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TURMOIL IN THE U.S. CREDIT MARKETS: EXAMINING THE REGULATION OF INVESTMENT BANKS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES AND INSURANCE AND INVESTMENT

OF THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

STEPS TAKEN BY THE AGENCY THEN AND NOW TO ENCOURAGE THE INVESTMENT BANKS THAT IT REGULATES TO BETTER MANAGE THEIR RISKS AND HOW THE SEC CAN BE STRENGTHENED TO MEET ITS MISSION AS THE ADVOCATE FOR INVESTORS WHILE OVERSEEING SECURITIES MARKETS AND FINANCIAL STABILITY OF WALL STREET FIRMS

WEDNESDAY, MAY 7, 2008

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TURMOIL IN THE U.S. CREDIT MARKETS: EXAMINING THE REGULATION OF INVESTMENT BANKS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION

WEDNESDAY, MAY 7, 2008

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order.

The events of the past year make it critically clear that there is a need to review the adequacy of the country's existing financial services regulations, use lessons from the current market problems as an opportunity to improve regulation, and review the adequacy of resources devoted to regulation. Before we can look forward to determine what, if any, changes need to be made, there needs to be a sober review of how we got to this point.

The intent of today's hearing is to conduct such a review. It is critical that the review not only examine the authority of the Securities and Exchange Commission, but also assess the way it undertakes its responsibilities when it implements its regulations and supervises some of the largest securities firms through its Consolidated Supervised Entities (CSE) program. Through this program, the SEC has a window into these major firms that act as underwriters, issuers, dealers, and investors in many of the complex securities products that are in the market today.

A little over a year ago, I chaired a Subcommittee hearing, along with my Ranking Member, Senator Allard, examining the role of securitization where witnesses from Bear Stearns, Lehman Brothers, S&P, and Moody's, who all four are within the oversight of the SEC, testified that problems in the subprime area were confined to a small part of the market. Of course, since then we have learned that the fallout from the subprime turmoil is deeper and broader than we were led to believe.

Recent estimates on worldwide losses stemming from the U.S. subprime mortgage crisis range from $600 billion to $1 trillion. To date, some of the largest banks and securities firms have recognized roughly $285 billion in losses. Moreover, writedowns in the financial services industry have led S&P to forecast 20 to 30 percent revenue reduction in the securities industry overall, with the potential for even greater revenue reductions.

Throughout, the SEC and other financial regulators did not fully appreciate the risks that were piling up in SIVs and in the CDOs that have now collapsed and have come back on the balance sheets of some of these large institutions. Use of these ill-advised structures has led to massive losses and significantly depleted capital levels.

On March 12th, merely days before the failure of Bear Stearns, I received a response from the SEC to my inquiry on disclosure and reporting requirements that applied to the structured finance market. In its response, the SEC stated that it is "actively engaged in investigating possible fraud or breaches of fiduciary duty involving structured finance products, such as CDOs, and also whether bank holding companies and securities firms made proper disclosure in their filings and public statements of what they knew about their CDO portfolios and their valuations. The letter further stated that the Commission was taking appropriate steps to ensure that there was proper disclosure in terms of firms' CDO exposures and whether the deals considered suitability requirements when selling complex debt-related securities such as mortgage-backed securities.

These are all appropriate actions by the regulator. However, in response to the current crisis, what needs to be addressed is how the SEC can avoid or mitigate the effects of these market problems for the future. We are interested in learning what knowledge has the SEC gained in response to the market turmoil and how is it applying that knowledge to improve oversight under the CSE program. Did the SEC's CSE program, with a focus on the CSEs' own models, lead to increased leverage and reduced capital? What is the SEC doing now to improve risk assessment procedures to ensure that future problems of this kind are caught at the outset and are not allowed to grow to the degree that they threaten the global economy and lead to the failure of another investment firm?

What question does this raise about the reliance on CSEs' risk models which could not adequately measure the risk of new financial products? How are some of the CSEs allowed to place significant amounts of liabilities in SIVs and SPEs beyond the scrutiny of investors and, indeed, the regulator? How did the SEC monitor and ensure that potential conflicts were managed within CSE firms as issuers of mortgage-backed securities and the NRSROs? How should regulation of CSEs change the result of the Federal Reserve's dramatic action to stand behind certain firms which some have referred to as the "too interconnected to fail" doctrine? Finally, what is the balance between a principles-based approach and a rules-based approach that focuses more on examination and reviews of the firms' activities to gain a better understanding of these firms' operations?

As everyone in the room knows, safety and soundness is not just about adequate capital levels, but also about ensuring that products offered by these entities are transparent and appropriate for consumers and investors and, indeed, the institutions themselves. We are again reminded that in times of easy money and access to cheap credit made possible by a low-interest-rate environment, regulators need to be more vigilant, not less. And, finally, in times of crisis, it is as important to understand what went wrong as it is to heed the lessons learned so we do not see repeated events.

Now I would like to recognize Senator Allard for his opening statement. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. First of all, Mr. Chairman, I would like to thank you for convening this hearing of the Securities Subcommittee to examine regulation of investment banks.

As Chairman Cox said at our recent hearing on Bear Stearns, and I quote, "The SEC's mission—the protection of investors, the maintenance of orderly markets, and the promotion of capital formation—is more important now than it has ever been. The recent turmoil in credit markets has made this a particularly challenging time."

That may be a bit of an understatement.

Since 2004, the Securities and Exchange Commission has allowed a broker-dealer holding company and its affiliates to undergo consolidated, what we call, SEC supervision. The Consolidated Supervised Entity (CSE) program was created partly in response to a European Union requirement that brokerage firms doing business in the countries needed to be regulated on a consolidated basis.

Unlike bank regulations, we are not talking about a large universe. The CSE program covered five entities, so naturally, when one of them—Bear Stearns—imploded, it raised a number of questions regarding the adequacy of the CSE regulation.

Many people have happily taken on the role of Monday morning quarterback and offered all sorts of suggestions or criticisms of the CSE program. And I commend Chairman Reed for taking a step that is becoming all too rare around here and holding a hearing to get the facts. We need to understand the history of the CSE program as well as its goals, functioning, and failings. Only by understanding the current landscape can we make decisions about potential legislative actions.

I would like to welcome our witnesses to the hearing today. Erik Sirri has testified before us on a number of occasions, and it is good to welcome him back today. I know that Mr. Sirri is currently leading an agency-wide task force composed of senior leadership, so his comments will be helpful.

It is also a pleasure to welcome two distinguished former SEC Chairmen, David Ruder and Arthur Levitt, back before the Senate. Both of you led the SEC through challenging times, and so you bring a unique perspective to today's discussion. Your experience as Chairmen gives us a keen understanding of the SEC, yet you have the luxury of being outside the politics of the SEC—something not enjoyed by the current Commissioners or staff.

The question of how to best regulate large investment banks will, unfortunately, not be settled here today. However, this hearing is an important part of that ongoing process. I am confident that all our witnesses will aid our understanding of the matter. I sincerely thank them for being here today, and I look forward to their testimony.

Thank you, Mr. Chairman.

Chairman REED. Well, thank you very much, Senator Allard.

As Senator Allard indicated, we are pleased to be joined today by Dr. Erik Sirri, the Director of the Division of Trading and Markets at the Commission. We are also on our second panel very delighted to have our distinguished former Chairmen of the Securities and Exchange Commission, Arthur Levitt and David Ruder. And I would also point out that former Chairman William Donaldson very much wanted to attend.

Chairman REED. At this point I would like to recognize Dr. Sirri. Dr. Sirri.

STATEMENT OF ERIK SIRRI, DIRECTOR, DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Reed, Senator Allard, I am pleased to have the opportunity this morning to describe the SEC's program for regulation of investment banks and the lessons learned from the recent turmoil in the credit markets.

Under the statutory scheme that Congress devised, most recently reflected in the Gramm-Leach-Bliley Act, the SEC is responsible for regulating the broker-dealer subsidiaries of investment banks, but no regulator in the Federal Government is given explicit authority and responsibility for the supervision of investment bank holding companies with bank affiliates. For investment banks that do not have U.S. banks within the consolidated group, it provides for holding company supervision in a structure that is purely voluntary. The four largest investment bank holding companies in the U.S. are ineligible because they have specialized bank affiliates, such as industrial banks or certain savings banks.

Because the existing statutory scheme does not address how and by whom investment bank holding companies with specialized bank affiliates should be supervised, and in part because of the implications of the European Union's Financial Conglomerates Directive, which required consolidated supervision either internationally or at the European level, the SEC adopted its Consolidated Supervised Entities—or CSE—program for U.S. investment banks in 2004. This, too, is a purely voluntary program, but in 2004 and 2005, the five largest investment banks volunteered to participate.

The CSE program has been recognized as "equivalent" to that of other internationally recognized supervisors for purposes of the EU's Financial Conglomerates Directive. It provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with the Federal Reserve's oversight of bank holding companies. It allows the Commission to monitor for financial or operational weakness in a CSE holding company or its unregulated affiliates that might place the U.S.-regulated broker-dealers or other regulated entities at risk.

It is within this context that the SEC confronted the rapid deterioration of liquidity at Bear Stearns during the week of March 10th. I will not rehash the events of that week because they were covered amply in testimony before the Banking Committee last month. But I would like to reiterate to this Committee what Chairman Cox observed in his testimony before the full Committee on April 3, 2008. While the Federal Reserve, by extending temporary access to the discount window to Bear Stearns as well as to other major investment banks, forestalled a similar run on the bank from playing out elsewhere, it, nonetheless, remains for Congress to determine whether to provide more predictable access to an external liquidity provider and to harmonize any such measures with other aspects of the existing statutory scheme, in particular the framework established by Congress for considering the resolution of difficulties experienced by commercial banks, but not investment banks, similar to the framework in the Federal Deposit Insurance Improvement Act and the Federal Deposit Insurance Act for systemically important investment bank holding companies.

In the wake of Bear Stearns, the SEC has taken a number of steps and additional protections that are being contemplated by CSEs in the wake of Bear Stearns. In addition to strengthening the liquidity requirements for CSE firms relative to their unsecured funding needs, we are closely scrutinizing the secured funding activities of each CSE firm, with a view to lengthening the average term of secured and unsecured funding arrangements. We are currently obtaining funding and liquidity information for all CSEs on a daily basis and discussing with CSEs the amount of excess secured funding capacity for less liquid positions. Further, we are in the process of establishing additional scenarios, focused on shorter duration but more extreme events that entail a substantial loss of secured funding, that will be layered on top of the existing scenarios as a basis for sizing liquidity pool requirements. This additional analysis is providing the basis for requiring firms to take steps such as increasing the term of secured funding and the diversity of funding sources. Also, we are discussing with CSE senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

Because the CSEs now have temporary access to the Primary Dealer's Credit Facility—or PDCF—which would operate as a backstop liquidity provider should circumstances require, and assures the necessary breathing space to implement the various measures outlined above, the SEC is in frequent discussions with the Federal Reserve Bank of New York about the financial and liquidity positions of the CSEs and issues related to the use and potential use of the PDCF. The SEC and the Federal Reserve Board are developing a formal Memorandum of Understanding that would provide an agreed-upon scope and mechanism for information sharing, both related to the PDCF and other areas of overlapping supervisory interest. Moreover, should Congress enact legislation to provide access to an external liquidity provider under exigent conditions in the future, the SEC stands ready to develop a process by which the Commission would formally communicate with the Federal Reserve or other relevant agencies in the event that an institution required access to any successor facility. Finally, the Chairman has publicly requested dedicated funding for the CSE program and a significant expansion in staff.

In conclusion, Bear Stearns' experience has challenged a number of assumptions, held by the SEC and by other regulators, relating to the supervision of large and complex securities firms. The SEC is working with other regulators to ensure that proper lessons are derived from these experiences and that changes are made to the relevant regulatory processes to reflect those lessons.

An imperative from the Bear Stearns crisis is addressing explicitly how and by whom large investment banks should be regulated and supervised, and specifically whether the Commission should be given an explicit mandate to perform this function at the holding company level, along with the authority to require compliance. We look forward to working with you on these broader questions.

Thank you again for this opportunity to discuss these important issues, and I am happy to take your questions.

Chairman REED. Thank you very much, Dr. Sirri, for your testimony, and you have raised some very interesting topics, and I appreciate the thoughtfulness of your statement and the work you are doing today to review and then look ahead to what we can do to make the situation better.

You state in your testimony that at no point did Bear Stearns' customers risk losing any of their cash, which raises sort of the issue of what was the focal point of the CSE. Was it simply to regulate the broker-dealer/customer relationship? Or was it the broader issue of regulating the entity? And I think you suggested an answer, which is it was not quite sure in the SEC mind. Can you comment on that?

Mr. SIRRI. Sure. I think you bring up two different but both very important aspects of our supervision generally. We obviously supervise broker-dealers, and in supervision of a broker-dealer, any broker-dealer, the focus is on preservation and the safety of a customer's security and cash. That goes for broker-dealers that sit outside consolidated supervised entities as well as the large broker-dealers that are inside of them.

The CSE program is a program that deals with the holding company that surrounds these large broker-dealers and deals with the financial and operational controls for risk that reside at the holding company. Those controls for risk also affect the broker-dealer itself.

