Consumer Federation of America

Testimony of
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Consumer Federation of America

Hearing on
"Enhancing Investor Protection and the Regulation of Securities Markets"

Before the
Committee on Banking, Housing & Urban Affairs
U.S. Senate

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Chairman Dodd, Ranking Member Shelby and Members of the Committee:

My name is Barbara Roper. I am Director of Investor Protection of the Consumer Federation of America (CFA). CFA is a non-profit association of approximately 280 organizations. It was founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the opportunity to appear before you today to discuss needed steps to strengthen investor protection.

The topic we have been asked to address today, "Enhancing Investor Protection and the Regulation of Securities Markets," is broad. It is appropriate that you begin your regulatory reform efforts by casting a wide net, identifying the many issues that should be addressed as we seek to restore the integrity of our financial system. In response, my testimony will also be broader than it is deep. In it, I will attempt to identify and briefly describe, but not comprehensively detail, solutions to a number of problems in three general categories: responding to the current financial crisis, reversing harmful policies, and adopting pro-investor reforms. I look forward to working with this Committee and its members on its legislative response.

Introduction

Before I turn to specific issues, however, I would like to take a few moments to discuss the environment in which this reform effort is being undertaken. I'm sure I don't need to tell the members of this Committee that the public is angry, or that investor confidence – not just in the safety of the financial markets but in their integrity – is at an all-time low. Perhaps you've seen the recent Harris poll, taken before the news hit about AIG's million-dollar bonuses, which found that 71 percent of respondents agreed with the statement that, "Most people on Wall Street would be willing to break the law if they believed they could make a lot of money and get away with it." If not, you've surely heard a variant on this message when you've visited your districts or turned on the evening news.

Right now, the public rage is unfocused, or rather it is focused on shifting targets in response to the latest headlines: Bernie Madoff's Ponzi scheme one day, bailout company conferences at spa resorts the next, AIG bonuses today. Imagine what will happen if the public ever really wakes up to the fact that all of the problems that have brought down our financial system and sent the global economy into deep recession – unsound and unsustainable mortgage lending, unregulated over-the-counter derivatives, and an explosive combination of high leverage and risky assets on financial institution balance sheets – were diagnosed years ago but left unaddressed by legislators and regulators from both political parties who bought into the idea that market discipline and industry self-interest were all that was needed to rein in Wall Street excesses and that preserving industry's ability to innovate was more important than protecting consumers and investors when those innovations turned toxic.

Now, this Committee and others in Congress have begun the Herculean task of rewriting the regulatory rulebook and restructuring the regulatory system. That is an

effort that CFA strongly supports. But, as the Securities Subcommittee hearing last week on risk management regulation made all too clear, those efforts are likely to have little effect if regulators remain reluctant to act in the face of obvious industry short-comings and clear signs of abuse. After all, we might not be here today if regulators had done just that – if the Fed had used its authority under the Home Ownership and Equity Protection Act to rein in the predatory subprime lending that is at the root of this problem, or if SEC and federal banking regulators had required the institutions under their jurisdiction to adopt appropriate risk management practices that could have made them less vulnerable to the current financial storm.

Before we heap too much scorn on the regulators, however, we would do well to remember that, in recent years at least, global competitiveness was the watchword, and regulators who took too tough a line with industry were more likely to be called on the carpet than those who were too lax. Even now, it is not clear how much that has changed. After all, just two weeks ago, the House Capital Markets Subcommittee subjected the Financial Accounting Standards Board (FASB) to a thorough grilling for doing too little to accommodate financial institutions seeking changes to fair value accounting, changes, by the way, that would make it easier for those institutions to hide bad news about the deteriorating condition of their balance sheets from investors and regulators alike. Unless something fundamental changes in the way we approach these issues, it is all too easy to imagine a new systemic risk regulator sitting in that same hot seat in a couple of years, asked to defend regulations industry groups complain are stifling innovation and undermining their global competitiveness. More than any single policy or practice, that anti-regulatory bias among regulators and legislators is what needs to change if the goal is to better protect investors and restore the health and integrity of our securities markets.

I. Respond to the Current Financial Crisis

It doesn't take a rocket scientist to recognize that, in the midst of a financial crisis of global proportions, the top investor protection priority today must be fixing the problems that caused the financial meltdown. Largely as the result of a coincidence in the timing of Bear Stearns' failure and the release of the Treasury Department's Blueprint for Financial Regulatory Reform, many people have sought solutions to our financial woes in a restructuring of the financial regulatory system. CFA certainly agrees that our regulatory structure can, and probably should, be improved. We remain convinced, however, that structural weaknesses were not a primary cause of the current crisis, and structural changes alone will not prevent a recurrence. We appreciate the fact that this Committee has recognized the importance of treating these issues holistically and has pledged to take an inclusive approach. As the Committee moves forward with that process, the following are among the key investor protection issues CFA believes must be addressed as part of a comprehensive response to the financial meltdown.

1) Shut down the "shadow" banking system.

The single most important step Congress can and should take immediately to reduce excessive risks in the financial system is to close down the shadow banking system completely and permanently. While progress is apparently being made (however slowly) in moving over-the-counter credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So, when Japanese insurers in the 1980s wanted to evade restrictions that prevented them from investing in the Japanese stock market, Bankers Trust designed a complex three-way derivative transaction between Japanese insurers, Canadian bankers, and European investors that allowed them to do just that. Institutional investors that were not permitted to speculate in foreign currencies could do so indirectly using structured notes designed by Credit Suisse Financial Products that, incidentally, magnified the risks inherent in currency speculation. And banks could do these derivatives deals through special purpose entities (SPEs) domiciled in business-friendly jurisdictions like the Cayman Islands in order to avoid taxes, keep details of the deal hidden, and insulate the bank from accountability.

These same practices, which led to a series of mini-financial crises throughout the 1990s, are evident in today's crisis, but on a larger scale. Banks such as Citigroup were still using unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks such as Merrill Lynch sold subprime-related CDOs to pension funds and other institutional investors in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter derivatives market, often by AIG, without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

To be credible, any proposal to respond to the current crisis must confront the "shadow banking system" issue head-on. This does not mean that all investors must be treated identically or that all financial activities must be subject to identical regulations, but it does mean that all aspects of the financial system must be subject to regulatory scrutiny based on appropriate standards. One focus of that regulation should be on protecting against risks that could spill over into the broader economy. But regulation should also apply basic principles of transparency, fair dealing, and accountability to

these activities in recognition of the two basic lessons from the current crisis: 1) protecting consumers and investors contributes to the safety and stability of the financial system; and 2) the sheer complexity of modern financial products has made former measures of investor "sophistication" obsolete.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors do not require the protections of the regulated market. According to this line of reasoning, these investors are capable both of protecting their own interests and of absorbing any losses. That myth should have been dispelled back in the early 1990s, when Bankers Trust took "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. Or when Orange County, California lost $1.7 billion, and ultimately went bankrupt, buying structured notes with borrowed money in what essentially amounted to a $20 billion bet that interest rates would remain low indefinitely. Or when a once-respected conservative government bond fund, Piper Jaffray Institutional Government Income Portfolio, lost 28 percent of its value in less than a year betting on collateralized mortgage obligations that involved "risks that required advanced mathematical training to understand."[1]

All of these deals, and many others like them, had several characteristics in common. In each case, the brokers and bankers who structured and sold the deal made millions while the customers lost fortunes. The deals were all carried out outside the regulated securities markets, where brokers, despite their best lobbying efforts throughout much of the 1990s, still faced a suitability obligation in their dealings with institutional clients. Once the deals blew up, efforts to recover losses were almost entirely unsuccessful. And, in many cases, strong evidence suggests that the brokers and bankers knowingly played on these "sophisticated" investors' lack of sophistication. Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[2]

More recent accounts suggest that little has changed in the intervening decades. As *Washington Post* reporter Jill Drew described in a story detailing the sale of subprime CDOs:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.

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[1] Frank Partnoy, *Infectious Greed*, *How Deceit and Risk Corrupted the Financial Markets*, Henry Holt and Company (New York), 2003, p. 123.

[2] Partnoy, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now … $20 Million: How Bankers Trust Sold Gibson Greetings a Disaster," *Washington Post,* June 11, 1995, p. A1.

> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[3]

The sophisticated investor myth survived earlier scandals thanks to Wall Street lobbying and the fact that the damage from these earlier scandals was largely self-contained. What's different this time around is the harm that victimization of "sophisticated" investors has done to the broader economy. Much as they had in the past, "sophisticated" institutional investors have once again loaded up on toxic assets – in this case primarily mortgage-backed securities and collateralized debt obligations – without understanding the risks of those investments. In an added twist this time around, many financial institutions also remained exposed to the risk of these assets, either because they made a conscious decision to retain a portion of the investments or because they couldn't sell off their inventory after the market collapsed. As events of the last year have shown, the damage this time is not self-contained; it has led to a 50 percent drop in the stock market, a freezing of credit markets, and a severe global recession. Meanwhile, the administration is still struggling to find a way to clear toxic assets from financial institutions' balance sheets.

