Testimony Before the
United States House of Representatives Committee on Financial Services

"Regulatory Perspectives on the Obama Administration's
Financial Regulatory Reform Proposals"
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by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Chairman Frank, Ranking Member Bachus, members of the Committee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("Commission" or "SEC"). I sincerely appreciate the support this Committee has shown the Commission, and I am pleased to have the opportunity to discuss the Commission's perspective with respect to the Administration's Financial Regulatory Reform Proposals.

Overview

President Obama recently unveiled his plan to build the foundation for a stronger and safer financial system. I believe the plan makes real progress in filling gaps in our financial regulatory framework that became apparent in the wake of the financial crisis. Although the Commission is just one part of that landscape, in my view the proposals described in the Administration's white paper and laid out in several recent legislative drafts do much to strengthen the Commission and improve investor protection in the process, as well as to help to restore confidence in the soundness and integrity of our financial system as a whole.

The Administration's plan covers an extraordinarily broad spectrum of issues that impact the U.S. financial regulatory system. Today, I will focus on those proposals that most directly bear on the SEC's regulatory mission, including those concerning:

- over-the-counter ("OTC") derivatives;
- harmonization of securities and futures regulation;
- hedge funds;
- broker-dealers and investment advisers;
- Commission enforcement;
- credit rating agencies; and
- the need to identify and address emerging systemic risks that pose a threat to the stability of our financial system.

At the outset, I want to emphasize to the Committee that I believe that the SEC and other financial regulatory agencies have been making solid progress using our existing authority to address the financial regulatory problems that face the country. These

problems did not arise overnight and can be extremely complex. To address these problems appropriately, there is no substitute for hard work and a focused determination to get the job done right. The SEC is devoted to meeting this challenge.

As I noted in my recent testimony before the Subcommittee on Capital Markets, the Commission is acting promptly and decisively on a number of different fronts. Some of the changes we have proposed through rulemaking concern topics that are not new: for example, short selling, money market funds, and shareholder rights. But we also are focused on the early identification of emerging risks to market integrity and efficiency that may need to be addressed, including, for example, issues surrounding dark pools and stock lending. Dark pools generally refer to automated trading systems that do not display quotes in the public quote stream. We have heard concerns that dark pools may lead to a lack of transparency, may result in the development of significant private markets, and may potentially impair the public price discovery function. Given the potential risks posed by dark pools, the Commission will take a serious look at what regulatory actions may be warranted to respond to the potential investor protection and market integrity concerns dark pools may raise. Similarly, we also are examining market related practices associated with securities lending to determine what, if any, future regulatory action is appropriate. Rest assured that the SEC is committed to using its existing tools and authority to address as best it can the financial regulatory issues the country now faces.

Despite this, it has become clear that some regulatory gaps and market issues cannot be fully addressed without statutory changes. This Committee, through its hearings and other work, already has made important progress on this essential task. As the Committee continues to move forward in the coming months, we are committed to assisting you to the best of our abilities as you fashion the landmark legislation necessary to rebuild a solid foundation for the U.S. financial system.

OTC Derivatives

One of the gaps exposed by the financial crisis concerns the lack of regulation of OTC derivatives, which are largely excluded from the securities regulatory framework by the Commodity Futures Modernization Act of 2000.[1] As the country's capital markets regulator, the SEC is primarily concerned about OTC derivatives products that are directly related to or based on securities or securities issuers, and as such are directly connected with the SEC's statutory mandate. A core principle of the approach we advocate to OTC oversight is to reduce the opportunity for regulatory arbitrage by ensuring that economically equivalent products are regulated in a similar manner.

[1] Section 2A of the Securities Act, Section 3A of the Exchange Act, and related provisions prohibit the SEC from: (1) promulgating, interpreting, or enforcing rules in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud or manipulation with respect to any security-based swap agreement; and (2) registering or requiring the registration of any security-based swap agreement. As noted below, some OTC derivatives products, such as certain equity-linked notes, always have been considered securities and currently are covered by the securities regulatory regime.

The Administration's proposals would establish a comprehensive framework for regulating OTC derivatives. The framework is designed to achieve four broad objectives: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

The Administration's plan recognizes that multiple federal regulatory agencies play critical roles in implementing the proposed framework, including the SEC and the CFTC. Among other things, it emphasizes that the securities and commodities laws should be amended to ensure that the SEC and CFTC, consistent with their respective missions, have the authority to achieve – together with the efforts of other regulators – the four policy objectives for OTC derivatives regulation.