The goal of the CSE program is to ensure that the risk is managed in such a way that none of the regulated subsidiaries of that holding company, whether U.S. broker-dealers, foreign broker-dealers, U.S. banks, or foreign depository institutions, are impaired because of issues in unregulated affiliates of that holding company.

Chairman REED. You suggest also, I think, in your testimony that explicit directions, legislative directions to you about your role of supervising investment banks would be appropriate. Is that a fair conclusion?

Mr. SIRRI. Yes, it is.

Chairman REED. And can you give us an outline of what you would think would be sort of the parameters of this role?

Mr. SIRRI. Sure. I want to point out that now, at the current time, our supervision, our CSE supervision, is by rule. It is through a modification to our net capital rule. What we are talking about when it comes to legislation is actually providing some legislative clarity that would allow us to have examination authority, capital setting and monitoring authority, and authority to impose various kinds of progressive restrictions on the firm itself based on its risk controls, its financial and operational risk controls.

I think we feel it is important to have the certainty that would arrive from having our authority embodied in legislation. Our rule-based system today accomplishes many of these, but there is an amount of certainty and clarity that arises from legislation that we think would be helpful.

Chairman REED. And another obvious point would be the fact that it would no longer be voluntary, that this would be mandatory if a firm fell into the guidelines or the definition?

Mr. SIRRI. Well, a firm could elect to fall under these guidelines. For example, a firm, if it wished to be supervised on a consolidated basis today, elects to come into it. I think, you know, it is for you to decide, and we are happy to have these conversations with you. But I think beginning a framework we are talking about, it is important that these holding companies be supervised. So it could be crafted on a voluntary basis, but if it were and one of these systemically important firms elected not to opt into it, I think there would be a difficult question of who was supervising that holding company.

Chairman REED. Also, I presume that you are not going to wait, that you are actually reviewing the rules as we speak to see if additional proposed rules should be made public and request comments. Is that fair?

Mr. SIRRI. It is a fair comment. I think we are reviewing many things. We are reviewing the way that we have supervised the firms and ways that we have been discussing. We are working in an integrated way with the Federal Reserve. We are looking at our rulemaking itself to see if those things can be improved and if there are steps that we can take in the interim. All of these things are on the table with the goal of accomplishing the goals of the CSE program.

Chairman REED. You mentioned, Dr. Sirri, that you are entering into a Memorandum of Understanding with the Federal Reserve, and that, I presume, has been significantly influenced by the Bear Stearns situation, where they actually went in and essentially supported the investment banking industry. Can you comment on the Memorandum of Understanding, where you are and where you are going with that?

Mr. SIRRI. Sure. The Memorandum of Understanding at the moment is in process. It is an interim draft, so it is in its early stages. The purpose of it is to cover a situation that we have now seen to say how are we going to work with the Federal Reserve in situations with the kind of exigencies that arose in Bear Stearns. But the Chairman has also asked us to look at our relationship with the Federal Reserve generally and see if in this Memorandum of Understanding we could broadly codify our working relationship with the goal of making it more useful and more clear.

Chairman REED. Let me switch to a specific topic, that is, from 2004 to 2007, at least three of the entities that you supervised under the CSE program—Bear Stearns, Lehman Brothers, and Merrill—made major purchases of subprime mortgage origination firms, placing them within the top 10 subprime mortgage originators in the country.

What is the scope of your authority over these subsidiaries? Did you actively engage in any type of review of the transaction or the effect on the investment bank?

Mr. SIRRI. We were fully aware of those transactions, and we were aware of their purposes. We understood what we did with respect to the risks to the firms. One of the reasons that these firms cited for these transactions was to have better control of the quality of the mortgages that came in from the outside into these firms.

Chairman REED. That sounds somewhat ironic at the moment. Did you have the occasion or the ability to coordinate with the regulators of these mortgage firms, if they were regulated, State regulators or anyone else? Did you do that?

Mr. SIRRI. I am not sure that we had—particularly at the CSE level, I am not sure that we had conversations with the entities that regulated those mortgage firms.

Chairman REED. Now, the rationale was that they wanted to ensure better quality. Did you actually have the occasion to look at the process of origination and securitization so that you could evaluate what was going on with these subsidiaries?

Mr. SIRRI. What we tried to understand, again, the purpose of the CSE program was to look at the holding company level risk controls. So to the extent that these risks that were imposed by the mortgage process, whether they involved the purchase of a mortgage originator or whether these mortgages were acquired at a market basis, we looked at the kind of risks they imposed on the firms.

Chairman REED. But how deep did you drill down? I mean, did you go in and talk at the level of the firm about the ratings, the categorizations? Or were your examiners able to go out and look at the actual process and make an independent assessment?

Mr. SIRRI. We did not make independent assessments. What we focused on were the risk controls within the firms and how they handled those risks, but we did not go out, say, to the mortgage originators and visit them.

Chairman REED. Another aspect of this issue between 2004 and 2007 is the proprietary trading activities of these firms. Did you have a chance to assess the management of risks associated with proprietary trading? And the specific issue of trading for their own accounts in a different way that they were trading in public accounts or offering securities to the public, was that ever part of your review?

Mr. SIRRI. For the CSE program itself, we definitely paid attention to their proprietary trades. So, for example, we knew of their proprietary positions for various classes of securities and derivatives. Those would include equities, typical debt, as well as mortgage instruments, derivatives, and cash instruments. So we were aware of those positions. We were aware of the risk controls for those positions. And we were aware of the policies and operational controls they had in place.

Chairman REED. But you were not consciously or institutionally aware of any discrepancies between positions they were taking for their own account versus positions for public account?

Mr. SIRRI. When you say "public account," I am—what you mean here is——

Chairman REED. The information and recommendations that were given to clients.

Mr. SIRRI. Sure. I understand.

Chairman REED. Suggestions to buy this, et cetera.

Mr. SIRRI. I understand exactly what you mean. You are referring to sales practices, the way they approached customers in the purchase of these securities.

Chairman REED. Yes.

Mr. SIRRI. That would not properly be part of the CSE program. That said, you know, we do have, as part of our oversight of broker-dealers, authority over broker-dealers and their sales practices. So that was not part of the CSE program, but even now as we speak, we as a Commission are reviewing those sales practices, the suitability of those recommendations. And to the extent those recommendations were unsuitable, I think, you know, we will be looking at that.

Chairman REED. Thank you, Dr. Sirri.

We have the luxury of myself and Senator Allard, so I think we will do a second round, Senator, so go ahead. I have got one more series of questions. Senator Allard, please. And thank you for letting me go on.

Senator ALLARD. You bet. I just have a direct question to follow up on how this all came about. The fundamental question, do you believe the Bear Stearns implosion was an indictment of the CSE program and its failings or was it unforeseeable?

Mr. SIRRI. I believe that what happened at Bear Stearns was unprecedented. A liquidity event that characterized the failure of Bear Stearns was something we just had not seen. This was not the case as in the case, say, of a Drexel or other broker-dealers or large firms that have failed, of holding a class of instruments whose value declined over time and the firm was forced to liquidate. That did not happen at Bear Stearns.

What happened at Bear Stearns was that secured funding typified by repurchase transactions in which a "money good" piece of security or some instrument is given to someone who provides you funding, but that mechanism fell apart. That is a secured funding market, which means that the paper I give you, the security that I give you, provides you confidence and security in the short-term loan you make me. That mechanism we always believed was governed by the quality of the collateral I provided you. The quality that Bear Stearns provided—treasuries, agency securities, as well as some other securities whose value was perhaps more questionable—that market fell apart. It fell apart in a way that we never anticipated. In our scenarios for risk management and I must say in the scenarios for risk management that were maintained by many regulators in the world, as well as other street firms, that was unprecedented. We obviously are more intelligent about that now, and we are incorporating that new reality into our risk management process.

Senator ALLARD. Do you think you were too reliable on the value of real estate and the paper that went with the real estate because you had brokers, you had land appraisers, which is controlled by

State regulation, and you assumed that that was working, but I know of instances in Colorado there was some serious breakdown in that relationship, and ordinarily with the consumer relying on between the title company and the broker and the appraiser, it tended to break down because of various market pressures, I think at the local level, and I think that the assumption was that this real estate had more value than it really did because of how that system was breaking down.

How do you view that as it was coming up to your level when you were evaluating—taking on the value of the security?

Mr. SIRRI. It is a good question. I think there are two separate issues here. You are pointing out a good question about the quality of the collateral, the underlying value of that collateral. The second issue is the process by which repurchase transactions are done.

Senator ALLARD. Yes.

Mr. SIRRI. In the repurchase market, the failing in the repurchase markets that we saw occurred in agency securities that were essentially money good. These are pass-through securities from Federal agencies that, because of their implicit guarantees around them, did not have the kinds of concerns that you are citing.

The concerns that you are citing are also very important. They could relate to commercial mortgage-backed securities, which thus far, although we are watching very carefully, we have not seen the kind of issues that might loom large perhaps in the future. In the residential mortgage-backed security, which are the pieces of paper that underlay residential mortgage-backed, you know, collateralizations and CDOs, there, of course, we did see issues.

I do want to correct one statement I made to Senator Reed. I was corrected by my colleagues in back. The CSE program, in fact, did visit originators, both at Bear Stearns and Lehman, and we checked with their audit oversight. So let me correct that statement, if I might, that our team did go out and visit two of the three that captured them. So I apologize for the mistake there.

Senator ALLARD. The other question, this originated, this whole idea of the CSE originated because we had these investment banking holding companies that wanted to get involved in the European markets, and so there was a requirement from the European market that you had to have a regulated entity. And when you put together those regulations initially, were they basically the same regulations that European companies—a similar nature—had to deal with? Or were they less regulatory or more regulatory? How would you classify them?

Mr. SIRRI. What the European Union was concerned about in their Financial Conglomerates Directive was that there be a single supervisor for the consolidated holding company and that supervisor be able to look at the risk controls at the holding company level as they affected the holding company and the various regulated subsidiaries. That was the core issue.

If those firms that chose to do business in the EU did not have a consolidated supervisor, the EU would have forced them for their business in Europe to create a sub-holding company that had, if you will, a miniature consolidated supervisor. That was expensive in terms of doing business in Europe.

The consolidated supervision program that we put in by rule is broadly consistent with the kind of risk management controls, operational financial controls that are the holding company level in Europe and in the United States. So that I would say Europe, the Federal Reserve in the United States, and the Securities and Exchange Commission are broadly consistent in that area.

Senator ALLARD. Now, they have different accounting standards and approaches on accounting. How do you compensate for that?

Mr. SIRRI. For us, we are looking at risk controls. So what is absolutely true is that valuation of securities is critically important in the risk management process. We don't use accounting numbers per se in the risk management processes. The good thing, the thing that makes this easier, is that risk management in a securities firm is largely done on a marked-to-market basis.

Senator ALLARD. OK.

Mr. SIRRI. And marked-to-market is independent of your accounting framework.

Senator ALLARD. OK. So if we had problems with the regulatory environment here in this country, what does that say about the regulatory environment in Europe with a similar instrument?

Mr. SIRRI. Well, I think both us, the United States and our regulatory oversight, and worldwide securities and systemic regulators are thinking very carefully about the issue of liquidity when it comes to regulation of financial intermediaries. This issue is being revisited in the Basel II capital requirements. We are thinking more deeply about it, about what it means for securities firms, because liquidity is so much their lifeblood. And I know that in our conversations with the Federal Reserve, Tim Geithner is also thinking very deeply about those questions.

Senator ALLARD. OK. Let me move on to the PART program. I am a strong proponent of the President's PART program, where you put out measurable goals and objectives and then the OMB comes in and does an evaluation and they evaluate the program as to whether it is effective or not effective, depending on whether the agency actually even put any goals and objectives in. And I noticed in looking over the Internet on the PART program that you have not been evaluated—this particular program has not been evaluated by PART.

Could you give the Subcommittee a brief kind of PART-type analysis of the program? Do they have measurable goals and objectives, for instance?

Mr. SIRRI. The Division of Trading and Markets has been evaluated in the PART framework, and we received the highest evaluation. So that is for the division as a whole, but the CSE program was part of it. But let me——

Senator ALLARD. So the CSE program has been evaluated on goals and objectives?

Mr. SIRRI. Trading and Markets, the division in which the CSE program oversight sits——

Senator ALLARD. I know.

Mr. SIRRI [continuing]. Has been evaluated by PART. But I think you are asking about the CSE program itself.

Senator ALLARD. Right. That is what I am after.

Mr. SIRRI. Exactly. So I just wanted to point out there has been some measurement there.

Let me try to answer your question directly. I think if you were to try and craft a system—all these things are difficult when it comes to supervision—a system of outcomes and measures, outcomes—inputs and outcomes here, I think we would have to think about issues related to, you know, quality, issues like the amount of liquidity that is being held within these firms. So let me give you a concrete example.

Before the SEC came in and supervised on a consolidated basis, these firms had no requirement to hold liquidity at the holding company level. They just did not need to because there was a gap, as I said in my testimony, in Gramm-Leach-Bliley. As part of our supervisory program, we require tens of billions of dollars of liquidity at the holding company level, to the point that now for the largest of these firms, there is in excess of $90 billion of free cash sitting at the holding companies of these firms. That is cash that is unencumbered and that can be spent at the end of the day today. That cash was not there prior to our oversight of these programs. So I think a reasonable type of outcome measure would be something that related to the amount of free liquidity that was placed in these firms as a result of our oversight, perhaps as scaled to the risk of these firms. I think something like that would lend itself to a PART-type framework.

