Testimony Concerning the Lehman Brothers Examiner's Report
by Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission
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Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee, I appreciate the opportunity to testify regarding the failure of Lehman Brothers and the Lehman Brothers Examiner's Report (Examiner's Report). I should say at the outset that this testimony is on my own behalf as Chairman of the SEC, and does not necessarily represent the views of the Commission or individual Commissioners.

When I became Chairman of the SEC in late January 2009, the agency and financial markets were still reeling from the events of the fall of 2008. Since that time, the SEC has worked tirelessly to review its policies, improve its operations and address the legal and regulatory gaps that came to light during the crisis.

The Lehman failure, both individually and within the context of the broader financial crisis, sheds light on many interconnected and mutually reinforcing causes that contributed to the failure of many major financial institutions, both bank and non-bank, including:

- Irresponsible lending practices, which were facilitated by a securitization process that originally was viewed as a risk reduction mechanism;

- Excessive reliance on credit ratings by investors;

- A wide-spread view that markets were almost always self-correcting and an inadequate appreciation of the risks of deregulation that, in some areas, resulted in weaker standards and regulatory gaps;

- The proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood;

- Perverse incentives and asymmetric compensation arrangements that encouraged excessive risk-taking;

- Insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products;

- A siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets; and

- The lack of an adequate statutory framework for the oversight of large investment bank holding companies on a consolidated basis.

My testimony will describe the SEC structure for the supervision of investment banks and their holding companies, the failure of Lehman, the lessons learned from the Consolidated Supervised Entity program, and the legislative and regulatory initiatives necessary to address the supervision and resolution of systemic entities in the future.

The Consolidated Supervised Entity Program

Beginning in 2004[1] through September 2008, the SEC was recognized as the consolidated supervisor for the five large independent investment banks – including Lehman Brothers – under its Consolidated Supervised Entity (CSE) program. The CSE program was created, in part, as a way for U.S. global investment banks that lacked a consolidated holding company supervisor to voluntarily submit to consolidated regulation by the SEC.[2] The SEC had no statutory authority to regulate these holding companies, and thus prior to the CSE program they were not subject to any consolidated supervision or capital requirements.

The CSE program was viewed as an effort to fill a significant gap in the U.S. regulatory structure that was left when the Gramm-Leach-Bliley Act failed to require investment bank holding companies to be regulated at the holding company level and to improve the Commission's oversight of broker-dealers. In retrospect, the program created classic regulatory arbitrage – a system in which a regulated entity was permitted to select its regulator. The arbitrage was facilitated by a prevailing regulatory consensus at the time of the program's inception that focused on meeting regulatory objectives while being careful not to undermine the competitiveness of American financial institutions and capital markets vis-à-vis their overseas, more lightly regulated, counterparts.

In addition, the program was implemented at a time when many believed that the inherently self-correcting nature of markets would prevent institutions from taking on excessive risk, including in the origination or trading of exotic financial instruments.

Under the CSE regime, the holding company was required to provide the Commission with information concerning its activities and risk exposures on a consolidated basis; submit its non-regulated affiliates to SEC examinations; and compute on a monthly basis, risk-based consolidated holding company capital in general accordance with the Basel Capital Accord, an internationally recognized method for computing regulatory capital at the holding company level. In connection with the

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[1] The SEC was recognized as the consolidated supervisor of Merrill Lynch in 2004. The other investment banks came into the CSE program beginning in 2005.

[2] Exchange Act Rel. 34-49830, 69 Fed Reg 34428, June 21, 2004.

establishment of the CSE program, the largest U.S. broker-dealer subsidiaries of these entities were permitted to utilize an alternate net capital (ANC) computation.[3] Other large broker-dealers, whose holding companies were subject to consolidated supervision by banking authorities, also were permitted to use this ANC approach.[4]

Under the CSE program, the SEC undertook for the first time the consolidated oversight of the five largest U.S. investment banks, whose operations were global in scope and extended well beyond the types of products and business lines typically found in a registered broker-dealer. Participation by the CSE firms in this regime was voluntary, and the consolidated oversight of these holding companies was more prudential in nature than the SEC's traditional rule-based approach for broker-dealer regulation. In brief, this program reflected a profoundly different approach to oversight and supervision for the Commission. Properly executing the program called for a correspondingly significant expansion in human, financial, managerial, technological and other resources devoted to the oversight and examination of CSE holding companies and their subsidiaries.

