus the staff would operate independently from the functional regulators. Nonetheless, the background and experience of the staff would help assure the kind of strong working relationships with the functional regulators necessary for the council's success. Such a staff could be recruited and at work in a relatively short period of time. The focus in recruiting such a staff should be on quality, not quantity, and the council's staff accordingly should not and need not be large.

Such a council structure has many advantages to recommend it:

- Systemic risks may arise in different ways and affect different parts of the domestic and global financial system. No existing agency or department has a comprehensive frame of reference or the necessary expertise to assess and respond to any and all such risks. Creating such an all-purpose systemic risk manager would be a long and complex undertaking, and would involve developing expertise that duplicates that which exists in today's functional regulators. The council structure by contrast would enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. It also could be established and begin operation much more quickly.
- The council structure would avoid risks inherent in the leading alternative that has been proposed—*i.e.,* designating an existing agency like the Federal Reserve Board to serve as an all-purpose systemic risk regulator. In this role, the Federal Reserve understandably may tend to view risks and risk mitigation through its lens as a bank regulator focused on prudential regulation and "safety and soundness" concerns, potentially to the detriment of consumer and investor protection concerns and of non-bank financial institutions. In my view, a council such as I have outlined would bring all these competing perspectives to bear and, as a result, would seem far more likely to strike the proper balance.
- Such a council would provide a high degree of flexibility in convening those Federal and State regulators whose input and participation is necessary to addressing a specific issue, without creating an unwieldy or bureaucratic structure. As is the case with the NSC, the council should have a core membership

of senior Federal officials and the ability to expand its participants on an *ad hoc* basis when a given issue so requires.

- With an independent staff dedicated solely to pursuing the council's agenda, the council would be well positioned to test or challenge the policy judgments or priorities of various functional regulators. Moreover, by virtue of their participation on the council, the various functional regulators are themselves likely to be more attentive to emerging risks or regulatory gaps. This would help assure a far more coordinated and integrated approach. Over time, the council also would assist in identifying and promoting political consensus about significant regulatory gaps and necessary policy responses.
- The council model anticipates that functional regulators, as distinct from the council itself, would be charged with implementing regulations to mitigate systemic risks as they emerge. This operational role is appropriate because the functional regulators will have the greatest in depth knowledge of their respective regulated industries. Nonetheless, the council and its staff will have an important independent role in evaluating the effectiveness of the measures taken by functional regulators to mitigate systemic risk and, where necessary, in prompting further actions.
- A potential criticism of the council structure is that it may diffuse responsibility and pose difficulties in assuring proper follow-through by the functional regulators. I agree it is important that the council have "teeth," and this can be accomplished, in crafting the legislation, through appropriate amendments to the organic statutes governing the functional regulators.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM PAUL SCHOTT STEVENS

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

A.1. In his March 10 speech to the Council on Foreign Relations, Chairman Bernanke suggested that policymakers should begin to think about "reforms to the financial architecture, broadly conceived, that could help prevent a similar [financial] crisis from developing in the future." He further highlighted the need for "a strategy that regulates the financial system as a whole, in a holistic way." ICI concurs with Chairman Bernanke that the four areas outlined in the question, and discussed in turn below, are key elements of such a strategy. It bears emphasizing that this list is not exclusive (and that Chairman Bernanke himself did not suggest otherwise). In ICI's view, other key elements of a reform strategy include consolidating and strengthening the primary regulators for each financial sector, and ensuring more effective coordination and information sharing among those regulators. These issues are addressed in detail in ICI's March 3, 2009, white paper, *Financial Services Regulatory Reform: Discussion and Recommendations.* [1]

"Too big to fail": ICI agrees that the notion of financial institutions that are too big or too interconnected to fail deserves careful attention. The financial crisis has highlighted how the activities of large financial institutions can have wide-ranging effects on the economy. It is incumbent upon policymakers and other interested parties to consider how best to mitigate the risks that the activities of large financial institutions can pose to the financial system as a whole.

As part of this analysis, one issue is how to define what is meant by "too big to fail." If it means that certain large financial institutions will receive either explicit or implicit Federal guarantees of their debt, such institutions will gain an unfair competitive advantage. Allowing these institutions to borrow at risk-free (or near risk-free) interest rates could encourage them to take excessive risks, and may cause them to grow faster than their competitors, both of which potentially would magnify systemic risks. Ultimately, U.S. taxpayers would bear the costs of such actions.

Chairman Bernanke echoed these concerns in his March 10 remarks. He described the undesirable effects if market participants believe that a firm is considered too big to fail, indicating that this belief:

> reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently.

Legislative or regulatory reforms aimed at addressing risks to the financial system posed by the activities of large and complex financial firms must be designed to avoid these results.

Strengthening the Financial Infrastructure: ICI strongly concurs with Chairman Bernanke's comments about the need to strengthen the financial infrastructure, in order to improve the ability of the financial system to withstand future shocks and "reduc[e] the range of circumstances in which systemic stability concerns might prompt government intervention." For example, we support current initiatives toward centralized clearing for credit default swaps (CDS). Central clearing should help reduce counterparty risk and bring transparency to trading in the types of CDS that can be standardized. Not all CDS are sufficiently standardized to be centrally cleared, however, and institutional investors will continue to need to conduct over-the-counter transactions in CDS. For those transactions, we support reasonable reporting requirements, in

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[1] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

order to ensure that regulators have enough data on the CDS market to provide effective oversight. In addition, we would be generally supportive of efforts to improve the market for repurchase agreements. Steps such as those we have outlined may serve to deepen the relevant markets, encourage buyers and sellers to continue to transact during times of market turmoil and, in particular, help foster greater price transparency.

We further concur with Chairman Bernanke's assessment of the importance of money market funds—particularly their "crucial role" in the commercial paper market and as a funding source for businesses—and his call for policymakers to consider "how to increase the resiliency of those funds that are susceptible to runs." Similarly, Treasury Secretary Geithner has outlined the Administration's position on systemic risk and called for action in six areas, including the adoption of new requirements for money market funds to reduce the risk of rapid withdrawals. In this regard, ICI and its members, working through our Money Market Working Group, recently issued a comprehensive report outlining a range of measures to strengthen money market funds and help them withstand difficult market conditions in the future.[2] More specifically, the Working Group's recommendations are designed to strengthen and preserve the unique attributes of a money market fund as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability in principal value, and a market-based yield. The proposed standards and regulations would ensure that money market funds are better positioned to sustain prolonged and extreme redemption pressures and that mechanisms are in place to ensure that all shareholders are treated fairly if a fund sees its net asset value fall below $1.00.

Secretary Geithner specifically identified the SEC as the agency to implement any new requirements for money market funds. ICI wholeheartedly concurs that the SEC, as the primary regulator for money market funds, is uniquely qualified to evaluate and implement potential changes to the existing scheme of money market fund regulation. SEC Chairman Shapiro and members of her staff have indicated on several occasions that her agency is currently conducting such a review on an expedited basis, and we are pleased that the review will include consideration of the Working Group's recommendations.

Preventing Excessive Procyclicality: Some financial institutions have criticized the use of mark-to-market accounting in the current environment as overstating losses, diminishing bank capital, and exacerbating the crisis. Others have applauded its use as essential in promptly revealing the extent of problem assets and the deteriorating financial condition of institutions. Investment companies, as investors in securities, rely upon financial reporting that accurately portrays the results and financial position of companies competing for investment capital. ICI supports the work of the Financial Accounting Standards Board and its mission to develop financial reporting standards that provide investors with relevant, reliable and transparent information about corporate financial performance.

[2] See Report of the Money Market Working Group, Investment Company Institute (March 17, 2009), available at *http://www.ici.org/pdf/ppr_09_mmwg.pdf*

Certainly, regulatory policies and accounting rules should not induce excessive procyclicality. At the same time, accounting standards should not be modified to achieve any objective other than fair and accurate reporting to investors and the capital markets. Any concerns regarding the procyclical effects of mark-to-market accounting on lending institutions' capital may be better addressed through changes to capital standards themselves. Consideration should be given to, for example, developing countercyclical capital standards and requiring depositaries and other institutions to build up capital more amply in favorable market conditions and thus position themselves to weather unfavorable conditions more easily.

Monitoring and Addressing Systemic Risk: Over the past year, various policymakers and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks to the financial system as a whole. ICI concurs with those commentators that creation of such a mechanism is necessary. The ongoing financial crisis has highlighted the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. A mechanism that will allow Federal regulators to look across the system should equip them to better anticipate and address such risks.

In its recent white paper on regulatory reform, ICI endorsed the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." Broadly stated, the goal in establishing a Systemic Risk Regulator should be to provide greater overall stability to the financial system as a whole. The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators.

In ICI's view, Congress should determine the composition and authority of the Systemic Risk Regulator with two important cautions in mind. First, the legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies. Second, the Systemic Risk Regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance. Rather, the Systemic Risk Regulator should focus principally on protecting the financial system—as discussed in detail in our white paper, we believe that a strong and independent Capital Markets Regulator (or, until such agency is established by Congress, the SEC) should focus principally on the equally important mandates of protecting investors and maintaining market integrity.

Legislation establishing the Systemic Risk Regulator should define the nature of the relationship between this new regulator and the primary regulator(s) for each industry sector. This should involve carefully defining the extent of the authority granted to the Systemic Risk Regulator, as well as identifying circumstances under which the Systemic Risk Regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators have a critical role to play by acting as the first line of defense with regard to detecting potential risks within their spheres of expertise.

