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

Hearing: Regulatory Restructuring: Enhancing
Consumer Financial Products Regulation

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Chairman Frank, Ranking Member Bachus, and the members of this committee, thank you for this opportunity to testify on these important issues of consumer and investor protection.

As Secretary of the Commonwealth of Massachusetts, my office administers the Massachusetts Securities Act through the Massachusetts Securities Division. As such, I am the chief securities regulator for Massachusetts.

The Congress is now considering an array of initiatives to improve consumer and investor protection. These include the proposals contained in the White House white paper on Financial Regulatory Reform,[1] as well as bills proposing the creation of the Consumer Financial Protection Agency.

I commend and support the President's plan to strengthen and rationalize financial regulation, to provide greater protection against systemic risks in the financial markets, and to create a federal agency to protect consumers in credit transactions. The Massachusetts Securities Division looks forward to consulting and working with this new agency as an equal partner.

I support the proposal to strengthen the U.S. Securities and Exchange Commission. This will enhance the ability of the SEC, alongside the states, to oversee the securities markets and protect consumers.

I also applaud other elements of the White House plan that would directly improve investor protection. These include:

> Making securities brokers fiduciaries. True consumer protection requires that financial firms be fiduciaries for their customers, whether those firms happen to be licensed as investment advisers or brokers.
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> Mandatory arbitration. The White House proposal asks the SEC to study the use of mandatory arbitration clauses in investor contracts. We need to act now on the documented problems of mandatory arbitration. Investor arbitration should be optional for investors, rather than mandatory.
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> Hedge fund registration. We urge that both hedge fund managers and the funds themselves should register with the SEC. Hedge funds are often nearly-invisible participants in the financial markets. Moreover, hedge funds have been the source of abusive trading in the commodity and securities markets, including trades that have distorted the oil markets and market-timing of mutual funds. Hedge fund registration will bring a myriad of benefits, particularly market transparency.

[1] Financial Regulatory Reform, A New Foundation, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

Consumer Financial Protection Agency

We support the creation of a Consumer Financial Protection Agency (CFPA) to enhance the protection of consumers entering into credit, savings, and payment transactions.

Sadly, this hearing on the creation of a Consumer Financial Protection Agency is necessary because existing regulatory agencies dropped the ball. While some problems have slipped through the cracks of existing rules, too often regulators failed to maintain their independence from the industries they regulate, and they failed to use their powers to promulgate and enforce rules to protect the public. A key lesson is that regulators must maintain their independence, which often means standing up to powerful interests.

The problems of abusive credit transactions are well documented: predatory mortgage lending, unfair and abusive credit card and consumer loan terms, payday loans, purported loan restructuring companies, and abusive financial transactions that target the elderly and members of the armed forces.

I have seen the impact of bad lending practices. My duties include supervising most of the registries of deeds in Massachusetts. Through the real estate filings with those registries, we have seen the mortgage defaults and foreclosures that resulted from lax lending standards and predatory lending. The impact of foreclosures falls hardest on poor communities, which are ill equipped to deal with consequences like boarded-up properties, deteriorating neighborhoods, and homelessness.

Bad lending standards and unsound mortgages are also at the root of many failed mortgage-backed securities, which in turn led to the collapse of major financial institutions and markets. Recent history demonstrates that we cannot count on these markets to police themselves.

We need a Consumer Financial Protection Agency to ensure that the basic terms of consumer credit transactions will be transparent, understandable, and reasonable. My office looks forward to consulting and working with the CFPA as a co-equal agency.

Preserve and Enhance the Role of State Securities Regulators

As with the CFPA, the goal of the Massachusetts Securities Division is to protect investors against abuse and fraud. Massachusetts and the other states have a distinguished record of protecting retail investors and savers. As U.S. financial regulation is redesigned, I urge you to preserve and enhance the ability of the state securities regulators to protect investors. I urge you to give us the tools to do this work even more effectively.

There is an acute need for this protection. Retail investors and savers have been forced into the risk market to meet their basic financial goals. As a result, consumers are as vulnerable to abusive securities transactions as they are to abusive credit transactions.

Reverse Past Preemption of State Authority

Investors and consumers have been particularly harmed when the states have been preempted from protecting their interests. This includes the preemption of state usury laws, predatory mortgage lending laws, and state securities laws. It is exactly the areas where state laws have been preempted from regulating that have been focus points of the current financial crisis.

The National Securities Markets Improvement Act of 1996 ("NSMIA")[2] preempted state authority in key areas where the states protected investors.

Mutual Funds. In the past, the states regulated pro-actively to protect mutual fund investors. Prior to NSMIA, the states required enhanced disclosure in mutual funds, including: periodic payment plans (which often resulted in consumers paying disproportionate fees for their funds); "plain English" disclosure for junk bond funds; and disclosures regarding layering of fees in "funds of funds." NSMIA removed the states' ability to require these protective measures.

Rule 506 Offerings. Prior to the adoption of NSMIA, the states could require substantive filings from issuers selling securities pursuant to the Rule 506 exemption under SEC Regulation D. NSMIA prohibited the states from requiring any substantive filing from these issuers.[3] This resulted in a regulatory blind spot for hedge funds and similar issuers.