Once it has closed existing gaps in the regulatory system, Congress will still need to give authority to some entity – presumably whatever entity is designated as systemic risk regulator – to prevent financial institutions from opening up new regulatory loopholes as soon as the old ones are closed. That regulator must have the ability to determine where newly emerging activities will be covered within the regulatory structure. In making those decisions, the governing principle should be that activities and products are regulated according to their function. For example, where credit default swaps are used as a form of insurance, they should be regulated according to standards that are appropriate to insurance, with a focus on ensuring that the writer of the swaps will be able to make good on any claims. The other governing principle should be that financial institutions are not permitted to engage in activities indirectly that they would be prohibited from engaging in directly. Until that happens, anything else Congress does to reduce the potential for systemic risks is likely to have little effect.

2) Strengthen regulation of credit rating agencies.

Complex derivatives and mortgage-backed securities were the poison that contaminated the financial system, but it was their ability to attract high credit ratings that allowed them to penetrate every corner of the market. Over the years, the number of financial regulations and other practices tied to credit ratings has grown rapidly. For example, money market mutual funds, bank capital standards, and pension fund investment policies all rely on credit ratings to one degree or another. As Jerome S. Fons and Frank Partnoy wrote in a recent *New York Times* op ed: "Over time, ratings became

[3] Jill Drew, "Frenzy," *Washington Post*, December 16, 2008, p. A1.

valuable … because they "unlock" markets; that is, they are a sort of regulatory license that allows money to flow."[4] This growing reliance on credit ratings has come about despite their abysmal record of under-estimating risks, particularly the risks of arcane derivatives and structured finance deals. Although there is ample historical precedent, never was that more evident than in the current crisis, when thousands of ultimately toxic subprime-related mortgage-backed securities and CDOs were awarded the AAA ratings that made them eligible for purchase by even the most conservative of investors.

Looking back, many have asked what would possess a ratings agency to slap a AAA rating on, for example, a CDO composed of the lowest-rated tranches of a subprime mortgage-backed security. (Some, like economists Joshua Rosner and Joseph Mason, pointed out the flaws in these ratings much earlier, at a time when, if regulators had heeded their warning, they might have acted to address the risks that were lurking on financial institutions' balance sheets.)[5] Money is the obvious answer. Rating structured finance deals pays generous fees, and ratings agencies' profitability has grown increasingly dependent in recent years on their ability to win market share in this line of business. Within a business model where rating agencies are paid by issuers, the perception at least is that they too often win business by showing flexibility in their ratings. Another possibility, no more attractive, is that the agencies simply weren't competent to rate the highly complex deals being thrown together by Wall Street at a breakneck pace. One Moody's managing director reportedly summed up the dilemma this way in an anonymous response to an internal survey: "These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both."[6]

The Securities and Exchange Commission found support for both explanations in its July 2008 study of the major ratings agencies.[7] It documented both lapses in controls over conflicts of interest and evidence of under-staffing and shoddy practices: assigning ratings despite unresolved issues, deviating from models in assigning ratings, a lack of due diligence regarding information on which ratings are based, inadequate internal audit functions, and poor surveillance of ratings for continued accuracy once issued. Moreover, in addition to the basic conflict inherent in the issuer-paid model, credit rating agencies can be under extreme pressure from issuers and investors alike to avoid downgrading a company or its debt. With credit rating triggers embedded in AIG's credit default swaps agreements, for example, a small reduction in rating exposed the company to billions in obligations and threatened to disrupt the CDS market.

It is tempting to conclude, as many have done, that the answer to this problem is simply to remove all references to credit ratings from our financial regulations. This is the recommendation that Fons and Partnoy arrive at in their *Times* op ed. "Regulators

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[4] Jerome S. Fons and Frank Partnoy, "Rated F for Failure," *New York Times*, March 16, 2009.
[5] Joseph R. Mason and Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?* (preliminary paper presented at Hudson Institute) February 15, 2007.
[6] Gretchen Morgenson, "Debt Watchdogs: Tamed or Caught Napping?" *New York Times,* December 7, 2008.
[7] U.S. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies,* July 2008.

and investors should return to the tool they used to assess credit risk before they began delegating responsibility to the credit rating agencies," they conclude. "That tool is called judgment." Unfortunately, Fons and Partnoy may have identified the only thing less reliable than credit ratings on which to base our investor protections.

The other frequently suggested solution is to abandon the issuer-paid business model. Simply moving to an investor-paid model suffers from two serious shortcomings, however. First, it is not as free from conflicts as it may on the surface appear. While investors generally have an interest in receiving objective information before they purchase a security – unless they are seeking to evade standards they view as excessively restrictive – they may be no more interested than issuers in seeing a security downgraded once they hold it in their portfolio. Moreover, we stand to lose ratings transparency under a traditional investor-paid model, since investors who purchase the rating are unlikely to want to share that information with the rest of the world on a timely basis. SEC Chairman Mary Schapiro indicated in her confirmation hearing before this Committee that she was exploring other payment models designed to get around these problems. We look forward to reviewing concrete suggestions that could form an important part of any comprehensive solution to the credit rating problem.

While it is easier to diagnose the problems with credit ratings than it is to prescribe a solution, we believe the best approach is found in simultaneously reducing reliance on ratings, increasing accountability of ratings agencies, and improving regulatory oversight. Without removing references to ratings from our legal requirements entirely, Congress could reduce reliance on ratings by clarifying, in each place where ratings are referenced, that reliance on ratings does not substitute for due diligence. So, for example, a money market fund would still be restricted to investing in bonds rated in the top two categories, but they would also be accountable for conducting meaningful due diligence to determine that the investment in question met appropriate risk standards.

At the same time, credit rating agencies must lose the First Amendment protection that shields them from accountability. Although we cannot be certain, we believe ratings agencies would have been less tolerant of the shoddy practices uncovered in the SEC study and congressional hearings if they had known that investors who relied on those ratings could hold them accountable in court. First Amendment protections based on the notion that ratings are nothing more than opinions are inconsistent with the ratings agencies' legally recognized status and their legally sanctioned gatekeeper function in our markets. Either their legal status or their protected status must go. As noted above, we believe the best approach is to retain their legal function but to add the accountability that is appropriate to that function.

Finally, while we appreciate the steps Congress, and this Committee in particular, took in 2006 to enhance SEC oversight of ratings agencies, we believe this legislation stopped short of the comprehensive reform that is needed. New legislation should specifically address issues raised by the SEC study (a study made possible by the earlier legislation), such as lack of due diligence regarding information on which ratings are based, weaknesses in post-rating surveillance to ensure continued accuracy, and

inadequacy of internal audits. In addition, it should give the SEC express authority to oversee ratings agencies comparable to the authority the Sarbanes-Oxley Act granted the PCAOB to oversee auditors. In particular, the agency should have authority to examine individual ratings engagements to determine not only that analysts are following company practices and procedures but that those practices and procedures are adequate to develop an accurate rating. Congress would need to ensure that any such oversight function was adequately funded and staffed.

3) Address risks created by securitization.

Few practices illustrate better than securitization the capacity for market innovations to both bring tremendous benefits and do enormous harm. On the one hand, securitization makes it possible to expand consumer and business access to capital for a variety of beneficial purposes. It was already evident by the late 1990s, however, that securitization had fundamentally altered underwriting practices in the mortgage lending market. By the middle of this decade, it was glaringly obvious to anyone capable of questioning the wisdom of the market that lenders were responding to those changes by writing huge numbers of unsustainable mortgages. Unfortunately, the Fed, which had the power to rein in unsound lending practices, was among the last to wake up to the systemic risks that they posed.

In belated recognition that incentives had gotten out of whack, many are now advocating that participants in securitization deals be required to have "skin in the game," in the form of some retained exposure to the risks of the deal. This is an approach that CFA supports, although we admit it is easier to describe in theory than to design in practice. We look forward to working with the Committee as it seeks to do just that. However, we also caution against putting exclusive faith in this approach. Given the massive fees that lenders and underwriters have earned, it will be difficult to design an incentive strong enough to counter the lure of high fees. Financial regulators will need to continue to monitor for signs that lenders are once again abandoning sound lending practices and use their authority to rein in those practices wherever they find them.

Another risk associated with securitization has gotten less attention, though it is at the heart of the difficulties the administration now faces in restoring the financial system. Their sheer complexity makes it extremely difficult, if not impossible to unwind these deals. As a result, that very complexity becomes a source of systemic risk. New standards to counteract this design flaw should be included in any measure to reduce securitization risks.

4) Improve systemic risk regulation.