We recognize that it may be appropriate, for example, to lodge responsibility for ensuring effective consolidated global supervision of the largest bank holding companies with a designated regulator such as the Federal Reserve Board. Beyond this context, however, and in view of the two cautions outlined above, ICI believes that responsibility for systemic risk management more broadly should be assigned to a Systemic Risk Regulator structured as a statutory council comprised of senior Federal regulators. Membership should include, at a minimum, the Secretary of the Treasury, Chairman of the Federal Reserve Board of Governors, and the heads of the Federal bank and capital markets regulators (and insurance regulator, if one emerges at the Federal level).

Q.2. Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

A.2. *Establishment of a New Capital Markets Regulator:* ICI strongly believes that a merger or rationalization of the roles of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) would be a valuable reform. Currently, securities and futures are subject to separate regulatory regimes under different Federal regulators. This system reflects historical circumstances that have changed significantly. As recently as the mid-1970s, for example, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. In addition, as new, innovative financial instruments were developed, the lines between securities and futures often became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection and market oversight. With the increasing convergence of securities and futures products, markets, and market participants, the current system simply makes no sense. To bring a consistent policy focus to U.S. capital markets, ICI strongly recommends the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and those of the CFTC that are not agriculture-related.

As the Federal regulator responsible for overseeing all financial investment products, it is imperative that the Capital Markets Regulator—like the SEC and the CFTC—be established by Congress as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission. A critical part of that mission should be for the new agency to maintain a sharp focus on investor protection and law enforcement. And Congress should ensure that the agency is given the resources it needs to fulfill its mission. Most notably, the Capital Markets Regulator must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

To preserve regulatory efficiencies achieved under the National Securities Markets Improvement Act of 1996, Congress should affirm the role of the Capital Markets Regulator as the regulatory standard setter for all registered investment companies. ICI further envisions the Capital Markets Regulator as the first line of defense with respect to identifying and addressing risks across the capital markets. The new agency should be granted explicit authority to regulate in certain areas where there are currently gaps in regulation—in particular, with regard to hedge funds, derivatives, and municipal securities—and explicit authority to harmonize the legal standards applicable to investment advisers and brokerdealers. These areas are discussed in greater detail in ICI's March 3, 2009, white paper, *Financial Services Regulatory Reform: Discussion and Recommendations.* [3]

Organization and Management of the Capital Markets Regulator: In the private sector, a company's success is directly related to the soundness of its management. The same principle holds true for public sector entities. Establishing a new agency presents a very valuable opportunity to "get it right" as part of that process. There is also an opportunity to make sound decisions up-front about how to organize the new agency. In so doing, it is important not to simply use the current structure of the SEC and/or the CFTC as a starting point. The SEC's current organizational structure, for example, largely took shape in the early 1970s and reflects the operation of the securities markets of that day. Rather, the objective should be to build an organization that not only is more reflective of today's markets, market participants and investment products, but also will be flexible enough to regulate the markets and products of tomorrow.

ICI offers the following thoughts with regard to organization and management of the Capital Markets Regulator:

- Ensure high-level focus on agency management. One approach would be to designate a Chief Operating Officer for this purpose.
- Implement a comprehensive process for setting regulatory priorities and assessing progress. It may be helpful to draw upon the experience of the United Kingdom's Financial Services Authority, which seeks to follow a methodical approach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.
- Promote open and effective lines of communication among the regulator's Commissioners and between its Commissioners and staff. Such communication is critical to fostering awareness of issues and problems as they arise, thus increasing the likelihood that the regulator will be able to act promptly and effectively. A range of approaches may be appropriate to consider in meeting this goal, including whether sufficient flexibility is

[3] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

provided under the Government in the Sunshine Act, and whether the number of Commissioners should be greater than the current number at the SEC and at the CFTC (currently, each agency has five).

- Align the inspections and examinations functions and the policymaking divisions. This approach would have the benefit of keeping staff in the policymaking divisions updated on current market and industry developments, as well as precluding any *de facto* rulemaking by the regulator's inspections staff.
- Develop mechanisms to facilitate coordination and information sharing among the policymaking divisions. These mechanisms would help to ensure that the regulator speaks with one voice.

Process of Merging the SEC and CFTC: Legislation to merge the SEC and CFTC should outline a process by which to harmonize the very different regulatory philosophies of the two agencies, as well as to rationalize their governing statutes and current regulations. There is potential peril in leaving open-ended the process of merging the two agencies. ICI accordingly recommends that the legislation creating the Capital Markets Regulator set forth a specific timetable, with periodic benchmarks and accountability requirements, to ensure that the merger of the SEC and CFTC is completed as expeditiously as possible.

The process of merging the two agencies will be lengthy, complex, and have the potential to disrupt the functioning of the SEC, CFTC, and their regulated industries. ICI suggests that, in anticipation of the merger, the SEC and CFTC undertake detailed consultation on all relevant issues and take all steps possible toward greater harmonization of the agencies. This work should be facilitated by the Memorandum of Understanding the two agencies signed last year regarding coordination in areas of common regulatory interest.[4] ICI believes that its recommendations with respect to the Capital Markets Regulator, outlined in detail in its white paper, may provide a helpful framework for these efforts.

Q.3. How is it that AIG was able to take such large positions that it became a threat to the entire Financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

A.3. ICI does not have particular insight to offer with regard to AIG, the size of its positions in credit default swaps (CDS), and the effect that those positions ultimately had on the broader financial markets. Nevertheless, our sense is that the answers lie in a combination of all the factors outlined above. We note that Congress seems poised to establish a bipartisan commission to investigate the causes of the current financial crisis. A thorough examination of what happened with AIG would no doubt be a very useful part of the commission's inquiry.

With regard to CDS generally, ICI believes that a single independent Federal regulator for capital markets should have clear authority to adopt measures to increase transparency and reduce

[4] See SEC, CFTC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products (SEC press release dated March 11, 2008), available at *http://www.sec.gov/news/press/2008/2008-40.htm*

counterparty risk, while not unduly stifling innovation.[5] We support current initiatives toward centralized clearing for CDS, which should help to reduce counterparty risk and bring transparency to trading in the types of CDS that can be standardized. Not all CDS are sufficiently standardized to be centrally cleared, however, and institutional investors will continue to need to conduct over-the counter transactions in CDS. For those transactions, we support reasonable reporting requirements, in order to ensure that regulators have enough data on the CDS market to provide effective oversight. Finally, we believe that all institutional market participants should be required to periodically disclose their CDS positions publicly, as funds are currently required to do.

Q.4. How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.4. Experience during the financial crisis has prompted calls to establish a better process for dealing with large, diversified financial institutions whose solvency problems could have significant adverse effects on the financial system or the broader economy. Depository institutions already have in place a resolution framework administered by the Federal Deposit Insurance Corporation. In contrast, other "systemically important" financial institutions facing insolvency either have to rely on financial assistance from the government (as was the case with AIG) or file for bankruptcy (as was the case with Lehman Brothers).

The Treasury Department has expressed concern that these "options do not provide the government with the necessary tools to manage the resolution of [a financial institution] efficiently and effectively in a manner that limits systemic risk with the least cost to the taxpayer."[6] Treasury has sent draft legislation to Congress that is designed to address this concern. The legislation would authorize the FDIC to take a variety of actions (including appointing itself as conservator or receiver) with respect to a "financial company" if the Treasury Secretary, in consultation with the President and based on the written recommendation of the Federal Reserve Board and the "appropriate Federal regulatory agency," makes a systemic risk determination concerning that company.

ICI agrees that it would be helpful to establish rules governing the resolution of certain large, diversified financial institutions in order to minimize the impact of the potential failure of such an institution on the financial system and consumers as a whole. Such a resolution process could benefit investors, including investment companies (and their shareholders). The rules for a federally-facilitated wind down should be clearly established so that creditors and other market participants understand the process that will be followed and the likely ramifications. Uncertainty associated with *ad hoc* approaches that differ from one resolution to the next will be very destabilizing to the financial markets. Clear rules and a trans-

[5] In our March 3, 2009 white paper, *Financial Services Regulatory Reform: Discussion and Recommendations* (which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf*), ICI recommended the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and those of the CFTC that are not agriculture-related. To the extent that no Capital Markets Regulator is formed, we believe that the SEC is the regulator best suited to provide effective oversight of financial derivatives, including CDS.

[6] See Treasury Proposes Legislation for Resolution Authority (March 25, 2009), available at *http://www.treas.gov/press/releases/tg70.htm*

parent process are critical to bolster confidence and avoid potentially creating reluctance on the part of market participants to transact with an institution that is perceived to be "systemically important."

In determining which institutions might be subject to this resolution process, we recommend taking into consideration not simply "size" or the specific type of institution but critical factors such as the nature and extent of an institution's leverage and trading positions, the nature of its borrowing relationships, the amount of difficult-to-value assets on its books, its off-balance sheet liabilities, and the degree to which it engages in activities that are opaque or unregulated.

More broadly, the reforms recommended in ICI's recent white paper,[7] if enacted, would lead to better supervision of systemically critical financial institutions and would help avoid in the future the types of situations that have arisen in the financial crisis, such as the failure or near failure of systemically important firms. Our recommendations include:

- Establishing a "Systemic Risk Regulator" that would identify, monitor and manage risks to the financial system as a whole;
- Creating a consolidated Capital Markets Regulator that would encompass the combined functions of the Securities and Exchange Commission and those of the Commodity Futures Trading Commission that are not agriculture-related;
- Considering consolidation of the regulatory structure for the banking sector;
- Authorizing an optional Federal charter for insurance companies; and
- Promoting effective coordination and information sharing among the various financial regulators.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM MERCER E. BULLARD

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets?

Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. Witness declined to respond to written questions for the record.

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[7] See Financial Services Regulatory Reform: Discussion and Recommendations, which is available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf.* We note that the white paper was included as an attachment to ICI's written testimony.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. Witness declined to respond to written questions for the record.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. Witness declined to respond to written questions for the record.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. Witness declined to respond to written questions for the record.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not per-

mitting them to perform consulting activities for the firms they rate.

2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. Witness declined to respond to written questions for the record.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. Witness declined to respond to written questions for the record.

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. Witness declined to respond to written questions for the record.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. Witness declined to respond to written questions for the record.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. Witness declined to respond to written questions for the record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MERCER E. BULLARD

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.1. Witness declined to respond to written questions for the record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM ROBERT PICKEL

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets? Also, would you recommend more transparency for investors:

- By publicly held banks and other financial firms of off-balance sheet liabilities or other data?

- By credit rating agencies of their ratings methodologies or other matters?
- By municipal issuers of their periodic financial statements or other data?
- By publicly held banks, securities firms, and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. Transparency plays an important role in encouraging market participation. At the same time, in some instances proprietary information must be kept confidential in order to encourage market participation. There is a balancing act that must be performed with respect to when enhanced transparency will assist the proper functioning of a market (which should be the default assumption) and when it might prove counter-productive.

Q.2. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the Nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.2. Credit default swaps play an important role in facilitating financing, and ensuring their continued availability to sophisticated market participants is in the best interest of promoting U.S. economic growth. At the same time it is clear that our regulatory system as a whole is in need of reform and restructuring in order to accommodate new types of products and markets. CDS and OTC derivatives in general are currently subject to a range of oversight, extending from regulation of the primary dealers in these markets (such as banks), through to different levels of oversight by the CFTC and SEC with respect to different types of underlying products. With regard to CDS in particular, change in the current regulatory structure should be focused on ensuring the continued availability of the product while preventing potentially destabilizing regulation of certain types of CDS as insurance at the State level.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM ROBERT PICKEL

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

Would a merger or rationalization of the roles of the SEC-and CFTC be a valuable reform, and how should that be accomplished?

How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.1. ISDA supports legislative efforts to create a governmental authority to monitor, assess and take action to address potential systemic risk within the financial system. This systemic risk regulator should have the authority to: monitor large exposures across firms and markets; assess potential deficiencies in risk management practices; analyze the exposures of highly connected firms; identify regulatory gaps; and have the ability to promulgate rules necessary to carry out its authorities. The powers of the systemic risk regulator should be focused on markets as a whole, and not limited to narrow categories of products or participants. The systemic risk regulator should work cooperatively with other regulators globally to help promote internationally consistent standards.

Merger of the SEC and CFTC is a complicated issue which presents many issues extending beyond the OTC derivatives industry. The framework of regulation created by the Commodity Futures Modernization Act of 2000, which provides elements of oversight of OTC derivatives activity by both agencies, has been very successful in promoting the growth of the business in the United States.

AIG's ability to take large positions appears to stem primarily from a failure of AIG to follow widely used, generally accepted best practices with respect to collateralization. It appears that a failure of prudent risk management as well as lax oversight contributed to AIG's downfall.

The U.S. Bankruptcy Code and Federal Deposit Insurance Corporation Act provide mechanisms for the orderly wind down of qualified financial contracts; these provisions appear to have functioned well during the failures of both banks and non-banks (such as Lehman Bros.).

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM DAMON A. SILVERS

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets?

Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. (1) I do not understand why after Enron we continued to allow off-balance sheet activities as a general matter. FASB has finally acted to tighten the rules on off-balance sheet activity, it is unclear whether those efforts will be successful. In my view, if a liability is close enough to a company to be called an off-balance sheet liability, it should be on-balance sheet.

(2) Yes, credit rating agencies should both be required to disclore their methods, and should be substantively regulated, much as audit firms are, by either the SEC, the PCAOB, or a new agency. However, I am opposed to undoing the NRSRO approach to ratings agencies, there needs to be a basic minimum standard for firms holding themselves out to the public as ratings agencies, just as we have such standards for banks, broker dealers, lawyers, *etc.*

(3) I am unaware of a good reason there should not be periodic financial disclosures by public debt issuers.

(4) There should be increased disclosure of risk management policies and practices, and there should be changes to SEC current practices around shareholder proposals to allow shareholders to file proposals under Rule 14a-8 addressing risk management policies and the creation of risk management committees of boards in publicly held financial institutions.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. Conflicts of interest are a permanent feature of our markets, where both people and firms have vast webs of relationships. However, certain types of conflicts are simply inconsistent with doing the jobs we ask key gatekeepers and intermediaries to perform. I do not think it is consistent with the role of proxy advisor to also be a hired consultant to the firms whose governance the proxy advisor is supposed to analyze on behalf of investors.

The crisis should lead Congress to take a close look at conflicts of interest in the dealings between originators, servicers, and investors in the mortgage markets and other secondary markets, and in the business model of ratings agencies.

Finally, there is a conflict of interest inherent in executive pay—we ask executives to be loyal to the firm they work for, knowing that they also will seek to enhance their own personal economic interests through their pay packages. That is why executive pay must be closely watched, by boards, by shareholders, by the press, and by investors. In this respect, the advisors to board of directors in negotiating executive pay should be particularly free of conflict. It is inappropriate for executive pay consultants working for boards to simultaneously receive lucrative consulting engagements from the very CEO's whose pay they evaluate. This is substantially the same problem as infected outside auditors prior to the passage of Sarbanes-Oxley.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. Credit default swaps are a form of insurance economically. They should be regulated according to the same principles as insurance-full disclosure of terms, and most importantly, capital requirements.

More generally, credit default swaps are one example of financial derivatives, contracts that can replicate any financial transaction or investment. It is possible to synthesize an insurance contract, *e.g.,* a credit default swap, to synthesize an equity or debt investment through a total return swap, or to synthesize a short position. Derivatives need to be regulated based on what they actually are economically, or to put it a different way, what the underlying assets are referred to in the derivative contract. So for example, the SEC should require the disclosure of synthetic positions in public securities under Section 13 of the Securities Exchange Act by large investors, just as it requires the disclosure of actual positions.

A key step in derivatives regulation should be to require all derivatives written based on a standard contract, such as the ISDA forms, be traded on exchanges, with transparency to all market participants, and collateral requirements. A clearinghouse approach is insufficient because it lacks transparency. Exceptions to this requirement should be very narrowly tailored. In this respect, as many commentators have noted, the Treasury Department White Paper falls short.

I support and endorse the efforts at closing some of the loopholes in the Treasury white paper made in correspondence with Congress by CFTC Chairman Gary Gensler. The details of my views are in the attached written statement I made to a joint roundtable convened by the SEC and the CFTC on coordinating their regulation of derivatives and futures.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;

3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. (1) Majority voting has become common practice in corporate America in recent years, thanks in large part to the efforts of institutional investors, including workers' pension funds. I think this is a positive development. However, in many cases the form of majority voting is weak, more of a guideline than a rule. Companies should adopt clear bylaws embodying the principle of majority voting.

(2) I believe this question is designed to get at the SEC's somewhat convoluted decision to reverse the court's finding in *AIG v. AFSCME* and bar shareholder proposals addressing proxy access, the right of shareholder nominated directors, if they enjoy substantial shareholder support, to appear on the company's proxy materials. This decision was mistaken and should be reversed. Furthermore, the SEC should move promptly to adopt a mandatory floor process for proxy access. Proxy access makes real the mandate to the Commission under Section 14 of the Securities Exchange Act to ensure that proxies fairly represent the agenda before company annual meetings. When shareholder nominated candidates have significant support, their candidacy is clearly a relevant fact that shareholders should be aware of when the management solicits their vote. I strongly support the draft rule proposed by the Commission earlier this summer, and urge Congress to support the Commission in this effort.

(3) Shareholder advisory votes on executive pay have been a feature of the corporate governance system in the United Kingdom for several years. Pension funds in the UK are strongly supportive of this measure, and that enthusiasm is shared by institutional investors in the United States. It is important to note that in the UK say on pay is advisory, and most proposals I am aware of for adopting the practice in the United States are for an advisory vote.

I should note that say on pay might not be necessary if boards were strong on the issue of executive pay. But after 20 years of runaway executive pay, it seems clearly necessary to involve shareholders directly in trying to control this excess.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. Please see my answer to Question 1 from Chairman Dodd in terms of general reforms to the regulation of credit ratings agencies.

For the reasons discussed above in response to a general question on conflicts of interest, I think a ban on side consulting arrangements for credit rating agencies is appropriate and necessary.

I do not see how the NRSRO structure, which makes clear that rating agencies are acting as a gatekeeper, is consistent with absolute legal immunity for misconduct in the role of gatekeeper. On the other hand, Congress should recognize the reality that credit rating agencies cannot act as insurers of the credit market. The way to do that is to have liability standards that recognize liability for extraordinary misconduct, and to pair that liability regime with a strong regime of oversight and inspection, modeled on that created by the Sarbanes-Oxley Act for auditors. Professor Coffee's formulation of such a thoughtful liability standard seems reasonable to me. As a general matter, the AFL–CIO supports the approach taken to these issues in S. 1073, the Rating Accountability and Transparency Enhancement Act of 2009, and we are appreciative of Senator Reed's leadership on this issue.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. It is true that hedge funds as a group, and certain large funds, are systemically significant. It is also true that hedge funds are not a distinct form of economic activity, they are a legal structure designed to enable people who manage money to evade regulatory oversight. If regulatory arbitrage of this type is allowed to continue, we will repeat the events of 2008, and probably with greater severity.