The SEC believed at the time that it was stepping in to address an existing gap in the oversight of these entities. Once, the agency took on that responsibility, however, it had to follow through effectively. Notwithstanding the hard work of its staff, in hindsight it is clear that the program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate.

During 2008, the CSE institutions failed, were acquired, or converted to bank holding companies which enabled them to access government support. The CSE program was discontinued in September 2008 by former Chairman Christopher Cox.

The Failure of Lehman Brothers

Events leading up to the failure of Lehman. In retrospect, the seeds of Lehman's failure were sown well before 2008. Key risk-taking activities that eventually contributed to Lehman's collapse began when the firm embarked in 2006 on an aggressive growth strategy. As part of this strategy, Lehman invested its own capital in assets such as subprime and Alt-A residential mortgages and mortgage-backed securities, commercial real estate, and leveraged lending commitments. After the subprime

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[3] In 2004, the SEC amended its net capital rule to permit certain broker-dealers subject to consolidated supervision to use their internal mathematical models to calculate net capital requirements for the market risks of certain positions and the credit risk for OTC derivatives-related positions rather than the prescribed charges in the net capital rule, subject to specified conditions. These models were thought to more accurately reflect the risks posed by these activities, but were expected to reduce the capital charges by the broker-dealer subsidiaries. Accordingly, the SEC required that these broker-dealers have, at the time of their ANC approval, at least $5 billion in tentative net capital (i.e., "net liquid assets"), and thereafter to provide an early warning notice to the SEC if that capital fell below $5 billion. This level was considered an effective minimum capital requirement.

[4] Currently six broker-dealers utilize the ANC regime and all are subject to consolidated supervision by banking authorities.

mortgage crisis emerged, Lehman scaled back exposures in this area, but continued its growth strategy and increased its exposures to leveraged finance and to commercial real estate before liquidity dried up in these markets beginning in August 2007.

During this time, Lehman reported its risk-taking activities under the CSE program. The program's oversight of Lehman's risk-taking focused on whether Lehman had an appropriate system of controls designed to ensure that the risk tolerance of Lehman's management and Board was effectively communicated to Lehman staff and that the risks assumed by the firm were appropriately captured and communicated to senior management. The CSE program also was focused on whether the firm had sufficient capital, under then-current standards, and liquidity, to support these activities. Clearly, the firm and the SEC did not anticipate the extent of the coming market dislocation and the issues that the dislocation would create for the firm.

The near collapse of Bear Stearns in March 2008, which was averted only through a government assisted sale to JPMorgan Chase, resulted in a heightened focus on Lehman. Of the four remaining CSE holding companies then supervised by the SEC, Lehman was considered to have the business model closest to Bear Stearns in that it was heavily dependent on fixed income securitization revenues. In March, however, Lehman reported a first quarter profit and a $34 billion liquidity pool.

In April 2008, Lehman issued approximately $4 billion in preferred securities. In June 2008, Lehman posted its first quarterly loss as a public company. Lehman attributed this $2.8 billion loss primarily to write-downs on residential and commercial mortgage securities and hedges related to these securities. Even though the firm reported that its liquidity pool had grown to $45 billion, it still had significant amounts of illiquid assets, consisting primarily of commercial and residential loans and securities.

Throughout the summer, Lehman embarked on various strategies to raise capital and to reduce the size of its exposure to mortgage-related and other illiquid assets. In June 2008, Lehman issued $4 billion in common stock and $2 billion in mandatory convertible debt. Management sought to raise additional capital through direct equity investments in the firm and by selling a stake in its investment management division. They also sought to spin off the bulk of the firm's commercial real estate assets. By the end of August, these additional efforts failed and the firm's write-downs continued to grow, while the sale of illiquid assets slowed.

The immediate causes of failure. The immediate cause of Lehman's bankruptcy filing on September 15, 2008 stemmed from a loss of confidence in the firm's continued viability resulting from concerns regarding its significant holdings of illiquid assets and questions regarding the valuation of those assets. The loss of confidence resulted in counterparties and clearing entities demanding increasing amounts of collateral and margin, such that eventually Lehman was unable to obtain routine financing from certain of its lenders and counterparties.