Contrary to conventional wisdom, the current crisis did not stem from the lack of a regulator with sufficient information and the tools necessary to protect the financial system as a whole against systemic risks. In the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an

unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in the case of former CFTC Chair Brooksley Born, were denied the authority they requested to rein in those risks. Unless that reluctance to regulate changes, simply designating and empowering a systemic risk regulator is unlikely to have much effect.

Nonetheless, CFA agrees that, if accompanied by a change in regulatory approach and adoption of additional concrete steps to reduce existing systemic threats, designating some entity to oversee systemic risk regulation could enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain in some areas regarding the best way to accomplish that goal. Certain issues we believe are clear: 1) systemic risk regulation should not be focused exclusively on a few "systemically significant" institutions; 2) the systemic risk regulator should have broad authority to survey the entire financial system; 3) regulatory oversight should be an on-going responsibility, not emergency authority that kicks in when we find ourselves on the brink of a crisis; 4) it should include authority to require corrective actions, not just survey for risks; 5) it should, to the degree possible, build incentives into the system to discourage private parties from taking on excessive risks and becoming too big or too inter-connected to fail; and 6) it should include a mechanism for allowing the orderly unwinding of troubled or failing non-bank financial institutions.

CFA has not yet taken a position on the controversial question of who should be the systemic risk regulator. Each of the approaches suggested to date – assigning this responsibility to the Federal Reserve, creating a new agency to perform this function, or relying on a panel of financial regulators to coordinate systemic risk regulation – has its

flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation. Problems that have been identified with assigning this role to the Fed strike us as particularly difficult to overcome. Regardless of the approach Congress chooses to adopt, it will need to take steps to address the weaknesses of that particular approach. One step we urge Congress to take, regardless of which approach it chooses, is to appoint a high-level advisory panel of independent experts to consult on issues related to systemic risk.

Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such an assignment. The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of regulators and reduce the risks of group-think and complacency.

The above discussion merely skims the surface of issues related to systemic risk regulation. Included at the back of this document is testimony CFA presented last week in the House Financial Services Committee that goes into greater detail on the various strengths and weaknesses of the different approaches that have been suggested to enhance systemic risk regulation and, in particular, the issue of who should regulate.

5) Reform executive compensation practices.

Executive pay practices appear to have contributed to excessive risk-taking at financial institutions. Those who have analyzed the issues have typically identified two factors that contributed to the problem: 1) a short-term time horizon for incentive pay that allows executives to cash out before the consequences of their actions are apparent; and 2) compensation practices, such as through stock options, that provide unlimited up-side potential while effectively capping down-side exposure. While the first encourages executives to focus on short-term results rather than long-term growth, the latter may make them relatively indifferent to the possibility that things could go wrong. As AFL-CIO General Counsel Damon Silvers noted in recent testimony before the House Financial Services Committee, this is "a terrible way to incentivize the manager of a major financial institution, and a particularly terrible way to incentivize the manager of an institution the Federal government might have to rescue." Silvers further noted that adding large severance packages to the mix further distorts executive incentives: "If success leads to big payouts, and failure leads to big payouts, but modest achievements either way do not, then there is once again a big incentive to shoot for the moon without regard to downside risk."

In keeping with this analysis, we believe executive compensation practices at financial institutions should be examined for their potential to create systemic risk. Practices such as tying incentive pay to longer time horizons, encouraging payment in stock rather than options, and including claw-back provisions should be encouraged. As with other practices that contribute to systemic risk, compensation practices that do so could trigger higher capital requirements or larger insurance premiums as a way to make risk-prone compensation practices financially unattractive. At the same time, reforms that go beyond the financial sector are needed to give shareholders greater say in the operation of the companies they own, including through mandatory majority voting for directors, annual shareholder votes on company compensation practices, and improved proxy access for shareholders. This is the great unfinished business of the post-Enron era. Adoption of crucial reforms in this area should not be further delayed.

6) Bring enforcement actions for law violations that contributed to the crisis.

CFA is encouraged by the changes we see new SEC Chairman Mary Schapiro making to reinvigorate the agency's enforcement program. Mounting a tough and effective enforcement effort is essential both to deterring future abuses and to reassuring investors that the markets are fair and honest. While we recognize that many of the activities that led to the current crisis were legal, evidence suggests that certain areas deserve further investigation. Did investment banks fulfill their obligation to perform due diligence on the deals they underwrote? Did they provide accurate information to credit rating agencies rating those deals? Did brokers fulfill their obligation to make suitable recommendations? In many cases, violations of these standards may be out of reach of regulators, either because the sales were conducted through private placements or the products sold were outside the reach of securities laws. Nonetheless, we urge the agency to determine whether at least some of what appear to have been rampant abuses were conducted in ways that make them vulnerable to SEC enforcement authority. Such an investigation would not only be crucial to restoring investor confidence that the agency is committed to representing their interests, it could also provide regulators with a roadmap to use in identifying regulatory gaps that increase the potential for systemic risks.

II. Reverse Harmful Policies

Instead of identifying and addressing emerging risks that contributed to the current crisis, the SEC has devoted its energies in recent years to advancing a series of policy proposals that would reduce regulatory oversight, weaken investor protections, and limit industry accountability. In all but one case, these are issues that can be dealt with through a reversal in policy at the agency, and new SEC Chair Mary Schapiro's statements at her confirmation hearing suggested that she is both aware of the problems and prepared to take a different course. The role of the Committee in these cases is simply to provide appropriate support and oversight to ensure that those efforts remain on track. The other issue, where this Committee can play a more direct role, is in ensuring

that the SEC receives the resources it needs to mount an effective regulatory and enforcement program.

1) Increase funding for the SEC.

The new SEC chairman inherited a broken and demoralized agency. By all accounts, she has begun to undertake the thorough overhaul that the situation demands. Some, but not all, of the needed changes can be accomplished within the agency's existing budget, but others (such as upgrading agency technology) will require an infusion of funds. Moreover, while we recognize this Committee played an important role in securing additional funds for the agency in the wake of the accounting scandals earlier in this decade, we are convinced that the agency remains under-funded and under-staffed to fulfill its assigned responsibilities.

Perhaps you recall a study Chairman Dodd commissioned in 1988 to explore the possibility of self-funding for the SEC. It documented the degree to which the agency had been starved for resources during the preceding decade, a period in which its workload had undergone rapid growth. Although agency resources experienced more volatility in the 1990s – with years that saw both significant increases and substantial cuts – the overall picture was roughly the same: a funding level that did not keep pace with either the market's overall growth or, of even greater concern, the dramatic increase in market participation by average, unsophisticated retail investors.

After the Enron and Worldcom scandals, Congress provided a welcome and dramatic increase in funding. Certainly, the approximate doubling of the agency's budget was as much as the SEC could be expected to absorb in a single year. Operating under the compressed timeline that the emergency demanded, however, no effort was made at that time to thoroughly assess what funding level was needed to allow the agency to fulfill its regulatory mandate. The previous Chairman proved reluctant to request additional resources once the original infusion of cash was absorbed. We believe that the time has come to conduct an assessment, comparable to the review provided by this Committee in 1988, of the agency's resource needs. Once conducted, that review could provide the basis for a careful, staged increase in funding targeted at specific short-comings in agency operations.

2) Halt mutual recognition negotiations.

Last August, the SEC announced that it had entered a mutual recognition agreement with Australia that would allow eligible Australian stock exchanges and broker-dealers to offer their services to certain types of U.S. investors and firms without being subject to most SEC regulation. At the same time, the agency announced that it was negotiating similar agreements with other jurisdictions. The agency adopted this radical departure in regulatory approach without first assessing its potential costs, risks and unintended consequences, without setting clear standards to be used in determining whether a country qualifies for mutual recognition and submitting them for public

comment, and without offering any evidence that this regulatory approach is in the public interest.

It is our understanding that, thanks in part to the intervention of members of this Committee, this agreement has not yet been implemented. We urge members of this Committee to continue to work with the new SEC Chair to ensure that no further actions are taken to implement a mutual recognition policy at least until the current financial crisis is past. At a bare minimum, we believe any decision to give further consideration to mutual recognition must be founded on a careful assessment of the potential risks of such an approach, clear delineation of standards that would be used to assess whether another jurisdiction would qualify for such treatment, and transparency regarding the basis on which the agency made that determination.
CFA believes, however, that this policy is ill-advised even under the best of circumstances, since no other jurisdiction is likely to place as high a priority on protecting U.S. investors as our own regulators. As such, we believe the best approach is simply to abandon this policy entirely and to focus instead on promoting cooperation with foreign regulators on terms that increase, rather than decrease, investor protections.

At the same time, we urge Congress and the SEC to work with the Public Company Accounting Oversight Board (PCAOB) to ensure that it does not proceed with its similarly ill-conceived proposal to rely on foreign audit oversight boards to conduct inspections of foreign audit firms that play a significant role in the audits of U.S. public companies. This proposal is, in some ways, even more troubling than the SEC's mutual recognition proposal, since the oversight bodies to be relied are, many of them, still in their infancy, lack adequate resources, and do not meet the Sarbanes-Oxley Act's standards for independence. Prior to issuing this proposal, the PCAOB had focused its efforts on developing a program of joint inspections that is clearly in the best interests of U.S. and foreign investors alike. This proposed change in policy at the PCAOB has thrown that program into jeopardy, and it is important that it be gotten back on track.

