INVESTMENT COMPANY INSTITUTE

TESTIMONY OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ON

"INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS"

MARCH 10, 2009

EXECUTIVE SUMMARY

Overview: Recommendations for Financial Services Regulatory Reform

- The current financial crisis provides policymakers with the public mandate needed to take bold steps to strengthen and modernize our financial regulatory system. It is imperative to registered investment companies (also referred to as "funds"), as both issuers of securities to investors and purchasers of securities in the market, that the regulatory system ensure strong investor protection and foster competition and efficiency in the capital markets. The ultimate outcome of reform efforts will have a direct and lasting effect on the fund industry and the millions of investors who choose funds to help them save for the future.

- As detailed in a recently released white paper (attached as Appendix A), ICI recommends: (1) establishing a Systemic Risk Regulator; (2) creating a Capital Markets Regulator representing the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission; (3) considering consolidation of the bank regulatory structure and authorization of an optional federal charter for insurance companies; and (4) enhancing coordination and information sharing among federal financial regulators.

- If enacted, these reforms would improve regulators' capability to monitor and mitigate risks across the financial system, enhance regulatory efficiency, limit duplication, close regulatory gaps, and emphasize the national character of the financial services industry.

Systemic Risk Regulator

- The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting in coordination with other responsible regulators to mitigate such risks.

- Careful consideration should be given to how the Systemic Risk Regulator will be authorized to perform its functions and its relationship with other, specialized regulators.

Capital Markets Regulator

- The Capital Markets Regulator should have oversight responsibility for the capital markets, market participants, and all financial investment products. It should be the regulatory standard setter for funds, including money market funds.

- The agency's mission should focus on investor protection and law enforcement, as well as maintaining the integrity of the capital markets. Like the SEC, it should be required to consider whether proposed regulations protect investors and promote efficiency, competition, and capital formation.

- The Capital Markets Regulator should be an independent agency, with the resources to fulfill its mission and the ability to attract experienced personnel who can fully grasp the complexities of today's markets. ICI's white paper offers recommendations for organizing and managing the new agency and for how the agency can maximize its effectiveness.

Selected Other Areas for Reform

- The Capital Markets Regulator should have express authority to regulate in areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace. These areas include: (1) hedge funds; (2) derivatives; (3) municipal securities; and (4) the regulation of investment advisers and broker-dealers.

Recent Market Events and Money Market Funds

- Money market funds, stringently regulated by the SEC, are one of the most notable product innovations in American history. These funds—which seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost—serve as an effective cash management tool for retail and institutional investors, and are an exceptionally important source of short-term financing in the U.S. economy.

- Until September 2008, money market funds, in some cases with support from their sponsors, largely weathered severe pressures in the fixed income markets that had been striking banks and other financial services firms since 2007. In mid-September, a series of extraordinary developments, including the failure of Lehman Brothers, roiled financial markets around the globe, affecting all market participants. In the midst of this market storm, one money market fund holding a substantial amount of Lehman commercial paper was unable to sustain its $1.00 price per share. The news of this fund "breaking the buck," combined with broader concerns about the building stresses in the money market and possible failures of other financial institutions, led to heavy redemptions in prime money market funds as investors sought safety and liquidity in Treasury securities.

- Unprecedented government initiatives—designed to provide stability and liquidity to the markets and to support money market funds—successfully bolstered investor confidence. To date, the Treasury Temporary Guarantee Program for Money Market Funds has received no claims for its guarantee, and none are anticipated. Assuming continued progress in restoring the health of the money market, there will be no need to extend the Temporary Guarantee Program beyond its current one-year maximum period.

- To capture the lessons learned from recent experience, ICI formed a Money Market Working Group of senior fund industry leaders, led by John J. Brennan of The Vanguard Group. The Working Group has conducted a thorough examination of how the money market can function better, and how all funds operating in that market, including registered money market funds, should be regulated. The Working Group intends to report its findings, conclusions, and recommendations later this month. We believe that prompt implementation of its recommendations will help assure a smooth transition away from the Temporary Guarantee Program.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $9.88 trillion and serve over 93 million shareholders. ICI is pleased to testify today about investor protection and the regulation of securities markets.

