
Testimony of
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“Enhancing Investor Protection and the Regulation of the Securities Markets”
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Introduction

Chairman Dodd, Ranking Member Shelby, members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association (“SIFMA”).¹ Thank you for your invitation to testify at this important hearing. The purpose of my testimony is to share SIFMA’s views on how we might improve investor protection as well as the regulation of our financial markets.

Overview

Our current financial crisis, which has affected nearly every American family, underscores the imperative to modernize our financial regulatory system. Our regulatory structure and the plethora of regulations applicable to financial institutions are based on historical distinctions among banks, securities firms, insurance companies and other financial institutions – distinctions that no longer conform to the way business is conducted. Today, financial services institutions perform many similar activities without regard to their legacy charters, and often provide investors with similar products and services, yet may be subject to different rules and to the authority of different regulatory agencies because of the functions performed in a bygone era.

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA’s mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public’s trust in the industry and the markets. (More information about SIFMA is available at <http://www.sifma.org>.)

Regulators continue to operate under authorities largely established many decades ago. They also often operate without sufficient coordination and cooperation and without a complete picture of the market as a whole. For example, the Securities and Exchange Commission (“SEC”) oversees broker-dealer activity. Futures firms are regulated by the Commodity Futures Trading Commission (“CFTC”), while the insurance industry is regulated by 50 state insurance regulators. Thrifts are regulated by the Office of Thrift Supervision, and banks may be overseen at the federal level by the Office of the Comptroller of the Currency, the Federal Reserve Board or the Federal Deposit Insurance Corporation. At the same time, some financial institutions, such as hedge funds, largely escape regulation altogether.

As a result, our current regulatory framework is characterized by duplicative or inconsistent regulation, and in some instances insufficient or insufficiently coordinated oversight. The negative consequences to the investing public of this patchwork of regulatory oversight are real and pervasive. Investors do not have comparable protections across the same or similar financial products. Rather, the disclosures, standards of care and other key investor protections vary based on the legal status of the intermediary or the product or service being offered. For example, similar financial advisory services may be delivered to retail clients via a broker-dealer, an investment adviser, an insurance agent, or a trustee, thereby subjecting similar advisory activities to widely disparate regulatory requirements. From the perspective of financial institutions, many are subject to duplicative, costly and unnecessary regulatory burdens, including

multiple rulebooks, and multiple examinations and enforcement actions for the same activity, that provide questionable benefits to investors and the markets as a whole.

This regulatory hodgepodge unnecessarily exposes investors, market participants, and regulators alike to the potential risk of under-regulation, overregulation, or inconsistent regulation, both within the U.S. and globally. A complex and overlapping regulatory structure results in higher costs on all investors, depriving them of investment opportunities. Simply enhancing regulatory cooperation among the many different regulators will not be sufficient to address these issues.

In light of these concerns, SIFMA advocates simplifying and reforming the financial regulatory structure to maximize and enhance investor protection and market integrity and efficiency. More specifically, we believe that a reformed – and sound – regulatory structure should accomplish the following goals: First, it must minimize systemic risk. Second, through a combination of structural and substantive reforms, it must be as effective and efficient as possible, while at the same time promoting and enhancing fair dealing and investor protection. Finally, it should encourage consistent regulation across the same or similar businesses and products, from country to country, to minimize regulatory arbitrage.

I. Creation of a Financial Markets Stability Regulator

Systemic risk has been at the heart of the current financial crisis. While there is no single, commonly-accepted definition of systemic risk, we think of “systemic risk” as the risk of a system wide financial crisis characterized by a

significant risk of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the U.S. or have other serious adverse effects on economic conditions or financial stability. SIFMA has devoted considerable time and resources to thinking about systemic risk, and what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future. A regulatory reform committee of our members has met regularly in recent months to consider these issues and to develop a workable proposal to address them. We have sponsored roundtable discussions with former regulators, financial services regulatory lawyers and our members, as well as other experts, policymakers and stakeholders to develop solutions to the issues that have been exposed by the financial crisis and the challenges facing our financial markets and, ultimately and most importantly, America's investors.

Through this process, we have identified a number of questions and trade-offs that will confront policymakers in trying to mitigate systemic risk. Although our members continue to consider this issue, there seems to be consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. The G30, in its report on financial reform, supports a central body with the task of promoting and maintaining financial stability, and the Treasury, in its blueprint, also has supported a market stability regulator.

