Testimony Concerning

Reform of the Financial Regulatory System

by

Christopher Cox
Chairman
U.S. Securities and Exchange Commission

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

July 24, 2008

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about reform of the U.S. financial regulatory system.

Unquestionably, the financial regulatory structure that was forged in the Great Depression has served the nation well over the intervening eight decades. Even amidst the current strains on the financial sector, the U.S. capital market is larger, deeper, and more liquid than any other market in the world. In large measure due to the world-class protections that investors enjoy in the United States, more capital is raised, and more capital is efficiently allocated within our market economy, than anywhere else on earth. These are accomplishments which should be protected.

In the decades since many of the critical institutions of the financial regulatory system were chartered, the capital markets and the broader economy have undergone profound changes. The regulatory system has adapted well to some of these changes. But other changes have presented new challenges that are rightly the subject of Congressional review. Given the current regulatory system's record of accomplishment, we don't need to start from scratch. Instead we can build on what has worked, take lessons from what hasn't worked, and modernize the current system to reflect developments in the markets.

One thing that has worked exceptionally well is the regulatory concept of an agency chartered to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Each of these elements of the SEC's mission is integrally important and mutually reinforcing of the others. An important reason the SEC has been able to accomplish so much is the expertise gained in each of its complementary roles.

The agency's work to protect investors through the enforcement program has been greatly benefited by the expertise of SEC staff who specialize in the regulation and supervision of broker-dealers or investment advisers. The agency's regulatory program, including our commitment to ensuring full disclosure of public company information in the capital markets, has been informed by the experience of the enforcement and examinations staffs. Our ability to oversee accounting and auditing standard setting has likewise been aided by our concurrent responsibilities in each of these areas.

Regulation, as well as the approach the government takes to the enforcement of law and regulation, cannot be viewed as static. Our markets are characterized by the innovations of thousands of firms and millions of market participants that keep America's capital markets at the leading edge. For this reason, securities and capital markets regulation can never stand still. With the tremendous benefits of innovation also come new problems that must be managed. Some of the new challenges can be met within the traditional regulatory system, and only require the focus of regulators. But addressing others in the best way will almost certainly require new authority from Congress.

The current market turmoil has demonstrated how interconnected markets have become. In the past, stovepipe regulation of different products could be justified on the grounds that the boundaries in the marketplace were clear enough. Today, when derivatives compete with securities and futures and insurance products are sold for their investment features, that is no longer true. As we approach the end of the first decade of the 21st century, the growing gaps and crevices in our venerable system are beginning to show.

Because the current credit market crisis began with the deterioration of mortgage origination standards, it could have been contained to banking and real estate were our markets not so interconnected. But in today's markets these problems quickly spread throughout the capital markets through securitization. And while the securitization process served at first to disperse risk, it did not eliminate it – and ultimately, the growing size of the risk combined with its dispersion created a need for greater transparency for financial institutions of all kinds. This is but one way in which the seamlessness which characterizes today's markets has confronted our regulatory system with new challenges.

One example, where the regulatory system has responded well is in the area of disclosure. In recent months the SEC's Division of Corporation Finance has asked financial institutions, including both commercial banks and investment banks, to provide additional disclosure regarding off-balance sheet arrangements and the application of fair value to financial instruments. The Division also provided suggestions to improve the transparency and content of this disclosure to investors. It encouraged disclosure about the types of events that could require consolidation of off-balance sheet arrangements, as well as the implications of consolidating if it were to occur. And it encouraged disclosures that would help an investor understand the significance of fair value measurements, including how they were determined by management and the judgments used by management. Financial institutions have improved their disclosures in subsequent public filings by taking into consideration these suggestions. A related set of issues concerns the application of accounting rules to balance sheet consolidation and fair value accounting. The Commission's Chief Accountant has asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether the subprime experience points to the need for changes, and this review by the FASB is underway. Here the problems that have arisen in the credit crisis have been amenable to resolution within the current framework.

The need for greater transparency to rebuild confidence in the financial system, however, extends beyond the public reporting that is a bedrock of the U.S. capital markets. The explosive growth of the over-the-counter derivatives markets in recent years is a case in point. OTC derivatives have grown largely in the interstices of the current regulatory system. These innovative financial products have increased the efficiency of capital markets and offered new opportunities for firms to manage risk efficiently. At the same time these markets have drawn together the world's major financial institutions into a tangled web of interconnections. These interconnections are not necessarily bad for the system, but the lack of readily available information about who is exposed to whom creates a situation ripe for rumor and misinformation. While the SEC has undertaken enforcement and examination action to limit the spread of intentionally false and misleading market rumors, the ultimate solution lies not only in enforcement but in greater transparency that provides investors with better information.