This hearing takes place at a time when the United States and a host of other nations are grappling with the most significant financial crisis in generations. In this country, the crisis has revealed significant weaknesses in our current system for oversight of financial institutions. At the same time, it offers an important opportunity for robust dialogue about the way forward. And it provides policymakers with the public mandate needed to take bold steps to strengthen and modernize regulatory oversight of the financial services industry. We strongly commend this Committee for the substantial attention it is devoting to examining the causes of the current crisis and considering how the regulatory system can best be improved, with particular focus on protecting consumers and investors.

It is no exaggeration that the ultimate outcome of these reform efforts will have a direct and lasting impact on the future of our industry. By extension, the decisions you make will affect the millions of American investors who choose registered investment companies (also referred to as "funds") as investment vehicles to help them meet the costs of college, their retirement needs, or other financial goals. Funds themselves are among the largest investors in U.S. companies, holding about one quarter of those companies' outstanding stock. Funds also hold approximately 40 percent of U.S. commercial paper, an important source of short-term funding for corporate America, and more than one third of tax-exempt debt issued by U.S. municipalities. It is thus imperative to funds, as both issuers of securities to investors and purchasers of securities in the market, that our financial regulatory system ensure strong protections for investors and foster competition and efficiency within the capital markets.

Like other stakeholders, we have been thinking very hard about how to revamp our current system so that our nation emerges from this crisis with stronger, well-regulated institutions operating within a fair, efficient, and transparent marketplace. Last week, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of investment companies.[1] Section II of my testimony provides a summary of these recommendations.

In addition to demonstrating the need to reform our financial regulatory system, events of the past year have highlighted the need for greater protections for both investors and the marketplace in several specific areas. Section III of my testimony outlines ICI's recommendations for legislative authority to address certain regulatory gaps that have the potential to affect the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace.

Finally, as discussed in Section IV of my testimony, events of the past year have brought into sharp focus the significance of money market funds and the critical role they play as a low-cost funding vehicle for the American economy. While the regulatory regime for money market funds has proven to

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[1] *See* Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf and attached as Appendix A.

be flexible and resilient, lessons learned from recent events suggested the need for a thorough examination of how the money market can function better and how all funds operating in that market should be regulated. To that end, ICI last November formed a working group of senior fund industry leaders with a broad mandate to develop recommendations in these areas. The Money Market Working Group is chaired by John J. Brennan, Chairman of The Vanguard Group, and expects to issue a detailed report by the end of March. We would welcome the opportunity to discuss with this Committee the recommendations of the Money Market Working Group following the release of its report.

II. FINANCIAL SERVICES REGULATORY REFORM

Overview of ICI Recommendations

Broadly speaking, ICI recommends changes to our regulatory structure that would create a framework to enhance regulatory efficiency, limit duplication, close regulatory gaps, and emphasize the national character of the financial services industry. To improve the government's capability to monitor and mitigate risks across the financial system, ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." A new "Capital Markets Regulator" should encompass the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission, thus creating a single independent federal regulator responsible for oversight of U.S. capital markets, market participants, and all financial investment products. ICI further recommends that Congress consider consolidating the regulatory structure for the banking sector and authorizing an optional federal charter for insurance companies. Such a regulatory framework—with one or more dedicated regulators to oversee each major financial services sector—

would maintain specialized regulatory focus and expertise, as well as avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or the allocation of resources.

To ensure the success of this new financial regulatory structure, there must be effective coordination and information sharing among the financial regulators, including in particular the Systemic Risk Regulator. Stronger links among these regulators should greatly assist in developing sound policies and should facilitate U.S. cooperation with the international regulatory community. In our white paper, we discuss why the President's Working Group on Financial Markets, with certain modifications, may be the most logical mechanism through which to accomplish these purposes.

Systemic Risk Regulator

The current financial crisis has exposed the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. Analyses of the causes of the current crisis suggest that systemic risks may be occasioned by, for example, excessive leveraging, lack of transparency regarding risky practices, and gaps in the regulatory framework.

ICI agrees with the growing consensus that our regulatory system needs to be better equipped to anticipate and address systemic risks affecting the financial markets. Some have called for the establishment of a "Systemic Risk Regulator." Subject to important cautions, ICI supports designating a new or existing agency or inter-agency body to serve in this role. We recommend that the Systemic Risk Regulator have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting in coordination with other responsible regulators to mitigate such risks.

The specifics of creating and empowering the Systemic Risk Regulator will require careful attention. By way of example, to perform its monitoring functions, this regulator likely will need information about a range of financial institutions and market sectors. The types of information that the regulator may require, and how the regulator will obtain that information, are just two of the discrete issues that will need to be fully considered.