We are realistic in what we believe a financial markets stability regulator can accomplish. It will not be able to identify the causes or prevent the occurrence of all financial crises in the future. But at present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. We believe that a single, accountable financial markets stability regulator will improve upon the current system.

While our position on the mission of the financial markets stability regulator is still evolving, we currently believe that its mission should consist of mitigating systemic risk, maintaining financial stability and addressing any financial crisis, all of which will benefit the investing public. It should have authority over all markets and market participants, regardless of charter, functional regulator or unregulated status. In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, as applicable, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries. It should have the authority to gather information from all financial institutions and markets, adopt uniform regulations related to systemic risk, and act as a lender of last resort. It should probably have a more direct role in supervising systemically important financial organizations, including the power to conduct examinations, take prompt corrective action and appoint or act as the receiver or conservator of

all or part of a systemically important organization. These more direct powers would end if a financial group were no longer systemically important.

II. Other Reforms that Would Enhance Investor Protection and Improve Market Efficiency

While we believe that a financial markets stability regulator will contribute to enhancing investor protection and improving market efficiency, we also believe, as a second step, that we must work to rationalize the broader financial regulatory framework to eliminate regulatory gaps and imbalances that contribute to systemic risk. Specifically, SIFMA believes that more effective and efficient regulation of financial institutions – resulting in greater investor protection – is likely to be achieved by regulating similar activities and firms in a similar manner and by consolidating certain financial regulators.

A. Core Standards Governing Business Conduct

Currently, the regulation of the financial industry is based predominantly on rules that were first established during the 1930s and 1940s, when the products and services offered by banks, broker-dealers, investment advisors and insurance companies were distinctly different. Today, however, the lines and distinctions among these companies and the products and services they offer have become largely blurred. Development of a single set of standards governing business conduct of financial institutions towards individual and institutional investors, regardless of the type of industry participant or the particular products or services being offered, would promote and enhance investor protection, and reduce potential regulatory arbitrage and inefficiencies that are inherent in the existing system of multiple regulators and multiple, overlapping rulebooks.

The core standards should be crafted so as to be flexible enough to adapt to new products and services as well as evolving market conditions, while providing sufficient direction for firms to establish enhanced compliance systems. As Federal Reserve Board Chairman Ben Bernanke once suggested, “a consistent, principles-based, and risk-focused approach that takes account of the benefits as well as the risks that accompany financial innovation” is an effective way to protect investors while maintaining the integrity of the marketplace.²

This core standards approach, however, must be accompanied by outcome-oriented rules (where rules are necessary), an open dialogue between the regulator and regulated, and enforcement efforts focused on addressing misconduct and fraud and protecting the investing public.

B. Harmonize Investment Advisor and Broker-Dealer Regulation

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for investment advisory, brokerage and other financial services in order to promote investor protection. A 2007 RAND Corporation report commissioned by the SEC found that efforts to describe a financial service provider’s duties or standard of care in legalistic terms, such as “fiduciary duty” or “suitability,” contributes to – rather than resolves – investor confusion.³ Further complicating matters, the laws that apply to many customer

² See Ben S. Bernanke, Federal Reserve Board Chairman, Remarks at the Federal Reserve Bank of Atlanta’s 2007 Financial Markets Conference, Sea Island, Georgia (May 15, 2007), at <http://www.federalreserve.gov/boarddocs/Speeches/2007/20070515/default.htm>.

³ Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, December 31, 2007, available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

accounts, such as ERISA (for employer-sponsored retirement plans) or the Internal Revenue Code (for IRAs), have different definitions of fiduciaries, and prohibitions on conduct and the sale of products that differ from those under the Investment Advisers Act and state law fiduciary concepts. The RAND report makes clear that individual investors generally do not understand, appreciate, or care about such legal distinctions.

Rather than perpetuating an obsolete regulatory regime, SIFMA recommends the adoption of a “universal standard of care” that avoids the use of labels that tend to confuse the investing public, and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers. Such a standard could provide a uniform code of conduct applicable to all financial professionals. It would make clear to individual investors that their financial professionals are obligated to treat them fairly by employing the same core standards whether the firm is a financial planner, an investment adviser, a securities broker-dealer, a bank, an insurance agency or another type of financial services provider. A universal standard would not limit the ability of individual investors to contract for and receive a broad range of services from their financial services providers, from pure execution of customer orders to discretionary investment advice, nor would it limit the ability of clients to define or modify relationships with their financial services providers in ways they so choose.