What we recommend is a straightforward and principled approach to help the Administration achieve its policy objectives. Stated simply, primary responsibility for all "securities-related" OTC derivatives would be retained by the SEC, which is already responsible for the oversight of markets affected by this subset of OTC derivatives. Primary responsibility for all other OTC derivatives, including derivatives related to interest rates, foreign exchange, commodities, energy, and metals, would rest with the CFTC.

Under this functional and sensible approach to regulation, OTC derivatives markets that are interconnected with the regulated securities markets would be incorporated within a unified securities regulatory regime. The direct link between securities-related OTC derivatives and securities is such that SEC regulation of the former is essential to the effectiveness of the SEC's statutory mission with respect to the securities markets. The securities regulatory regime is specifically designed to promote the Congressional objectives for capital markets, which include investor protection, the maintenance of fair and orderly markets, and the facilitation of capital formation. Securities-related OTC derivatives should be subject to the federal securities laws so that the risk of arbitrage and manipulation of interconnected markets is minimized.

Over the years, Congress has fashioned a broad and flexible regulatory regime for securities that long has accommodated a wide range of products and trading venues. The products include equities, debt, other fixed income securities, options on securities, exchange-traded funds and other investment companies, and many other types of derivative contracts on securities. Some of these securities products are among the most actively traded financial products in the world, with exchange-listed US equities currently trading approximately 11 billion shares per day. Many other securities products trade rarely, if at all. In addition, securities products trade in many different ways in a wide variety of venues, depending on the particular features of the product. These venues include 11 national securities exchanges with self-regulatory responsibilities, more than 70 alternative trading systems that execute OTC transactions, and hundreds of broker-dealers that execute OTC transactions. Finally, securities products are cleared and settled in a variety of ways depending on the particular characteristics of the product.

The current securities laws are broad and flexible enough to regulate all of these varied securities products and trading venues. The regulatory requirements are specifically tailored to reflect the particular nature of products and venues and to promote the Congressional objectives for capital markets. Accordingly, under our proposal, securities-related OTC derivatives would be brought under the same umbrella of oversight as the related, underlying securities markets in a relatively straightforward manner with little need to "reinvent the wheel." Specifically, Congress could make a limited number of discrete amendments to the statutory definition of a security and certain other provisions to cover securities-related OTC derivatives. With these changes, securities-related OTC derivatives could be incorporated within an existing regulatory framework that is appropriate for these products.

The Administration's plan stresses the importance of a "robust and appropriate regime of prudential supervision and regulation" for OTC derivatives dealers. Under our proposal, all dealers in securities-related OTC derivatives would be subject to prudential supervision and regulation to ensure there are no gaps. To reduce duplication, OTC derivatives dealers that are banks would be subject to prudential supervision by their federal banking regulator. All other dealers in securities-related OTC derivatives would be subject to supervision and regulation by the SEC.

The SEC also would have authority to establish business conduct standards and recordkeeping and reporting requirements (including an audit trail) for all securities-related OTC derivatives dealers and other firms with large counterparty exposures in securities-related OTC derivatives ("Major OTC Participants"). This "umbrella" authority would help ensure that the SEC has the tools it needs to oversee the entire market for securities-related OTC derivatives. Major OTC Participants also would be required to meet appropriate standards for the segregation of customer funds and securities.

In addition, under our approach, clearinghouses for securities-related OTC derivatives would be subject to oversight as clearing agencies by the SEC and trading markets would be subject to oversight by the SEC. To achieve the important goal of clearing standardized OTC derivatives through central counterparties, the SEC should be provided authority to establish which securities-related OTC derivatives or class of securities-related OTC derivatives are standardized. Such a determination would have to take into account whether the product can be effectively risk managed by a central counterparty, whether there is a liquid market for the product, and whether there are fair, reliable and generally accepted pricing sources. In carrying out this responsibility, the SEC would, of course, consult with the Commodity Futures Trading Commission and the Federal Reserve Board. It is also important to consider whether there are certain standardized OTC derivatives that are clearing-eligible but nonetheless may not need to be centrally cleared, such as trades between related parties.