Several key events in early September contributed to this loss of confidence. On September 9, the Korean Development Bank, which had been in talks to acquire a stake in Lehman, announced that it would not be doing so. In addition, although Lehman retained most of its secured funding lines, its clearing banks demanded more collateral as a condition to continuing their clearing relationship.

According to information provided by Lehman to the SEC, Lehman claimed its liquidity pool was $41.5 billion at the beginning of the week of September 8, and ended the week at $1.4 billion. The largest drains on the liquidity pool included an increase in the amount of clearing deposits required by the firm's lenders and a decline in the amount of secured funding provided by the firm's counterparties.

Over the weekend of September 12th – 14th, representatives from the Treasury, the Federal Reserve Bank of New York and the Commission met with management from Lehman and other major financial firms in an effort to address the situation. According to the Examiner's Report, the government's analysis was that it did not have the legal authority to make a direct capital investment in Lehman, and Lehman's assets were insufficient to support a loan large enough to avoid Lehman's collapse.[5] On September 15th, Lehman's U.K. broker-dealer filed for administration and Lehman's holding company filed for bankruptcy.

On September 19, 2008 a district judge in the Southern District of New York entered an order commencing the liquidation of the Lehman broker-dealer under the Securities Investor Protection Act.

The CSE program's supervision of Lehman. As noted above, under the CSE regime, Lehman's holding company was required to provide the Commission with information concerning its activities and exposures on a consolidated basis, submit its non-regulated affiliates to SEC examinations, and compute on a monthly basis risk-based consolidated holding company capital in general accordance with the Basel Capital Accord. As with all CSE firms, SEC staff had a core set of monthly meetings with Lehman's market and credit risk groups and regular quarterly meetings with other internal control functions, including treasury, internal audit, and financial controllers. Beyond this core set of meetings, SEC staff had frequent conversations with the Lehman staff as questions and issues arose.

As noted above, supervision of Lehman was increased in March 2008 after Bear Stearns nearly collapsed. SEC staff had more frequent interaction with the firm, either through on-site visits or telephone calls, with a focus on the firm's liquidity and funding. Lehman also began submitting more frequent reports to the SEC, including reports on the liquidity pool on a daily basis. SEC staff monitoring Lehman also began to have more frequent communications with the staff of the Federal Reserve Bank of New York regarding Lehman's financial position.

[5] See Examiner's Report at 11-12.

As others have noted, once the markets turned, and particularly once Bear Stearns averted collapse only through a government-assisted sale, it is not clear that anything the SEC could have done would have prevented Lehman's bankruptcy. It is also clear that the SEC did not do enough as consolidated supervisor to identify certain risks and require additional capital and liquidity commensurate with the risks. As stated previously, the program was in my view insufficiently resourced, staffed, and managed from its inception. At the time the program was terminated in September 2008, it had approximately 21 staff, including 10 monitoring staff. Further, in light of the prudential nature of the program, it was a substantial departure from the agency's traditional approach of establishing clear rules and enforcing compliance with them. The Examiner's Report appears to confirm these and other shortcomings and the need to continue our reforms to breakdown stovepipes and instill a culture of collaboration.

Lehman's Repo 105 transactions. Lehman funded itself in large part through short term repurchase transactions, borrowing tens of billions of dollars on a daily basis. In a repurchase transaction, or repo, a company sells securities in exchange for cash with a simultaneous agreement for the purchaser to return the same or similar securities for a fixed price at a later date, generally a short period of time. Accounting standards establish guidance for whether a repurchase transaction should be reported as a financing transaction (debt) or a sale based in part on whether the reporting entity has surrendered control over the asset. Typically, repos are accounted for as financings (debt) as control over the assets is not fully surrendered.

The availability of repo funding was highly dependent upon the confidence of counterparties, rating agencies and the market in general. Beginning in late 2007 and throughout 2008, amidst increase concern about Lehman's leverage, Lehman significantly increased their reliance on repurchase agreements that Lehman referred to as "Repo 105s." Unlike typical repo transactions, Lehman treated Repo 105 transactions as sales for accounting purposes. The Examiner's Report concluded that the motive for the transactions was ultimately to reduce its leverage: to temporarily remove tens of billions of dollars in assets from its balance sheet at the end of financial reporting periods and use the cash to pay down liabilities as a means to reduce its reported leverage.[6] Lehman did not disclose that it accounted for its repurchase transactions as sales. Instead, it reported that it accounted for its repo transactions as financings, the common accounting treatment for repurchase transactions.