3) Do not approve the IFRS Roadmap.

In a similar vein, the SEC has recently proposed to abandon a long and fruitful policy of encouraging convergence between U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. In its place, the agency has proposed to move rapidly toward U.S. use of international standards. Once again, the agency has proposed this change in policy without adequate regard to the potentially enormous costs of the transition, the loss of transparency that could result, or the strong opposition of retail and institutional investors to the proposal. We urge the Committee to work with the SEC to ensure that we return to a path of encouraging convergence of the two sets of standards so that, eventually, as that convergence is achieved, financial statements prepared under the two sets of standards would be comparable.

4) Enhance investor representation on FASB.

In arguing against adoption of the IFRS roadmap, CFA has in the past cited IASB's lack of adequate due process and susceptibility to industry and political influence. Unfortunately, FASB's recent proposal to bow to industry pressure and weaken fair value accounting standards – and to do so after a mere two-week comment period and with no meaningful time for consideration of comments before a vote is taken – suggests that FASB's vaunted independence and due process are more theoretical than real. We recognize and appreciate that leaders of this Committee have long shown a respect for the independence of the accounting standard-setting process. Moreover, we appreciate the steps that this Committee took, as part of the Sarbanes-Oxley Act, to try to enhance FASB's independence. However, in light of recent events, CFA believes more needs to be done to shore up those reforms. Specifically, we urge you to strengthen the standards laid out in SOX for recognition of a standard-setting body by requiring that a majority of both the board itself and its board of trustees be investor representatives with the requisite accounting expertise.

5) Ignore calls to weaken materiality standards and lessen issuer and auditor accountability for financial misstatements.

The SEC Advisory Committee on Improvements of Financial Reporting (CIFiR) released its final report last August detailing recommendations to "increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors." While the report includes positive suggestions – including a suggestion to increase investor involvement in the development of accounting standards – it also includes anti-investor proposals to: 1) revise the guidance on materiality in order to make it easier to dismiss large errors as immaterial; 2) revise the guidance on when errors have to be restated to permit more material errors to avoid restatements; and 3) offer some form of legal protection to faulty professional judgments made according to a recommended judgment framework. Weakening investor protections in this way is ill-advised at any time, but it is particularly so when we find ourselves in the midst of a financial crisis of global proportions. While we are confident that the new SEC Chair understands the need to strengthen, not weaken, financial reporting transparency, reliability, and accountability, we urge this Committee to continue to provide oversight in this area to ensure that these efforts remain on track.

III. Adopt Additional Pro-Investor Reforms

In addition to responding directly to the financial crisis and preventing a further deterioration of investor protections, there are important steps that Congress and the SEC can take to strengthen our markets by strengthening the protections we offer to investors. These include issues – such as regulation of financial professionals and restoring private remedies – that have already been raised in the context of financial regulatory reform. We look forward to a time, once the crisis is past, when we have the luxury of also returning our attention to additional issues, such as disclosure, mutual fund, and broker

compensation reform, where a pro-investor agenda has languished and is in need of revival. For now, however, we will focus in this testimony only on the first set of issues.

1) Adopt a rational, pro-investor policy for the regulation of financial professionals.

Reforming regulation of financial professionals has been a CFA priority for more than two decades, with precious little to show for it. Today, investment service providers who use titles and offer services that appear indistinguishable to the average investor are still regulated under two very different standards. In particular, brokers have been given virtually free rein to label their salespeople as financial advisers and financial consultants and to offer extensive personalized investment advice without triggering regulation under the Investment Advisers Act.

As a result, customers of these brokers are encouraged to believe they are in an advisory relationship but are denied the protections afforded by the Advisers Act's fiduciary duty and obligation to disclose conflicts of interest. Moreover, customers still don't receive useful information to allow them to make an educated choice among different types of investment service providers. This inconsistent regulatory treatment and lack of effective pre-engagement disclosure are of particular concern given research that shows that the selection of an investment service provider is the last real investment decision many investors will ever make. Once they have made that choice, most are likely to rely on the recommendations they receive from that individual with little or no additional research to determine the costs or appropriateness of the investments recommended.

Some now suggest that the efforts being undertaken by Congress to reform our regulatory system offer an opportunity to "harmonize" regulation of brokers, investment advisers, and financial planners. CFA agrees, but only so long as any "harmonization" strengthens investor protections. It is not clear that most proposals put forward to date meet that standard. Instead, the broker-dealer community appears to be trying to use this occasion to distract from the central issue – that brokers have over the years been allowed to transform themselves into advisers without being regulated as advisers – and to push an investment adviser SRO and a watered down "universal standard of care." Unfortunately, this is one area where the new SEC Chairman's Finra background appears to have influenced her thinking, and she echoed these sentiments during her confirmation hearing. It will therefore be incumbent on members of this Committee to ensure that investor interests predominate in any reforms that may be adopted to "harmonize" our system of regulating investment professionals.

As a first principle, CFA believes that investment service providers should be regulated according to what they do rather than what type of firm they work for. Had the SEC implemented the Investment Advisers Act consistent with the clear intent of Congress, this would be the situation we find ourselves in today. That is water under the bridge, however, and we are long past the point where we can recreate the clear divisions that once was envisioned between advisory services and brokers' transaction-based

services. Instead, we believe the best approach is to clarify the responsibilities that go with different functions and to apply them consistently across the different types of firms.[8]

> A Fiduciary Duty for Advice: All those who offer investment advice should be required to place their clients' interests ahead of their own, to disclose material conflicts of interest, and to take steps to minimize those potential conflicts. That fiduciary duty should govern the entire relationship; it must not be something the provider adopts when giving advice but drops when selling the investments to implement recommendations.
>
> A Suitability Obligation for Sales: Those who are engaged exclusively in a sales relationship should be subject to the know-your-customer and suitability obligations that govern brokers now.
>
> No Misleading Titles: Those who choose to offer solely sales-based services should not be permitted to adopt titles that imply that they are advisers. Either they should be prohibited from using titles, such as financial adviser or financial consultant, designed to mislead the investor into thinking they are in an advisory relationship, or use of such titles should automatically carry with it a fiduciary duty to act in clients' best interests.

Because of the obvious abuses in this area that have grown up over the years, we have focused on the inconsistent regulatory treatment of advice offered by brokers, investment advisers, and financial planners. If, however, there are other services that investment advisers or financial planners are being permitted to offer outside the appropriate broker-dealer protections, we would apply the same principle to them. They should be regulated according to what they do, subject to the highest existing level of investor protections.

One issue that has come up in this regard is whether investment advisers should be subject to oversight by a self-regulatory organization. The underlying argument here is that, while the Investment Advisers Act imposes a higher standard for advice, it is not backed by as robust a regulatory regime as that which governs broker-dealers. Finra has made no secret of its ambition to expand its authority in this area, at least with regard to the investment advisory activities of its broker-dealer member firms. There is at least a surface logic to this proposal. As Finra is quick to note, it brings significant resources to the oversight function and has rule-making authority that in some areas appears to go beyond that available to the SEC.

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[8] While we have discussed this approach here in the context of investment service providers, CFA believes this is an appropriate approach throughout the financial services industries: a suitability obligation for sales – whether of securities, insurance, mortgages or whatever – and an over-riding fiduciary duty that applies in an advisory relationship.

Despite that surface logic, there are several hurdles that Finra must overcome in making its case. The first is that Finra's record of using its rule-making authority to benefit investors is mixed at best. Nowhere is that more evident than on this central question of the obligation brokers owe investors when they offer advice or portray themselves as advisers. For the two decades that this debate has raged, Finra and its predecessor, NASD regulation, have consistently argued this issue from the broker-dealer industry point of view. This is not an isolated instance. Finra has shown a similar deference to industry concerns on issues related to disclosure and arbitration. This is not to say that Finra never deviates from the industry viewpoint, but it does mean that investors must swim against a strong tide of industry opposition in pushing reforms and that those reforms, when adopted, tend to be timid and incremental in nature.

This is, in our view, a problem inherent to self-regulation. Should Congress choose to place further reliance on bodies other than the SEC to supplement the agency's oversight and rulemaking functions, it should at least examine what reforms are needed to ensure that those authorities are not captured by the industries they regulate and operate in a fully transparent and open fashion. We believe the governance model at the PCAOB offers a better model to ensure the independence of any body on which we rely to perform a regulatory function.