One way that this can be achieved is to improve the infrastructure of the market itself. In close cooperation with the Commodity Futures Trading Commission and the Federal Reserve and building on our long experience with the regulation of securities clearance and settlement, the SEC has been working to strengthen the OTC derivatives infrastructure so that these markets are more transparent and less vulnerable to failures in confidence in the event of financial difficulties at a major financial institution. President Geithner and the New York Federal Reserve Bank have taken a special interest in this because of the importance of reducing the risks that the current system presents to bank safety and soundness.

Another way in which changes in the marketplace have challenged existing regulatory norms is the supervision of investment banks.

When this Committee, and eventually the entire Congress and the President, devised the Gramm-Leach-Bliley Act in 1999, you – or rather we, since I was a member of the Commerce Committee which then had jurisdiction over securities and the Conference Committee at the time – decided that the SEC would serve as a functional regulator with responsibility over broker-dealers, investment advisers, and mutual funds. And we decided that the federal banking regulators similarly would be functional regulators for banking activities. Under this approach, the securities-related activities would be pushed out of banks and savings associations, and into broker-dealers and investment advisers where the SEC could examine them. This was a valiant attempt to reconcile the traditional model of regulation with the increasing interconnectedness of the securities and banking industries.

After considering the very different aims and methods of banking regulators and securities regulators, Congress decided that the SEC would continue to be responsible for regulating broker-dealers that are the central entities in investment banks. The Federal Reserve Board was given consolidated oversight of holding companies that contain both broker-dealers and most types of insured depository institutions, while the SEC retained among other things the authority to regulate the net capital of those broker-dealers. But no explicit arrangement for regularly sharing information between the SEC and the Federal Reserve Board was established that took into account the desirability of viewing capital and liquidity on an entity-wide basis. Likewise, neither the Commission nor the Federal Reserve Board was authorized to exercise mandatory consolidated supervision over investment bank holding companies.

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 do the statutes explicitly provide for a consolidated supervisor that is knowledgeable in their core securities business, and that would be recognized for this purpose by international regulators.

In 2004, the Commission adopted two regimes to fill this statutory gap. One provided group-wide supervision of holding companies that include broker-dealers based on the specific statutory authority in the Gramm-Leach-Bliley Act concerning voluntary consolidated supervision of investment bank holding companies. The other provided for voluntary consolidated supervision based on an exemptive authority. Both regimes imposed similar requirements on the holding companies of broker-dealers.

Only one investment banking group, Lazard, currently participates in the first regime based on the specific Gramm-Leach-Bliley Act provisions granting the Commission limited authority over holding companies that voluntarily submit to consolidated supervision. (This is because the four largest investment bank holding companies in the United States are ineligible by virtue of their specialized bank affiliates, such as industrial loan companies or certain savings banks.) The second regime, our Consolidated Supervised Entities program, is based on the Commission’s long-standing and comprehensive authority regarding the financial responsibility of broker-dealers. Today, Goldman Sachs, Lehman Brothers, Morgan Stanley, and Merrill Lynch participate in this voluntary program.

The programs’ objectives are clearly important in light of recent market developments. It is important to keep in mind, moreover, that all of the other parts of the SEC’s regulatory program for investment banks’ broker-dealers, including all of our sales practice rules, remain in effect as well. This mutually reinforcing aspect is of vital importance, for example, in reviewing the adequacy of internal controls and their implementation, and in monitoring firms for financial and operational weaknesses, where taking into account the unique business of the firm is highly relevant.

An important component of the CSE program is the regular interaction of Commission staff with senior managers in the firm’s own control functions, including risk management, treasury, financial controllers, and the internal auditor, as well as onsite testing to determine whether the firms are implementing robustly their documented controls. These interactions with the investment banks are informed by and build upon the Commission’s experience regulating their broker-dealers and their securities business for three-quarters of a century.

Immediately after the events of mid-March, when the run-on-the-bank phenomenon to which Bear Stearns was exposed demonstrated the importance of incorporating loss of short-term secured funding into regulatory stress scenarios, the CSE program revised the analysis of liquidity risk management, with enhanced focus on the use and resilience of secured funding. The SEC has also worked closely with the Federal Reserve in directing this additional stress testing. This testing incorporates new scenarios involving severe dislocations. The SEC and the Federal Reserve have conveyed revised supervisory expectations with respect to liquidity for CSE firms as a result of these stress tests. Additionally, the SEC has directed firms to strengthen their balance sheets, in part by shedding or marking down illiquid assets, a deleveraging process that continues.