Thus the MFA position is an effort to avoid oversight by the SEC, to perpetuate regulatory arbitrage in our system of financial regulation and to prevent meaningful regulation of hedge funds in the public interest, and meaningful protection of hedge fund investors. It also illustrates the danger that systemic risk regulation can, in the wrong hands, be a vehicle for insulating irresponsible market practices from effective regulation.

The AFL–CIO strongly supports the Treasury Department's recommendation that Congress require hedge fund and private equity fund managers to register as investment advisors with the Securities and Exchange Commission. However, regulating the manager is not sufficient. Congress should adopt a regulatory framework for hedge funds and private equity funds themselves, a version of the Investment Company Act that recognizes these funds are different than mutual funds, but nonetheless are money management enterprises profoundly embedded in our public markets. Such regulation should recognize that hedge funds are not directly marketed to the general public, but the general public is exposed to hedge fund risks through pension funds, university endowments, and foundations. Most importantly, giving the SEC clear jurisdiction over the fund itself would enable the Commission to oversee the governance of these funds and to ensure they operate in the best interests of their investors.

Ultimately, no financial reform is more important than closing jurisdictional loopholes in ways that will not allow new loopholes to open. This was the genius of the New Deal securities laws until they began to be eaten away during the 1980s and 1990s. We need to restore this type of comprehensive regulatory approach to SEC jurisdiction.

The MFA's proposal is to do the opposite.

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. In general, I am not supportive of self-regulatory structures. I think there is however a general view among investors that NASD is superior to the structures that preceeded it. It is not clear to me that given the scale of what NASD does, it makes sense to bring it within the SEC. However, I think Congress may want to look closely at the NASD's governance, and those regulatory functions that remain with the exchanges themselves, to see if NASD's governance can be improved, and to see whether it is sensible for any regulatory functions to remain with the exchanges. Part of this examination should include an in-depth look at how the NASD and the exchanges performed their functions during the runup to the financial crisis. In this respect, the new Financial Crisis Commission chaired by Philip Angelides may be helpful.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. In general, the SEC's needs expanded jurisidiction to cover all financial products that interact with the public markets-derivatives linked to publically traded securities, financial futures, hedge funds and private equity funds. As I mentioned above, the lack of comprehensive jurisdiction that cannot be evaded is the principal structural problem facing the SEC.

The AFL–CIO strongly supports the Treasury Department's proposal for creating a consumer financial protection agency with the jurisdiction outlined in the Treasury's report. That jurisdiction does not include taking anything away from the SEC. Investments are different than financial services such as mortgages, credit cards, and bank accounts, and need to be regulated in a consolidated way by the SEC.

As to taking away responsibilities from the SEC and giving them to a systemic risk regulator, that would be an invitation to further regulatory arbitrage, and would be opposed by the AFL–CIO. See my answer to Question 6 for an example of why this would be a bad idea.

The SEC is fundamentally about ensuring that we have fair and transparent securities market. It is not about protecting the safety and soundness of particular participants in that market. Merging those two obligations would ensure we will have unfair and opaque securities markets, run in the interests of ensuring the safety and soundness of issuers.

Congress should in general keep in mind that safety and soundness, consumer protection and investor protection are three distinct, important regulatory functions that are nonetheless in tension with each other. They need to be as much as possible consolidated within each category, but kept in separate categories. Much of the failure of regulation in the mortgage bubble came from asking the Federal Reserve to be both guardian of safety and soundness of bank holding companies, and protector of consumers in the mortgage market. Ultimately the Fed did neither effectively. Some of the most embarrassing moments of the financial crisis have come from efforts to have the same people make decisions about safety and soundness and investor protection, most notably at Bank of America. These incidents should not be the model of our regulatory future.

I think that the CFTC should be merged with the SEC, or alternatively its financial jurisdiction, as opposed to its jurisdiction over instruments linked to physical commodities, should be transferred to the SEC in the interests of preventing regulatory arbitrage. As to the NASD and the exchanges, see my answer to Question 7.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. The SEC is underfunded, and suffers from funding uncertainty. In the immediate aftermath of disasters like Enron, the SEC gets big budget increases, only to see them taken away when the spotlight moves on. The consequences for the Commission go beyond a general lack of resources to profound difficulties in attracting and developing career staff.

The AFL–CIO supports both substantial budget increases and dedicated funding for the Commission similar to that which the Board of Governors of the Federal Reserve enjoys.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DAMON A. SILVERS

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

A.1. I would cover some of the same ground that Chairman Bernanke did in a different way. I think regulatory reform must:

1. Protect the public by creating an independent consumer protection agency for financial services, which would, among other duties, ensure mortgage markets are properly regulated
2. Reregulate the shadow markets-in particular, derivatives, hedge funds, private equity funds, and off-balance sheet vehicles, so that it is no longer possible for market actors to choose to conduct activities like bond insurance or money management either in a regulated or an unregulated manner. As President Obama said in 2008 at Cooper Union, financial activity should be regulated for its content, not its form.
3. Provide for systemic risk regulation by a fully public entity, including the creation of a resolution mechanism applicable to any financial firm that would be the potential subject of government support. The Federal Reserve System under its current governance structure, which includes significant bank involvement at the Reserve Banks, is too self-regulatory to be a proper systemic risk regulator. Either the Federal Reserve System needs to be fully public, or the systemic risk regulatory function needs to reside elsewhere, perhaps in a committee that would include the Fed Chairman in its leadership.

The issue of procyclicality is complex. I think anticyclicality in capital requirements may be a good idea. I have become very skeptical of the changes that have been made to GAAP that have had the effect, in my opinion, of making financial institutions' balance sheets and income statements less transparent and reliable. See the August, 2009, report of the Congressional Oversight Panel. Most importantly, moves that appear to be anticyclical may be procyclical, by allowing banks not to write down assets that are in fact impaired, these measures may be a disincentive, for example, for banks to restructure mortgages in ways that allow homeowners to stay in their homes.

Q.2. Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

A.2. A merger of the SEC and the CFTC would be a valuable reform. Alternatively, jurisdiction over financial futures and derivatives could be transferred from the CFTC to the SEC so that there is no possibility of regulatory arbitrage between securities on the one hand and financial futures and derivatives on the other. Recent efforts by both agencies to harmonize their approaches to financial regulation, while productive, have highlighted the degree to which they are regulating the same market, and the extent of the continuing threat of regulatory arbitrage created by having separate agencies.

If there were to be a merger, it must be based on adopting the SEC's greater anti-fraud and market oversight powers. The worst idea that has surfaced in the entire regulatory reform debate, going back to 2006, was the proposal in the Paulson Treasury blueprint to use an SEC-CFTC merger to gut the investor protection and enforcement powers of the SEC.

For more details on these issues, the Committee should review the transcript of the second day of the joint SEC-CFTC roundtable on coordination issues held on September 3, 2009. I have attached my written statement to that roundtable. [See, *Joint Hearing Testimony,* below.]

Q.3. How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

A.3. AIG took advantage of three regulatory loopholes that should be closed. Their London-based derivatives office was part of a thrift bank, regulated by the OTS, an agency which during the period in question advertised itself to potential "customers" as a compliant regulator. This ability to play regulators off against each other needs to end. Second, the Basel II capital standards for banks allowed banks with AAA ratings not to have to set capital aside to back up derivatives commitments. Third, thanks to the Commodities Futures Modernization Act, there was no ability of any agency to regulate derivatives as products, or to require capital to be set aside to back derivative positions.

Within AIG, the large positions taken by the London affiliate represent a colossal managerial and governance failure. It is a managerial failure in that monitoring capital at risk and leverage is a central managerial function in a financial institution. It is a governance failure in that the scale of the London operation, and its apparent contribution to AIG's profits in the runup to the collapse, was such that the oversight of the operation should have been of some importance to the board. The question now is, what sort of accountability has there really been for these failures?

Q.4. How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.4. We need to make the following changes to our financial regulatory system to address the need to protect the financial system against systemic risk:

1. We need to give the FDIC and a systemic risk regulator the power to resolve any financial institution, much as that power is now given to the FDIC to resolve insured depositary institutions, if that financial institution represents a systemic threat.
2. Capital requirements and deposit insurance premiums need to increase as a percentage of assets as the size of the firm increases. The Obama Administration has proposed a two tier approach to this idea. More of a continuous curve would be better for a number of reasons—in particular it would not tie the hands of policy makers when a firm fails in the way a two tier system would. If we have a two tier system, the names of the firm in the top tier must be made public. These measures both operate as a deterrent to bigness, and compensate the government for the increased likelihood that we will have to rescue larger institutions.
3. Bank supervisory regulators need to pay much closer attention to executive compensation structures in financial institutions to ensure they are built around the proper time horizons and the proper orientation around risk. This is not just true for the CEO and other top executives—it is particularly relevant for key middle management employees in areas like trading desks and internal audit. Fire alarms should go off if internal audit is getting incentive pay based on stock price.
4. We need to close regulatory loopholes in the shadow markets so that all financial activity has adequate capital behind it and so regulators have adequate line of site into the entire market landscape. This means regulating derivatives, hedge funds, private equity and off-balance sheet vehicles based on the economic content of what they are doing, not based on what they are called.
5. We need to end regulatory arbitrage, among bank regulators; between the SEC and the CFTC, and to the extent possible, internationally by creating a global financial regulatory floor.
6. We need to adopt the recommendation of the Group of Thirty, chaired by Paul Volcker, to once again separate proprietary securities and derivatives trading from the management of insured deposits.

AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Joint Hearing of the CFTC and the SEC—Harmonization of Regulation

September 3, 2009

Good morning Chairman Schapiro and Chairman Gensler. My name is Damon Silvers, I am an Associate General Counsel of the AFL–CIO, and I am the Deputy Chair of the Congressional Oversight Panel created under the Emergency Economic Stabilization Act of 2008 to oversee the TARP. My testimony reflects my views and the views of the AFL–CIO unless otherwise noted, and is not on behalf of the Panel, its staff or its chair, Elizabeth Warren. I should however note that a number of the points I am making in this testimony were also made in the Congressional Oversight Panel's Report on Financial Regulatory Reform's section on reregulating the shadow capital markets, and I commend that report to you.[1]

Thank you for the opportunity to share my views with you today on how to best harmonize regulation by the SEC and the CFTC. Before I begin, I would like to thank you both for bringing new life to securities and commodities regulation in this country. Your dedication to and enforcement of the laws that ensure fair dealing in the financial and commodities markets has never been more important than it is today.

Derivatives are a classic shadow market. To say a financial instrument is a derivative says nothing about its economic content. Derivative contracts can be used to synthesize any sort of insurance contract, including most prominently credit insurance. Derivatives can synthesize debt or equity securities, indexes, futures and options. Thus the exclusion of derivatives from regulation by any federal agency in the Commodity Futures Modernization Act ensured that derivatives could be used to sidestep thoughtful necessary regulations in place throughout our financial system.[2] The deregulation of derivatives was a key step in creating the Swiss cheese regulatory system we have today, a system that has proven to be vulnerable to shocks and threatening to the underpinnings of the real economy. The result—incalculable harm throughout the world, and harm in particular to working people and their benefit funds who were not invited to the party and in too many cases have turned out to be paying for the cleanup.

There are three basic principles that the AFL–CIO believes are essential to the successful harmonization of SEC and CFTC regulation and enforcement, and to the restoration of effective regulation across our financial system:

1. Regulators must have broad, flexible jurisdiction over the derivatives markets that prevents regulatory arbitrage or the creation of new shadow markets under the guise of innovation.
2. So long as the SEC and the CFTC remain separate agencies, the SEC should have authority to regulate all financial markets activities, including derivatives that reference financial products. The CFTC should have authority to regulate physical commodities markets and all derivatives that reference such commodities.
3. Anti-fraud and market conduct rules for derivatives must be no less robust than the rules for the underlying assets the derivatives reference.

The Administration's recently proposed Over-the-Counter Derivatives Markets Act of 2009 ("Proposed OTC Act") will help to close many, but not all, of the loopholes that make it difficult for the SEC and the CFTC to police the derivatives markets. It will also make it even more important that the SEC and the CFTC work together to ensure that regulation is comprehensive and effective.

Regulators Must Have Broad, Flexible Jurisdiction Over the Entire Derivatives Market

Derivatives as a general matter should be traded on fully regulated, publicly transparent exchanges. The relevant regulatory agencies should ensure that the exchanges impose tough capital adequacy and margin requirements that reflect the risks inherent in contracts. Any entity that markets derivatives products must be required to register with the relevant federal regulators and be subject to business conduct rules, comprehensive recordkeeping requirements, and strict capital adequacy standards.

[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 22-24 (Jan. 29, 2009), available at *http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf*

[2] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

The Proposed OTC Act addresses many of the AFL–CIO's concerns about the current lack of regulation in the derivatives markets. If enacted, the Proposed OTC Act would ensure that all derivatives and all dealers face increased transparency, capital adequacy, and business conduct requirements.[3] It would also require heightened regulation and collateral and margin requirements for OTC derivatives.

The Proposed OTC Act would also require the SEC and CFTC to develop joint rules to define the distinction between "standardized" and "customized" derivatives.[4] This would make SEC/CFTC harmonization necessary to the establishment of effective derivatives regulation.

The AFL–CIO believes that the definition of a customized contract should be very narrowly tailored. Derivatives should not be permitted to trade over-the-counter simply because the counterparties have made minor tweaks to a standard contract. If counter-parties are genuinely on opposite sides of some unique risk event that exchange-trading could not accommodate, then they should be required to show that that is the case through a unique contract. The presence or absence of significant arms-length bargaining will be indicative of whether such uniqueness is genuine, or artificial.

In a recent letter to Senators Harkin and Chambliss, Chairman Gensler flagged several areas of the Proposed OTC Act that he believes should be improved.[5] The AFL–CIO strongly supports Chairman Gensler's recommendation that Congress revise the Proposed OTC Act to eliminate exemptions for foreign exchange swaps and forwards. We also strongly agree with Chairman Gensler that mandatory clearing and exchange trading of standardized swaps must be universally applicable and there should not be an exemption for counterparties that are not swap dealers or "major swap participants."

The SEC Should Regulate Financial Markets and the CFTC Should Regulate Commodities Markets

The SEC was created in 1934, due to Congress' realization that "national emergencies . . . are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."[6] As a result of the impact instability in the financial markets had on the broader economy during the Great Depression, Congress gave the SEC broad authority to regulate financial markets activities and individuals that participate in the financial markets in a meaningful way.[7]

As presently constituted, the CFTC has oversight not only for commodities such as agricultural products, metals, energy products, but also has come to regulate—through court and agency interpretation of the CEA—financial instruments, such as currency, futures on U.S. government debt, and security indexes.[8]

So long as two agencies continue to regulate the same or similar financial instruments, there will be opportunities for market participants to engage in regulatory arbitrage. As we have seen on the banking regulatory side and with respect to credit default swaps, such arbitrage can have devastating results.

As long as the SEC and the CFTC are separate, the SEC should regulate all financial instruments including stocks, bonds, mutual funds, hedge funds, securities, securities-based swaps, securities indexes, and swaps that reference currencies, U.S. government debt, interest rates, *etc.* The CFTC should have authority to regulate all physical commodities and commodities-based derivatives.

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[3] Available at *http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf*

[4] Proposed OTC Act § 713(a)(2) (proposing revisions to the Commodity Exchange Act, 7 U.S.C. 2(j)(3)(A)).

[5] Letter from Gary Gensler, Chairman of the Commodity Futures Trading Commission, to The Honorable Tom Harkin and The Honorable Saxby Chambliss, August 17, 2009, page 4, available at *http://tradeobservatory.org/library.cfm?refid=106665*

[6] 15 U.S.C. § 78b.

[7] See generally The Securities Act of 1933 (15 USC § 77a *et seq.*); The Securities Exchange Act of 1934 (15 USC § 78a *et seq.*); The Investment Company Act of 1940 (15 USC § 80a-1 *et seq.*); The Investment Advisers Act of 1940 (15 USC § 80b-1 *et seq.*).

[8] 7 U.S.C. § 1a(4) provides the CFTC with jurisdiction over agricultural products, metals, energy products, *etc.* See *Commodity Futures Trading Com'n v. International Foreign Currency, Inc.,* 334 F.Supp.2d 305 (E.D.N.Y. 2004), *Commodity Futures Trading Com'n v. American Bd. of Trade, Inc.,* 803 F.2d 1242 (2d Cir 1986) discussing the CFTC's authorities with regard to currency derivatives. Since 1975, the CFTC has determined that all futures based on short-term and long-term U.S. government debt qualifies as a commodity under the CEA. See CFTC History, available at *http://www.cftc.gov/aboutthecftc/historyofthecftc/history—1970s.html.* Other financial products regulated by the CFTC include security indexes, *Mallen v. Merrill Lynch.,* 605 F.Supp. 1105 (N.D.Ga.1985).

We recognize that the proposed Act does not in all cases follow the principles laid out above. To the extent financial derivatives remain under the jurisdiction of the CFTC, it is critical that the CFTC and the SEC seek the necessary statutory changes to bring the CFTC's power to police fraud and market manipulation in line with the SEC's powers. In this respect, we are heartened by the efforts by the CFTC under Chairman Gensler's leadership to address possible gaps in the Administration's proposed statutory language. A vigorous and coordinated approach to enforcement by both agencies can in some respects correct for flaws in jurisdictional design. They cannot correct for lack of jurisdiction or weak substantive standards of market conduct.

In his letter to Senators Harkin and Chambliss, Chairman Gensler raised concerns about the Administration's proposal for the regulation of "mixed swaps," or swaps whose value is based on a combination of assets including securities and commodities. Because the underlying asset will include those regulated by both the SEC and the CFTC, the Administration proposes that both agencies separately regulate these swaps in a form of "dual regulation." Chairman Gensler expresses concern that such dual regulation will be unnecessarily confusing, and suggests instead that each mixed swap be assigned to one agency or the other, but not both. In that proposed system, the mixed swap would be "primarily" deriving its economic identity from either a security or a commodity. [9] Under the Chairman's view, only one agency would regulate any given mixed swap, depending on whether the swap was "primarily" a security- or a commodity-based swap.