Senator ALLARD. We are going to send you a question after the hearing, at least from my office, and I think maybe the Committee would be interested, too, and what I would like to have you do, a PART-type analysis. In other words, what is the specific purpose of the CSE program? Get that down on a piece of paper for us. And what are the specific measurable goals and how well is it achieving those goals? And how can it be improved?

Mr. SIRRI. I would be happy to give you that.

Senator ALLARD. That is sort of all encompassing, and I would like to see what kind of response we get back on that.

Mr. SIRRI. Thank you.

Senator ALLARD. Thank you.

Chairman REED. Senator Schumer.

Senator SCHUMER. Thank you, Chairman Reed, and thank you for calling this hearing. I thank our witnesses.

I guess the thing I would say is that I understand why the CSE program is there. It came about because of the great dilemma we face in regulation here, which is globalization, and that is, we are in global financial markets, we have national regulation, and it really allows a flight to the lowest common denominator if we are not careful. And that does two things: First, it hurts jobs in America, which I care a lot about. I think it is cavalier to say just keep all the regulations the same here, and then if the jobs flee, that is nothing, there are hundreds of thousands of people in America, hundreds of thousands in my area who work there. But, second, it does not accomplish anything. We are talking now, for instance—this is a different area, but it is related, increasing margin requirements on oil futures. In my view, that ought to be done. But if we just do it here, all oil futures will be traded in London, and we will not accomplish anything. We just will not accomplish anything.

So there is a balance here, and I know why you set up the CSE program, and that is because, otherwise, American companies would have had two choices: have two sets of regulation governing them, and that is not very good, especially when the regulations are in conflict. Just try to do it. It sounds benign. Try to be there when you are hearing different things from different regulators. Or they would have gone to Europe and had their regulation, for whatever that is worth. So I understand why you have it, and I think any call to abolish it is irresponsible given the dilemma.

Having said that, it is weak regulation by nature. And I am for much stronger—you know, I think in the 1980s we had sort of an exquisite balance between entrepreneurial vigor and regulation. You need a balance. If you have too much of one, you do not get the benefits of capitalism. You have too much of the other, and you get the excesses of capitalism. And so having a good balance makes a great deal of sense.

The trouble is that fundamentally when you regulate—one of the main reasons we regulate holding companies is safety and soundness, not only of the institution but of the system, systemic risk. And the SEC has never been a good safety and soundness regulator. It is not intended—the Fed is basically the experts on safety and soundness, particularly to the system. The SEC regime worked great. The basic view was since most of the people who were involved had some degree of sophistication that disclosure and going after fraud and other types of things was the way to go. But that is not the same way—it is not even the same mind-set as safety and soundness regulation. The Fed was always regarded as a friendlier regulator because it was more interested in safety and soundness, and the SEC was regarded as a more hostile regulator because it was interested in disclosure and fraud. And before technology had the two, banking and investment banking, blend—and, again, Glass-Steagall dealt with a reality, not created a reality—or getting rid of Glass-Steagall, which, again, in all due—I defended it for the longest time. But, second, the whole atmosphere of regulation is different.

And so I think, frankly, Mr. Chairman, the problem here is far greater than how well is CSE functioning. We need to revamp our structure of regulation. We have a different financial structure than we did when all of this was set up. And we need a strong regulator. We need, in my judgment, a more unified regulator. And we need a regulator who can look at a company like Bear Stearns from both points of view together as opposed to having the SEC look and see if Bear Stearns is disclosing or defrauding its potential investors; and, second, a different regulator—in this case, the Fed—coming in at the last minute and not knowing and not being prepared, saying we are worried about safety and soundness.

So I think that, again, the weakness of CSE is not the fault of the program itself. The weakness of CSE, which I would like to see a stronger regulatory regime, is because of the changes in the system, both technology and globalization. I think one of the reasons we had trouble with Bear Stearns, there should have been some regulator who went in in the summer and said, "You have got to raise capital. You have got to reduce your exposure to mortgages." The SEC never does that. And it is not adept at doing things like that. And the Fed did not have jurisdiction, and the Bear Stearns mess fell between the cracks.

And that is why I think, Mr. Chairman, one of the things we should be doing on this Committee is studying how we change our system of regulation. I would not do it quickly. I would do it carefully. And somehow we have to figure out a framework where whatever we do is in sync with the other major financial centers, London and Hong Kong and others, so you do not have—we can do all the regulating we want on our own. If everything goes somewhere else, as I said, we have not accomplished anything regulatory-wise, even if you do not care about the jobs, which I do.

Would you just comment on my little rambling peroration here? Because I have thought a lot about this. I care a lot about this, obviously.

Mr. SIRRI. Well, it is clear you have thought about it because what you said was extremely insightful. Let me begin with where I think you started, and I want to agree with you completely. You made a point about regulation and the balance that it strikes in the context perhaps—you used the example of oil futures and margin requirements in oil futures and the point that that business would just flee that higher margin setting.

In our supervision of firms, generally, stepping even back from the CSE program, we are always conscious of that. We may have a wish at times to tighten regulation in a particular place, but the firms that we are talking about, the large globally incorporated firms that we are talking about, will shift that business in other places.

I was speaking on a panel the other day with the general counsel of a very, very large financial intermediary, and I made a point about something where we thought additional oversight was needed. And the gentleman, whom I knew well, who is a very intelligent man, turned to me and said, "Well, you may elect to do this, but we will just do business in one of the other 17 countries in which we are incorporated." And that is a reality that we face every day and which I think I appreciate that you said.

Turning to the CSE program itself, you parsed regulation, I think quite correctly, into, the way I understand it, three distinct buckets, if you will.

You pointed out that the SEC is typically involved in issues about sales practices or, you know, disclosure, our typical regime for investor protection. And that is a core mission of the SEC.

You then pointed out that the Federal Reserve often takes on issues of supervision and prudential regulation. That is typically where they reside.

And you pointed out there was, in fact, a third function, the function of a guarantor, also something that is often done by the Federal Reserve.

The CSE program actually allows the SEC to fit in there in a particular way. We view the CSE program as a prudential program. It is not a disclosure program. It is not an investor protection program. Admittedly, it is done through rule and not through statute, something that our Chairman has said he would like to see change. But the framework that we have there is one that says if you want to get this alternate capital treatment for broker-dealers, then you must submit to the following, and to condense that down, it means supervision at the holding company and going through a set of undertakings. Within that set of undertakings, we have the ability to compel a firm to unwind a line of business, to compel a firm to increase their capital, to compel a firm to raise more liquidity at the holding company.

I admit that it is not the same as statutory authority, but it is derived from a rule. What we do not have the ability to do is to provide a monetary safety net through access to a discount window.

Senator SCHUMER. But it is true that the people at the SEC do not have a long history, long experience, even in that second function, do they?

Mr. SIRRI. I am going to step up to that and say that for the building itself, we are building that pays greatest attention to investor protection. For this program itself, it is staffed uniquely. It is staffed with PhDs in finance, in economics, masters in statistics. It is staffed differently than any other program. There is but one attorney in that group when I came in. It is a group that is very, very similar to the staffing at the Fed or any kind of regulator like that in such a program,

So, whereas, I will absolutely agree with you that it is the case that we are not typified by such staffing, for the purposes of this program it is staffed effectively, and it meets very well those requirements. Myself being—I am a finance PhD type. I was happy to see that kind of staffing when I came in because it is the kind of toolkit you need to do the work that is required. It is a quantitative discipline.

Senator SCHUMER. Could I just ask—and I beg the Chairman's indulgence—how many staff are there that are, you know, non-secretarial/clerical, but actually doing the looking?

Mr. SIRRI. There are 25 professionals involved in the CSE program. The Chairman has indicated that he would like to raise staffing of that to the level of 40 people, and that staffing would come both—in various aspects of the program.

Senator SCHUMER. Thank you, and sorry for going over my time.

Chairman REED. Thank you, Senator Schumer.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much, and I want to thank you, Doctor, for being here and for your testimony. Some of this may be redundant in terms of your testimony and some of the earlier questions, but I wanted to clarify or amplify the record on a few questions.

One is, I guess, a broad question about conflicts or potential conflicts. Could you just take me through the perspective of the SEC's ability in the role the SEC plays in monitoring conflicts between the rating organizations, the so-called NRSROs, and the consolidated supervised entities, the CSEs, as underwriters? Could you just kind of walk through in terms of this program how you will deal with and try to prevent conflicts?

Mr. SIRRI. Sure, I would be happy to.

Credit rating agencies fell—our oversight of credit rating agencies was extremely, extremely light, only through "no-action" letters that we granted. That was up until late 2006 when the Credit Rating Agency Reform Act was passed. We passed rules. The Commission approved final rules in June of 2007 to operationalize that new act. That covered several things. Broadly, that covered several things.

We specifically are charged with drafting rules and enforcing issues around transparency for the credit rating agencies, as well as mitigating certain conflicts of interest. That goes for any firm that—that goes for the CSEs as a whole—excuse me, the credit rating agencies as a whole. So in that sense, the CSEs are not unique amongst underwriters who would come to these credit rating agencies. But let me turn to the conflict of interest point you asked about.

In the rulemaking that we did, we basically prohibited certain kinds of conflicts. An example of one of those would be that someone, an employee who is involved in the actual crafting of a credit rating could not own the security being rated. That would be an example of a conflict we thought was unsupportable, and so we prohibited that directly.

More broadly, we require policies and procedures to manage other conflicts. Examples of that would include the notion that there is payment made by the person, the underwriter, bringing the security. That payment is being made. Their paper is being rated. There is a clear conflict there. So policies and procedures would need to be in place to manage that conflict.

Our Chairman has asked us to engage in rule writing immediately to try to improve and strengthen the regulatory framework for these entities. That rule writing will cover transparency, and it will cover additional rules in the area of conflicts of interest.

Senator CASEY. Let me ask you where you are in that process. In other words, is this a question of procedures in place for conflicts of interest that have yet to be fully implemented or tested? Or do you still have more work to do in terms of developing procedures?

Mr. SIRRI. It is a good question. We have been engaged in an examination of the credit rating agencies, so we have used our examination authority. We have been in there with teams at the three large credit rating agencies. Those examinations, we are not going to wait for them to be complete. They will inform our rulemaking because we have learned some things there. So an example of something that we may ask the Commission to consider would be perhaps a kind of prohibition that says that if a firm is involved in providing certain kinds of consulting or advice services to an underwriter related to a particular offering, they not be allowed, they be completely prohibited from rating that offering.

I cannot tell you the precise form of that, but that is something that staff is giving consideration to.

Senator CASEY. So the rulemaking is ongoing.

Mr. SIRRI. The rulemaking is advanced at our stage in terms of a draft stage within the building. It is, of course, up to the Commission to decide when they want to consider it. But the Chairman's instructions to me as the Director were to do that with all haste and try to bring that forward as rapidly as reasonably possible.

Senator CASEY. Thank you. And I wanted to ask you the second question or second area of questioning about the examiners. I was the elected Auditor General of Pennsylvania for two terms and then State Treasurer after that, and one thing we were always concerned about in the context of State government in terms of auditors who were auditing public programs is that our auditors, our experts in that department, were well trained so they could go up against some pretty touch customers. That is mostly within the context of State government.

But could you describe for us the profile of the typical examiner? What kind of training do they get or what are you hoping that they would get, their background, their experience? Just the profile that either you demand or you are developing for an examiner.

Mr. SIRRI. It is an interesting issue to raise. Of course, there never have been examiners of credit rating agencies per se. These entities were registered as advisors before, so our Office of Compliance, Inspections, and Examinations did so some books and records type exams, but they are not going at the thrust of your question.

I think the kinds of backgrounds that are reasonable, that you want to have here are varied. There is no one type of person. So, for example, the models that are run of credit rating agencies are very similar to the models that are run at principal investors, people who would be putting their own money at risk. That would include investment banks, hedge funds and such, because they are evaluating the probability that payments are made to the various tranches of securities.

So, in fact, you need some—the credit rating agencies themselves need some fairly highfalutin talent to do that. We in turn need some people who are very teched up to understand those models.

Now, again, the statute is very clear. We are not to second-guess their models or their methods. That is not what I am talking about. But within the statute, we want to understand that if they say they are applying their model in a certain way, that they, in fact, are applying that model in a certain way and that it is not being fudged, it is not being tilted for a favored client. Because the process is a process that is algorithmic, it is quantitative, you need people with similar skills. So I think that would account for one set of folks.

Farther down the line, we need people who have just typical compliance and auditing backgrounds to go at the kind of conflicts issues, some of the ones that you were raising. So, for example, what are the indicia of situations where you believe that process—you know, codified written processes and procedures are not being obeyed? We need people who have skills at looking for that.

We will be reviewing e-mails, so you need people who are willing to sit and read a lot of e-mails, and that is yet a different kind of person.

So I think we really need a portfolio of people, and to be honest, I think we will be learning as we go because it is a new process. We have been using people from our Office of Compliance, Inspections, and Examinations to do this work now, but I expect, you know, that over time we will develop a specialized group of people here.

Senator CASEY. I know I am out of time almost, but just one quick question about personnel and resources. Do you think as we stand here today that you have the resources and the—I will try to use a primitive or simplistic phrase here, but the ramp-up capability to get this job done? Or do you need an infusion of either personnel or resources to do that?