Moreover, the SEC is closely scrutinizing the secured funding activities of each CSE firm, to encourage the establishment of additional term funding arrangements and a reduced dependence on "open" transactions, which must be renewed as often as daily. We are also focusing on the so-called matched book, a significant locus of secured funding activities within investment banks, to ensure that the firms are guarding against potential mismatches between the "asset side," where positions are financed for customers, and the "liability side," where positions are financed by other financial institutions and investors. We are obtaining expanded funding and liquidity information for all CSEs on a continual basis, and monitoring the amount of excess secured funding capacity for less-liquid positions available to each firm. The additional stress scenarios that we have developed with the Federal Reserve are being layered on top of the existing scenarios as a basis for sizing liquidity pool requirements. Also, we have discussed with senior management of each CSE firm their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

While maintaining broad consistency with Federal Reserve bank 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 the daily marking-to-market of positions as a critical risk and governance control. (Because of applicable accounting standards commercial banks are not required to mark-to-market in many cases.) Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity for holding companies that rely on ongoing credit market funding. This reflects a fundamental difference between commercial banks with insured deposits, which have access to Fed liquidity, and investment banks, which except for the current emergency provision of external liquidity do not. Our latest stress scenarios are based on the assumption of no external liquidity provider.

While the CSE program itself is perhaps the most obvious way in which the SEC has adapted regulation to changes in the marketplace, information sharing among regulators is another important area in which this has occurred.

The importance of good information flow among regulators, especially during periods of market stress, is essential if the government is to meet its responsibilities to investors and the marketplace. To this end, the SEC has recently executed memoranda of understanding with the Commodity Futures Trading Commission and the Federal Reserve Board, and we are exploring similar undertakings with the Department of Labor and other agencies.

The MOU with the Federal Reserve is relevant to the regulation of investment banks because it includes, in addition to pledges of cooperation on anti-money laundering, bank brokerage activities, and clearance and settlement in the banking and securities industries, information sharing and cooperation in each agency's execution of its responsibilities for the regulation of bank holding companies and the CSEs that own securities firms. The MOU will improve the ability of the SEC to perform its role as primary supervisor of CSEs and Primary Dealers, and improve the ability of the Federal Reserve to perform its role in overseeing the stability of the financial system.

On a regular basis, and particularly in light of market developments, the SEC has also engaged broadly with both international and domestic regulators to draw the appropriate lessons from recent market events. In particular, we participate in the Senior Supervisors Group, which published a paper highlighting risk management practices that proved particularly effective or ineffective over the last year, and are participating in the Policy Development Group of the Basel Committee on Banking Supervision that is overseeing a number of projects aimed at increasing the resiliency of financial institutions, including publication of revised liquidity guidance and capital standards.

The Commission also engages bilaterally with other financial supervisors, notably those who supervise regulated entities affiliated with CSEs. While the Commission defers to those functional regulators with respect to the legal entity, we recognize that these supervisors have an interest in and need to obtain information about the financial and operational state of the consolidated entity. We regularly share relevant information concerning the CSE holding company with such fellow regulators, both domestically and internationally.

The recent formulation of the CSE program, and the establishment of information sharing arrangements with both domestic and international regulators, have gone far to adapt the existing regulatory structure to today's exigencies. But I believe that legislative improvements are necessary as well. In particular, recent events have highlighted the need to fill the Gramm-Leach-Bliley regulatory gap by amending the existing statutory authorization for voluntary SEC supervision of investment bank holding companies to make it mandatory for all of what today are regulated as CSE firms. The Commission should be given a statutory mandate to perform this function at the holding company level, along with the authority to require compliance. In addition, legislation should prescribe explicitly how the resolution of financial difficulties at investment bank holding companies will be organized and funded.

The core business of investment banking is facilitating capital raising – whether through trading, underwriting, or ancillary services – while the core business of commercial banks is taking deposits and making loans. As a result, investment banks' assets are overwhelmingly securities and other financial instruments that must be financed (often through repurchase agreements). These assets are marked-to-market daily. In addition to deposits, commercial banks have larger portfolios of loans which, under applicable accounting standards, are treated as held at the originating institution until maturity or for investment. This means that while investment banks must mark their assets based on an exit price or market conditions, commercial banks value their loans on, for instance, the performance of the loan itself. In addition, investment banks are prohibited from financing their investment bank activities with customer funds or fully-paid securities held in a broker-dealer. Commercial banks, however, can fund their banking business with customer deposits.