The second issue regarding expanded Finra authority relates to its oversight record. It is ironic at best, cynical at worst, that Finra has tried to capitalize on its oversight failure in the Madoff case to expand its responsibilities to cover investment adviser activities. There may be good reasons why Finra's predecessor, NASD Regulation, missed a fraud that operated under its nose for several decades. NASD Regulation was not, as we understand it, privy to the whistleblower reports that the SEC received. One factor that clearly was not responsible for NASD Regulation's oversight failure, however, was its lack of authority over Madoff's investment adviser operations. This should be patently obvious from the fact that there was no Madoff investment adviser for the first few decades in which the fraud was apparently being conducted. During that time, Madoff's regulatory reports apparently indicated that he was engaged exclusively in proprietary trading and market making and did not have clients. NASD Regulation apparently did not take adequate steps to verify this information, despite general industry knowledge and extensive press reports to the contrary.

What concerns us most about this situation is not that Finra missed the Madoff fraud. Individuals and institutions make mistakes, and the problems that lead to those mistakes can be corrected. We are far more concerned by what we view as Finra's lack of honesty in accounting for this failure. That suggests a problem with the culture of the organization that is not as easily corrected. We have nothing but respect for new Finra President and CEO Rick Ketchum. However, the above analysis suggests he faces a significant task in overhauling Finra to make it more responsive to investor concerns, more effective in providing industry oversight, and more transparent in its dealings. Until that has been accomplished, we would caution against any expansion of Finra's authority or any increased reliance on self-regulatory bodies generally.

2) Restore private remedies.

In an era in which investors have been exposed to constantly expanding risks and repeated frauds, they have also experienced a continual erosion of their right to redress. This has occurred largely through unfavorable court decisions that have undermined investors' ability to recover losses from those who aided the fraud and, with recent decisions on loss causation, even from those primarily responsible for perpetrating it. To restore balance and fairness to the system, CFA supports legislation to restore aiding and abetting liability, to eliminate the ability of responsible parties to avoid liability by manipulating disclosures, and to protect the ability of plaintiffs to aggregate small claims and access federal courts.

CFA also supports the elimination of pre-dispute binding arbitration clauses in all consumer contracts, including those with securities firms. For many, even most investors, arbitration will remain the most attractive means for resolving disputes. However, not all cases are suitable for resolution in a forum that lacks a formal discovery process or other basic procedural protections. By forcing all cases into an industry-run arbitration process, regardless of suitability, binding arbitration clauses undermine investor confidence in the fairness of the system while making the system more costly and slower for all. While Finra has taken steps to address some of the worst problems, these reforms have been slow to come and have been incremental at best. We believe investors are best served by having a choice of resolution mechanisms that they are currently denied because of the nearly universal use of pre-dispute binding arbitration clauses.

Conclusion

For roughly the past three decades, regulatory policy has been driven by an irrational faith that market discipline and industry self-interest could be relied on to rein in Wall Street excesses. Regulation was seen as, at best, a weak supplement to these market forces and, at worst, a burdensome impediment to innovation. The recent financial meltdown has proven the basic fallacy of that assumption. In October testimony before the House Oversight and Government Reform Committee, former Federal Reserve Chairman Alan Greenspan acknowledged, in clearer language than has been his wont, the basic failure of this regulatory approach:

> Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance … If it fails, as occurred this year, market stability is undermined …
>
> I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms.

Former Chairman Greenspan deserves credit for this forthright acknowledgement of error.

What remains to be seen is whether Congress and the Administration will together devise a regulatory reform plan that reflects this fundamental shift. A bold and comprehensive plan is needed that restores basic New Deal regulatory principles and recognizes the role of regulation in preventing crises, not simply cleaning up in their wake. This approach, adopted in response to the Great Depression, brought us decades of economic growth, free from the recurring financial crises that have characterized the last several decades. If, on the other hand, policymakers do not acknowledge the pervasive and deep-seated flaws in financial markets, they will inevitably fail in their efforts to reform regulation, setting the stage for repeated crises and prompting investors to question not just the integrity and safety of our markets, but the ability of our policymakers to act in their interest.

Even as we testify here today, Treasury Secretary Geithner is reportedly scheduled to present the Administration's regulatory reform plan before another congressional committee. We will be subjecting that proposal and others that are developed as this process moves forward to a thorough analysis to determine whether it meets this standard: does the boldness and scope of the plan match the severity of the current crisis? We look forward to working with members of this Committee in the days and months ahead to craft a regulatory reform plan that meets this test and restores investors' faith in the integrity of our markets and the effectiveness of our government.

Appendix

Consumer Federation of America

Testimony of Travis Plunkett
Legislative Director
Consumer Federation of America

Hearing on "Systemic Risk"

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

March 17, 2009

Mr. Chairman and Members of the Committee, my name is Travis Plunkett. I am Legislative Director of the Consumer Federation of America (CFA). CFA is a non-profit association of 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

I greatly appreciate the opportunity to appear before you today to testify about one of the most important issues Congress will need to address as it develops a comprehensive agenda to reform our nation's failed financial regulatory system – how to better protect the system as a whole and the broader economy from systemic risks. Recent experience has shown us that our current system was not up to the task, either of identifying significant risks, or of addressing those risks before they spun out of control, or of dealing efficiently and effectively with the situation once it reached crisis proportions. The effects of this failure on the markets and the economy have been devastating, rendering reform efforts aimed at protecting the system against systemic threats a top priority.

In order to design an effective regulatory response, it is necessary to understand why the system failed. It has been repeated so often in recent months that it has taken on the aura of gospel, but it is simply not the case that the systemic risks that have threatened the global financial markets and ushered in the most serious economic crisis since the Great Depression arose because regulators lacked either sufficient information or the tools necessary to protect the financial system as a whole against systemic risks. (Though it is true that, once the crisis struck, regulators lacked the tools needed to deal with it effectively.) On the contrary, the crisis resulted from regulators' refusal to heed overwhelming evidence and repeated warnings about growing threats to the system.

- Former Congressman Jim Leach and former CFTC Chairwoman Brooksley Born both identified the potential for systemic risk in the unregulated over-the-counter derivatives markets in the 1990s.

- Housing advocates have been warning the Federal Reserve since at least the early years of this decade that securitization had fundamentally changed the underwriting standards for mortgage lending, that the subprime mortgages being written in increasing numbers were unsustainable, that foreclosures were on the rise, and that this had the potential to create systemic risks.

- The SEC's risk examination of Bear Stearns had, according to the agency's Inspector General, identified several of the risks in that company's balance sheet, including its use of excessive leverage and an over-concentration in mortgage-backed securities.

Contrary to conventional wisdom, these examples and others like them provide clear and compelling evidence that, in the key areas that contributed to the current crisis – unsound mortgage lending, the explosive combination of risky assets and excessive leverage on financial institutions' balance sheets, and the growth of an unregulated "shadow" banking system – regulators had all the information they needed to identify the crucial risks that threatened our financial system but either didn't use the authority they had or, in Born's case, were denied the authority they needed to rein in those risks.

Regulatory intervention at any of those key points had the potential to prevent, or at least greatly reduce the severity of, the current financial crisis – either by preventing the unsound mortgages from being written that triggered the crisis, or by preventing investment banks and other financial institutions from taking on excessive leverage and loading up their balance sheet with risky assets, leaving them vulnerable to failure when the housing bubble burst, or by preventing complex networks of counterparty risk to develop among financial institutions that allowed the failure of one institution to threaten the failure of the system as a whole. This view is well-articulated in the report of the Congressional Oversight Panel, which correctly identifies a fundamental abandonment of traditional regulatory principles as the root cause of the current financial crisis and prescribes an appropriately comprehensive response.

So what is the lesson to be learned from that experience for Congress's current efforts to enhance systemic risk regulation? The lesson is emphatically not that there is no need to improve systemic risk regulation. On the contrary, this should be among the top priorities for financial regulatory reform. But there is a cautionary lesson here about the limitations inherent in trying to address problems of inadequate systemic risk regulation with a structural solution. In each of the above examples, and others like them, the key problem was not insufficient information or inadequate authority; it was an unwillingness on the part of regulators to use the authority they had to rein in risky practices. That lack of regulatory will had its roots in an irrational faith among members of both political parties in markets' ability to self-correct and industry's ability to self-police.

Until we abandon that failed regulatory philosophy and adopt in its place an approach to regulation that puts its faith in the ability and responsibility of government to serve as a check on industry excesses, whatever we do on systemic risk is likely to have little effect. Without that change in governing philosophy, we will simply end up with systemic risk regulation that exhibits the same unquestioning, market-fundamentalist approach that has characterized substantive financial regulation to a greater or lesser degree for the past three decades.

If the "negative" lesson from recent experience is that structural solutions to systemic risk regulation will have limited utility without a fundamental change in regulatory philosophy, there is also a positive corollary. Simply closing the loopholes in the current regulatory structure, reinvigorating federal regulators, and doing an effective job at the day-to-day tasks of routine safety and soundness and investor and consumer protection regulation would go a long way toward eliminating the greatest threats to the financial system.