In ICI's view, legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition, or efficiencies. For example, it has been suggested that a Systemic Risk Regulator could be given the authority to identify financial institutions that are "systemically significant" and to oversee those institutions directly. Despite its seeming appeal, such an approach could have very serious anticompetitive effects if the identified institutions were viewed as "too big to fail" and thus judged by the marketplace as safer bets than their smaller, "less significant" competitors.

Additionally, the Systemic Risk Regulator should be carefully structured so as not to simply add another layer of bureaucracy or to displace the primary regulators responsible for capital markets, banking, or insurance. Legislation establishing the Systemic Risk Regulator thus should define the nature of the relationship between this new regulator and the primary regulators for these industry sectors. The authority granted to the Systemic Risk Regulator should be subject to explicit limitations, and the specific areas in which the Systemic Risk Regulator and the primary regulators should work together will need to be identified. We believe, for example, that the primary regulators have a critical role to play as the first line of defense for detecting potential risks within their spheres of expertise.

Capital Markets Regulator

Currently, securities and futures—and their respective markets and market participants—are subject to separate regulatory regimes under different federal regulators. This system reflects historical circumstances and is out of step with the increasing convergence of these two industries. It has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. To bring a consistent policy focus to U.S. capital markets, ICI recommends the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and the CFTC. As the federal regulator responsible for overseeing the capital markets and all financial investment products, the Capital Markets Regulator—like the SEC and the CFTC—should be established as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission.

It is critically important that the Capital Markets Regulator's statutory mission focus the agency sharply on investor protection and law enforcement, as distinct from the safety and soundness of regulated entities. At the same time, the Capital Markets Regulator (like the SEC today) should be required to consider, in determining whether a proposed regulation is consistent with the public interest, both the protection of investors and whether the regulation would promote efficiency, competition, and capital formation. The Capital Markets Regulator's mission also should include maintaining the integrity of the capital markets, which will benefit both market participants and consumers. Congress should ensure that the agency is given the resources it needs to fulfill its mission. Most notably, the Capital Markets Regulator must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

ICI envisions the Capital Markets Regulator as the regulatory standard setter for registered investment companies, including money market funds (as is the case now with the SEC). In so authorizing this new agency, Congress would be continuing the important benefits that have flowed from the shared system of federal and state oversight established by the National Securities Markets Improvement Act of 1996. Under this system, federal law governs all substantive regulation of investment companies, and states have concurrent authority to protect against fraud. We believe that this approach is consistent with the national character of the market in which investment companies operate and would continue to achieve the regulatory efficiencies Congress intended, without compromising investor protection in any way.

The Capital Markets Regulator should continue to regulate registered investment companies under the Investment Company Act of 1940. While funds are not immune to problems, the substantive protections embodied in the Investment Company Act and related rules have contributed significantly to the protection of investors and the continuing integrity of funds as an investment model. Among these protections are: (1) daily pricing and redeemability of the fund's shares, with a requirement to use mark-to-market valuation; (2) separate custody of fund assets (typically with a bank custodian); (3) restrictions on complex capital structures and leveraging; (4) prohibitions or restrictions on affiliated transactions and other forms of self-dealing; and (5) diversification requirements. In addition, funds are subject to more extensive disclosure and transparency requirements than any other financial product. This regulatory framework has proven resilient through difficult market conditions, and has shielded fund investors from some of the problems associated with other financial products and services. Indeed, recent experience suggests that consideration should be given to extending the greater discipline that has worked so well in core areas of fund regulation—such as valuation[2], independent custody, affiliated transaction prohibitions, leveraging restrictions, diversification, and transparency—to other marketplace participants.

With the establishment of a new Capital Markets Regulator, Congress has a very valuable opportunity to "get it right" in terms of how the new agency is organized and managed. Our white paper outlines several recommendations in this regard, including the need for high-level focus on management of the agency. We stress the importance, for example, of the agency's having open and effective lines of internal communication, mechanisms to facilitate internal coordination and information sharing, and a comprehensive process for setting regulatory priorities and assessing progress.