As discussed in the Examiner's Report, regulators (including Commission staff), rating agencies and the Lehman Board, were unaware of Lehman's use of Repo 105 transactions.[7] For purposes of the CSE program, the Commission did not perform an audit of Lehman's balance sheet. Instead, the Commission depended on the integrity of the balance sheet information provided by Lehman's management which was audited or, in the case of quarterly reports, reviewed, by Lehman's auditors. Lehman did not disclose in its audited financials that it was undertaking repos as sales – on the contrary,

[6] See, e.g., Examiner's Report at 732-4.
[7] See id. at 739.

Lehman's disclosure would lead one to believe that it accounted for all of its repos as financings and that the repos were properly reported as such on the balance sheet.

The findings of the Examiner's Report raise critical and legitimate questions about the use of these transactions to manage Lehman's balance sheet at the close of financial reporting periods, and also raise questions as to how widespread this practice may be. Last month our Division of Corporation Finance issued letters to various public companies requesting detailed information about their use of repurchase agreements or similar transactions involving the transfer of assets where they have an obligation to repurchase them. Among other things, these letters instruct companies to (1) describe their accounting for these transactions, their business purpose for engaging in them, and their impact upon liquidity; (2) provide detailed information about the financial statement impact of these transactions throughout each quarter; and (3) discuss how that impact differed from that presented at each quarter end. Not only will this information enable us to better evaluate each company's disclosure, it will help us understand whether companies are complying with our current requirements, and whether changes to current requirements should be made. Where we find that companies are engaging in financial transactions that are inconsistent with their publicly reported financial condition, we will take appropriate action.

Concerns Identified in the Examiner's Report. The Examiner's Report also raised concerns about the SEC's oversight of Lehman's liquidity pool. Ensuring adequate liquidity was a key part of the CSE program's stated objectives, but the Examiner's Report identified a number of issues with how this objective was implemented.

Each CSE firm was expected to maintain a liquidity pool consisting of cash or highly liquid and highly rated unencumbered debt instruments. However, the standards regarding the types of assets that could be included in this liquidity pool, and the manner in which those assets could be held, were not set forth in a Commission regulation and were otherwise unclear. In fact, practices varied across CSE firms. Though the CSE program began an inspection in early 2008 to gain a better understanding of liquidity practices across the CSE firms, the inspection was not completed prior to the termination of the CSE program. In my view, consolidated supervision requires detailed and clearly stated criteria for what assets are eligible for inclusion in a liquidity pool, meaningful verification efforts and established procedures for addressing concerns that are identified.

In addition, the CSE program appears to have been insufficiently skeptical about the information provided by the firm regarding its liquidity or other risk indicators. As discussed in the Examiner's Report, it appears that Lehman did not fully report to the Commission significant changes affecting assets in its liquidity pool in the period leading up to Lehman's bankruptcy. Although each firm is fully responsible for providing accurate information to its regulators, in certain instances it appears there was insufficient follow-up on issues that should have raised potential concerns.

The Examiner's Report concludes that the SEC did not aggressively restrain Lehman's appetite for taking on increasing risk between 2005 and 2008.[8] The requirement of having sound internal risk management controls was a key element of the CSE regime. However, in practice, the firm apparently treated risk limits not as requirements, but as softer guidelines or thresholds that would trigger necessary internal management approvals when exceeded. The philosophy of the CSE program and its management was that regulators should avoid substituting their views for the business judgment of the firm's management and its Board, as long as the firm continued to satisfy applicable capital requirements and was following its internal controls and escalation processes around increasing risk limits.

While it may be true that ultimate responsibility for the management of financial institutions rest with their management and boards of directors, it is necessary that regulators of large interconnected financial institutions demand more of a firm's management. In the Lehman case, management should have been challenged more forcefully with respect to the types of risks they were taking and, where necessary, had meaningful requirements or limitations imposed.