The "Shadow" Banking System Represents the Greatest Systemic Threat

In keeping with that notion, the single most significant step Congress could and should take right now to decrease the potential for systemic risk is to shut down the shadow banking system completely and permanently. While important progress is apparently being made (however slowly) in moving credit default swaps onto a clearinghouse, this is just a start, and a meager start at that. Meaningful financial regulatory reform must require that all financial activities be conducted in the light of regulatory oversight according to basic rules of transparency, fair dealing, and accountability.

As Frank Partnoy argued comprehensively and persuasively in his 2003 book, *Infectious Greed,* a primary use of the "shadow" banking system – and indeed the main reason for its existence – is to allow financial institutions to do indirectly what they or their clients would not be permitted to do directly in the regulated markets. So banks used unregulated special purpose entities to hold toxic assets that, if held on their balance sheets, would have required them to set aside additional capital, relying on the fiction that the bank itself was not exposed to the risks. Investment banks sold Mezzanine CDOs to pension funds in private placements free from disclosure and other obligations of the regulated marketplace. And everyone convinced themselves that they were protected from the risks of those toxic assets because they had insured them using credit default swaps sold in the over-the-counter market without the basic protections that trading on an exchange would provide, let alone the reserve or collateral requirements that would, in the regulated insurance market, provide some assurance that any claims would be paid.

The basic justification for allowing two systems to grow up side-by-side – one regulated and one not – is that sophisticated investors are capable of protecting their own interests and do not require the basic protections of the regulated market. That myth has been dispelled by the current crisis. Not only did "sophisticated" institutional investors load up on toxic mortgage-backed securities and collateralized debt obligations without understanding the risks of those investments, but financial institutions themselves either didn't understand or chose to ignore the risks they were exposing themselves to when they bought toxic assets with borrowed money or funded long-term obligations with short-term financing. By failing to protect their own interests, they damaged not only themselves and their shareholders, but also the financial markets and the global economy as a whole. This situation simply cannot be allowed to continue. Any proposal to address systemic risk must confront this issue head-on in order to be credible.

Other Risk-Related Priorities Should Also Be Addressed

There are other pressing regulatory issues that, while not expressly classified as systemic risk, are directly relevant to any discussion of how best to reduce systemic risk. Chairman Frank has appropriately raised the issue of executive compensation in this context, and CFA supports efforts to reduce compensation incentives that promote excessive risk-taking.

Similarly, improving the reliability of credit ratings while simultaneously reducing our reliance on those ratings is a necessary component of any comprehensive plan to reduce systemic risk. Ideally, some mechanism will be found to reduce the conflicts of interest associated with the agencies' issuer-paid compensation model. Whether or not that is the case, we believe credit rating agencies must face increased accountability for their ratings, the SEC must have increased authority to police their ratings activities to ensure that they follow appropriate due diligence standards in arriving at and maintaining those ratings, and laws and rules that reference the ratings must make clear that reliance on ratings alone does not satisfy due diligence obligations to ensure the appropriateness of the investment.

In addition, CFA believes one of the most important lessons that have been learned regarding the collapse of our financial system is that improved, up-front product-focused regulation will significantly reduce systemic risk. For example, if federal regulators had acted

more quickly to prevent abusive sub-prime mortgage loans from flooding the market, it is likely that the current housing and economic crisis would not have been triggered. As a result, we have endorsed the concept advanced by COP Chair Elizabeth Warren and legislation introduced by Senator Richard Durbin and Representative William Delahunt to create an independent financial safety commission to ensure that financial products meet basic standards of consumer protection. Some opponents of this proposal have argued that it would stifle innovation. However, given the damage that recent "innovations" such as liar's loans and Mezzanine CDOs have done to the global economy, this hardly seems like a compelling argument. By distinguishing between beneficial and harmful innovations, such an approach could in our view play a key role in reducing systemic risks.

Congress Needs To Enhance the Quality of Systemic Risk Oversight

In addition to addressing those issues that currently create a significant potential for systemic risk, Congress also needs to enhance the quality of systemic risk oversight going forward. Financial Services Roundtable Chief Executive and CEO Steve Bartlett summed up the problem well in earlier testimony before the Senate Banking Committee when he said that the recent crisis had revealed that our regulatory system "does not provide for sufficient coordination and cooperation among regulators, and that it does not adequately monitor the potential for market failures, high-risk activities, or vulnerable interconnections between firms and markets that can create systemic risk."

In keeping with that diagnosis of the problem, CFA believes the goals of systemic risk regulation should be: 1) to ensure that risks that could threaten the broader financial system are identified and addressed; 2) to reduce the likelihood that a "systemically significant" institution will fail; 3) to strengthen the ability of regulators to take corrective actions before a crisis to prevent imminent failure; and 4) to provide for the orderly failure of non-bank financial institutions. The latter point deserves emphasis, because this appears to be a common misconception: the goal of systemic risk regulation is not to protect certain "systemically significant" institutions from failure, but rather to simultaneously reduce the likelihood of such a failure and ensure that, should it occur, there is a mechanism in place to allow that to happen with the minimum possible disruption to the broader financial markets.

Although there appears to be near universal agreement about the need to improve systemic risk regulation, strong disagreements remain over the best way to accomplish that goal. The remainder of this testimony will address those key questions regarding such issues as who should regulate for systemic risk, who should be regulated, what that regulation should consist of, and how it should be funded. CFA has not yet reached firm conclusions on all of these issues, including on the central question of how systemic risk regulation should be structured. Where our position remains unresolved, we will discuss possible alternatives and the key issues we believe need to be resolved in order to arrive at a conclusion.

Should there be a central systemic risk regulator?

As discussed above, we believe all financial regulators should bear a responsibility to monitor for and mitigate potential systemic risks. Moreover, we believe a regulatory approach

that both closes regulatory loopholes and reinvigorates traditional regulation for solvency and consumer and investor protection would go a long way toward accomplishing that goal. Nonetheless, we agree with those who argue that there is a benefit to having some central authority responsible and accountable for overseeing these efforts, if only to coordinate regulatory efforts related to systemic risk and to ensure that this remains a priority once the current crisis is past.

Perhaps the best reason to have one central authority responsible for monitoring systemic risk is that, properly implemented, such an approach offers the best assurance that financial institutions will not be able to exploit newly created gaps in the regulatory structure. Financial institutions have devoted enormous energy and creativity over the past several decades to finding, maintaining, and exploiting gaps in the regulatory structure. Even if Congress does all that we have urged to close the regulatory gaps that now exist, past experience suggests that financial institutions will immediately set out to find new ways to evade legal restrictions.

A central systemic risk regulatory authority could and should be given responsibility for quickly identifying any such activities and assigning them to their appropriate place within the regulatory system. Without such a central authority, regulators may miss activity that does not explicitly fall within their jurisdiction or disputes may arise over which regulator has authority to act. CFA believes designating a central authority responsible for systemic risk regulation offers the best hope of quickly identifying and addressing new risks that emerge that would otherwise be beyond the reach of existing regulations.

Who should it be?

Resolving who should regulate seems to be the most vexing problem in designing a system for improved systemic risk regulation. Three basic proposals have been put forward: 1) assign responsibility for systemic risk regulation to the Fed; 2) create a new market stability regulator; and 3) expand the President's Working Group on Financial Markets (PWG) and give it an explicit mandate to coordinate and oversee regulatory efforts to monitor and mitigate systemic threats. Each approach has its flaws, and it is far easier to poke holes in the various proposals than it is to design a fool-proof system for improving risk regulation.

The Federal Reserve Board – Many people believe the Federal Reserve Board (the "Fed") is the most logical body to serve as systemic risk overseer. Those who favor this approach argue that the Fed has the appropriate mission and expertise, an experienced staff, a long tradition of independence, and the necessary tools to serve in this capacity (e.g., the ability to act as lender of last resort and to provide emergency financial assistance during a financial crisis). Robert C. Pozen summed up this viewpoint succinctly when he testified before the Senate Committee on Homeland Security and Governmental Affairs. He said:

> "Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system … If the Federal Reserve Board is going to bail out a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure."

Two other, more pragmatic arguments have been cited in favor of giving these responsibilities to the Fed: 1) its ability to obtain adequate resources without relying on the congressional budget process and 2) the relative speed and ease with which this expansion of authority could be accomplished, particularly in comparison with the challenges of establishing a new agency for this purpose.

Others are equally convinced that the Fed is the last agency that should be entrusted with responsibility for systemic risk regulation. Some cite concerns about conflicts inherent in the governance role bank holding companies play in the regional Federal Reserve Banks. Particularly when combined with the Board's closed culture and lack of public accountability, this conflict is seen as likely to undermine public trust in the objectivity of agency decisions about which institutions will be bailed out and which will be allowed to fail in a crisis. Opponents of the Fed as systemic risk regulator also cite a conflict between its role setting monetary policy and its potential role as a systemic risk regulator. One concern is that its role in setting monetary policy requires freedom from political interference, while its role as systemic risk regulator would require full transparency and public accountability. Another involves the question of how the Fed as systemic risk regulator would deal with the Fed as central banker if its monetary policy was contributing to systemic risk (as it clearly did in the run-up to the current crisis).