In fashioning a regulatory framework for OTC derivatives, it is crucial to recognize the close relationship between the regulated securities markets and the now mostly

unregulated markets for securities-related OTC derivatives. Securities-related OTC derivatives can be used to establish either a synthetic "long" exposure to an underlying security or group of securities, or a synthetic "short" exposure to an underlying security or group of securities. In this way, market participants can replicate the economics of either a purchase or sale of securities without purchasing or selling the securities themselves.

For example, an equity swap on a single equity security or on an index, such as one of the Dow stocks or the Dow itself, would give the holder of the "long" position all of the economic exposure of owning the stock or index, without actual ownership of the stock or index. This would include exposure to price movements of the stock or index, as well as any dividends or other distributions. Similarly, credit default swaps ("CDS") can be used as synthetic substitutes for the debt securities of one or more companies. In addition, market participants also may use a securities-related OTC derivative to establish a short position with respect to the debt of a specific company. In particular, a market participant that does not own a bond or other debt instrument of a company may purchase a CDS as a way to short that company's debt. Trading practices in the CDS market, whether legitimate or abusive, can affect the securities markets, including rules designed to regulate short sales.

Because market participants can readily use securities-related OTC derivatives to serve as synthetic substitutes for securities, the markets for these OTC derivatives directly and powerfully implicate the policy objectives for capital markets that Congress has established in the federal securities laws. These objectives include investor protection, the maintenance of fair and orderly markets, and the facilitation of capital formation.

Bringing securities-related OTC derivatives under the umbrella of the federal securities laws would be based on sound principles of functional regulation, would be relatively straightforward to implement, and would promote Congressional policy objectives for the capital markets. A clear delineation of primary regulatory responsibility for OTC derivatives also would help avoid regulatory gaps from arising in the future. Finally, integrating oversight of securities-related OTC derivatives with oversight of the related, underlying securities markets would minimize the extent of dislocation with respect to existing participants and current practices in the OTC derivatives markets, while still achieving the objectives for OTC derivatives regulation set forth in the Administration's proposals.

Harmonization

The SEC and CFTC have been working closely together this year, and I am confident that we will make progress on the goals expressed in the Administration's white paper as we seek to build a common foundation for market regulation. While the cultures and mission of the two agencies are in some ways different, we agree on the need for a robust regulatory framework for our financial markets.

As is noted in the Administration's white paper, securities regulation and futures regulation share many of the same public policy objectives. In this regard, we appreciate the benefits that could be achieved through greater coordination and harmonization between the SEC and the CFTC for regulation and oversight of economically equivalent instruments. More efficient oversight consistent with the protection of investors could be achieved by filling regulatory gaps and fostering harmonization between the SEC and the CFTC with respect to similar financial instruments.

To advance this initiative, the SEC staff has undertaken a coordinated effort to identify and explain significant differences in oversight and regulation of similar types of financial instruments such as options and futures in light of the underlying public policy objectives. The SEC staff is also working with the CFTC staff in developing a coordinated approach to this task.

Hedge Funds

Over the past two decades, private funds, including hedge, private equity and venture capital funds, have grown to play an increasingly significant role in our capital markets both as a source of capital and the investment vehicle of choice for many institutional investors. Our staff estimates that advisers to hedge funds have almost $1.4 trillion under management. Since many hedge funds are very active and often leveraged traders, this amount understates their impact on our trading markets. Hedge funds reportedly account for 18-22 percent of all trading on the New York Stock Exchange. Venture capital funds manage about $257 billion of assets,[2] and private equity funds raised about $256 billion last year.[3]

The securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles. Sponsors of private funds—typically investment advisers—are able to organize their affairs in such a way as to fall within certain exemptions or exceptions to the registration requirements of the federal securities laws. The Commission only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes we administer. Private funds, however, often structure their operations to take advantage of certain exemptions from registration of the offer or sale of securities under the Securities Act of 1933, registration of the funds under the Investment Company Act of 1940, and in many cases registration of their advisers under the Investment Advisers Act of 1940. Consequently, private funds and many of their advisers are outside the purview of the SEC, and we have no detailed

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2 The National Venture Capital Association (NVCA) estimates that 741 venture capital firms and 1,549 venture capital funds were in existence in 2007, with $257.1 billion in capital under management. NVCA, Yearbook 2008 at 9 (2008). In 2008, venture capital funds raised $28.2 billion down from $35.6 billion in 2007. Thomson Reuters & NVCA, News Release (Apr. 13 2009). In 2007, the average fund size was $166 million and the average firm size was $347 million. Id. at 9.