It is because of these essential differences between investment banks and commercial banks that Congress has sought to insulate the government-insured deposit funding advantage that commercial banks enjoy from broader business risk. To this end, the commercial bank supervisory regime administered by the Federal Reserve and other bank regulators limits commercial banks' entry into certain lines of businesses such as merchant banking and commodities, and limits affiliations with commercial enterprises.

Nonetheless, investment banks and commercial banks compete in a number of lines of business. Many of the bright lines that previously distinguished them have blurred. For this reason, it would be exceptionally useful for regulators to have common financial reporting and supervisory metrics for both industries. As yet, however, there is no agreed upon “apples to apples” comparison for assessing balance sheets and leverage metrics of investment banks and commercial banks.

Given these business, accounting, and regulatory differences, imposing the existing commercial bank regulatory regime on investment banks would be a mistake. It is conceivable that Congress could create a framework for investment banking that would intentionally discourage risk taking, reduce leverage, and restrict lines of business, but this would fundamentally alter the role that investment banks play in the capital formation that has fueled economic growth and innovation domestically and abroad. Such a course could be justified, if at all, only on the grounds that, like commercial banks which have long enjoyed explicit access to government-provided liquidity, investment banks’ activities must be controlled in order to protect the taxpayer. This, however, makes clear that the more fundamental question is not whether investment banks should be regulated like commercial banks, but whether they should have permanent access to government-provided backstop liquidity. And if Congress were to answer that question in the affirmative, it is difficult to imagine that our markets would not produce new entities, perhaps hedge funds or other non-regulated firms, to take over the higher-risk capital markets functions of the formerly robust investment banks. That, in turn, would simply raise today’s questions anew.

Rather than extend the current approach of commercial bank regulation to investment banks, I believe Congress and regulators must recognize that different regulatory structures are needed for oversight of these industries. Put simply, regulatory reform should not, and need not, amount to the elimination of the investment banking business model.

The mandatory consolidated supervision regime for investment banks should provide the SEC with several specific authorities. Broadly, these include authority, with respect to the holding company, to: set capital and liquidity standards; set recordkeeping and reporting standards; set risk management and internal control standards; apply progressively more significant restrictions on operations if capital or liquidity adequacy falls, including requiring divestiture of lines of business; conduct examinations and generally enforce the rules; and share information with other regulators. Any future legislation should also establish a process for handling extraordinary problems, whether institution-specific or connected with broader market events, to provide needed predictability and certainty.

If Congress were to deem it necessary to identify a category of complex, systemically important institutions that cannot be allowed to fail upon insolvency, it should take care to limit any changes to the bankruptcy rules to such entities. In particular, there are five aspects of the current regulatory regime that should be carefully considered.

First, the Federal Reserve based its decision to provide funding to Bear Stearns through JPMorgan Chase on Bear Stearns’ extensive participation in a range of critical markets, which meant that a chaotic unwinding of its positions could have cast doubt on the financial positions of some of Bear Stearns’ thousands of counterparties, including many commercial banks. This decision was made under severe time pressure, in a matter of days, without the benefit of explicit statutory guidance on the conditions for any government intervention. Were the Congress to consider addressing the potential for future action of this kind in statute, any such authority should be reserved for exceptionally rare cases and clearly targeted to achieve not only the objective of addressing an immediate critical situation, but also the objectives of mitigating moral hazard, protecting investors, avoiding unnecessary preemptive takings of private rights and property, and maintaining a robust investment banking business model.

Second, the securities and bankruptcy laws currently provide an explicit statutory framework for liquidating a failing securities brokerage firm, and for protecting customer cash and securities. This framework generally works well, even in instances of fraud. I would not recommend changing this system. Specifically, for broker-dealers with customers the Securities Investor Protection Act of 1970 ("SIPA") replaces the process for liquidation under Title11, though these processes are similar in many respects. SIPA also established the Securities Investor Protection Corporation ("SIPC"), which administers a fund that can be used to fund the liquidation of a broker-dealer. SIPC is a nonprofit membership corporation. Its members are, with some exceptions, all broker-dealers registered with the Commission. SIPC has seven directors, five are appointed by the President subject to Senate approval, one is appointed by the Secretary of the Treasury, and one is appointed by the Federal Reserve Board. I should note that SIPA was intended primarily as a liquidation mechanism. However, it follows the Bankruptcy Code provisions that permit a trustee to operate a business for a limited period if it is in the best interest of the estate. The trustee in a SIPA liquidation is responsible for distributing customer property and liquidating the failed broker-dealer. Whenever feasible, customer accounts are quickly transferred to another operating broker-dealer to facilitate customers' orderly receipt of cash and securities and continuing access to brokerage services. If customer securities or cash are missing, the trustee can use advances from the SIPC fund to pay up to $500,000, per customer ($100,000 for cash claims) to replace missing securities or cash. The SIPC fund currently stands at approximately $1.5 billion and maintains $1 billion in revolving credit lines with a consortium of banks. The SEC may also borrow up to $1 billion from the Treasury on behalf of SIPC.