Finally, the Examiner's Report expresses concerns about a lack of information sharing among the federal regulators involved in Lehman. Effective information sharing by regulators is critical to fulfilling our regulatory obligations, and it is something that the American public has every right to expect. Cooperation and coordination with other financial institution regulators is essential. I expect SEC staff to work closely with our colleagues in other agencies. In addition, I am demanding full information sharing within the SEC – without silos that undermine our effectiveness.

Incorporating Lessons Learned from the CSE Program

The CSE program was terminated in September 2008, and the SEC is no longer the consolidated supervisor of these firms.[9] However, the SEC is taking steps to incorporate the lessons learned from the CSE experience into its ongoing role as primary functional regulator of broker-dealers. Lessons learned include the following.

Capital Adequacy Rules Were Flawed and Assumptions Regarding Liquidity Risk Proved Overly Optimistic. The applicable Basel capital adequacy standards depended heavily on the models developed by the financial institutions themselves. All models depend on assumptions. Assumptions about such matters as correlations, volatility, and market behavior developed during the years before the financial crisis were

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[8] In addition, the Examiner's Report notes that Lehman management excluded some of Lehman's riskiest assets from its stress testing, thereby substantially limiting the usefulness of these tests. See Examiner's Report at 67-9. While Commission staff believed Lehman had other ways of measuring these risks, those procedures plainly were insufficient.

[9] The Gramm-Leach-Bliley Act had created a voluntary program for the oversight of certain investment bank holding companies (i.e., those that did not have a U.S. insured depository institution affiliate). The firms participating in the CSE program did not qualify for that program or did not opt into that program. Only one firm (Lazard Ltd.) has ever opted for this statutory program and remains in the program today.

not necessarily applicable for the market conditions leading up to the crisis, nor during the crisis itself.

The capital adequacy rules did not sufficiently consider the possibility or impact of modeling failures or the limits of such models. Indeed, regulators worldwide are reconsidering how to address such issues in the context of strengthening the Basel regime. Going forward, risk managers and regulators must recognize the inherent limitations of these (and any) models and assumptions – and regularly challenge models and their underlying assumptions to consider more fully low probability, extreme events.

While capital adequacy is important, it was the related, but distinct, matter of liquidity that proved especially troublesome with respect to CSE holding companies. Prior to the crisis, the SEC recognized that liquidity and liquidity risk management were critically important for investment banks because of their reliance on private sources of short-term funding.

To address these liquidity concerns, the SEC imposed two requirements. First, a CSE holding company was expected to maintain funding procedures designed to ensure that it had sufficient liquidity to withstand the complete loss of all short term sources of unsecured funding for at least one year. In addition, with respect to secured funding, these procedures incorporated a stress test that estimated what a prudent lender would lend on an asset under stressed market conditions (a haircut). Second, each CSE holding company was expected to maintain a substantial "liquidity pool" that was composed of unencumbered highly liquid and creditworthy assets that could be used by the holding company or moved to any subsidiary experiencing financial stress.

The SEC assumed that these institutions, even in stressed environments, would continue to be able to finance their high-quality assets in the secured funding markets (albeit perhaps on less favorable terms than normal). In times of stress, if the business were sound, there might be a number of possible outcomes. For example, the firm might simply suffer a loss in capital or profitability, receive new investment injections, or be acquired by another firm. If not, the sale of high quality assets would at least slow the path to bankruptcy or allow for self-liquidation.

As we now know, these assumptions proved much too optimistic. Some assets that were considered liquid prior to the crisis proved not to be so under duress, hampering their ability to be financed in the repo markets. Moreover, during the height of the crisis, it was very difficult for some firms to obtain secured funding even when using assets that had been considered highly liquid.

Thus, the financial institutions, the Basel regime, and the CSE regulatory approach did not sufficiently recognize the willingness of counterparties to simply stop doing business with well-capitalized institutions or to refuse to lend to CSE holding companies even against high-quality collateral. Runs could sometimes be stopped only with significant government intervention, such as through institutions agreeing to become bank holding companies and obtaining access to government liquidity facilities or through other forms of support.

Consolidated Supervision is Necessary but Not a Panacea. Although large interconnected institutions should be supervised on a consolidated basis, policymakers should remain aware of the limits of such oversight and regulation. This is particularly the case for institutions with many subsidiaries engaging in different, often unregulated, businesses in multiple countries.