Mr. SIRRI. We have been having that conversation internally. I believe our Chairman asked the Appropriations Committee for an increase in our staffing in the program for credit rating agencies.

Senator CASEY. It is a good idea to do that around here.

Mr. SIRRI. So he has asked for that. He has emphasized that this is a critically important part of what we do, and he is committed to say that he wants to see an increase in staffing in that area.

Senator CASEY. Thank you very much.

Chairman REED. Thank you very much, Senator Casey, and let's take a brief second round.

Senator ALLARD. Yes, Mr. Chairman, I just have one other question I can think of with other questions and everything.

Chairman REED. Well, let me proceed quickly to my questions. Then I will turn it over to you, and then welcome our distinguished Chairmen who are going to join us.

Now that the discount window is open to investment banks, that raises two possibilities: one is that they will be better risk managers; the other possibility is that now that they have in the wings the cavalry, they will be more cavalier. What do you think will happen? And how are you going to structure it so it is better risk management?

Mr. SIRRI. Well, as part of that process, we have been meeting with the Federal Reserve to go over exactly those issues. Of course, the Federal Reserve is most focused on exactly that. I have met with Tim Geithner, and I met with him when we were meeting with the firms. I think he understands better than anyone the notion of moral hazard that you are citing that says that if you have access to this facility, you might actually let certain things lapse.

There are some things that allow us—that give me comfort in this area. We, of course, know what their risk management practices were and what the benchmark was before they had access to these facilities. Admittedly, that baseline may be low, and it is something we want to raise. But at least we can tell when there is recidivistic behavior in that area.

I think we know we want to step up capital liquidity requirements for these firms and our risk oversight for these firms. So the extent that we can implicitly—we can ask those kinds of questions that say, look, when we run a risk scenario and we see that they do not have adequate funding for pools of assets, if their answer to us is, "Well, don't worry, we have access to the window there," that is not going to be an acceptable answer in the long run unless, you know, that is a wholesale change that Congress would be involved in.

So I think the precise answer to your question is that we would just not—in asking very precise, targeted questions, we would suss our way through those kinds of answers and see that our risk scenarios make them provide for the kind of funding they need.

Chairman REED. Let me focus on an issue that a number of commentators have raised, and that is that under the alternative net capital rule, potentially questionable assets like subordinated debt, deferred return of taxes, and some securities for which there is no ready market, were allowed to be classified as risk-free capital. And for one, David Einhorn has suggested that the implication of this has been a reduction in the amount of required capital to engage in increasingly risky activities.

At this moment, when we are all looking for sounder capital positions, have these net capital rules produced exactly the opposite effect, capital that is far from risk free?

Mr. SIRRI. There has been a great deal of confusion around capital, liquidity, and whether you are talking about the broker-dealer itself or the holding company. There is an alternate capital treatment applied to the broker-dealer when they opt into this program. But I will tell you that when those broker-dealers opted into the program, a value at risk or some type of model like that was put in place that may have allowed for a lower minimum. But, in fact, what happened is that broker-dealers elected to keep higher levels of capital in there, so you basically saw almost no reduction in capital in those broker-dealers from before they entered the CSE program to after. It may have been that the minimums allowed them to take some out, but as a practical matter, they did not.

But what I really want to emphasize is the massive gain in liquidity that was provided at the holding company level. Those are tens of billions of dollars that were just not there. If there was a practical reduction in liquidity at the broker-dealer, it is on the order of $1 to $2 billion. You are talking about tens of billions of dollars that came in. Net from coming into this program, I think it is fair to say that there was no decrease in capital at the broker-dealer, and there was a massive increase in liquidity at the holding company.

Chairman REED. There is another aspect of this whole issue of liquidity and capital, and that is the asset issue, Level 3 assets in particular. There has been some question about the impact of these Level 3 assets on the balance sheets of these companies. Do you have a rough notion of how much on the balance sheets are Level 3? You don't have to be specific and detailed. But, also are you looking at these assets, since essentially the Level 3 means they are hard to price and maybe impossible to price, which would also suggest hard to sell? Can you comment?

Mr. SIRRI. Sure, I can. You are referring to FAS 157. There are three buckets of assets there. You are referring to—FAS 157 fundamentally looks at the availability of inputs to price those assets, and you are pointing out a problem where, you know, over time that lower bucket may have—you know, assets may have dropped into that lower bucket.

You know, we are tracking that. The Commission has recently—the Chairman has asked and the Division of Corporation Finance has issued a letter providing for additional guidance by issuers to talk about the kind of—the nature of the assets that are held in that Level 3 area. I know there is a lot of discussion going on recently about value at risk, so we are tracking this area very carefully, paying particular attention—I can also tell you that we have such discussions at the President's Working Group, and we talk about marked-to-market accounting and the effects of FAS 157. So there is a great deal of attention being paid to this right now.

Chairman REED. Let me ask a final question that is related. We talked about capital. We talked about assets. And you have also suggested the issue of leverage. One of the issues that is throughout the financial system is, it seems, the increasing amount of leverage on balance sheets. Bank regulators have consistently been requiring reduction in leverage. Are you taking the same approach toward these regulated entities? And was that done with Bear Stearns in particular?

Mr. SIRRI. For us, you know, we have many discussions about leverage. When comparing leverage to a bank and leverage to a securities firm, the comparison is very, very difficult because of the different nature of the securities firm. They held a lot of match book repo. Their assets are typically very, very liquid because they hold securities.

I think rather than speak about leverage per se, we talk about liquidity and capital. So as you raise capital, you implicitly decrease leverage. And as you raise liquidity, you implicitly lower the risk that is typified by leverage.

So we have been focusing primarily on those, but they are a different way of getting at the risks that are typified by the leverage that you talked about.

Chairman REED. Thank you very much, Dr. Sirri.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I have a couple of brief questions.

Would you classify those group of businesses that fall under the CSE regulatory as "too big to fail"?

Mr. SIRRI. "Too big to fail" is a difficult way to characterize them. I would characterize these as systemically important firms. I think when one thinks back to something like Bear Stearns, it is not necessarily the case that the firm is too large to fail. It was, after all, the smallest of the CSE firms. But it was the manner and the rapidity with which it got into trouble.

Were you to have a CSE firm that, let's say in a hypothetical example, found itself holding classes of assets that deteriorated in value over time, that firm may find itself slowly degrading in financial condition, hypothetically, over a period of 6 months. In such a world, it is quite likely that that firm could unwind and contract its balance sheet in such a way that the notion of too big to fail or too interconnected to fail might not be that large an issue. The key thing that came up most recently with Bear Stearns was the absolute rapidity with which funding disappeared.

So, whereas, I am not—I appreciate the import of your question with too big to fail, but I would also add the dimension of rapidity and the interconnectedness of these firms.

Senator ALLARD. If you take the smallest of the firms, which is Bear Stearns, and you did not allow them to fail, felt like you had to have Government support in that particular case, doesn't that send a message that they are too big to fail?

Mr. SIRRI. Well, again, Drexel Burnham a number of years ago also failed, but it failed over a period of time. I cannot—you know, this is a world that did not happen, but were the funding issues at Bear to have played out over a longer period of time, assistance in terms of liquidity may not need to have been provided. So I think when one of these firms gets into trouble rapidly, liquidity support is needed, and I think that is the import of—I understand that to be the import.

But what I want to make the distinction is that were that trouble to play out more slowly, liquidity support might not be required. And I think, as I remember some of the comments that the individuals from the Federal Reserve made in their testimony, they talked about phrases like "breathing room" and "time" being important. I know our Chairman talked about that as well.

Senator ALLARD. Now, I want to talk a little bit about the timeline. In opening of the Prime Dealer Credit Facility, it gave the SEC some breathing room that you talked about to do a real careful analysis of the CSE program. How much time does the Prime Dealer Credit Facility buy you? And what is your timeline?

Mr. SIRRI. Well, we went to work immediately on the kind of issues that we are talking about, questions about liquidity and risk management. That happened. Those conversations began, in fact, before the Bear Stearns event. We realized that we needed to revisit some basic questions. They continue on today.

The Primary Dealer Credit Facility was opened by the Federal Reserve, so I cannot speak to how long that—I just cannot speak to how long they will keep it open. But I will tell you we are coordinating with the New York Fed in our oversight of these firms, and, you know, I expect that in those conversations we will be working with them, talking to them about how we see oversight of these firms in such a way, and they will be telling us about their thoughts of the Primary Dealer Credit Facility.

They have announced that it was—they have said at the outset it was a 6-month facility. Whether they choose to shorten or lengthen it is a question I just cannot answer.

Senator ALLARD. So we have got the 6-month facility. You do not know whether it will go beyond that or not.

Mr. SIRRI. I just cannot answer that question.

Senator ALLARD. OK. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Allard, and thank you, Dr. Sirri, for your testimony.

At this time I would like to welcome the second panel. I would like to welcome David Ruder and Arthur Levitt, former Chairmen of the Securities and Exchange Commission, distinguished Chairmen. When Chairman Levitt took over, he was, as many of his predecessors and successors, an advocate for investor rights, and he was particularly effective in creating the Office of Investor Education and Assistance. He also was active in reforming NASD, the penny stock rule, and many other critical efforts to protect investors and markets alike.

Chairman Ruder assumed responsibilities a few weeks before the 1987 market crash, and some of the steps he took are still guiding the activities of the SEC today.

Both gentlemen are graduates of Williams College, and so we are proud to organize this reunion of Williams College.

Mr. LEVITT. Thank you.

Chairman REED. And we are glad to see you here. Chairman Levitt, would you begin, please?

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

Mr. LEVITT. Thank you very much, Chairman Reed, Ranking Member Allard, Members of the Subcommittee. Thanks for the opportunity to testify in front of you today and sitting alongside my very distinguished fellow Chairman, and for holding this hearing on such an important and timely topic.

The downfall of Bear Stearns, the uncertainty and volatility in the capital and debt markets, and the close to $300 billion in writedowns and the resulting losses by some of the world's largest financial institutions have created a crisis on Wall Street—one that rightly has gotten the attention of all of us who worry about the health of our capital markets.

Yet the current crisis is one that involves Main Street as much as Wall Street. It has directly touched the lives of millions of people—investors and homeowners alike.

And that is why I think it essential that we determine precisely what went wrong, to provide a basis for determining if there was a breakdown in regulation, and if any new regulatory structures and powers may be needed to restore trust in our markets and prevent this kind of run from happening again.

As David, Bill Donaldson, and I recently argued in the New York Times, we believe that a high-level, bipartisan, and impartial examination must be launched to explore a series of possible business and regulatory failures that has produced this credit crisis. This is what President Reagan did after Black Monday in 1987, and I hope we soon have a similar Presidential level task force examining these complex issues.

From where we stand today, it is apparent that a variety of players—including regulators, ratings agencies, standard-setters, and gatekeepers as well as institutional investors—simply did not live up to their responsibilities.

In some cases—such as mortgage brokers—it was because there was a lack of meaningful regulation.

In other cases—such as ensuring banks had adequate underwriting standards for loans—the relevant regulators simply refused to act.

And in other cases, regulatory standards did not keep pace with financial engineering.

Those who bought these new complex, financial instruments had no idea as to the extent of the risks that they were assuming since the creators of these instruments were either purposely—and legally—hiding these risks by placing them off the balance sheet in structured investment vehicles; or the banks themselves were clueless as to the magnitude of such risks.

At the same time, investors were basing investment decisions on the judgments of rating agencies who were either conflicted or just plain careless in how they exercised their immense credit rating power.

Moving forward, there are some obvious holes that need to be plugged immediately, and none more glaring than the issues surrounding the credit rating agencies.

While those agencies have initiated a process of constructive self-analysis and in some cases reform, Congress must take these conflict-of-interest issues head on or at least empower the SEC with the proper oversight and disciplinary powers so they can do the job.

The issue I believe is critical to the proper functioning of our markets.

Just looking to the longer term, we must also consider whether new regulatory structures and authority may be needed to restore public confidence in the markets.

I am a great believer in free markets as the very best way to allocate capital. At their best, markets are self-regulating and self-correcting.

Integral to the functioning of a free market, however, is the presence of someone to ensure that the rules of the road are enforced fairly and swiftly. That is why we need to make sure that, moving forward, the market's referees keep pace with the players.

What worries me is that these creations of the financial engineers, while adding liquidity and depth to the market, have simply not been self-correcting but, rather, they have been destructively destabilizing.

Assessing and monitoring the risk that these products have introduced into the financial system goes beyond the ability of one nation's central bank. Indeed, I think it is a problem that begs for a global solution.

It does not mean that solutions to the current crisis are beyond our reach. There is a series of steps we can take in our own regulatory structure to improve the functioning of our markets.

That is why I welcomed Secretary Paulson's recommendations about the structure of our financial regulatory architecture. There are aspects to it that I like very much, some that I do not, but I think it is a vitally important starting point in getting a dialog going that will continue, I believe, for months and years to come.

Without getting into the details, let me sketch what I believe investors need from a capital markets regulator.

First and foremost, any market regulator must put investor interests above all others. It is not only good for investors, but it is this focus which has made our capital markets the envy of the world.

Second, as part of this commitment, such an agency must ensure that the public gets whatever information it needs to make informed investing decisions.

Third, it must be a law enforcement agency. Vigorous enforcement of the rules of the road is a powerful deterrent to bad behavior and usually prevents the use for heavy-handed regulation.