ICI's white paper also suggests ways in which the Capital Markets Regulator would be able to maximize its effectiveness in performing its responsibilities. I would like to highlight two of the most significant suggestions for the Committee. First, the Capital Markets Regulator should seek to facilitate close, cooperative interaction with the entities it regulates as a means to identify and resolve

[2] From the perspective of funds as investors in corporate and fixed income securities, ICI believes that financial reporting that requires the use of mark-to-market or fair value accounting to measure the value of financial instruments serves the interests of investors and the capital markets better than alternative cost-based measures. For a more detailed discussion of our views, *see* Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated November 14, 2008, available at http://www.ici.org/statements/cmltr/08_sec_mark-to-market_com.html.

problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions. Second, the Capital Markets Regulator should establish mechanisms to stay abreast of market and industry developments. Ways to achieve this end include hiring more agency staff with significant prior industry experience and establishing by statute a multidisciplinary "Capital Markets Advisory Committee" comprised of private-sector representatives from all major sectors of the capital markets.

Expected Benefits of these Reforms

If implemented, the recommended reforms outlined above and discussed in detail in our white paper would help to establish a more effective and efficient regulatory structure for the U.S. financial services industry. Most significantly, these reforms would:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system;
- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry;
- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products;
- Preserve specialized regulatory focus and expertise while avoiding the potential for uneven attention to different industries or products;

- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern; and
- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

We recognize that some have criticized sector-based regulation because it may not provide any one regulator with a full view of a financial institution's overall business, and does not give any single regulator authority to mandate actions designed to mitigate systemic risks across financial markets as a whole. Our proposed approach would address those concerns through the establishment of the Systemic Risk Regulator to undertake this market-wide monitoring of the financial system and through specific measures to strengthen inter-agency coordination and information sharing.

We further believe that retaining some elements of the current multi-agency structure would offer advantages over a single, integrated regulator approach. Even though a single regulator could be organized with separate units or departments focusing on different financial services sectors, it is our understanding that, in practice, there can be a tendency for agency leadership or staff to gravitate to certain areas and devote insufficient attention to financial sectors perceived to be less high profile or prone to fewer problems. Such a result has the potential to stifle innovation valuable to consumers and produce regulatory disparities.

Finally, we believe that a streamlining of the current regulatory structure may be more effective and workable than an approach that assigns regulatory responsibilities to separate agencies based on broad regulatory objectives, such as market stability, safety and soundness, and business conduct. These functions often are highly interrelated. Not only could separating them prove quite challenging, but it would force regulators to view institutions in a less integrated way and to operate with a narrower, less-informed knowledge base. For example, a Capital Markets Regulator is likely to be more effective in protecting investors if its responsibilities require it to maintain a thorough understanding of capital market operations and market participants. And while an objective-based structure could be one way to promote consistent regulation of similar financial products and services, it is not the only way. Under our proposed approach, minimizing regulatory disparities for like products and services would be an express purpose of enhanced inter-agency coordination and information sharing efforts.

III. SELECTED OTHER AREAS FOR REFORM

Recent experiences in the markets have underscored the need for the Capital Markets Regulator (or, until Congress creates such a new agency, the SEC) to have express authority to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants, and to modernize regulation that has not kept pace with changes in the marketplace.[3] ICI supports reforms for these purposes in the areas discussed below.

- ***Hedge funds and other unregulated private pools of capital.*** The Capital Markets Regulator should have the power to oversee hedge funds and other unregulated pooled products with respect to, at a minimum, their potential impact on the capital markets. For

[3] Although not necessitating legislative action, another area for reform is regulation of credit rating agencies. ICI has long supported increased regulatory oversight, disclosure, and transparency requirements for credit rating agencies. We strongly support recent regulatory initiatives that will impose additional disclosure, reporting, and recordkeeping requirements on a nationally recognized statistical ratings organization (NRSRO) for products that it rates. These requirements, which are intended to increase disclosure and transparency surrounding NRSRO policies and procedures for issuing ratings and to increase an NRSRO's accountability for its ratings, are a welcome step forward that should help to restore investor confidence in the integrity of credit ratings and, ultimately, the market as a whole. We expect to file a comment letter on the SEC's latest proposal to enhance NRSRO regulation at the end of this month.

example, the Capital Markets Regulator should require nonpublic reporting of information, such as investment positions and strategies, that could bear on systemic risk and adversely impact other market participants.