Others simply point to what they see as the Fed's long history of regulatory failure. This includes not only failures directly related to the current crisis – its failure to address unsound mortgage lending on a timely basis, for example, as well as its failure to prevent banks from holding risky assets in off-balance-sheet special purpose entities and its cheerleading of the rapid expansion of the shadow banking system – but also a perceived past willingness at the Fed to allow banks to hide their losses. According to this argument, Congress ultimately passed FDICIA in 1991 (requiring regulators to close financial institutions before all the capital or equity has been depleted) precisely because the Fed had been unwilling to do so absent that requirement.

Should Congress determine to give systemic risk responsibility to the Fed, we believe it is essential that you take meaningful steps to address what we believe are compelling concerns about this approach. Even some who have spoken in favor of the Fed in this capacity have acknowledged that it will require significant restructuring. As former Federal Reserve Chairman Paul Volcker noted in remarks before the Economic Club of New York last April:

> "If the Federal Reserve is also … to have clear authority to carry effective 'umbrella' oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability …, all backed by a stronger, larger, highly experienced and reasonably compensated professional staff."

CFA concurs that, if systemic risk regulation is to be housed at the Fed, systemic risk regulation must not be relegated to Cinderella status within the agency. Rather, it must be given a high

priority within the organization, and significant additional staff dedicated to this task must be hired who have specific risk assessment expertise. Serious thought must also be given to 1) how to resolve disputes between these two potentially competing functions of setting monetary policy and mitigating systemic risks, and 2) how to ensure that systemic risk regulation is carried out with the full transparency and public accountability that it demands.

A New Systemic Risk Regulatory Agency – Some have advocated creation of an entirely new regulatory agency devoted to systemic risk regulation. The idea behind this approach is that it would allow a singular focus on issues of systemic risk, both providing clear accountability and allowing the hiring of specialized staff devoted to this task. Furthermore, such an agency could be structured to avoid the significant concerns associated with designating the Fed to perform this function, including the conflict between monetary policy and systemic risk regulation.

Although it has its advocates, this approach appears to trigger neither the broad support nor the impassioned opposition that the Fed proposal engenders. Those who favor this approach, including Brookings scholar Robert Litan, tend to do so only if it is part of a more radical regulatory restructuring. Adding such an agency to the existing regulatory structure would "add still another cook to the regulatory kitchen, one that is already too crowded, and thus aggravate current jurisdictional frictions," Litan said in recent testimony before the Senate Committee on Homeland Security and Governmental Operations. Moreover, even its advocates tend to acknowledge that it would be a challenge, and possibly an insurmountable challenge, to get such an agency up and running in a timely fashion.

Expanded and Refocused President's Working Group – The other approach that enjoys significant support entails giving an expanded version of the President's Working Group for Financial Markets clear, statutory authority for systemic risk oversight. Its current membership would be expanded to include all the major federal financial regulators as well as representatives of state securities, insurance, and banking officials. By formalizing the PWG's authority through legislation, the group would be directly accountable to Congress, allowing for meaningful congressional oversight.

Among the key benefits of this approach: the council would have access to extensive information about and expertise in all aspects of financial markets. The regulatory bodies with primary day-to-day oversight responsibility would have a direct stake in the panel and its activities, maximizing the chance that they would be fully cooperative with its efforts. For those who believe the Fed must play a significant role in systemic risk regulation, this approach offers the benefit of extensive Fed involvement as a member of the PWG without the problems associated with exclusive Fed oversight of systemic risk.

This approach, while offering attractive benefits, is not without its short-comings. One is the absence of any single party who is solely accountable for regulatory efforts to mitigate systemic risks. Because it would have to act primarily through its member bodies, it could result in an inconsistent and even conflicting approach among regulators. It also raises the risk that systemic risk regulation will not be given adequate priority. In dismissing this approach, Litan acknowledges that it may be the most politically feasible but he maintains: "A college of

regulators clearly violates the Buck Stops Here principle, and is a clear recipe for jurisdictional battles and after-the-fact finger pointing."

Despite the many attractions of this approach, this latter point is particularly compelling, in our view. Regulators have a long history of jurisdictional disputes. There is no reason to believe those problems would simply dissipate under this arrangement. Decisions about who has responsibility for newly emerging activities would likely be particularly contentious. If Congress were to decide to adopt this approach, it would need to set out some clear mechanism for resolving any such disputes. Alternatively, it could combine this approach with enhanced systemic risk authority for either the Fed or a new agency, as the Financial Services Roundtable has suggested, providing that agency with the benefit of the panel's broad expertise and improving coordination of regulatory efforts in this area.

FDIC – A major reason federal authorities were forced to improvise in managing the events of the past year is that we lack a mechanism for the orderly unwinding of non-bank financial institutions that is comparable to the authority that the FDIC has for banks. Most systemic risk plans seem to contemplate expanding FDIC authority to include non-bank financial institutions, although some would house this authority within a systemic risk regulator. CFA believes this is an essential component of a comprehensive plan for enhanced systemic risk regulation. While we have not worked out exactly how this should operate, we believe the FDIC, the systemic risk regulator, or the two agencies working together must also have authority to intervene when failure appears imminent to require corrective actions.

A Systemic Risk Advisory Panel – One of the key criticisms of making the Fed the systemic risk regulator is its dismal regulatory record. But if we limited our selections to those regulators with a credible record of identifying and addressing potential systemic risks while they are still at a manageable stage, we'd be forced to start from scratch in designing a new regulatory body. And there is no guarantee we would get it right this time.

A number of academics and others outside the regulatory system were far ahead of the regulators in recognizing the risks associated with unsound mortgage lending, unreliable ratings on mortgage-backed securities and CDOs, the build-up of excessive leverage, the questionable risk management practices of investment banks, etc. Regardless of what approach Congress chooses to adopt for systemic risk oversight, we believe it should also mandate creation of a high-level advisory panel on systemic risk. Such a panel could include academics and other analysts from a variety of disciplines with a reputation for independent thinking and, preferably, a record of identifying weaknesses in the financial system. Names such as Nouriel Roubini, Frank Partnoy, Joseph Mason, and Joshua Rosner immediately come to mind as attractive candidates for such a panel.

The panel would be charged with conducting an on-going and independent assessment of systemic risks to supplement the efforts of the regulators. It would report periodically to both Congress and the regulatory agencies on its findings. It could be given privileged access to information gathered by the regulators to use in making its assessment. When appropriate, it might recommend either legislative or regulatory changes with a goal of reducing risks to the financial system. CFA believes such an approach would greatly enhance the accountability of

regulators and reduce the risks of group-think and complacency. We urge you to include this as a component of your regulatory reform plan.

Who should be regulated?

The debate over who should be regulated for systemic risk basically boils down to two main points of view. Those who see systemic risk regulation as something that kicks in during or on the brink of a crisis, to deal with the potential failure of one or more financial institutions, tend to favor a narrower approach focused on a few large or otherwise "systemically important" institutions. In contrast, those who see systemic risk regulation as something that is designed, first and foremost, to prevent risks from reaching that degree of severity tend to favor a much more expansive approach. Recognizing that systemic risk can derive from a variety of different practices, proponents of this view argue that all forms of financial activity must be subject to systemic risk regulation and that the systemic risk regulator must have significant flexibility and authority to determine the extent of its reach.

CFA falls firmly into the latter camp. We are not alone; this expansive view of systemic risk jurisdiction has many supporters, at least when it comes to the regulator's authority to monitor the markets for systemic risk. The Government Accountability Office, for example, has said that such efforts "should cover all activities that pose risks or are otherwise important to meeting regulatory goals." Bartlett of the Financial Services Roundtable summed it up well in his testimony when he said that:

> "… authority to collect information should apply not only to depository institutions, but also to all types of financial services firms, including broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy. Also, this authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk."

The case for giving a systemic risk regulator broad authority to monitor the markets for systemic risk is obvious, in our opinion. Failure to grant a regulator this broad authority risks allowing risks to grow up outside the clear jurisdiction of functional regulators, a situation financial institutions have shown themselves to be very creative at exploiting.

While the case for allowing the systemic risk regulator broad authority to monitor the financial system as a whole seems obvious, the issue of whether to also grant that regulator authority to constrain risky conduct wherever they find it is more complex. Those who favor a narrower approach argue that the proper focus of any such regulatory authority should be limited to those institutions whose failure would be likely to create a systemic risk. This view is based on the sentiment that, if an institution is too big to fail, it must be regulated. While CFA shares the view that those firms that are "too big to fail" must be regulated, we take that view one step further. As we have discussed above, we believe that the best way to reduce systemic risk is to

ensure that all financial activity is regulated to ensure that it is conducted according to basic principles of transparency, fair dealing, and accountability.