Chairman Gensler's proposal certainly has a great deal of appeal—it's simpler, and eliminates the concern that duplicative regulation becomes either unnecessarily burdensome, or worse, completely ineffective. One could imagine a situation where each agency defers to the other, leaving mixed swaps dealers with free reign to develop their market as they see fit.

But a proposal that focuses on the boundary between an SEC mixed swap and a CFTC mixed swap will run into a clear problem. There are swaps that are not primarily either security- or commodity-based: in fact, by design, they are swaps that, at the time of contract, are exactly 50/50, where the economic value of the SEC-type asset is equivalent to the economic value of the CFTC based asset. 50/50 swaps aren't that unusual, and Chairman Gensler's approach does not address what to do in those instances.

These kinds of boundary issues become inevitable when we decide not to merge the two agencies. In order to prevent these problems from becoming loopholes, a solution must either eliminate the boundary—*e.g.,* the Administration's dual regulation proposal—or it must adequately police that boundary. One potential alternative would be to form a staff-level joint task force between the CFTC and the SEC to ensure that these 50/50 swaps—those that are neither obviously SEC-swaps nor CFTC-swaps—would be regulated comprehensively, and consistently, across the system.

Anti-Fraud and Market Conduct Rules

In considering enforcement issues for derivatives, it is critical to consider the appropriate level of regulation of the underlying assets from which these derivatives flow. Some of the strongest tools in the agencies' toolboxes are anti-fraud and market conduct enforcement. Derivatives must be held at a minimum to the same standards as the underlying assets. The Administration's Proposed OTC Derivatives Act makes important steps in this direction. However, there will be a continuing problem if the rules governing the underlying assets are too weak.

Here the CFTC's current statutory framework is substantially weaker in terms of both investor protection and market oversight than the SEC. The Commodities Exchange Act (CEA) does not recognize insider trading as a violation of the law. This is a serious weakness in the context of mixed derivatives and both financial futures and derivatives based on financial futures. It also appears to be an obstacle to meaningful oversight of the commodities markets themselves in the light of allegations of market manipulation in the context of the recent oil price bubble.

Similarly, the CEA has an intentionality standard for market manipulation, while the SEC operates under a statutory framework where the standard in general is recklessness. Intentionality as a standard for financial misconduct tends to require that the agency be able to read minds to enforce the law. Recklessness is the proper common standard.

[9] *Id.*

Rules Versus Principles

The Treasury Department's White Paper on Financial Regulatory Reform suggests there should be a harmonization between the SEC's more rules-based approach to market regulation and the CFTC's more principles-based approach. [10] Any effective system of financial regulation requires both rules and principles. A system of principles alone gives no real guidance to market actors and provides too much leeway that can be exploited by the politically well connected. A system of rules alone is always gameable.

Unfortunately, in the years prior to the financial crisis that began in 2007 the term "principles based regulation" became a code word for weak regulation. Perhaps the most dangerous manifestation of this effort was the Paulson Treasury Department's call in its financial reform blueprint for the weakening of the SEC's enforcement regime in the name of principles based regulation by requiring a merged SEC and CFTC to adopt the CEA's approach across the entire securities market. [11]

The SEC and the CFTC should build a strong uniform set of regulations for derivatives markets that blend principles and rules. These rules should not be built with the goal of facilitating speedy marketing of innovative financial products regardless of the risks to market participants or the system as a whole. In particular, the provisions of the Commodities Exchange Act that place the burden on the CFTC to show an exchange or clearing facilities operations are not in compliance with the Act's principles under a "substantial evidence" test are unacceptably weak, and if adopted in the area of derivatives would make effective policing of derivatives' exchanges and/or clearinghouses extremely difficult.

It remains a mystery to us why "innovation" in finance is uncritically accepted as a good thing when so much of the innovation of the last decade turned out to be so destructive, and when so many commentators have pointed out that the "innovations" in question, like naked credit default swaps with no capital behind them, were well known to financial practitioners down through the ages and had been banned in our markets for good reason, in some cases during the New Deal and in some cases earlier.

This approach is not a call for splitting the difference between strong and weak regulation. It is a call for building strong, consistent regulation that recognizes that the promotion of weak regulation under the guise of "principles based regulation" was a major contributor to the general failure of the financial regulatory system.

Conclusion

The last 2 years have shown us the destructive consequences of the present system—destructive not only to our overall economy, but also to the lives and livelihoods of the men, women, and families least positioned to weather these storms. We have seen firsthand how regulatory arbitrage in the financial markets create tremendous systemic risks that can threaten the stability of the global economy. Derivatives are a primary example of how jurisdictional battles among regulators can result in unregulated and unstable financial markets. We urge you to work together to create a system that will ensure that nothing falls through the cracks when the SEC and the CFTC are no longer under your collective leadership.

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[10] Financial Regulatory Reform: A New Foundation. Department of the Treasury (June 17, 2009). See also *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf*

[11] *http://www.treas.gov/press/releases/reports/Blueprint.pdf*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM THOMAS DOE

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets? Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. In MMA's written testimony there was extensive discussion regarding the issue of inadequate enforcement of financial disclosure by municipal issuers. The greatest inhibiting aspect of disclosure is the ambiguity regarding rule 15c2-12. The vagueness of the rule has inhibited FINRA from enforcing the regulation and has only ensured that investors are not provided with pertinent financial information, but also that taxpayers do not have access to updated financial information.

As the MSRB's EMMA system approaches July 1 hegemony, participants' discussions over the problems with municipal disclosure have become more heated. Last Thursday, Moody's Investors Service withdrew more than a dozen local government ratings based on issuers' failure to provide timely financial or operating information. Although this does not follow a policy change by Moody's, it does reflect increased resources for surveillance and, in our opinion, is a preface to additional rating withdrawals in the coming months. In theory, if investors grow more broadly aware that bond ratings are vulnerable to disclosure lapses, the offending issuers will be forced to pay higher interest rates to borrow in the future.

The problem: Disclosure failings undermine liquidity in affected bonds and have led to mistrust of issuers by investors and, likely, modestly higher system-wide interest rates. Disclosure gaps occur because the current regulation is both weak and evasive. Rule 15c2-12 does force primary market participants to require that issuers pledge to disclose future financial and operating information; however, there is little penalty to these same firms if issuers do not honor those pledges. The issuers themselves rarely suffer by letting disclosure languish. Further, firms trading bonds in the secondary market have little effective responsibility to ensure that the bonds being placed in customer accounts (and thus recommended) are actually in compliance with issuers' primary market promises. MMA has elsewhere detailed why we believe issuers fail to disclose as promised, but our assessment that they do fail, and often, is a direct product of our experience analyzing credits in both primary and secondary market trades.

Recommendation: Substantive disclosure improvements do not require an end to the Tower Amendment, which bars the Federal

Government from regulating State and local issuers. The loss of Tower would needlessly compromise State autonomy and open the door to incremental Federal intervention in State and local affairs. Instead, we advocate a market-based solution:

1. Congress should position a single entity as arbiter to determine whether or not each issuer is in compliance with their stated disclosure requirements. This arbiter would likely need to be physically associated with the MSRB's EMMA system (or its successor). We recommend that a national issuer group control arbiter staffing to reduce potential issuer/investor conflicts in the future.
2. The arbiter would focus on regular, recurring disclosure items; however, regulated market participants should be required to pass along instances of non-recurring disclosure violations when discovered.
3. The arbiter would assign two statistics to each municipal Cusip. First, those issuers not currently in disclosure compliance would be flagged (red, versus green). Second, the arbiter would keep a database to track the number or percent of days the issuer was out of compliance over the last ten years. This historical statistic could be called the "disclosure compliance score" (or, "DCS").
4. Buyers evaluating primary or secondary market purchases could then evaluate the issuer's current disclosure flag and its historical DCS, increasing or reducing their bid accordingly. Flags could be easily integrated into customer portfolio statements, mutual fund quarterly statements, trading inventory discussions, *etc.*
5. In addition, all primary market participants (underwriters, bond counsel and other legal staffs, financial and swap advisors, bond insurers, and rating agencies) would be associated with an aggregated DCS for all issuers that they've helped bring to market in the last decade. This firm-by-firm DCS reading could give issuers another means to choose among potential intermediaries, while giving investors some insight into future disclosure compliance of first time issuers. It could also help regulators discover legal or financial firms whose issuer clients' record of disclosure compliance has been poor.
6. All firms trading municipal bonds, regardless of their status, would need to track how many trades, and the volume of par traded, that that firm had made with disclosure-flagged bonds. Registered firms could be prohibited from trading in red-flagged Cusips altogether. Again, this could be very important data for investors evaluating with which firm to invest and for firms' own risk management efforts.
7. New Federal regulations (*e.g.,* the upcoming revisions to 2a-7, any extension of Build America Bond programs, hypothetical SEC rules for financial advisors and dealers, *etc.*) could leverage disclosure flags and DCS scores in addition to other factors.
8. With respect to the MSRB's EMMA system, we strongly recommend that Congress and/or the SEC ensure that the

EMMA database include all historical primary and secondary market disclosure documents now being archived by the four current NRMSRs. This will be a critical factor for investor protection once EMMA becomes the sole NRMSR, as, once that happens, the current providers will lose their incentive (and possibly their financial ability) to adequately maintain the databases that have been painstakingly collected over the last ten years. The failure to add past databases will also allow the MSRB to postpone real disclosure reform on the basis that more time is needed to collect information before the SRO can determine if lapses have actually occurred. We also encourage Congress to require a formal advisory role, with respect to EMMA's organization and delivery of primary and secondary market disclosure items, to the National Federation of Municipal Analysts (NFMA)—which represents the substantial majority of EMMA's users (including, we should note, both buy-side and sell-side firms).