Conduct Violations by Federally Registered Investment Advisers. NSMIA created a split system for the regulation of investment advisers, whereby large investment advisers register with the SEC and the smaller ones register with the states.[4] Under this system the states cannot take action against federally registered investment advisers for conduct violations, even when those violations rise to the level of unfair or deceptive practices in the securities industry.

The States Have a Demonstrated Record of Effectiveness as Securities Regulators

In my testimony before this Committee on March 20, 2009, I listed specific examples of cases where Massachusetts and other states have taken the lead in bringing enforcement actions and recovering funds for investors. These include: auction-rate securities, illegal market timing of mutual fund shares, misleading and false securities analyst reports, and Ponzi schemes, and misleading "senior designations."

The states remain the regulators that are closest to the investing public and they have demonstrated they can respond quickly and effectively to help investors. The states

[2] National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996).
[3] *See*, Section 18(b)(4)(D) of the Securities Act of 1933, as amended (15 U.S.C. §77r(b)(4)(D)).
[4] *See*, Section 203(a) of the Investment Advisers Act of 1940 (15 U.S.C. §80b-3(a)).

have also cooperated effectively with the SEC and other regulators in structuring global settlements, including market timing, auction-rate securities, and stock analyst cases.[5]

The states have added value precisely because they are independent of other agencies and self-regulatory organizations. The states have been another set of eyes watching the markets. The states have also served as a regulatory backstop or circuit breaker, protecting investors in cases when other regulators have not taken action.

Do Not Curtail the Ability of the States to Protect Investors.

Based on the principle of federalism, we urge the Congress not to make the state securities agencies subject to the authority of any federal body, whether it be the Financial Services Oversight Council (the systemic risk regulator) or the Federal Reserve. Similarly, we urge that the states not be made subject to the Consumer Financial Protection Agency.

The independence of the states means that they are less likely to yield to pressure from regulated entities, and the states agencies therefore are much less likely to be "captured" by the firms and industries that they regulate.

We urge that any new legislation should not curtail the states' ability to:

- Require that firms, persons, or offerings register with the states;
- Police and inspect firms and persons; and
- Bring enforcement actions for violations of securities laws and industry rules.

In this regard, I must emphasize that the states have a strong record of cooperating with the SEC and FINRA, and that this record will continue. The states will cooperate and coordinate with the Consumer Financial Protection Agency. However, it is crucial that the states not be put under the CFPA's authority. The states' independence is vital, and it is the key to our record of success.

Give State Securities Regulators the Tools We Need to Be Effective

Give the states the tools we need to regulate effectively:

-Restore states' authority over non-public offerings, particularly hedge funds, which are typically sold pursuant to the exemption provided under Rule 506 of SEC Regulation D.

-Permit the states to police larger, federally-registered investment advisers for unethical and dishonest practices in the securities industry and for violation of industry conduct standards. The states are now limited to bringing fraud actions against these firms.

[5] See, e.g., S.E.C. Litigation Release 18438, October 31, 2003, "Federal Court Approves Global Research Analyst Settlement," http://www.sec.gov/litigation/litreleases/lr18438.htm.

-As financial regulatory reform is designed implemented, give the state securities agencies a place at the table to share information and views.

Further Reforms.

Restore Investors' Private Right of Action to Sue for Securities Fraud. The right for investors to sue for violations of the states and federal securities laws is a powerful tool to promote compliance with the law. I urge the Congress to review the detrimental impacts of the Private Securities Litigation Reforms Act (PSLRA)[6] and the Securities Law Uniform Standards Act (SLUSA)[7] order to permit defrauded investors to access to the courts and have their cases heard. When the securities laws have been violated, investor suits can be a valuable corrective measure and tool for recovery. The risk of being sued is a powerful incentive for companies and their executives not to engage in misconduct. We need to strengthen, not weaken, investors' remedies.

Make Arbitration a Voluntary Option for Investors. Customers who have disputes with their brokerage firms cannot go to court and must go to arbitration run by the Financial Industry Regulatory Authority (a self regulatory organization), even when serious fraud is alleged. Many investors regard FINRA arbitration as a pro-industry forum.[8] Reform of the arbitration system could include making arbitration a voluntary option that is available alongside litigation. Another reform to consider would be to give the SEC or CFPA oversight over the arbitration system, rather than a securities self-regulatory organization.

We Must Put the Interests of Retail Investors and Consumers First

I urge the Congress to put the interest of consumers and retail investors first. Creating a Consumer Financial Protection Agency will be a significant step toward this goal. I also urge the congress to maintain and strengthen the role of the states as securities regulators. We have been effective; give us the tools to better protect investors.

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[6] Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. 104-67, 109 Stat. 737, (codified in various Sections of 15 U.S.C., particularly the pleading standards in 15 U.S.C. § 78u-4).

[7] Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. 105-353 (amending various sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 to cause state securities class actions to be removed to federal jurisdiction).

[8] See, Jill I. Gross and Barbara Black, *Perceptions of Fairness in Securities Arbitration: an Empirical Study* (Feb 26, 2008) http://ssrn.com/abstract=1090969 (Survey commissioned by the Securities Industry Conference on Arbitration found, among other findings, that participants disagreed with statements that securities arbitration is conducted without bias and in a way that is fair to all parties).