- ***Derivatives.*** The Capital Markets Regulator should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, while not unduly stifling innovation.
- ***Municipal Securities.*** The Capital Markets Regulator should be granted expanded authority over the municipal securities market, and should use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized, and often stale, and there are numerous disparities from the corporate issuer disclosure regime.
- ***Investment Advisers and Broker-Dealers.*** The Capital Markets Regulator should have explicit authority to harmonize the regulatory regimes governing investment advisers and broker-dealers. What once were real distinctions in the businesses of advisers and broker-dealers are no longer so clear, to the point that retail investors are largely unable to distinguish the services of an adviser from those of a broker-dealer. These two types of financial intermediaries, and their customers and clients, deserve a coherent regulatory structure that provides adequate investor protections without overlapping or unnecessary regulation. Of particular importance is devising a consistent standard of care in which

investor protection must be paramount. The standard thus should be a high one. We recommend that both types of intermediaries be held to a fiduciary duty to their clients.[4]

IV. RECENT MARKET EVENTS AND MONEY MARKET FUNDS

Evolution and Current Significance of Money Market Funds

Money market funds are registered investment companies that seek to maintain a stable net asset value (NAV), typically $1.00 per share. They are comprehensively regulated under the Investment Company Act and subject to the special requirements of Rule 2a-7 under that Act that limit the funds' exposure to credit risk and market risk.

These strong regulatory protections, administered by the SEC for nearly three decades, have made money market funds an effective cash management tool for retail and institutional investors. Indeed, money market funds represent one of the most notable product innovations in our nation's history, with assets that have grown more than 2,000 percent (from about $180 billion to $3.9 trillion) since Rule 2a-7 was adopted in 1983. Money market fund assets thus represent about one third of an estimated $12 trillion U.S. "money market," the term generally used to refer to the market for debt securities with a maturity of one year or less.[5]

Money market funds also are an exceptionally important source of short-term financing in the U.S. economy. They lower the cost of borrowing to the U.S. Treasury, businesses, and banks and finance companies by investing in a wide array of money market instruments. By way of example,

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[4] *See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 84 S. Ct. 275 (1963) (holding that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers by operation of law).

[5] Other participants in the money market include corporations, state and local governments, unregistered cash pools, commercial banks, broker-dealers, and pension funds.

money market funds hold roughly 40 percent of the commercial paper issued by U.S. corporations. In addition, tax-exempt money market funds are a significant source of funding for state and local governments. As of December 2008, these funds had $491 billion under management. Tax-exempt money market funds held more than 20 percent of all state and local government debt outstanding.

Money market funds seek to offer investors stability of principal, liquidity, and a market-based rate of return, all at a reasonable cost. Although there is no guarantee that money market funds can always achieve these objectives (and investors are explicitly warned of this), they have been highly successful in doing so. Since Rule 2a-7 was adopted over 25 years ago, $325 trillion has flowed in and out of money market funds. Yet only twice has a money market fund failed to repay the full principal amount of its shareholders' investments. One of these instances is directly related to recent market events and is discussed below. The other occurred in 1994, when a small institutional money market fund "broke the buck" because it had a large percentage of its assets in adjustable-rate securities that did not return to par at the time of an interest rate readjustment. Shareholders in that fund ultimately received $0.96 per share (representing a 4 percent loss of principal). In contrast, during roughly the same time period, nearly 2,400 commercial banks and savings institutions have failed in the United States.

Impact of Recent Market Events

Until September 2008, money market funds largely had weathered severe pressures in the fixed income market that had been striking banks and other financial services firms since 2007.[6] That

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[6] During the period from September 2007 to September 2008, many money market fund advisers or related persons did purchase structured investment vehicles from, or enter into credit support arrangements with, their affiliated funds to avoid any fund shareholder losses.

changed as a series of extraordinary events, in rapid succession, roiled financial markets both in the United States and around the globe:

- On September 7, the U.S. Government placed Fannie Mae and Freddie Mac into receivership, wiping out shareholder equity;
- Long-circulated rumors about the stability of Merrill Lynch, AIG, and Lehman Brothers gained traction;
- Over the weekend of September 13-14, Merrill Lynch hastily arranged to be sold to Bank of America;
- On September 15, the federal government declined to support Lehman Brothers, despite having arranged a buyout of Bear Stearns, a smaller investment bank, earlier in the year. Unable to find a buyer, Lehman declared bankruptcy; and
- On September 16, the Federal Reserve Board announced a bailout of AIG, in which the Federal Reserve Bank of New York agreed to lend AIG up to $85 billion and to take a nearly 80 percent stake in the company.