3 U.S. private equity funds raised $256.9 billion in 2008 (down from $325.2 billion in 2007). Private Equity Analyst, 2008 Review and 2009 Outlook at 9 (2009) (reporting Dow Jones LP Source data), available at http://fis.dowjones.com/products/privateequityanalyst.html.

insight into how they manage their trading activities, business arrangements or potential conflicts-of-interest.

Furthermore, the private funds data that we are often requested to provide members of Congress (including the data provided above) or other federal regulators are based on industry sources, which frequently have proven over the years to be unreliable and inconsistent because neither the private funds nor their advisers are required to report even the most basic census-type information.

In my view, this situation presents a significant regulatory gap in need of closing. I support the recommendation discussed in the Administration's white paper that advisers to hedge funds and other private pools of capital should be required to register with the SEC under the Investment Advisers Act. I believe the bill the Treasury Department put forth last week, titled the "Private Fund Investment Advisers Registration Act of 2009," would accomplish this important goal. I look forward to working with Congress on issues regarding the level of additional resources that would be necessary if private fund managers were required to register with the SEC, as well as ensuring that any law passed would provide the Commission with sufficient time to establish and make effective any necessary recordkeeping requirements. I firmly believe that such registration and the resulting oversight would better protect our markets and would enable investors, regulators and the marketplace to have more complete and meaningful information about private fund advisers, the funds they manage and their market activities.

Broker-Dealers and Investment Advisers

The Commission has been closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct or the regulatory requirements applicable to broker-dealers and investment advisers. When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to the same standard of conduct and equivalent regulatory requirements, regardless of the label attached to the providers.

I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients and be subject to equivalent regulation. As such, I support the standard contained in the Department of the Treasury bill recently put forth entitled the "Investor Protection Act of 2009." That bill explicitly would enable the Commission to promulgate rules to provide all broker-dealers and investment advisers providing investment advice to retail customers act solely in the interest of their customers or clients without regard to the financial or other interests of the financial service professional. The establishment of this investor-focused approach as a consistent standard for all broker-dealers and investment advisers providing investment advice would represent a significant step forward in the protection of retail investors.

The Treasury bill also calls for the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals. This disclosure could further buttress an investor-oriented standard of care and greatly enhance investor understanding of the nature of the services various financial service professionals provide.

The Treasury bill also authorizes the SEC to promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries that are contrary to the public interest and the interest of investors. This authority would enable the SEC to better rationalize the regulatory landscape applicable to broker-dealers and investment advisers and eliminate practices that subvert, rather than further, investor interests.

To the extent that additional authority would be necessary to further harmonize the broker-dealer and investment adviser regulatory regime, we would expect to work with Congress on that issue.

Enhancing Enforcement

The Administration's proposals in the white paper and the "Investor Protection Act of 2009" would also seek to enhance the SEC's enforcement powers. Specifically, the SEC would gain expanded authority to pay whistleblowers who bring significant information to the Enforcement Division, pursue expanded sanctions against wrongdoers, and to increase the potential grounds for seeking sanctions.

Whistleblowers

Whistleblowers can be a source of high quality evidence leading to enforcement actions. The bill provides the SEC with the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards using funds collected in enforcement actions not otherwise distributed to investors. Currently, the SEC has the authority to compensate sources in insider trading cases; the Administration's proposal would extend that authority to compensate whistleblowers who bring substantial evidence of other securities law violations, which I believe would greatly enhance the SEC's ability to enforce the securities laws.

Expanded Sanctions

Currently, a securities professional barred from being an investment adviser for serious misconduct could still participate in the industry as a broker-dealer. I believe that the SEC should be permitted to impose collateral bars against such regulated persons. The Administration's proposal gives the SEC the authority to bar a regulated person who violates the securities laws in one part of the industry, for example a broker-dealer who misappropriates customer funds, from access to customer funds in another part of the securities industry (such as an investment adviser). By expressly empowering the SEC to impose broad prophylactic relief in one action in the first instance, the Administration's

proposal would enable the SEC to more effectively protect investors and the markets while more efficiently using SEC resources.