9. Finally, we note that we have included no recommendations with respect to the content of required secondary market disclosures in 15c2-12. While we believe that what is now being disclosed is unsatisfactory in some respects and superfluous in others, changes should be a product of broad industry discussion—as they were when rule 15c2-12 was created. We recommend that the MSRB and SEC be required to revisit this process to make regular adjustments to 15c2-12 in a fully transparent and recurring fashion.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, CT, on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. Witness declined to respond to written questions for the record.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. Witness declined to respond to written questions for the record.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans;

A.4. Witness declined to respond to written questions for the record.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
2. The G30 Report "Financial Reform; A Framework for Financial Stability" recommended that regulators should permit users of ratings to hold NRSROs accountable for the quality of their work product. Similarly, Professor Coffee recommended creating potential legal liability for recklessness when "reasonable efforts" have not been made to verify "essential facts relied upon by its ratings methodology."

A.5. In the past year, substantial blame has been placed on the rating agencies for: (1) implicit conflicts of interest in the issuer-pays (*i.e.,* banker-pays) system; (2) faulty ratings; and (3) the facilitation of regulators' and the financial industry's over-reliance on ratings generally. We believe all these points are well made; however, the SEC has already taken positive strides by bolstering the regulation of rating agency performance. We do not believe that incremental regulation of the rating agencies themselves, beyond these new rules, will substantially benefit investor protection. Rather, we encourage Congress to focus on changing regulations that deal with how regulators and investors use ratings.

1. The issuer-pays system cannot be abandoned as, in particular in the municipal bond market, there would reasonably be insufficient investor demand to pay for, and consistently maintain, a rating on each and every bond. Were rating agencies no longer able to bill issuers for ratings, the number and quality of ratings available would likely contract, increasing the

informational advantage of dealers and large institutional investors versus individuals and small investors.

2. Still, any issuer-pays system has obvious potential conflicts of interest, and our firm has long advised our subscribers to treat rating agency ratings as sales material and consider the rating agencies to be effectively part of bond selling groups. We believe this more adversarial framework should be employed when including ratings or rating requirements in any regulatory documents in the future.
3. To this point, we believe that Congress should create a set of rating definitions (which would speak to investors' expected loss—meaning a combined measure of probability of default and loss if a default were to occur) and require that ratings adhere to these definitions if they are to be used with respect to any Federal regulations (for example, Rule 2a-7). In other words, the rating agencies should be able to promulgate and sell ratings under any scheme of their choosing, but those ratings could only be used by issuers and investors for compliance with Federal regulations if the rating scale's definitions match those explicitly defined by Congress. This addresses what we see as an enormous current problem in that regulations include reference to ratings, but the rating agencies are free to define those ratings to their best judgment. Thus the problem in the municipal industry where municipal ratings reside on a more conservative rating scale than do corporate bonds (AAA corporate bonds have defaulted at 10x the rate of BBB municipals) but Federal regulations, such as money market fund eligibility rules, use identical rating benchmarks for both. Similarly, both commercial mortgage backed securities and the US Treasury can be rated AAA but there are obvious differences in the rating agencies' assumptions about the meaning behind those ratings. The new SEC rules will greatly help that entity monitor the rating agencies' success in plotting individual ratings along specified, expected-loss-based rating scales.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

A.6. Witness declined to respond to written questions for the record.

Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. The current system of SROs has failed municipal investors during the current financial crisis, noting:

1. The MSRB and FINRA have been almost entirely reactive to developing crises. MSRB did not issue comments on the collapse of the Auction Rate Securities (ARS) market until February 19, more than a month after the failure of most ARS auctions. Instead, the MSRB should have had a more thorough understanding of the ARS product's almost complete dependency on the: (1) ratings of the bond insurers; and (2) balance sheets of dealer banks. MSRB should have begun an aggressive investor education program starting in August 2007 and should have provided clear guidance to dealer firms over their management of failed auctions.
2. The MSRB has chosen to pursue derivatives regulation after substantial pain has already been felt by the industry. Further, the MSRB's plan to regulate swap and financial advisors, while likely to the benefit of the industry, would have done little to arrest many of the problems actually felt by municipal issuers. For example, widespread derivative problems in Tennessee have emanated from derivative sales by Morgan Keegan (a broker/dealer already regulated by MSRB). There are several other similar instances (in Wisconsin and Pennsylvania and Alabama) where it has been regulated firms' derivative sales practices, and not failings of unregulated swap advisors, that ultimately created problems for issuers and ultimately individual investors.
3. Claiming lack of resources, FINRA has been unable to proactively pursue (or, investigate without a specific customer complaint to guide their actions) clear evidence of broad market manipulation. We believe that FINRA's funding for proactive regulation is minimized by design, as their focus on specific, trade-by-trade pricing violations limits their potential influence on systemic market characteristics such as how bonds are valued and how bonds are distributed.
4. Indeed, MSRB's history of avoiding the pursuit of better transparency in the municipal market has exaggerated dealer banks' informational advantage versus their customers and individual investors. Specifically we note how better information on issuers' rate and counterparty exposure via derivatives and interest rate swaps could have helped both individual investors and the issuers themselves manage their particular exposure.
5. The MSRB has not aggressively pursued widespread instances of current disclosure failure in the municipal industry. While

the MSRB has worked to create and rollout their EMMA system that may bring an ultimate improvement to disclosure, they have avoided taking any opinion or making any immediate corrective actions to ongoing disclosure problems hurting investors today. Further, we believe that the MSRB's plans to rollout EMMA, collect information for a year, and then see if disclosure is really a problem reflects an intent to maintain dealers' informational advantage (gained by limiting investors' access to disclosure documents) for as long as possible.

6. And perhaps most importantly, the MSRB has largely failed to educate and keep informed the macro regulators and US legislature on issues involving municipal bonds. We believe this is a fundamental problem with SROs in that, fearing more formal regulation, they attempt to shield specific details and developments from broad review; thus our phrase, "municipals are a backwater by design." MMA was first contacted by regulators (in the summer of 2007) and since that time we have maintained a highly active dialogue with both Congressional staffs and macro regulators. We have been shocked at the lack of understanding of even the rudiments of our industry, the flows of capital and data, the important players and pressures. In fact, we believe that, had the MSRB more actively attempted to educate Washington policymakers prior to the current crisis, the Federal response could have been more rapid and better informed.

Given the events of the past 18 months, I believe that regulation must be integrated and centralized. Because of these failures, it would be prudent to either move the MSRB into the SEC—or, at a minimum certain changes must be made to the MSRB structure.

If Congress deems it necessary that a SRO is an inappropriate model for regulation of the municipal industry, the following should take place:

1. Create a Division of Municipal Securities that would report directly to the Chairman of the SEC. Move the current Office of Municipal Securities out of the Division of Trading and Markets into this new Division. Move all MSRB staff and its current funding structure into this new Division. The municipal industry is such a unique market and functions in such a different way from other markets that it should be separate from other markets. In creating a new division, the industry would benefit from specialized staff and researchers as well as having a direct line of communication with the office of the Chairman.
2. The MSRB staff must be bolstered with more seasoned municipal experts and create specific offices within the Municipal division focused on: secondary markets, underwriting, derivatives, accounting, disclosure, ratings, and bond insurance and tax issues. Compensation should and can be competitive to ensure the best staff possible. Under current MSRB funding structure, in 2008 the MSRB received $22.1 million in revenue and in 2007 it relieved $21.4 million in revenue. The Board derives revenue from primary and secondary trans-

actions that market participants pay. Detailed financial statements are available on the Board's Web site.

3. Similar to our conclusions above in the disclosure responses, substantive regularly improvements do not require an end to the Tower Amendment, which bars the Federal Government from regulating State and local issuers. The loss of Tower would needlessly compromise State autonomy and open the door to incremental Federal intervention in State and local affairs. Instead, we advocate a market-based solution.
4. Create a Municipal Securities Rulemaking Advisory Board (MSRAB) that will be made up of 15 "at large" current and retired market participants. The MSRAB will produce a report to Congress and the Treasury Dept. annually on new trends in the market and potential regulatory shortcomings. The MSRAB should have continual communication with the Division of Municipals Securities.
5. Create a SEC-FINRA enforcement coalition council whereby information is shared in a fluid basis on future enforcement actions.
6. Create regional SEC municipal offices under the Division to monitor regional activities on closer basis. The municipals market, more than any other market in the U.S., is dominated by local politics and is quite fragmented. Having staff on the ground in every major region is essential to productive regulation and timely enforcement.

On the other hand, we do note that there remains strong industry and perhaps even issuer support for the current SRO structure; MMA has received multiple comments to this effect since our Senate testimony. Thus, while we do believe that integrating the MSRB's components into an independent regulator is the better course of action, Congress may instead choose to preserve the current MSRB as an SRO structure. In preserving the SRO, we recommend Congress do the following:

1. Replace the current, dealer-centric MSRB board with representative members who provide independent and objective insight into the various aspects of the purpose of the municipal industry—the efficient and effective raising of capital for municipal entities.
2. Require that there be frequent and regular communication between the municipal regulatory network (MSRB, FINRA, Treasury, SEC, and the Federal Reserve), perhaps in the form of weekly or monthly committee meetings. The SEC should be given full access to minutes of any discussions; these minutes should be made publicly available to the extent possible. A semi-annual report to Congress on the status of the industry should be required.
3. Regulate and collect real-time information on municipal derivatives including interest rate swaps and credit default swaps. All derivatives information should be made publicly available, illustrating, among other points: counterparty exposure, termination and cost exposure under absolute worst case scenarios, and price volatility assumptions.