Beginning with news of the Lehman bankruptcy on Monday, September 15, money markets in the U.S. and elsewhere began to freeze, with a severity that was unexpected. Although Lehman's viability had been questioned for several months, its failure—and that of Bear Stearns several months earlier—led to mounting concerns about the health of other financial institutions such as Wachovia, Citigroup, and many foreign banks. There was also growing uncertainty about whether and how the U.S. and foreign governments would support these institutions and their creditors.

With investors running for cover, yields on Treasury securities fell, while those on commercial paper jumped. Inter-bank rates soared with the uncertainty about financial institutions' exposure to Lehman and other failing financial institutions. Governments around the globe, attempting to calm panicked markets, injected billions of dollars of liquidity into their markets. The U.S. stock market declined nearly 5 percent on September 15 alone, reflecting broad losses to financial companies.

Certainly the Federal Reserve seems to have been surprised by the market's reaction to this chain of events. Appearing before this Committee on September 23, 2008, Federal Reserve Chairman Ben Bernanke noted:

> The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized—as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps—that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures. While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets.

Intense pressure in the money market was brought to bear, affecting all market participants. In the midst of this market storm, a further pressure point occurred for money market funds. The Lehman bankruptcy meant that securities and other instruments issued by Lehman became ineligible holdings for money market funds, in accordance with the requirements of Rule 2a-7. One such fund that held a substantial amount of Lehman Brothers commercial paper, the $62 billion Reserve Primary Fund, received $25 billion in redemption requests on September 15; the following day, September 16, its NAV dropped below $1.00 per share. News of this development, combined with investors' broader concerns about the building stresses in the money market and possible failures of other financial institutions, led to heavy redemptions in prime money market funds as investors sought safety and liquidity in Treasury securities. To meet these unprecedented redemption requests, many money market funds were forced to sell commercial paper and other assets. It should be emphasized that other market participants, including unregistered cash pools seeking to maintain a stable NAV but not subject to Rule 2a-7, and money market funds in other jurisdictions, experienced difficulties as least as great as those experienced by U.S. registered money market funds.

Actions by Federal Regulators to "Unfreeze" the Credit Markets

The Federal Reserve and U.S. Treasury Department, seeking to cope with completely illiquid short-term fixed income markets, on September 19 announced a series of unprecedented initiatives designed to provide market stability and liquidity, including programs designed to support money market funds and the commercial paper market. The Federal Reserve established the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and the Commercial Paper Funding Facility (CPFF).[7] The Treasury Department announced its Temporary Guarantee Program for Money Market Funds, which guaranteed account balances as of September 19 in money market funds that signed up for, qualified for, and paid a premium to participate in the program. According to press reports, virtually all money market funds signed up for the initial term of the Treasury Temporary Guarantee Program.

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[7] The AMLF provided non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance purchases of high-quality asset-backed commercial paper (ABCP) from money market funds. The CPFF provided a backstop to U.S. issuers of commercial paper through a special purpose vehicle that would purchase three-month unsecured commercial paper and ABCP directly from eligible issuers. On February 3, 2009, the Federal Reserve extended these and other programs for an additional six months, until October 30, 2009.

The government's programs successfully bolstered investor confidence in the money market and in money market funds. Shortly after the programs were announced, prime money market funds stabilized and, by mid-October 2008, began to see inflows once again. By February 2009, owing to renewed confidence in money market funds at both the retail and institutional levels, assets of money market funds had achieved an all-time high of just less than $3.9 trillion.

The initial three-month term of the Treasury Temporary Guarantee Program expired on December 18, 2008, but the Treasury Department extended the program until April 30, 2009. If extended again, the program will expire by its own terms no later than September 18, 2009. At the time of this hearing, an estimated $813 million has been paid in premiums.[8] There has been—and we are hopeful that there will be—no occasion for the Treasury Guarantee Program to pay *any* claim. Assuming continued progress in restoring the health of the money market, we would not anticipate any need to extend the Treasury Guarantee Program beyond the one-year maximum period.

Industry-Led Reform Initiative

The market events described above have brought into sharp focus the significance of money market funds and the critical role they play as a low-cost funding vehicle for the American economy. To us, these events and their impact also signaled a need to devote serious effort to capturing the lessons learned—by conducting a thorough examination of how the money market can function better, and how all funds operating in that market, including registered money market funds, should be regulated.