Fourth, to be effective in any of these roles, the regulator must have the resources in terms of funding, tools, staffing, and competencies to get the job done right.

Right now, I fear that the SEC does not have what it needs to meet the demands of the day.

The SEC's 2009 enforcement budget does not keep pace with inflation. Staffing levels have not kept pace with the urgent work that needs to be done. And the Enforcement Division, I believe, has been unnecessarily hamstrung in negotiating corporate penalties because of recent procedural changes at the Commission. The result has been a lessening of the imposition of corporate penalties against egregious wrongdoers and a reduction in the corporate penalty numbers over the past year.

Fifth, it is important that, by design, any capital markets regulator be independent—be independent of the White House—and depoliticized from the fights of the day.

Finally, as we consider the future of the SEC and financial regulation in general, let us not forget that more powerful than any rule that can be written, regulation that can be passed, or standard that can be set is the power of the bully pulpit.

Whatever leadership is chosen for a future agency, it needs to be led by an individual who understands the importance of public pronouncements and signals that are sent to the marketplace, signals in terms of the kind of aspirations that that leader wants for the Commission, whether he gets it or not. This is something that SEC Chairmen have understood from its founding 75 years ago up until the present day, and it must be preserved.

In sum, the future of the financial markets and of the regulatory structures we construct to oversee them is in flux, and it should be.

The gravity of the situation we are in today calls for everything to be on the table. Make no mistake: no agency, no existing structure, no gatekeeper should be immune from a thoroughgoing, hardheaded analysis of its relevance to today's extraordinarily complex electronic markets.

As we move forward with such a review, we must keep in mind that the strength of America's capital markets lies in how high our standards of transparency, independence, and accountability may be.

And no matter what changes we undertake, we have got to ensure that we have in place a market regulator that is as sensitive to the demands of the individual investor Main Street as it is to the demands of the institutional investors on Wall Street.

Thank you.

Chairman REED. Thank you very much, Chairman Levitt.

Chairman Ruder, please.

STATEMENT OF DAVID S. RUDER, FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Mr. Chairman, Senator Allard, and Members of the Subcommittee, my testimony today will address the role of the Securities and Exchange Commission in regulating investment banks in today's complex global financial markets. I will discuss the SEC's regulatory obligations stemming from the recent credit crisis and its obligations relating to supervision of the securities markets, concluding that the SEC should have increased resources in order to fulfill its regulatory missions. I will argue that the SEC should not be required to substitute principles-based regulation of investment banks for its current enforcement-based regulation. I will urge the SEC to continue to communicate with investment banks regarding market innovations and risk positions. I will advocate giving the SEC new powers enabling it to improve its oversight of the financial stability of investment bank holding companies.

Any investigation of the role of investment banks in the credit crisis will probably evaluate the role and responsibilities of the Securities and Exchange Commission, as you have started to do this morning. Now, one question will be whether the SEC's enforcement practices and other policies regarding investment banks will be adequate.

In my view, the SEC's enforcement program is vital to its mission. The SEC has extensive power to impose sanctions on investment banks through court injunctive or administrative actions. The SEC's enforcement activities are effective because they not only punish wrongdoing, but also send strong messages of deterrence.

In the wake of the credit crisis, the SEC is undertaking investigations. Once it has gathered sufficient evidence, it will undoubtedly bring regulatory actions. Possible areas of inquiry regarding investment banks include failures to disclose the poor quality of structured securities when selling them to investors, sales of high-risk structured securities to investors for whom they were unsuitable, sales of auction rate securities without revealing possible market illiquidity, and failures to reveal known investment bank holding company low asset valuations to purchasers of holding company securities.

The SEC's ability to bring enforcement actions is dependent upon the size of its enforcement staff, which I believe, as does Chairman Levitt, should be increased so that it may be better able to engage in enforcement activities related to the credit crisis. I believe the additional communication and monitoring responsibilities that I will discuss in the remainder of my testimony will also require additional resources.

In March of 2008, the U.S. Treasury released a Blueprint for Reform of the Financial Regulatory System containing both near-term and long-term proposals for financial system regulatory reform. The Treasury blueprint contains proposals that would change the SEC's oversight of stock exchanges and investment banks from an enforcement system to a principles-based system. First, the Treasury urges the SEC to adopt the CFTC's principles-based regulation approach to securities clearing agencies and securities exchanges. That approach involves discussions with the regulated entities regarding the appropriate means of achieving compliance with the principles.

Treasury support for a principles-based system may come in part from a comparison with recent changes in the financial services regulatory system in the United Kingdom. In the U.K., regulation of banking, securities, insurance and investments has recently been merged into a single, unified regulator, the Financial Services Authority, utilizing a principles-based regulatory system. That system has been described by the FSA as follows:

Principles-based regulation means, where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their businesses. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified. We will increasingly shift the balance of our activity toward setting out desirable regulatory outcomes in principles- and outcome-focused rules, enabling our people to engage with firms' senior management in pursuit of these outcomes. We expect firms' behavior, in turn, to change to adjust to this shift in emphasis.

As a second step, the Treasury recommends a merger between the CFTC and the SEC and urges legislation that will merge regulatory philosophies and harmonize futures and securities statutes and regulations, including, I believe, adoption of a principle-based approach. I sought legislation calling for the combination of the SEC and the CFTC following the market crash of 1987, but to no avail. I welcome and support the current Treasury proposal, but I do not believe the merger should be the vehicle for imposing a principles-based regulatory system in the securities markets and the elimination of great portions of our enforcement-based system.

Although I do not believe the SEC enforcement-based system should be abandoned, I am sensitive to the fact that the SEC is regulating U.S. investment banks and stock exchanges that are competing in a complicated and constantly changing world environment. And I believe, therefore, the Commission should embrace the communications objectives of principles-based regulation. Dramatic innovation and technological change in the world's securities markets have created a need for the SEC to communicate constantly with the leaders of our investment banks, securities exchanges, and futures exchanges, as well as with domestic and foreign regulators.

I also believe that the Commission should engage in prudential regulation with regard to the solvency, liquidity, and financial stability of investment banks. The Commission should play an active role in monitoring the overall risk management practices of investment banks. When possible, it should obtain information about the risk positions of unregulated entities controlled by those banks, such as hedge funds, private equity, and off-balance-sheet entities.

Investment banks that are part of a bank holding company are subject to prudential supervision by the Federal Reserve Board. Investment holding banks not regulated as part of bank holding companies are, as you have been discussing, subject to risk-based supervision by the SEC on its voluntary CSE program.

The CSE program requires the supervised entities to provide the SEC on a regular basis with extensive information regarding group-wide capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk. In practice, the operation of this program is prudential because it involves attention to the affairs of the supervised investment bank holding companies on an individual basis, with close and regular contact between the SEC staff and the supervised entity.

I believe the prudential supervision of investment bank holding companies by the SEC should continue and be expanded. It is extremely important that the risk positions of investment bank holding companies, including their unregulated affiliates, be known so that the SEC can confer with other regulators regarding systemic risk. This risk assessment regulatory function for investment banks should remain in the SEC because it is the agency that best understands the risk activities engaged in by investment banks. Indeed, using its expertise, the SEC might well cooperate with the Federal Reserve Board regarding the risk assessment of investment banks that are part of bank holding companies. I further believe that the voluntary program for SEC oversight of investment bank risk activities should be made mandatory through legislation, so that the non-bank holding company investment banks will not have the power to withdraw from the supervisory system when they are dissatisfied with the SEC's supervision or unwilling to provide information.

Thank you for the opportunity to be with you today.

Chairman REED. Well, thank you very much, Chairman Ruder. I want to thank both of you gentlemen. We are extremely grateful that you would come here today. We received thoughtful testimony from the Securities and Exchange Commission, but there are few people that have the perspective, the experience, and the deep concern for the Securities and Exchange Commission and the market overall than you two gentlemen. So thank you very, very much for coming today.

I just want to follow up, Chairman Ruder, with a question for both of you, but let me direct it to you first. The difference between a principles-based regulation and rule-based regulation, I think I heard in your testimony that at a certain level principles-based regulation might be appropriate, but at another level rules should be imposed. Can you help me understand if there is a line of demarcation?

Mr. RUDER. Yes. I think as Mr. Sirri was discussing, there is a difference between the systemic risk questions that need to be addressed throughout our system and the regulatory aspects of the SEC's supervision. The investment banks need to know by rules and an enforcement process that they may not engage in activities that are harmful to the investing public. They should not be allowed to have misrepresentations to engage in market activities that are unwholesome, to do a lot of other things that are prohibited by the Commission. I think that their activities in that regard ought to be effectively enforced by rules and enforcement.

On the systemic side, I think it is very important for the SEC to be part of the risk-based supervisory system and to have its powers and staff increase so that it can do the kind of job that we all think it should be doing. And that is to me the prudential supervision part of it, and the other part of—the principles-based part of a regulation would be the establishment of a system where, instead of having a regulatory system based upon enforcement and punishment and deterrence, you would simply talk to the regulated bodies and say you really did not do such a good job this time, but we want you to tell us how you can do better in the future.

I do not think that is a system that will work in the United States, but I do think that it is important that the SEC recognize the value of the communication process with the investment banks particularly. They need in their prudential supervision not only to look at what the risk problems are, but to look at the entire firm and see whether the firms' regulatory posture is one that the Commission wants. And for that we need a very close interaction between the firms and the Commission.

Chairman REED. Thank you very much.

Chairman Levitt, your comments on this issue of principles versus enforcement.

Mr. LEVITT. I agree with Chairman Ruder——

Chairman REED. Could you turn your microphone on?

Mr. LEVITT. I agree with Chairman Ruder. Principles-based regulation is often based upon the U.K. FSA model. I do not think it has worked particularly well over there. I do not think it will work well over here. I think Chairman Ruder draws a very important distinction between the use of prudential regulation with respect to systemic issues, but the crux and core and heart and soul of the SEC, which is based upon investor confidence, comes about from enforcement-based regulation rather than the mushier prudential or principles-based regulation that is practiced elsewhere.

Chairman REED. Well, let me follow up, I think, with a related question, and for both of you, but I will start with Chairman Levitt. In the Paulson recommendation, the suggestion that I saw was that the Federal Reserve sort of step up as the comprehensive regulator for all these different financial firms. Can you comment on that, Chairman Levitt?

Mr. LEVITT. I think it is premature to choose any agency right now. It is ironic that—the Federal Reserve certainly was not there with respect to the problems at Citibank. The Federal Reserve does have resources not available to the SEC or any other regulator. But I think such a judgment right now is premature until we study exactly what went wrong.

I think there is more that we do not know about what has happened in the past 2 years than that we do know about it. And I think that has got to precede any judgment as to who does what. I would be extremely cautious before I allocated to the Federal Reserve Board the total responsibility of regulating our markets until such a study is done.

Chairman REED. Thank you.

Chairman Ruder, your comments?

Mr. RUDER. I believe that the SEC has the ability to understand the risk activities of our investment banks. I think its approach is to understand that risk and at the same time learn about the systemic risk that is involved. I do not think that the Federal Reserve Board really would be playing a regulatory role that recognizes the risk positions taken by our investment banks as part of the securities markets. So I would be very cautious in letting the Federal Reserve Board have power over the entire securities and banking system.

Mr. LEVITT. Paulson did raise a very interesting suggestion about having a new agency created that would be concerned about investor considerations. I think that is an important idea. Whether that would be combined with the SEC I think remains to be seen. But the notion of the importance, the primacy of investor protection, implied by Paulson's suggestion is one that I think we should give careful consideration to.

Chairman REED. Thank you. I will recognize Senator Allard, and then I would like to do a second round also. This is, again, a great opportunity for us to ask questions. But just a final quick point. The SEC today suggested there would be some legislative definition that supports their CSE program. Would you concur, Chairman Levitt and Chairman Ruder?

Mr. LEVITT. All I would say is that I think that the CSE program can be more clearly defined, can be mandated. I think there is a lot of fuzziness about it now. Clearly, it has not provided the answers. Clearly, it has been around and we have gone through what we have gone through. So a lot of work has to be done.

Chairman REED. Chairman Ruder.

Mr. RUDER. As my earlier testimony indicated, I favor legislative support of that program.

Chairman REED. Thank you very much, gentlemen.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I will have one round of questions. Then I am going to have to get to the floor. So I will leave you in charge at that particular point in time.

Both of you now have indicated that you would support more of a congressional role in this and some authorizing legislation. How should the codified authority differ, if at all, from the current regulatory program?

Mr. RUDER. Well, the current regulatory program involves the Fed supervising the bank holding companies and the Securities and Exchange Commission supervising the non-bank investment bank holding companies. I think that should continue, and I think the Commission should be given more power to look at the systemic risk aspects of the bank holding companies, and then to confer with the Fed about the appropriate regulatory postures.

Senator ALLARD. Do you think we need to have some language in there that brings the Fed in specifically, then, do you?

Mr. RUDER. The systemic risk-based part of this, yes. I must say that my great concern about this legislative program is a possible attack on the independence of the Commission. I believe that the Commission, the SEC, must remain as an independent agency and not subject to the political powers which might come from the Treasury or even from Congress, if I may say.

Mr. LEVITT. That is a great danger. I share that feeling. The politicization of the SEC would be, if there is such a thing, an economic tragedy. I think that clearly the SEC needs greater resources in terms of risk management. Chairman Donaldson built up that capability at the time of his departure. It has diminished somewhat in recent years, and as I understand from the testimony before, there is a rapid buildup of that capability. I think that has got to be emphasized.