There is no question in my mind that better regulation comes from participants who understand the motivations of the participants and the environment in which market participants work on a daily basis. The theoretical concept or asset of the SRO regulatory concept is based on having knowledgeable people involved in the process—not bureaucrats or those susceptible to political pressures. However, as has been readily apparent, an SRO is inhibited by the time an active market participant can commit to a volunteer position (regardless of how well intended the individual) and the challenge of the participant to act for the industry's best interest (*i.e.,* altruistically) when it may run contrary to the interests of its employer and one's own employment viability.

Specific to the municipal industry, the current composition of the Board, with 10 of 15 spots allotted to security dealers, does not provide for a balanced perspective of the industry and participants. The board must be broad, independent and structure/composition must be adaptable and flexible in its construct to anticipate future industry change. A balance of board members from different constituencies of the market and who are predominantly, not necessarily exclusively, retired from active industry involvement would more likely provide independent counsel, industry practical knowledge and a more comprehensive overview being removed from day-to-day industry responsibilities.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. Witness declined to respond to written questions for the record.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. The SEC needs a mechanism to collect market information and input from participants so as to understand the impact both short and long-term regarding policy actions. My limited experience with the municipal division of the SEC is that there is an interest to understand and learn. However, the entrenched mechanisms that have historically inhibited timely action and response to consumer needs or systemic risks has reduced the initiative and innovation among a long standing staff. There would appear to be a need for new structure in order to enliven the current talent pool.

The MSRB funding structure is very profitable and moving the MSRB into a new SEC division should pay for itself. MSRB annual financial statements are available on its Web site.

Q.10. *MSRB's Data System:* Please explain in detail why the Congress should consider "End[ing] the MSRB as an SRO" and "Integrat[ing] the MSRB formally and directly into a larger entity, possibly the Securities Exchange Commission, Treasury or Federal Reserve" as you suggest in your written testimony. Also, what is your evaluation of the impact of the MSRB's new EMMA data system on investors and dealers?

A.10. In my oral and written testimony I did advocate for the end of the SRO era with specific reference to the MSRB. My advocacy comes from the direct experience of seeing:

1. Volunteer board members deferring decision-making and becoming over-reliant on staff;
2. Volunteer dealer members slowing down processes to inhibit the creation of regulation that would inhibit current profit-making enterprises;
3. Anti-regulation bias among dealer community inhibited innovative action;
4. That dealer participants, especially in larger firms, were compromised in advocating regulatory changes that might establish regulatory precedent which could potentially reduce their employer's near-term profitability because their own employment could be at risk for taking such action;
5. An absence of representation of the wide range of participants in the municipal industry has historically inhibited the gathering of pertinent information for appropriate regulation that would create better and more informed rules and policies.

The current structure of the SRO has resulted in the pockets of regulatory opacity not being addressed.

Had the MSRB been integrated into a larger entity in a coordinated manner, the risks being promulgated in the municipal industry might have been recognized sooner—not only to avert the chaos which ensued over the past 18 months but also might have raised awareness that similar excessive risks were occurring in other markets which could have prompted earlier and more prophylactic regulatory action to mitigate the systemic risks which ensued.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM THOMAS DOE

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.1. Witness declined to respond to written questions for the record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM LYNN E. TURNER

Q.1. *Transparency:* Are there additional types of disclosures that Congress should require securities market participants to make for the benefit of investors and the markets?

Also, would you recommend more transparency for investors:

1. By publicly held banks and other financial firms of off-balance sheet liabilities or other data?
2. By credit rating agencies of their ratings methodologies or other matters?
3. By municipal issuers of their periodic financial statements or other data?
4. By publicly held banks, securities firms and GSEs of their risk management policies and practices, with specificity and timeliness?

A.1. Witness declined to respond to written questions for the record.

Q.2. *Conflicts of Interest:* Concerns about the impact of conflicts of interest that are not properly managed have been frequently raised in many contexts—regarding accountants, compensation consultants, credit rating agencies, and others. For example, Mr. Turner pointed to the conflict of the board of FINRA including representatives of firms that it regulates. The Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Connecticut on March 2 proposed an industry-wide code of professional conduct for proxy services that includes a ban on a vote advisor performing consulting work for a company about which it provides recommendations.

In what ways do you see conflicts of interest affecting the integrity of the markets or investor protection? Are there conflicts affecting the securities markets and its participants that Congress should seek to limit or prohibit?

A.2. Witness declined to respond to written questions for the record.

Q.3. *Credit Default Swaps:* There seems to be a consensus among the financial industry, government officials, and industry observers that bringing derivative instruments such as credit default swaps under increased regulatory oversight would be beneficial to the nation's economy. Please summarize your recommendations on the best way to oversee these instruments.

A.3. Witness declined to respond to written questions for the record.

Q.4. *Corporate Governance—Majority Vote for Directors, Proxy Access, Say on Pay:* The Council of Institutional Investors, which represents public, union and corporate pension funds with combined assets that exceed $3 trillion, has called for "meaningful investor oversight of management and boards" and in a letter dated December 2, 2008, identified several corporate governance provisions that "any financial markets regulatory reform legislation [should] include." Please explain your views on the following corporate governance issues:

1. Requiring a majority shareholder vote for directors to be elected in uncontested elections;
2. Allowing shareowners the right to submit amendment to proxy statements;
3. Allowing advisory shareowner votes on executive cash compensation plans.

A.4. Witness declined to respond to written questions for the record.

Q.5. *Credit Rating Agencies:* Please identify any legislative or regulatory changes you believe are warranted to improve the oversight of credit rating agencies.

In addition, I would like to ask your views on two specific proposals:

1. The Peterson Institute report on "Reforming Financial Regulation, Supervision, and Oversight" recommended reducing conflicts of interest in the major rating agencies by not permitting them to perform consulting activities for the firms they rate.
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A.5. Witness declined to respond to written questions for the record.

Q.6. *Hedge Funds:* On March 5, 2009, the Managed Funds Association testified before the House Subcommittee on Capital Markets and said: "MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework." MFA supported the creation or designation of a "single central systemic risk regulator" that (1) has "the authority to request and receive, on a confidential basis, from those entities that it determines . . . to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system," (2) has a mandate of protection of the financial system, but not investor protection or market integrity and (3) has the authority to ensure that a failing market participant does not pose a risk to the entire financial system.

Do you agree with MFA's position? Do you feel there should be regulation of hedge funds along these lines or otherwise?

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Q.7. *Self-Regulatory Organizations:* How do you feel the self-regulatory securities organizations have performed during the current financial crisis? Are there changes that should be made to the self-regulatory organizations to improve their performance? Do you feel there is still validity in maintaining the self-regulatory structure or that some powers should be moved to the SEC or elsewhere?

A.7. Witness declined to respond to written questions for the record.

Q.8. *Structure of the SEC:* Please share your views as to whether you feel that the current responsibilities and structure of the SEC should be changed.

Please comment on the following specific proposals:

1. Giving some of the SEC's duties to a systemic risk regulator or to a financial services consumer protection agency;
2. Combining the SEC into a larger "prudential" financial services regulator;
3. Adding another Federal regulators' or self-regulatory organizations' powers or duties to the SEC.

A.8. Witness declined to respond to written questions for the record.

Q.9. *SEC Staffing, Funding, and Management:* The SEC has a staff of about 3,500 full-time employees and a budget of $900 million. It has regulatory responsibilities with respect to approximately: 12,000 public companies whose securities are registered with it; 11,300 investment advisers; 950 mutual fund complexes; 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); 600 transfer agents, 11 exchanges; 5 clearing agencies; 10 nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board and the Public Company Accounting Oversight Board.

To perform its mission effectively, do you feel that the SEC is appropriately staffed? funded? managed? How would you suggest that the Congress could improve the effectiveness of the SEC?

A.9. Witness declined to respond to written questions for the record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM LYNN E. TURNER

Q.1. Do you all agree with Federal Reserve Board Chairman Bernanke's remarks today about the four key elements that should guide regulatory reform?

> First, we must address the problem of financial institutions that are deemed too big—or perhaps too interconnected—to fail. Second, we must strengthen what I will call the financial infrastructure—the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets—to ensure that it will perform well under stress. Third, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality—that is, do not overly magnify the ups and downs in the financial system and the economy. Finally, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing.

Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform, and how should that be accomplished?

How is it that AIG was able to take such large positions that it became a threat to the entire financial system? Was it a failure of regulation, a failure of a product, a failure of risk management, or some combination?

How should we update our rules and guidelines to address the potential failure of a systematically critical firm?

A.1. Witness declined to respond to written questions for the record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER FROM LYNN E. TURNER

Q.1. Are you concerned that too much reliance on investor protection through private right of action against the credit ratings agencies will dramatically increase both the number of law suits the companies will have to deal with as well as their cost of doing business? Have you thought about alternative ways to ensure adequate investor protections that will not result in driving capital from the U.S. in the same way that the fear of litigation and costs created by Sarbanes-Oxley has resulted in a decline in new listings in American capital markets?

A.1. Witness declined to respond to written questions for the record.