As Congress contemplates regulatory reform, particularly in the wake of the Madoff and Stanford scandals and the recent turbulence in our financial

markets, we believe that the time has come to focus on the adoption of a universal investor standard of care.

In addition, we urge Congress to pursue a regulatory framework for financial services providers that is understandable, practical and provides flexibility sufficient for these intermediaries to provide investors with both existing and future products and services. Such a framework must also avoid artificial or vague distinctions (such as those based on whether any investment advice is “solely incidental” to brokerage or whether any compensation to the financial services provider is “special”). Finally, the framework should support investor choice through appropriate relief from the SEC’s rigid prohibitions against principal trading, particularly with respect to products traded in liquid and transparent markets, which has had the effect of foreclosing investors from obtaining more favorable pricing on transactions based on the requirement for transaction-by-transaction consent.

C. Broaden the Authority of the MSRB

The Municipal Securities Rulemaking Board (MSRB) regulates the conduct of only broker-dealers in the municipal securities market. We feel it is important to level the regulatory playing field by increasing the MSRB’s authority to encompass the regulation of financial advisors, investment brokers and other intermediaries in the municipal market to create a comprehensive regulatory framework that prohibits fraudulent and manipulative practices; requires fair treatment of investors, state and local government issuers of municipal bonds and

other market participants; ensures rigorous standards of professional qualifications; and promotes market efficiencies.

D. Merge the SEC and CFTC

The U.S. is the only jurisdiction that splits the oversight of securities and futures activities between two separate regulatory bodies. When the CFTC was formed, financial futures represented a very small percentage of futures activity. Now, an overwhelming majority of futures that trade today are financial futures. These products are nearly identical to SEC regulated securities options from an economic standpoint, yet they are regulated by the CFTC under a very different regulatory regime. This disparate regulatory treatment detracts from the goal of investor protection. An entity that combines the functions of both agencies could be better positioned to apply consistent rules to securities and futures.

D. OTC Derivatives

Although OTC derivatives transactions generally are limited to institutional participants, the use of OTC derivatives by American businesses to manage risks and reduce funding costs provides important benefits for our economy and, consequently, for individual investors as well. At the same time, problems with OTC derivatives can adversely affect the financial system and individual investors. Accordingly, we believe that steps should be taken to further develop the infrastructure that supports the OTC derivatives business and to improve the regulatory oversight of that activity.

In particular, we strongly support our members' initiative to establish a clearinghouse for credit default swaps ("CDS") and we are pleased to note that

ICE US Trust LLC opened its doors for clearing CDS transactions yesterday. We believe that development of a clearinghouse for credit derivatives is an effective way to reduce counterparty credit risk and, thus, promote market stability. In addition to reducing risk, the clearinghouse will facilitate regulatory oversight by providing a single access point for information about the CDS transactions it processes.

We also believe that all systemically significant participants in OTC derivatives markets should be subject to oversight by a single systemic regulator. (It is noteworthy that the AIG affiliate that was an active participant in the CDS market was not subject to meaningful regulatory supervision.) The systemic regulator should be given broad authority to promulgate rules and regulations to promote sound practices and reduce systemic risk. We recognize that effective regulation requires timely access to relevant information and we believe the systemic regulator should have the necessary authority to assure there is appropriate regulatory transparency.

III. Investor Protection Through International Cooperation and Coordination

Finally, the current financial crisis reminds us that markets are global in nature and so are the risks of contagion. To promote investor protection through effective regulation and the elimination of disparate regulatory treatment, we believe that common regulatory standards should be applied consistently across markets. Accordingly, we urge that steps be taken to foster greater cooperation and coordination among regulators in major markets in the U.S., Europe, Asia, and elsewhere around the world. There are several international groups in which

the U.S. participates that work to further regulatory cooperation and establish international standards, including IOSCO, the Joint Forum, the Basel Committee on Banking Supervision, and the Financial Stability Forum. Congress should support and encourage the efforts of these groups.

Conclusion

Recent challenges have highlighted the necessity of reforms to enhance investor protection. SIFMA strongly supports these efforts and commits to be a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers regulatory reform to minimize systemic risk, promote consistent and efficient regulation, eliminate regulatory arbitrage, and promote capital formation – all of which serve, directly or indirectly, the interest of investor protection. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.