Unfortunately, it takes an event, a crisis, to mobilize the attention of all the players, all the gatekeepers, all the regulators, all the legislators, and we have a real crisis.

Senator ALLARD. We had some questions earlier from a member of this panel here that talked about the amount of resources needed to be made available for the SEC to carry on with their regulatory setting process and staffing levels and all that. And you both have advocated for greater staff and budgetary resources for the SEC.

What level do you believe is necessary to do the right job?

Mr. LEVITT. Well, I think that clearly, when you see a diminution of budget allocated to the SEC—and there has been a sharp diminution. In 2005, the SEC spent $917 million. In the most recent budget, it was down to $842 million. The director of the Los Angeles office this morning mentioned that he has had to cut staff by 10 percent. That kind of statement in the midst of what we have been seeing says something has gone wrong.

I noticed that the Chairman of the House Banking Committee has called for a $30 billion increase in funding. It is difficult to place a number on this except to say that the need is great. It is not just dollar-related. I share Chairman Ruder's emphasis on the importance of prioritizing the enforcement program, the ability to have a cop on the beat, the ability to tell wrongdoers that our examiners, our enforcement people are out there looking at the marketplace and determining where steps should be taken. We have been moving in exactly the wrong direction, and I think that in—my long-winded response to your question is the agency needs greater resources in the areas of enforcement and inspection. Whether that be $30 billion, $20 billion, or $40 billion I leave to the dialog between appropriators and the agency.

Senator ALLARD. Well, I am an appropriator on the appropriating committee, too, so I was very interested in your response.

Mr. RUDER. If I may comment, in 2002, the SEC's budget was $514 million. Following the Sarbanes-Oxley Act, which contained a dramatic increase in budget, the budget went up to $716 million. And it since has gone up some, but only as Chairman Levitt has told you, to $906 million in the 2008 budget.

I think that the Commission's job in this very complicated world is increasing in many ways that are not really apparent. The ability to deal with the complicated structural problems in the securities area, including competition between securities exchanges, the creation of new, innovative products, the problems of the counterparty risk management in the unregulated portion of this market I think—and I may say the Commission's Mutual Recognition Project will require great—more assets for the Commission. And I think Congress ought to look very carefully at the whole Commission's budget to see whether some dramatic increase in funding is not necessary in order for it to meet its market-protective objectives.

Senator ALLARD. Yes, and I see also in here that the type of expertise that you have to have for the kind of oversight that we are talking about here is not readily available and may even demand a pretty high salary and benefits and whatnot, and just, you know, we need to make sure that we have that quality in the overseer as well as in the marketplace.

Mr. LEVITT. And the overseer must see that that money is spent wisely.

Senator ALLARD. Yes.

Mr. LEVITT. And spent in the areas that corrects the problem.

Senator ALLARD. Yes, where we need the expertise.

Mr. RUDER. If you contemplate how the risk-based assessment might have taken place under the CSE program and ask yourself what kinds of skills would be needed to find the appropriate analysis, I think you really do need to look at much better paid and much more highly sophisticated individuals.

Senator ALLARD. Thank you for your comments.

Thank you, Mr. Chairman.

Chairman REED. And we will keep the record open for 5 additional days for any statements or questions, and we would ask you gentlemen, if my colleagues submit questions, we look forward to your response. But let me ask a few quick questions.

Following up on what Senator Allard said, I get the impression and I share the impression that at present in some respects the SEC is outgunned by the resources and expertise of those they are trying to regulate. Is that a fair assessment?

Mr. LEVITT. Yes.

Chairman REED. Can you put your microphone on when——

Mr. LEVITT. I am sorry. Of what regulators?

Chairman REED. Well, the SEC regulators.

Mr. LEVITT. Outdone by?

Chairman REED. Outdone by the people they are regulating, the investment banks, all the broker-dealers with—instead of three SEC officials, there are 27 regulated personnel there, PhDs, and with models that will stun you.

Mr. RUDER. And the salaries are a little higher in the investment banking world.

Chairman REED. I have heard of that. But I think it raises several issues. One is the obvious point that both you gentlemen have made. We do have to invest in expertise at the SEC. And I think there is another issue, too, and it goes to the issue of anticipating innovation, because one of the problems and one of the issues today in the global markets is these products are innovative, so just as you develop kind of the feel for an expertise for a particular product, you find there is a different one.

Let me ask just your impression. To what extent is the SEC prepared today not only to match their regulated populations out there, but to stay ahead or be ahead of the innovation? Chairman Levitt?

Mr. LEVITT. I don't think that any regulator has ever led the regulated in terms of almost anything, in terms of assets, in terms of legislative scope of activities. It is just impossible. I think it is the job of the regulator to survey the field and see where the greatest systemic threats and investor threats may lie and then address those, and address them not just by rulemaking but by their enforcement efforts and by the bully pulpit. I think that the SEC has the ability to take a look at the landscape and see the risks that were being taken to examine the extraordinary leverage that some of these firms had been implying—Bear Stearns, something like 36 or 37 times—and say, "Hey, wait a second. What is going on?" And that note of skepticism, that note of caution and of care was absent from all sources.

We had a runaway marketplace where leverage and greed trumped the efforts of the gatekeepers, the rating agencies, the auditors, and the regulators. And now we are playing catch-up.

Chairman REED. Thank you.

Chairman Ruder, your comments?

Mr. RUDER. I have two comments. One is that although the SEC may be understaffed, it has a certain component of extremely bright, underpaid people whose dedication and loyalty will create results that are better than may take place in the larger firms.

Second, I think if Congress is going to look at the structure and budget for the SEC, it might contemplate something in the budget to allow the Commission to go outside of the agency to hire specialized groups to deal with specific problems on a contract basis so that it will not have to have these people there all the time, but it might be able to accomplish what it needs to on a special project.

Chairman REED. Thank you. This is a rare opportunity. Dr. Sirri gave very thoughtful and I think very substantive testimony today. But as you listened, were there any comments you might have with respect to his testimony or any other final conclusions you might want to give to us in terms of advice as we go forward? Chairman Ruder?

Mr. RUDER. Well, I thought one of his responses was marvelously bureaucratic because I could not understand it.

[Laughter.]

Mr. RUDER. But I will say that to look at the Commission and ask what it did in the CSE problem in the face of a market in which the Fed, the investment banks, the world banks, and the SEC did not really know what was going on is not an appropriate way to look at this. What we need to do is to look forward and find a mechanism to prevent similar problems in the future.

Chairman REED. Chairman Levitt.

Mr. LEVITT. I think that so much of the effectiveness of the agency lies in terms of cases that it brings or cases that it does not bring, speeches that are made, issues that are known as investor important. The Commission has dealt with over recent years and months the question of shareholder access, the change in the way enforcement cases have been ordered in terms of pre-clearance by the Commission, which I think has had some dampening effect on that enforcement program.

The New York Stock Exchange has called for shareholders to have a direct vote rather than giving to brokers that responsibility. The SEC has been sitting on this issue for some months.

I think these are all issues that could send a signal that the agency places investor interests above all others, and I would hope that the agency is encouraged to move ahead of some of these important issues.

Chairman REED. Thank you very much. Thank you for your testimony and your participation today and for your service to the Commission. I also ask that as we go forward and follow this issue, you are available for your advice and suggestions.

Mr. RUDER. With pleasure.

Chairman REED. Thank you very much, gentlemen. I will adjourn the hearing.

[Whereupon, at 11:49 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

TESTIMONY
OF

ERIK SIRRI, DIRECTOR
DIVISION OF TRADING AND MARKETS
U.S. SECURITIES AND EXCHANGE COMMISSION

THE REGULATION OF INVESTMENT BANKS BY THE SECURITIES AND EXCHANGE COMMISSION

BEFORE THE SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 7, 2008

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony Concerning Turmoil in the Credit Markets: Examining the Regulation of Investment Banks by the Securities and Exchange Commission

Erik Sirri
Director, Division of Trading and Markets
U.S. Securities & Exchange Commission

Before the Subcommittee on Securities, Insurance, and Investment
United States Senate

May 7, 2008

Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

I am pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for regulation of investment banks, and the lessons learned from the recent turmoil in the credit markets.

Under the statutory scheme that the Congress devised, most recently reflected in the Gramm-Leach-Bliley Act, the SEC is responsible for regulating the broker-dealer subsidiaries of investment banks, but no regulator in the federal government is given explicit authority and responsibility for the supervision of investment bank holding companies with bank affiliates. The law provides for mandatory consolidated supervision by the Federal Reserve Board for commercial bank holding companies, including financial holding companies. For investment banks that do not have U.S. banks within the consolidated group, it provides for a holding company supervision structure that is purely voluntary. Only one investment bank, Lazard Ltd., has elected for this supervision. The four largest investment bank holding companies in the U.S. are ineligible because they have specialized bank affiliates, such as industrial banks or certain savings banks. Therefore, there is simply no provision in the law that requires investment bank holding companies to compute capital measures and maintain liquidity on a consolidated basis. Nor does the law provide for a consolidated supervisor that is knowledgeable in their core securities business, and that would be recognized for this purpose by international regulators.

Because the existing statutory scheme does not address how and by whom investment bank holding companies with specialized bank affiliates should be supervised, and in part because of the implications of the European Union's Financial Conglomerates Directive, which required consolidated supervision either internationally or at a European level, the SEC adopted its Consolidated Supervised Entities ("CSE") program for U.S. investment banks in 2004. This, too, is a purely voluntary program, but in 2004 and 2005, the five largest investment banks volunteered to participate. The CSE program relies on the SEC's authority under the Securities Exchange Act of 1934 to determine net capital rules for regulated broker-dealer subsidiaries of investment banks. In essence, the entire CSE program was constructed as around an alternative net capital regime at the broker-dealer, which carried as a condition the affiliated holding company's consent to group-wide supervision by the Commission. This is a significant regulatory extrapolation that the Commission believed was necessary to fill a significant statutory gap.

The CSE program has been recognized as "equivalent" to that of other internationally recognized supervisors for purposes of the European Union's Financial Conglomerates Directive. It provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. It allows the Commission to monitor for financial or operational weakness in a CSE holding company or its unregulated affiliates that might place the U.S.-regulated broker-dealers and other regulated entities at risk.

It is within this context that the SEC confronted the rapid deterioration of liquidity at Bear Stearns during the week of March 10th. This was the first time, not only during the relatively brief existence of the voluntary CSE program, but at any time, that a major investment bank that was well-capitalized and fully liquid experienced a crisis of confidence that resulted in a loss not only of unsecured financing, but also short-term secured financing. This occurred even though the collateral it was able to provide was high quality, such as agency securities, and had a market value that exceeded the amount to be borrowed.

The sequence of events at Bear Stearns began when some over-the-counter derivatives counterparties sought to novate contracts – effectively replacing their trades with Bear Stearns by entering new contracts with other dealers – and some of Bear Stearns' prime brokerage clients began moving their cash balances elsewhere. These initial decisions to no longer transact with Bear Stearns apparently influenced others, and quickly other counterparties, clients, and lenders reduced their exposure to Bear Stearns. Ultimately, counterparties simply would not engage in derivatives transactions with Bear Stearns and lenders would not engage in stock lending and triparty repurchase transactions with Bear Stearns. Bear Stearns' hedge fund clients fled, and certain banks hesitated to clear for Bear Stearns. By the weekend of March 15th and 16th, Bear Stearns faced filing for bankruptcy or quickly concluding an acquisition agreement with a larger partner.

I would like to reiterate to this subcommittee what Chairman Cox observed in his testimony before the full committee on April 3, 2008. While the Federal Reserve, by extending temporary access to the discount window to Bear Stearns as well as to the other major investment banks, forestalled a similar run-on-the-bank from playing out elsewhere, it nonetheless remains for Congress to determine whether to provide more predictable access to an external liquidity provider and to harmonize any such measures with other aspects of the existing statutory scheme, in particular the framework established by Congress for considering the resolution of difficulties experienced by commercial banks, but not investment banks, similar to the framework in the Federal Deposit Insurance Improvement Act and the Federal Deposit Insurance Act for systemically important investment bank holding companies.

Detailed Description of the CSE Program

The Commission currently supervises the following U.S. securities firms on a group-wide basis: Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. For such firms, referred to as consolidated supervised entities, the Commission oversees not only the U.S.-registered broker-dealer, but also supervises the holding company and all affiliates on a consolidated basis, including other regulated entities, such as foreign-registered broker-dealers and banks, and unregulated entities such as derivatives dealers. All of the CSEs are of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions, and providing services to a variety of market participants. The Commission's supervision of CSEs is primarily concerned with the risks that counterparties and market events potentially pose to the CSE firms and thereby to the regulated broker-dealers and other regulated entities.

When a CSE firm has a regulated entity in the consolidated group that is subject to oversight by another functional regulator, the Commission defers to that functional regulator as the supervisor of the regulated affiliate. We also share relevant information concerning the CSE holding company with our fellow regulators, both domestically and internationally.

While maintaining broad consistency with Federal Reserve holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflects the reliance of securities firms on daily mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity for holding companies that, until recently, did not have access to an external liquidity provider.