Grounds for Seeking Sanctions

The Exchange Act and the Investment Advisers Act permit the SEC to bring actions for aiding and abetting violations of those statutes in civil enforcement actions.
The Administration's proposal would provide the SEC with authority to bring actions for aiding and abetting violations of the Securities Act and the Investment Company Act, which authority the SEC currently does not have. This would close a gap and create consistent remedies that the SEC can seek and eliminates significant limitations on the SEC's ability to pursue serious misconduct. In addition, the proposal would clarify that the Investment Advisers Act expressly permits imposition of penalties on aiders and abetters.

Oversight of Credit Rating Agencies

We are committed to working with Congress to ensure a strong and robust regulatory framework for credit rating agencies. In particular, my personal belief is that legislation to require mandatory registration by credit rating agencies would be a significant step forward in making sure that this sector of the market is brought under regulatory oversight without the danger that some credit rating agencies may fail to register in order to avoid regulation.

Operating under the current regulatory framework, we have already taken multiple steps to improve regulatory oversight of credit rating agencies. In response to the credit market turmoil, in February the Commission adopted several measures to increase transparency and accountability at nationally recognized statistical rating organizations' ("NRSROs") in order to address concerns about the integrity of their credit rating procedures and methodologies.[4] The requirements are designed to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions.

In conjunction with the adoption of these new measures, the Commission proposed an additional amendment which would require NRSROs to disclose ratings history information for 100% of all issuer-paid credit ratings.[5] Finally, on the same date, the Commission re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or

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4 *See* "Amendments to Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/final/2009/34-59342.pdf.

5 *See* "Re-proposed Rules for Nationally Recognized Statistical Rating Organizations," February 2, 2009, http://www.sec.gov/rules/proposed/2009/34-59343.pdf ("February 2, 2009 Re-proposing Release").

underwriter unless the information about the product provided to the NRSRO is made available to other NRSROs.[6]

To provide greater oversight of the NRSROs, I have also allocated additional resources to establish a branch of examiners dedicated specifically to conducting examination oversight of the NRSROs. This branch will conduct routine, special and cause examinations of the ratings agencies to review their activities and NRSRO compliance with the Credit Rating Agency Reform Act of 2006 and SEC rules.

In addition, I have directed the Commission staff to explore possible new regulations in this area, including limiting the potential for rating shopping. One possible approach would be to require disclosure by issuers of all pre-ratings obtained from NRSROs prior to selecting a firm to conduct a rating, as well as requiring NRSROs to provide additional disclosures.

Role of Financial Stability Oversight Council

I believe a multi-disciplinary group of financial regulators can play a critical role in assessing emerging systemic risks by setting standards for liquidity, capital and risk management practices. While a systemic risk regulator should play a critical role in this process (such as by working to implement and help set standards), in my view it is vital that its role be complemented by the creation of a strong and robust systemic risk council of primary financial regulators ("Financial Stability Oversight Council" or "Council").

I believe the Council should have authority to identify institutions, practices, and markets that create potential systemic risks, and also should be authorized to set standards for liquidity, capital and other risk management practices at firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness. A Council also would provide a forum for analyzing and recommending harmonization of certain standards at other significant financial institutions.

Importantly, however, a systemic risk regulator could collect information and be well informed on key matters, such as holding company liquidity and risk exposures, to be well positioned to respond quickly and effectively to any future crisis. In my view, a systemic risk regulator should have clearly defined authority to collect information and implement standards developed by the Council on capital, liquidity, and risk management. Further, I believe the systemic risk regulator also could be given narrow authority in extraordinary circumstances to act for a limited period of time when the holding company is at elevated risk to direct the sale of assets, reduce business, or cease activity. Beyond these extraordinary circumstances, all systemic risk regulator actions should be taken in coordination with the primary regulator of all significant U.S. subsidiaries and the Council.

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6 *See* February 2, 2009 Re-proposing Release.

I and many others feel that we must act now to restore investor confidence in our nation's markets and financial systems. I believe the steps the Administration, the SEC and other agencies are taking, in conjunction with Congress' extensive efforts, will help restore investor confidence through the creation of a robust financial regulatory framework better designed to withstand future periods of market or economic volatility.

I want to thank you for your continued strong support for the SEC and its critical mission, and would be happy to answer any questions you may have.