Those like Litan who favor a narrower approach focused on "systemically important" institutions defend it against charges that it creates unacceptable moral hazard by arguing that it is essentially impossible to expand on the moral hazard that has already been created by recent federal bailouts simply by formally designating certain institutions as systemically significant. We agree that, based on recent events and unless the approach to systemic risk is changed, the market will assume that large firms will be rescued, just as the market rightly assumed for years, despite assurances to the contrary, that the government would stand behind the GSEs. Nonetheless, we do not believe it follows that the appropriate approach to systemic risk regulation is to focus exclusively on these institutions that are most likely to receive a bailout. Instead, we believe it is essential to attack risks more broadly, before institutions are threatened with failure and, to the degree possible, to eliminate the perception that large institutions will always be rescued. The latter goal could be addressed both by reducing the practices that make institutions systemically significant and by creating a mechanism to allow their orderly failure.

Ultimately, we believe a regulatory approach that relies on identifying institutions in advance that are systemically significant is simply unworkable. The fallibility of this approach was demonstrated conclusively in the wake of the government's determination that Lehman Brothers, unlike Bear Stearns, was not too big to fail. As Richard Baker, President and CEO of the Managed Funds Association, said in his testimony before the House Capital Markets Subcommittee, "There likely are entities that would be deemed systemically relevant … whose failure would not threaten the broader financial system." We also agree with NAIC Chief Executive Officer Therese Vaughn, who said in testimony at the same hearing, "In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it."

The factors that might make an institution systemically important are complex – going well beyond asset size and even degree of leverage to include such considerations as nature and degree of interconnectivity to other financial institutions, risks of activities engaged in, nature of compensation practices, and degree of concentration of financial assets and activities, to name just a few. Trying to determine in advance where that risk is likely to arise would be all but impossible. And trying to maintain an accurate list of systemically important institutions going forward, considering the complex array of factors that are relevant to that determination, would require constant and detailed monitoring of institutions on the borderline, would be extremely time-consuming, and ultimately would almost certainly allow certain risky institutions and practices to fall through the cracks.

How should they regulate?

There are three key issues that must be addressed in determining the appropriate procedures for regulating to mitigate systemic risk:

- Should responsibility and authority to regulate for systemic risks kick in only in a crisis, or on the brink of a crisis, or should it be an on-going, day-to-day obligation of financial regulators?

- What regulatory tools should be available to a systemic risk regulator? For example, should a designated systemic risk regulator have authority to take corrective actions, or should it be required (or encouraged) to work through functional regulators?

- If a designated systemic risk regulator has authority to require corrective actions, should it apply generally to all financial institutions, products, and practices or should it be limited to a select population of systemically important institutions?

When the Treasury Department issued its Blueprint for regulatory reform a year ago, it proposed to give the Federal Reserve broad new authority to regulate systemic risk but only in a crisis. Despite the sweeping scope of its restructuring proposals, Treasury clearly envisioned a strictly limited role within systemic risk regulation for regulatory interventions exercised primarily through its role as lender of last resort. Although there are a few who continue to advocate a version of that viewpoint, we believe events since the Blueprint's release have conclusively proven the disadvantages of this approach. As Volcker stated in his New York Economic Club speech: "I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn." We share that skepticism, convinced like the authors of the COP Report that, "Systemic risk needs to be managed before moments of crisis, by regulators who have clear authority and the proper tools."

As noted above, most parties appear to agree that a systemic risk regulator must have broad authority to survey all areas of financial markets and the flexibility to respond to emerging areas of potential risk. CFA shares this view, believing it would be both impractical and dangerous to require the regulator to go back to Congress each time it sought to extend its jurisdiction in response to changing market conditions. Others have described a robust set of additional tools that regulators should have to minimize systemic risks. As the Group of 30 noted in its report on regulatory reform: "… a legal regime should be established to provide regulators with authority to require early warnings, prompt corrective actions, and orderly closings" of certain financial institutions. The specific regulatory powers various parties have recommended as part of a comprehensive framework for systemic risk regulation include authority to:

- Set capital, liquidity, and other regulatory requirements directly related to risk management;

- Require firms to pay some form of premium, much like the premiums banks pay to support the federal deposit insurance fund, adjusted to reflect the bank's size, leverage, and concentration, as well as the risks associated with its activities;

- Directly supervise at least certain institutions;

- Act as lender of last resort with regard to institutions at risk of failure;

- Act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition;

- Require corrective actions at troubled institutions that are similar to those provided for in FDICIA;

- Make regular reports to Congress; and

- Take enforcement actions, with powers similar to what Federal Reserve currently has over bank holding companies.

Without evaluating each recommendation individually or in detail, CFA believes this presents an appropriately comprehensive view of the tools necessary for systemic risk regulation.

Most of those who have commented on this topic would give at least some of this responsibility and authority – such as demanding corrective actions to reduce risks – directly to a systemic risk regulator. Others would require in all but the most extreme circumstances that a systemic risk regulator exercise this authority only in cooperation with functional regulators. Both approaches have advantages and disadvantages. Giving a systemic risk regulator this authority would ensure consistent application of standards and establish a clear line of accountability for decision-making in this area. But it would also demand, perhaps unrealistically, that the regulator have a detailed understanding of how those standards would best be implemented in a vast variety of firms and situations. Relying on functional regulators to act avoids the latter problem but sets up a potential for jurisdictional conflicts as well as inconsistent and delayed implementation. If Congress decides to adopt the latter approach, it will need to make absolutely clear what authority the systemic risk regulator has to require its regulatory partners to take appropriate action. Without that clarification, disputes over jurisdiction are inevitable, and inconsistencies and conflicts are bound to emerge. It would also be doubly important under such an approach to ensure that gaps in the regulatory framework are closed and that all regulators share a responsibility for reducing systemic risk.

Many of those who would give a systemic risk regulator this direct authority to demand corrective actions would limit its application to a select population of systemically important institutions. The Securities Industry and Financial Markets Association has advocated, for example, that the resolution system for non-bank firms apply only to "the few organizations whose failure might reasonably be considered to pose a threat to the financial system." In testimony before the House Capital Markets Subcommittee, SIFMA President and CEO T. Timothy Ryan, Jr. also suggested that the systemic risk regulator should only directly supervise systemically important financial institutions.

Such an approach requires a systemic risk regulator to identify in advance those institutions that pose a systemic risk. Others express strong opposition to this approach. As former Congressman Baker of the MFA said in his recent House subcommittee testimony:

> "An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against failure."

Unfortunately, the recent actions the government was called on to take to rescue a series of non-bank financial institutions has already created that implied backing. Simply refraining from designating certain institutions as systemically significant will not be sufficient to dispel that expectation, and it would at least provide the opportunity to subject those firms to tougher standards and enhanced oversight. As discussed above, however, CFA believes this approach to be unworkable.

That is a key reason why we believe it is absolutely essential to provide for corrective action and resolution authority as part of a comprehensive plan for enhanced systemic risk regulation. As money manager Jonathan Tiemann argued in a recent article entitled "The Wall Street Vortex":

> "Some institutions are so large that their failure would imperil the financial system. As such, they enjoy an implicit guarantee, which could … force us to nationalize their losses. But we need for all financial firms that run the risk of failure to be able to do so without causing a widespread financial meltdown. The most interesting part of the debate should be on this point, whether we could break these firms into smaller pieces, limit their activities, or find a way to compartmentalize the risks that their various business units take."

CFA believes this is an issue that deserves more attention than it has garnered to date. One option is to try to maximize the incentives of private parties to avoid risks, for example by subjecting financial institutions to risk-based capital requirements and premium payments. To serve as a significant deterrent to risk, these requirements would have to ratchet up dramatically as institutions grew in size, took on risky assets, increased their level of leverage, or engaged in other activities deemed risky by regulators. It has been suggested, for example, that the Fed could have prevented the rapid growth in use of over-the-counter credit default swaps by financial institutions if it had adopted this approach. It could, for example, have imposed capital standards for use of OTC derivatives that were higher than the margin requirements associated with trading the same types of derivatives on a clearinghouse and designed to reflect the added risks associated with trading in the over-the-counter markets. In order to minimize the chances that institutions will avoid becoming too big or too inter-connected to fail, CFA urges you to include such incentives as a central component of your systemic risk regulation legislation.

Conclusion

Decades of Wall Street excess unchecked by reasonable and prudential regulation have left our markets vulnerable to systemic shock. The United States, and indeed the world, is still reeling from the effects of the latest and most severe of a long series of financial crises. Only a fundamental change in regulatory approach will turn this situation around. While structural

changes are a part of that solution, they are by no means the most important aspect. Rather, returning to a regulatory approach that recognizes both the disastrous consequences of allowing markets to self-regulate and the necessity of strong and effective governmental controls to rein in excesses is absolutely essential to achieving this goal.