The CSE rule was designed to provide consolidated oversight only to those holding companies affiliated with a large and well-capitalized broker-dealer. The Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies affiliated with a broker-dealer that was only incidental to its primary business activity. To this end, the CSE rules limit the program to firms whose principal broker-dealer meets certain minimum requirements for tentative net capital (defined as regulatory capital less deductions of illiquid assets), and subjects these to a tentative net capital early warning requirement of $5 billion.

The CSE program has five principal components: First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission staff examines the implementation of these controls. Third, CSEs are monitored for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to maintain significant pools of liquid assets at the holding company, for use in any regulated or unregulated entity within the group without regulatory restriction. This liquidity pool is sized to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows without access to unsecured financing for a period of at least one year.

In particular, it is focused on fulfilling the SEC's explicit statutory responsibility to protect funds and securities of the customers of the investment bank's regulated broker-dealer affiliates.

Regulated broker-dealers are supervised by an extensive staff both at the SEC and at the primary self-regulatory organization, FINRA, which devotes a large amount of resources to overseeing the broker-dealers that are the core regulated entities within the CSE groups. This extensive supervision of the regulated entities in addition to the holding company is akin to bank supervision at the depository institution level as well as the holding company level.

The oversight of the registered broker-dealer is based on regulation at the SEC and SRO (such as FINRA) level, backed by examinations and enforcement. The oversight of the CSEs at the holding company level is similarly based on rules that incorporate principles of prudential oversight, backed by ongoing monitoring and examinations. When potential weaknesses are identified at the CSEs, the Commission has broad discretion under its authority to respond, for example by mandating changes to a firm's risk management policies and procedures, by effectively requiring an increase in the amount of regulatory capital maintained at the holding company, or by requiring an expansion of the liquidity pool held at the parent. These powers are not theoretical abstractions. All three of the steps that I just mentioned have been taken at various firms over the past two years. If these actions are unsuccessful, the Commission can limit the CSE's business or effectively terminate consolidated supervision, which would, inter alia, require disclosure and have significant implications in European jurisdictions.

Supervisory Next Steps

I will now turn to steps the SEC has taken and additional protections that are being contemplated by CSEs in the wake of Bear Stearns. In addition to strengthening the liquidity requirements for CSE firms relative to their unsecured funding needs, we are closely scrutinizing the secured funding activities of each CSE firm, with a view to lengthening the average term of secured and unsecured funding arrangements. We are currently obtaining funding and liquidity information for all CSEs on a daily basis, and discussing with CSEs the amount of excess secured funding capacity for less-liquid positions. Further, we are in the process of establishing additional scenarios, focused on shorter duration but more extreme events that entail a substantial loss of secured funding, that will be layered on top of the existing scenarios as a basis for sizing liquidity pool requirements. This additional analysis is providing the basis for requiring firms to take steps such as increasing the term of secured funding and diversity of funding sources. Also, we are discussing with CSE senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

Because, the CSEs now have temporary access to the Primary Dealer's Credit Facility ("PDCF"), which would operate as a back-stop liquidity provider should circumstances require, and assures the necessary breathing space to implement the various measures outlined above, the SEC is in frequent discussions with the Federal Reserve Bank of New York both about the financial and liquidity positions of the CSEs, and issues related to the use and potential use of the PDCF. The SEC and the Federal Reserve Board are developing a formal Memorandum of Understanding that would provide an agreed-upon scope and mechanism for information sharing, both related to the PDCF and other areas of overlapping supervisory interest. Moreover, should Congress enact legislation to provide access to an external liquidity provider under exigent conditions in the future, the SEC stands ready to develop a process by which the Commission would formally communicate with the Federal Reserve or other relevant agencies in the event that an institution required access to any successor facility. Finally, the Chairman has publicly requested dedicated funding for the CSE program, and a significant expansion in staff.

Conclusion

The CSE program adopted by the Commission has served to fill a serious gap left after the Gramm-Leach-Bliley Act broadly restructured the regulation of financial institutions. Although supervised on a elective basis by the Commission under the CSE program, and in compliance with applicable capital standards at the holding company and regulated entity level, Bear Stearns ultimately was overwhelmed by the unprecedented demands for liquidity it faced in a crisis of confidence. The CSE program ensured that, despite this unprecedented occurrence, the funds and securities of customers of the broker-dealer were never imperiled, and remained protected both by the significant capital at the holding company level and the Commission's financial responsibility requirements, including segregation of customer securities and funds, at the broker-dealer level. As a result, despite the run on the bank to which Bear Stearns was subjected, at no time during the week of March 10th, up to and including the date of the agreement with JPMorgan, were any of the customers of the Bear Stearns' broker-dealers at risk of losing their cash or their securities.

The CSE oversight of Bear Stearns also provided a ready source of information for banking supervisors of the deteriorating condition of Bear Stearns as the crisis unfolded, enabling rapid and knowledgeable decision-making by the Federal Reserve.

Bear Stearns' experience has challenged a number of assumptions, held by the SEC and by other regulators, relating to the supervision of large and complex securities firms. The SEC is working with other regulators to ensure that the proper lessons are derived from these experiences, and changes are made to the relevant regulatory processes to reflect those lessons. This work is occurring in a number of venues, including working groups operating under the auspices of IOSCO, the Basel Committee on Banking Supervision, and the Financial Stability Forum. For example, we are working in the Basel Committee to implement Chairman Cox's call for amended capital adequacy standards for internationally active sophisticated institutions to deal explicitly with liquidity risk.

An imperative from the Bear Stearns crisis is addressing explicitly how and by whom large investment banks should be regulated and supervised, and specifically whether the Commission should be given an explicit mandate to perform this function at the holding company level, along with the authority to require compliance. We look forward to working with you on these broader questions.

Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.

SENATE TESTIMONY BY ARTHUR LEVITT, JR.
6 May 2008

Chairman Reed, Ranking Member Allard, members of the Subcommittee – thank you for the opportunity to testify in front of you today and for holding this hearing on such an important – and timely – topic.

The downfall of Bear Stearns…the uncertainty and volatility in the capital and debt markets…and the close to $300 billion in writedowns and the resulting losses by some of the world's largest financial institutions have created a crisis on Wall Street – one that rightly has gotten the attention of all of us who worry about the health of our capital markets.

Yet the current credit crisis is one that involves Main Street as much as it does Wall Street. It has directly touched the lives of millions of people – investors and homeowners alike.

And that's why it's so important that we understand what went wrong – to provide a basis for determining if there was a breakdown in regulation…and if any new regulatory structures and powers may be needed to restore trust in the markets and prevent this from happening again.

As David, Bill Donaldson, and I recently argued in the New York Times, we believe that a high-level, bipartisan, and impartial examination must be launched to explore a series of possible business and regulatory failures that produced the credit crisis. This is what President Reagan did after Black Monday in 1987, and I hope we soon have a similar presidential level task force to examine these complex issues.

But from where we stand today, it is apparent that a variety of players – including regulators, ratings agencies, standard-setters, and gatekeepers as well as institutional investors -- did not live up to their responsibilities.

In some cases – such as mortgage brokers – it was because there was a lack of meaningful regulation.

In other cases – such as ensuring banks had adequate underwriting standards for loans – the relevant regulators refused to act.

And in other instances, regulatory standards did not keep pace with financial engineering.

Those who bought these new complex, financial instruments had no idea as to the extent of the risks they were assuming since the creators of these instruments either: 1) purposely -- and legally -- hid these risks by placing them off the balance sheet in Structured Investment Vehicles…or 2) the banks themselves were clueless as to the magnitude of these risks.

At the same time, investors were basing investment decisions on the judgments of ratings agencies who either were conflicted or just careless in how they exercised their immense credit rating power.

Moving forward, there are some obvious holes that need to be plugged immediately – and none more glaring than the issues surrounding the credit rating agencies.

While the credits rating agencies have initiated a process of constructive self-analysis and reform, Congress must take these conflict-of-interest issues head-on or empower the SEC with the proper oversight and disciplinary powers so they can do the job.

This issue is critical to the proper functioning of our markets.

But looking to the longer-term, we also must consider whether new regulatory structures and authority may be needed to restore public confidence in the markets.

I am a great believer in free markets as the best way to allocate capital. At their best, markets are self-regulating and self-correcting.

Integral to the functioning of a free market is the presence of someone to ensure that the rules of the road are enforced fairly and swiftly. That's why we need to make sure that, moving forward, the market's referees keep pace with its players.

What worries me is that the creations of the financial engineers, while adding some liquidity and depth to the market, have not been self-correcting…but rather they have been destructively destabilizing.

Assessing and monitoring the risk that these products have introduced into the financial system goes beyond the ability of one nation's central bank. Indeed, it is a problem that begs for a global solution.

But that does not mean that solutions to the current crisis are beyond our reach. There is a series of steps that we can take in our own regulatory structure to improve the functioning of our markets.

That is why I welcomed Secretary Paulson's recommendations about the structure of our financial regulatory architecture. There are aspects to it that I like, some that I do not -- but overall, it is an important starting point for a discussion about what we need and should demand from our market regulators.

Without getting in to the details, let me sketch out what I believe investors need from any capital markets regulator.

First and foremost, any capital markets regulator must put investor interests above all others. This is not only good for investors, but this focus is what has made our capital markets the envy of the world.

Second, as part of this commitment, this agency must ensure that the public gets whatever information it needs to make informed investing decisions. Information is the lifeblood of markets, and this agency must keep the information flowing freely.

Third, it must be a law enforcement agency. Vigorous enforcement of the rules of the road is a powerful deterrent to bad behavior – and usually prevents the use for heavy-handed regulation.

Fourth, to be effective in any of these roles, the regulator must have the resources in terms of funding, tools, staffing, and competencies to get the job done right.

Right now, I fear that the SEC does not have what it needs to meet the demands of the day.

The SEC's 2009 enforcement budget does not keep pace with inflation. Staffing levels have not kept pace with the urgent work that needs to be done. And the enforcement division, I believe, has been unnecessarily hamstrung in negotiating corporate penalties because of recent procedural changes at the Commission. The result has been a lessening of the imposition of corporate penalties against egregious wrongdoers and a reduction in the corporate penalty numbers over the past year.

Fifth, it's important that, by design, any capital markets regulator be independent – of the White House -- and de-politicized from the fights of the day.

Finally, as we consider the future of the SEC and financial regulation in general, let us not forget that more powerful than any rule that can be written, regulation that can be passed, or standard that can be set is the power of the bully pulpit.

Whatever leadership is chosen for a future agency, it needs to be led by an individual who understands the importance of public pronouncements and signals sent to the marketplace. This is something that SEC Chairmen have understood from its founding 75 years ago up until the present day -- and it must be preserved.

In sum, the future of the financial markets and of the regulatory structures we construct to oversee them is in flux – as it should be.

The gravity of the situation we are in today calls for everything to be on the table. Make no mistake: no agency, no existing structure, no gatekeeper should be immune from a thorough-going, hard-headed analysis of its relevance to today's extraordinarily complex electronic markets.

As we move forward with this review, we must keep in mind that the strength of America's capital markets lies in our high standards of transparency, independence, and accountability.

And no matter what changes we undertake, we must ensure that we have in place a market regulator that is as sensitive to the demands of the individual investor Main Street as it is to the demands of the institutional investors on Wall Street.

Thank you.

Testimony of David S. Ruder

Professor of Law, Northwestern University School of Law

Former Chairman, Securities and Exchange Commission (1987-1989)

The Regulatory Role of the Securities and Exchange Commission

in Complex Global Financial Markets

Before the Senate Banking, Housing, and Urban Affairs Committee's

Subcommittee on Securities, Insurance, and Investment

United States Senate

May 7, 2008

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Professor of Law, Northwestern University School of Law
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May 7, 2008
"The Regulatory Role of the Securities and Exchange Commission in Complex Global Financial Markets"

My testimony today will address the role of the Securities and Exchange Commission in regulating investment banks in today's complex global financial markets. I will discuss the SEC's regulatory obligations stemming from the recent credit crisis and its obligations relating to supervision of the securities markets, concluding that the SEC should have increased resources in order to fulfill its regulatory missions. I will argue that the SEC should not be required to substitute principles based regulation of investment banks for its current enforcement based regulation. I will urge the SEC to continue to communicate with investment banks regarding market innovations and risk positions. I will advocate giving the SEC new powers enabling it to improve its oversight of the financial stability of investment bank holding companies.

The Credit Crisis

As you know, the credit crisis arose from the so-called subprime housing market. In summary, mortgage originators loaned money to large numbers of home buyers, many of whom eventually were unable to meet their loan obligations. The mortgage originators sold these mortgages to others, including off balance sheet entities created by investment banks. Aided by investment banks, these entities issued debt instruments called structured notes whose obligations were secured by groups of home mortgage loans. These structured notes were divided into levels (or traunches) that had varying degrees of risk. Their notes were then sold by the investment banks on behalf of the investment entities to investors, primarily, sophisticated investors. In some cases, the structured notes received credit ratings from credit rating agencies, with the highest (AAA) ratings assigned to the safest debt levels. The structured notes were sometimes insured by firms specializing in insuring payment obligations for complicated structured products. In some cases as part of the selling process investment banks purchased structured notes in all risk categories and held them on their balance sheets. Additionally, many investment banks held some of the most highly rated structured notes on their balance sheets.