Third, for banks and thrifts, the FDIC has long served as the receiver of failed banks. In 1987, after the failure of Continental Illinois, Congress provided the FDIC with authority to charter bridge banks and expanded the FDIC's authority for open bank assistance. A bridge bank is a temporary national bank that assumes deposits and certain liabilities and preserves as much of the going concern and status quo as possible until a more permanent resolution can be achieved. Later, when Congress enacted the Federal Deposit Insurance Improvement Act ("FDICIA") in 1991, the FDIC and the other banking regulators obtained additional authority to take preemptive action to resolve a troubled bank or other federally insured depository institution. FDICIA also mandates a least-cost resolution analysis except in the case of systemically important institutions, and mandates supervisory and regulatory examination standards and new tiers of capital requirements tied to ever-increasing supervisory restrictions. FDICIA also prescribes intentionally onerous restrictions on a bank's ability to receive lender-of-last-resort credit leading up to a bank's failure.

Fourth, for resolution of systemically important banks and other insured depository institutions through other than the least cost method, FDICIA prescribes a detailed process involving super-majority approvals by the interested regulators (FDIC and the Federal Reserve) and formal approval of the Secretary of the Treasury after consultation with the President. It also requires detailed findings of serious adverse effects on economic conditions or financial stability, coupled with a finding that the proposed action or assistance would avoid or mitigate the adverse effects. Further, in the event a commercial bank must be wound down, a special assessment on the entire industry is mandated to pay the costs of a systemic risk resolution. Once systemic risk findings are made, however, the statute contains no prescribed method for dealing with the resolution, no limits on how this may be resolved, and no guidelines on the procedures that may be followed. These provisions ensure that the appropriate parties are involved while not dictating methods that could be unduly restrictive during a significant crisis. The statute does not speak to how to handle non-bank affiliates and the parent holding company.

Fifth, bank holding companies, financial holding companies, and CSE holding companies are all Title 11 bankruptcy-eligible entities as long as the holding company is not itself a bank or registered broker-dealer. Financial contracts, such as OTC derivative instruments, receive special treatment in a Title 11 proceeding, which is similar to the treatment in commercial bank or SIPA liquidation. In particular, in the event of insolvency, counterparties may exercise self-help to terminate contracts and to seize and sell collateral related to OTC derivative contracts. When there is considerable interconnectedness among financial firms, unwinding a significant portfolio would potentially cause market disruptions and systemic issues. An additional risk always exists when a major holding company is troubled, because neither the FDIC nor SIPC can control the liquidation of the holding companies or of their unregulated affiliates that generally hold most of the derivative positions. No one today has sufficient authority to take effective action if a major financial enterprise experiences rapid financial deterioration. In the statute, the SEC should be given explicit authority to do this for all investment bank holding companies in the statute. It is exceptionally important in crafting any future framework for resolution that provisions be carefully drafted to avoid precipitating anticipatory movement of business or breaches of OTC derivatives contracts before any intervention occurs.

Mr. Chairman, I hope that these observations from the SEC will be of assistance to you as the Committee considers the broad questions of whether, and if so how, to reform the existing federal regulatory system for financial services. It is the agency's view that an expanded statutory framework for mandatory SEC supervision of investment banks should be harmonized with other aspects of the existing statutory scheme, such as SIPA, and should be based on a thorough appreciation for the unique attributes of the securities broker-dealer business. The framework that has already been established by Congress for the resolution of difficulties experienced by commercial banks under the banking laws provides useful guidance for any reform effort, but it cannot be applied to investment banks without modification. The SEC, as the supervisory authority focused on the securities business and markets, should be vested with the responsibility for implementing this modified framework, as well for closely coordinating with other relevant supervisory agencies.

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