Consumer Federation of America

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STATEMENT OF
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to the

JOINT SEC-CFTC MEETING ON HARMONIZATION OF REGULATION

September 2, 2009

Chairwoman Schapiro, Chairman Gensler,

I am Dr. Mark Cooper, Director of Research at the Consumer Federation of America (CFA). CFA greatly appreciates the opportunity to testify before the Joint meeting of the Commodity Futures Trading Commission and the Securities and Exchange Commission to address the important topic of eliminating conflict in statutes and regulation in the effort to repair the financial system in the United States. The CFA has half a dozen people who work on various aspects of the financial melt down including investor protection, consumer protection, housing, financial, insurance and commodity markets. I analyze commodities issues and economic theory for CFA, so I will lay out some broad principles for this inquiry to follow.

Barbara Roper, CFA's Director of Investor Protection, and I recently co-authored a major report on *Reform of Financial Markets* that forms the basis for my remarks today, which I submit for the record. Our analysis shows that Alan Greenspan's admission that there is a flaw[1] in the theory that financial markets need little, if any, regulation is a gross understatement of the problem. We identified six fundamental imperfections in financial markets that led to a pervasive market failure – systemic risk, perverse incentives, imperfect information, agency, conflicts of interest and unfairness. Financial market reform must address all six if we are to repair the damage to our financial system and our economy. The SEC and CFTC must address all six if they are to provide a harmonized approach to securities, commodities and derivatives regulation that both protects investors and promotes market integrity and capital formation.

- The first principle of financial sector reform is simple. The purpose of the financial sector is to support the real economy.

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[1] "Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief… I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms." *The Financial Crisis and the Role of Federal Regulators,* Committee on Oversight and Government Reform, U.S. House of Representative, October 23, 2008.

For example, in the case of securities, the purpose of financial markets and instruments is to "channel savings and investment into economic activity, allowing for the efficient allocation of capital and risk, [which] is indispensable to any successful economy."[2] In the case of commodities, the purpose of financial markets and instruments is to smooth the flow of physical commodities through their production cycle, which in many cases is fraught with uncertainty.

In the past couple of decades, with the excessive financialization of the economy, we lost sight of this basic fact. As we move forward in repairing the damage to our financial system, we must get our priorities right. Rebuilding the economy is the paramount goal. Reforming the financial system is a means to that end.

One clear conclusion of our research is that it is no longer possible to maintain that sophisticated actors can be trusted to defend their own interests or that their transactions do not affect the public interest. Both claims are wrong. This is directly relevant to the topic before you today, since some, though not all, of the differences in regulatory approach between the SEC and CFTC derive from differences in the real and perceived sophistication of participants in the markets each regulates. To the degree that this is so, any harmonization in approach must be a harmonization upwards – to provide the highest level of investor protection.

- The effort to harmonize regulation of financial markets between different statutes and different agencies should proceed with one overriding objective in mind, to prevent these market imperfections from once again undermining the important function of the financial system.
- Harmony should never be achieved at the expense of the effectiveness of prudential regulation. Financial innovation, which nearly destroyed our economy, must take a back seat to safety and soundness.

Financial sector reform across all agencies needs to follow a simple philosophy of regulation:

- Accountability, and therefore effective oversight, derives from principles of prudential regulation expressed in clear rules that are strictly enforced in a transparent manner. There need be no conflict between principles and rules. Rules are, or should be, the embodiment of principles. Principles without rules are likely to be ineffective. Rules without principles are likely to be misguided.

Only after policy makers identify the principles that need to be applied and the rules that should be implemented can they even ask where harmonization is necessary. The inquiry should not start by asking financial market participants how they want to be regulated; it must start by asking how market participants should be regulated. Only after we know what regulation is

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[2] Congressional Oversight Panel issued a *Special Report on Regulatory Reform,* Washington, D.C., January 29, 2009, p. 2.

necessary can we know which conflicts stand in the way of effective regulation and should be removed.

- The purpose of this inquiry should be to raise the level of regulation to achieve the ultimate goal, not lower the level to eliminate conflicts.
- Not every difference is a conflict. Similar things should be treated similarly. Different things can be treated differently.
- Entities providing financial services should be regulated by what they do, not who they are. If they are providing bank-like services, they should be regulated like a bank; if they provide insurance services, they should be regulated like insurance companies.

The fact that a single entity might be selling different financial products in different markets that are regulated differently by different agencies is perfectly reasonable. It reflects a choice made by the entity regarding how to structure its business, not a flaw in regulation.

- The extent of regulation should be commensurate with the size, importance and complexity of institutions and products.

There is no better example of the important difference between products, grounded in differences in the real economy, than the difference between financial instruments in money markets and financial instruments in energy markets.

> [T]he deliverables in money markets consist of a "piece of paper" or its electronic equivalent, which are easily stored and transferred and are insensitive to weather conditions. Energy markets paint a more complicated picture. Energies respond to the dynamic interplay between producing and using; transferring and storing; buying and selling – and ultimately "burning" actual physical products. Issues of storage, transport, weather and technological advances play a major role here.
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> In energy markets, the supply side concerns not only the storage and transfer of the actual commodity, but also how to get the actual commodity out of the ground. The end user truly consumes the asset. Residential users need energy for heating in the winter and cooling in the summer, and industrial users' own products continually depend on energy to keep the plants running and to avoid the high cost of stopping and restarting them. Each of these energy participants – be they producers or end users – deals with a different set of fundamental drivers, which in turn affect the behavior of energy markets…
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> What makes energies so different is the excessive number of fundamental price drivers, which cause extremely complex price behavior.[3]

[3] Dragana Pilipovic, *Energy Risk: Valuing and Managing Energy Derivates* 3 (McGraw-Hill 1998).

Derivatives tied to securities may well be regulated differently than derivatives tied to commodities because the underlying assets and activities in the real economy have very different characteristics.

- If an entity that sells different products does not like the fact that it finds itself subject to different regulations, it should exit one of the lines of business, not complain about conflicts in regulation. There will be plenty of single purpose traders to take its place.

The bottom line is straightforward. Harmonization must not be an excuse for inadequate regulation. Applying these principles, the SEC and the CFTC should identify which prior statutory language, regulations and agency practices resulted in gaps in regulation that opened the door to market failure. They should identify the steps necessary to close those gaps and, where there are conflicts between agencies, they should adopt the approaches of the agency whose statutes and practices are better suited to get the job done.