When home buyers began to default on loans, the market value of these notes, including Triple A rated notes, fell dramatically because buyers were unwilling to accept valuation risks. As the market for structured notes dried up, market participants became uneasy about the value of the notes and other assets, and about the financial stability of other market participants, some of whom were investment banks. As a result credit became unavailable in the broader markets. One consequence of the credit crisis was the collapse of the market for auction rate securities, in part because investment banks withdrew from their normal roles as buyers of these securities.

Securities and Exchange Commission Enforcement Activities Regarding Investment Banks

Any investigation of the role of investment banks in the credit crisis will probably evaluate the role and responsibilities of the Securities and Exchange Commission. At the first level the question will be whether the SEC's enforcement practices and other policies regarding investment banks have been and will be adequate.

Investment banks are broker dealers engaged in the business of buying, selling or otherwise dealing in securities for their own account or for the accounts of others. As broker dealers they are subject to regulation by the SEC. The SEC regulates all investment banks as broker dealers, whether or not they are owned by bank holding companies. Broker dealer regulation is conducted directly by the Commission through its rules and enforcement actions and indirectly through its oversight of self regulatory organizations (SROs), including the Financial Industry Regulatory Authority (FINRA) and the stock exchanges.

In the investment banking area, the SEC's regulation centers on the federal securities laws and SEC rules. Regulated broker dealer activities include distribution of securities, conduct relating to customers, securities trading activities, securities fraud, and other securities related areas, such as proxies and takeovers.

In my view the SEC's enforcement program is vital to its mission. The SEC has power to bring injunctive actions in federal court seeking restitution, fines, disgorgement of improper gains, and orders barring individuals from serving as officers or directors of public companies. It can impose similar sanctions in administrative proceedings. It also has power in its administrative proceedings to bar or suspend broker dealers from the securities industry. The SEC's enforcement activities are effective because they not only punish wrong doing, but also send strong messages of deterrence.

In the wake of the credit crisis, the SEC is undertaking investigations. Once it has gathered sufficient evidence it will undoubtedly bring regulatory actions. Possible areas of inquiry regarding investment banks include failures to disclose the poor quality of structured securities when selling them to investors, sales of high risk structured securities to investors for whom they were unsuitable, sales of auction rate securities without revealing possible market illiquidity, and failures to reveal known investment bank holding company low asset valuations to purchasers of holding company securities.

Securities and Exchange Commission Resources

"The mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[1] In today's world, the SEC's regulatory tasks are increasingly more complicated. It must deal with interconnected global futures and securities markets, the growth of hedge fund and

[1] U.S. Securities and Exchange Commission, In Brief FY 2009 Congressional Justification, p.7 (February 2008).

private equity investing, and the existence of complicated derivative financial instruments.

One of the SEC's unique advantages as an enforcement agency is that it has its own enforcement staff. It does not have to persuade other government regulators to provide the staff and other resources necessary to perform is enforcement functions. Nevertheless, the SEC's ability to bring enforcement actions is dependent upon the size of its enforcement staff.

Despite the ever increasing need for SEC enforcement activity, the size of the Commission's enforcement staff has not grown markedly in recent years. During the fiscal year 2007 the SEC had 1,111 staff members devoted to enforcement. During the fiscal year 2008 staff levels increased slightly to 1,124, but for fiscal year 2009 the predicted enforcement staff level is expected to decrease to 1,093.[2] Although these staff levels are large compared to those in other countries, I believe the SEC needs substantial increases in its budget for enforcement in order to meet its credit crisis enforcement staffing needs.

In addition to increased SEC resources for enforcement activities related to the credit crisis I believe the additional communication and monitoring responsibilities that I will discuss in the remainder of my testimony will also require additional resources.

[2] *Id.*, p.35.

The SEC's actual budget for FY 2007 was $875.5 million. Its FY 2008 estimated budge was $906 million and its FY 2009 request if $913 million.[3] I believe these relatively small increases do not meet the SEC's real needs in regulating today's global market place.

The U.S. Treasury Principles Based Regulatory Proposals

In March of 2008, the U.S. Treasury released a Blueprint for Reform of the Financial Regulatory System containing both near term and long term proposals for financial system regulatory reform.[4] Although the Blueprint was published following the emergence of the credit crisis, it was developed during a period of a year or more, and followed four substantial study projects supporting various reforms in the financial regulatory system.[5] Each of the study projects emphasized the need for the U.S. to maintain its competitive position in the world's financial markets. These projects and the Treasury Blueprint raise important questions regarding the future of the SEC's regulatory function.

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[3] *Id.*, p.3.

[4] United States Treasury: Blueprint for a Stronger Regulatory Structure http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf (hereinafter "Treasury Blueprint").

[5] Interim Report of the Committee on Capital Markets Regulation http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ;U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century – Report and Recommendations http://www.uschamber.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf); Michael R. Bloomberg and Charles E. Schumer Sustaining New York's and the US' Global Financial Services Leadership http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf

The Treasury Department Blueprint contains proposals that would change the SEC's oversight of stock exchanges and investment banks from an enforcement system to a principles based system. The Blueprint seeks this change in a number of ways. First it urges that the Commodity Futures Trading Commission operation under the Commodity Futures Modernization Act (CFMA) serve as a model for the SEC's oversight of securities clearing agencies and exchanges. Under that Act core principles are utilized for regulation of futures exchanges and clearing organizations by the CFTC. [6] The idea is. that the CFTC will perform is regulatory mission by applying a guiding principles approach involving discussions with the clearing agencies and exchanges about appropriate means of achieving compliance with the principles. The Blueprint then urges the SEC to use its current exemptive authority now to adopt core principles for securities clearing agencies and securities exchanges, in part to facilitate a smoother merger of the CFTC and SEC.[7]

The Blueprint lists the CFMA core principles for exchanges:

> The CFMA required contract markets to comply with eighteen core principles relating to: having reasonable discretion in establishing their compliance with the core principles; rule compliance and enforcement; listing of contracts not readily susceptible to market manipulation; trade monitoring system; position limits; emergency authority; information availability; daily publication of trading information; contract execution; procedures for recording and safe storage of trade information; financial integrity; market participant protections; dispute resolution; fitness standards; conflict of interest management; governing board composition; recordkeeping; and antitrust considerations.[8]

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[6] Treasury Blueprint, p.111.
[7] *Id.*
[8] *Id.*, p.110.

The Blueprint indicates that futures exchanges are expected to comply with these core principles, but will have "reasonable discretion" in doing so.[9]

As a second step, the Treasury recommends a merger between the CFTC and the SEC and urges legislation that will "merge regulatory philosophies, in a sense, to continue and enhance the modernization in the aforementioned pre-merger steps, and to harmonize futures and securities statues and regulations."[10]

It notes the differences in CFTC and SEC rules involving "margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, the SRO rulemaking approval process, and the new agency's funding mechanism"[11] and recommends "harmonization" of the differences between futures and securities regulation.[12]

The Blueprint describes the benefits of the core principles approach to futures industry market participants as "flexibility to adapt to market changes, outcome-focused, acknowledgement of the possibility of more than one path of regulatory compliance, allowing for creativity and innovation, and facilitation of global regulatory

[9] *Id.*, Appendix F.
[10] *Id.*, p.115.
[11] *Id.*, p.116.
[12] *Id.*, p.118.

cooperation."[13] It would apply this regulatory approach to securities industry participants.

Treasury support for a principles based system may come in part from a comparison with recent changes in the financial services regulatory system in the United Kingdom. In the U.K., regulation of banking, securities, insurance and investments including supervision of the listing practices on the London Stock Exchange, has recently been merged into a single, unified regulator, the Financial Services Authority (FSA),[14] utilizing a principles based regulatory system. The system has been described by the FSA as follows:

> Principles-based regulation means, where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified. We will increasingly shift the balance of our activity towards setting out desirable regulatory outcomes in principles and outcome-focused rules, enabling our people to engage with firms' senior management in pursuit of these outcomes. We expect firms' behaviour, in turn, to change to adjust to this shift in emphasis. We will also measure and evaluate our own performance against identified regulatory outcomes.[15]

The Treasury proposal that the SEC and the CFTC be merged is not new. I sought legislation calling for the combination of the SEC and the CFTC following the market crash of 1987, but to no avail. I welcome and support the Treasury proposal as properly seeking to solve important problems stemming from the existence of two

[13] *Id.*, p.110.
[14] Financial Services Roundtable, "The Blueprint for U.S. Financial Competitiveness", p.26 (Nov. 7, 2007).
[15] Financial Services Authority (United Kingdom) "Principles Based Regulation" (April 2007).

agencies that are both regulating increasingly similar products and regulating markets that are engaged in active competition with each other, but I do not believe the merger should be the vehicle for imposing a principles based regulatory system in the securities markets.

Enforcement Based Regulation Should Not Be Abandoned

My concern is that the "principles based regulation" would result in the abandonment of an SEC enforcement based regulatory system that has been essential to preserving the integrity and honesty of the U.S. securities markets.

A principles based system relying upon market participants to police themselves is not likely to prevent the kind of misconduct engaged in by broker dealers and other participants in the securities industry. When I arrived at the Commission in 1987 the staff had just finished its Ivan Boesky insider trading case. It later successfully pursued Michael Milken and Drexel, Burnham for market manipulation. Subsequent successful SEC enforcement actions have been brought based upon price fixing in the Nasdaq Stock Market, false analyst recommendations, trading ahead by stock exchange specialists, laddering in the IPO market, and market timing and late trading. As I have indicated the SEC is now investigating probable misconduct in the credit markets.

The SEC Should Continue To Communicate With Investment Banks and Regulators Regarding Market Innovations

Although I do not believe the SEC enforcement based system should be abandoned, I am sensitive to the fact that the SEC is regulating U.S. investment banks and stock exchanges that are competing in a complicated and constantly changing world environment.

Thus, despite my concerns that principles based regulation would lead to abandonment of tried and true enforcement based regulation, I believe the SEC should embrace the communications objectives of principles based regulation. Dramatic innovation and technological change in the world's securities markets have created a need for the SEC to communicate constantly with the leaders of our investment banks, securities exchanges, and futures exchanges, as well as with domestic and foreign regulators.

I believe the SEC is currently highly aware of the need to communicate on all levels. It regularly meets with leaders of the U.S. securities industry. It participates in the President's Working Group on the Financial Markets, which is composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission. It has established strong contracts with securities regulators in other countries and with the International Organization of Securities Commissions (IOSCO).

The SEC Should Continue Its Oversight of the Financial Stability of Investment Bank Holding Companies

In one area, I believe the Commission should actively pursue principles based regulation. It should engage in "prudential regulation" with regard to the solvency, liquidity, and financial stability of investment banks, and related aspects of systemic risk. The Commission should play an active role in monitoring the overall risk management practices of investment banks. When possible it should obtain information about the risk positions of unregulated entities such as hedge funds, private equity, and off balance sheet entities.

Regulation of the financial stability of investment bank holding companies in the U.S. currently is bifurcated. Investment banks that are part of bank holding companies are subject to prudential supervision by the Federal Reserve Board. Investment bank holding companies not regulated as part of bank holding companies are subject to risk based supervision by the SEC through its Consolidated Supervised Entity (CSE) program. On July 8, 2004, the SEC adopted rules allowing it to supervise on a voluntary basis investment bank holding companies not subject to Federal Reserve oversight of bank holding companies. [16] The regulatory framework was established in part in order "to provide a basis for non-U.S. financial regulators to treat the Commission as the

[16] Final Rule: Supervised Investment Bank Holding Companies, Rel. 34-49831 (July 8, 2004).

principal U.S. consolidated home-country supervisor" for supervised investment bank holding companies.[17] The voluntary supervisory program was accepted by five holding companies: Bear Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.[18]

The CSE program requires the supervised entities to provide the SEC on a regular basis with extensive information regarding its group wide "capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk."[19] The aim of the program is to monitor both the regulated and unregulated entities within the holding company for financial or operational weaknesses. In practice the operation of the program is "prudential" because it involves attention to the affairs of the supervised investment bank holding companies on an individual basis, with close and regular contact between the SEC staff and the supervised entity.

I believe the prudential supervision of investment bank holding companies by the SEC should continue and be expanded. It is extremely important that the risk positions of investment bank holding companies, including their unregulated affiliates, be known, so that the SEC can confer with other regulators regarding systemic risk. This risk assessment regulatory function should remain in the SEC because it is the agency that best understands the risk activities engaged in by investment banks. Indeed, using its

[17] SEC Rel. 34-49831, p.4 (July 8, 2004).
[18] SEC Holding Company Supervision Program Description www.secgov/divisions/marketreg/hcsupervision.htm, p.3.
[19] SEC Holding Company Supervision With Regard to Capital Standards and Liquidity Planning, www.sec.gov/divisions/marketreg/hcliquidity,htm.

expertise, the SEC might well cooperate with the Federal Reserve Board regarding the risk assessment of investment banks that are part of bank holding companies. I further believe that the CSE voluntary program for SEC oversight of investment bank risk activities should be made mandatory through legislation, so that the non-bank holding company investment banks will not have the power to withdraw from the supervisory system when they are dissatisfied with the SEC's supervision or unwilling to provide information.

In conclusion, I urge that the SEC be given additional resources to fulfill its regulatory mission, that it should not be required to substitute principles based regulation for its current enforcement based regulation, that it should continue and expand its communication with investment banks and regulators regarding market innovations and risk positions, and that it should be given new power enabling it to improve its oversight of the financial stability of investment bank holding companies.