Before the crisis, there were many different types of large interconnected institutions subject to consolidated supervision by different regulators. During the crisis, many consolidated supervisors, including the SEC, saw large interconnected, supervised entities fail, merge, or seek government liquidity or direct assistance.

Systemic Risk Management Requires Meaningful Functional Regulation, Active Enforcement & Transparent Markets. While a consolidated regulator of large interconnected firms is an essential component to identifying and addressing systemic risk, a number of other tools must also be employed. These include more effective capital requirements, strong enforcement, functional regulation, and transparent markets that enable investors and other counterparties to better understand the risks associated with particular investment decisions. Given the complexity of modern financial institutions, it is essential to have strong, consistent functional regulation of individual types of institutions, along with a broader view of the risks building within the financial system.

Steps the SEC is taking to incorporate lessons learned from the CSE experience into its ongoing role as primary functional regulator of broker-dealers are as follows:

- ***Improvements to Broker-Dealer Reporting and Monitoring.*** With respect to the SEC's ongoing monitoring of certain large broker-dealers, the staff has developed enhanced reporting requirements for the firms, including information regarding balance sheet composition to monitor for the build-up of positions in particular asset classes. In addition, the SEC's 17-h Risk Assessment Program, under which it monitors for potential risks posed to broker-dealers by their affiliates, is in the process of being improved and upgraded.

- ***Improved Coordination.*** There must be full information sharing within the SEC. I have directed senior staff across all divisions to establish dedicated teams – including staff from the Division of Trading and Markets, Division of Risk, Strategy, and Financial Innovation, Division of Investment Management, and the Office of Compliance, Inspections and Oversight – with responsibility for key financial institutions for which the Commission is the primary functional regulator. We also will be seeking additional opportunities to coordinate more effectively with our fellow regulators.

In addition, we have created and staffed a new division – the Division of Risk, Strategy, and Financial Innovation (Risk Fin) – to develop and expand our institutional expertise. Risk Fin will re-focus the agency's attention on and response to new products, trading practices, and risks. Already, this new division has attracted renowned experts in the financial, economic, and legal implications of the financial innovations being crafted on Wall Street.

- ***Improved Examination, Oversight and Enforcement.*** The SEC's Office of Compliance Inspections and Oversight and our Division of Trading and Markets will be working together with Risk Fin to review and improve our broker-dealer oversight and examination program, initially starting with our ANC firms. This collaboration will address key supervision functions, including risk assessment, exam planning, information gathering and analysis, policy-making, interpretive guidance, monitoring, and reporting. A key theme will be to act in a more coordinated and integrated manner, improving information sharing on a Commission-wide basis and better realizing the potential synergies among our examination, supervision and rule-making functions. Another objective is to better enhance and deploy our expertise, particularly in connection with the planning and analysis of our supervision and examination programs. These programs must be aggressive in their execution, and possible violations of the securities laws and regulations will be vigorously investigated and enforced.

- ***Further Improvements to Rules and Requirements.*** Effective January 2010, the SEC staff instructed the ANC firms to take standardized net capital charges on certain less liquid mortgage and other asset-backed securities positions rather than using financial models to calculate net capital requirements. In addition to increasing the capital required to be held for these positions, this approach will reduce reliance on value-at-risk models.

  The SEC also is reviewing other ways to further enhance and strengthen our financial responsibility requirements for broker-dealers. With respect to ANC firms in particular, we are taking a fresh look at our rules with a view to determining whether the entire ANC approach should be substantially modified.

  With respect to all broker-dealers, some steps the staff is reviewing include: (1) raising minimum net capital requirements for broker-dealers; (2) enhancing the requirements for treating securities as liquid for purposes of the Commission's net capital rule; (3) limiting circumstances when clearing deposits would be allowable for net capital purposes; (4) narrowing the types of unsecured receivables that would be allowable for net capital purposes; and (5) imposing certain explicit leverage-based requirements, such as requiring broker-dealers to provide "early warning" notice to regulators if their leverage exceeds certain levels.

<u>**Regulatory Reform**</u>

The failure of Lehman demonstrates the need for important legislative changes in supervisory and resolution structures for large financial entities that can have a systemic impact on the financial system. The bills passed in the House and being considered in the Senate, although different in many details, are designed to address key issues raised by the financial crisis.

Regulation of Systemic Risk. The financial crisis demonstrated the need to watch for, warn about, and eliminate conditions that could cause a sudden shock and lead to a market seizure or cascade of failures that put the entire financial system at risk. While traditional financial oversight and regulation can help prevent systemic risks from developing, it is clear that this regulatory structure failed to identify and address systemic risks that were developing over recent years. The current structure was hampered by regulatory gaps that permitted regulatory arbitrage and failed to ensure adequate transparency. This contributed to the excessive risk-taking by market participants, insufficient oversight by regulators, and uninformed decisions by investors that were key to the crisis.

Given the shortcomings of the current regulatory structure, I believe there is a need to establish a framework for macro-prudential oversight that looks across markets and avoids the silos that exist today. Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and an empowered council of regulators is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should adverse circumstances arise, and benefit from the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences. This should be a mechanism for providing a second set of eyes over large interconnected firms and ensuring that standards and investor protections are <u>*raised*</u> so that there is no regulatory benefit to being large and interconnected.

End Too-Big-To Fail. One of most important regulatory arbitrage risks is the potential perception that large interconnected financial institutions are "too-big-to fail" and will therefore benefit from government intervention in times of crisis. This perception can lead market participants to favor large interconnected firms over smaller firms of equivalent creditworthiness, fueling greater risk.

In addition to establishing a strong Systemic Risk Council and higher standards, a key element to ending "too-big-to-fail" is the creation of a credible resolution regime to unwind and liquidate institutions of any size. In times of crisis when a systemically important institution may be teetering on the brink of failure, policymakers currently must immediately choose between two highly unappealing options: (1) providing government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but creating moral hazard; or (2) not providing government assistance but running the risk of market collapses and greater costs in the future. Markets recognize this dilemma and can fuel more systemic risk by "pricing in" the possibility of a government backstop of large interconnected institutions. This can give such institutions an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of a large, interconnected institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime could strengthen market expectations of government support, thereby fueling "too-big-to-fail" risks.

Insuring Independence and Resources for Market Regulation. Although traditionally independent of the executive branch, the SEC lacks an independent source of funding like most financial regulators. Most financial regulators have been established as independent entities with bipartisan management and dedicated funding sources. Unlike its regulatory counterparts, however, the SEC's funding is subject to the budget and appropriations process. As a result, the SEC has been unable to maintain stable, sufficient long-term funding necessary to conduct long-term planning and lacks the flexibility to apply resources rapidly to developing areas of concern.

Despite the damage done by the financial crisis, trading volume has more than doubled since 2003, the number of investment advisers has grown by roughly 50 percent, and the assets they manage have increased nearly 120 percent, to $46 trillion. The SEC's 3,800 employees oversee approximately 35,000 entities – including 11,500 investment advisers, 7,800 mutual funds, 5,400 broker-dealers, and more than 10,000 public companies – a nearly 10 to 1 ratio that is only growing larger. These numbers do not include the many unregulated entities that our enforcement staff must pursue to protect investors.

By guaranteeing independence, facilitating long-term planning, and closing the resource gap between the agency and the entities it regulates, independent funding will allow the SEC to better protect millions of investors. In addition, independent funding will ensure an SEC that is more effective at identifying and addressing the kinds of risk that dealt a significant blow to the American economy. An independently funded SEC will be better able to take strong action to prevent future risky activities by the entities under its supervision and to fulfill the important new responsibilities assigned to it under any future legislation.

Conclusion

In conclusion, there are many lessons to be learned from both the Lehman failure and the larger financial crisis. The enormity and worldwide scope of the crisis, and the unprecedented government response required to stabilize the system, demands a full and careful evaluation of every aspect of our financial system. As I have said in previous testimony, we cannot hesitate to admit mistakes, learn from them and make the changes needed to address the identified shortcomings and reduce the likelihood that such crises reoccur. More vigorous regulation and a new culture and approach are essential, and I look forward to continuing to work with you as you consider ways to strengthen our financial system. Thank you again for the opportunity to discuss these important issues with you today, and I look forward to answering your questions.