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[8] *See* Shefali Anand, "Treasury Pads Coffers in Bailout," *The Wall Street Journal* (February 17, 2009), available at http://online.wsj.com/article/SB123483112001495707.html.

To that end, in November 2008 ICI formed a Money Market Working Group, led by John J. Brennan, Chairman of The Vanguard Group. The Working Group was given a broad mandate to develop recommendations to improve the functioning of the money market as a whole, and the operation and regulation of funds investing in that market. The Working Group intends to report its findings, conclusions, and recommendations later this month, and we look forward to sharing that information with the Committee at that time. We believe that prompt implementation of the Working Group's recommendations will help assure a smooth transition away from the Treasury Guarantee Program.

IV. CONCLUSION

ICI applauds the Committee for its diligent efforts on the very important issues discussed above, and we thank you for the opportunity to testify. We believe our recommendations for reforming financial services regulation would have significant benefits for investors and the capital markets. We look forward to continuing to work with the Committee and its staff on these matters.

Appendix A

Investment Company Institute

Financial Services Regulatory Reform: Discussion and Recommendations

March 3, 2009

INVESTMENT COMPANY INSTITUTE®

EXECUTIVE SUMMARY

Today's financial crisis has demonstrated that the current system for oversight of U.S. financial institutions is insufficient to address modern financial markets. Yet it also affords policymakers with the public mandate necessary to take bold steps to strengthen and modernize regulatory oversight of the financial services industry. In this paper, the Investment Company Institute (ICI), the national association of U.S. investment companies, offers its recommendations on how to achieve meaningful reforms, with particular emphasis on those reforms that most directly affect the functioning of the capital markets and the regulation of investment companies (also referred to as "funds").

To improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system, ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." As the financial crisis has shown, our system is vulnerable to risks that have the potential to spread rapidly throughout the system and cause significant damage. The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators. At the same time, very careful consideration should be given to the specifics of how the Systemic Risk Regulator will be authorized to perform its functions and how it will relate to other financial regulators.

More broadly, ICI recommends changes to create a regulatory framework that enhances regulatory efficiency, limits duplication, closes regulatory gaps, and emphasizes the national character of the financial services industry. A new "Capital Markets Regulator" should encompass the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission, thus creating a single independent federal regulator responsible for oversight of U.S. capital markets, market participants, and all financial investment products. Also to achieve these goals, ICI recommends that Congress consider consolidation of the regulatory structure for the banking sector and authorization of an optional federal charter for insurance companies. Such a regulatory framework—with one or more dedicated regulators to oversee each major financial services sector—would maintain specialized regulatory focus and expertise, as well as avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or the allocation of resources.

To preserve regulatory efficiencies achieved under the National Securities Markets Improvement Act of 1996, Congress should affirm the role of the Capital Markets Regulator as the regulatory standard setter for all registered investment companies. The Capital Markets Regulator's jurisdiction should include money market funds.[1] ICI further envisions the Capital Markets Regulator as the first line of defense with respect to risks across the capital markets. The new agency should be granted explicit authority to regulate in certain areas where there are currently gaps in regulation—in particular, with

[1] ICI has formed a Money Market Working Group that is developing recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. The group will identify needed improvements in market and industry practices; regulatory reforms, including improvements to SEC rules governing money market funds; and possibly legislative proposals. The Working Group expects to report its recommendations in the first quarter of 2009.

regard to hedge funds, derivatives, and municipal securities—and explicit authority to harmonize the legal standards applicable to investment advisers and broker-dealers. In performing its mission, the Capital Markets Regulator should maintain a sharp focus on investor protection and law enforcement. It also should be required to carefully consider the impact of its rulemaking activity on efficiency, competition and capital formation.

Establishing the Capital Markets Regulator presents a very valuable opportunity to "get it right" in terms of how the agency is organized and managed. It is imperative, for example, that the Capital Markets Regulator be able to keep current with market and industry developments and understand their impact on regulatory policy. Ways to achieve this end include hiring more agency staff with significant prior industry experience and establishing a multidisciplinary "Capital Markets Advisory Committee" comprised of private sector representatives from all major sectors of the capital markets. There should be a high-level focus on agency management, perhaps through the designation of a Chief Operating Officer. To perform effectively, the agency must have open and effective lines of internal communication, and mechanisms to facilitate internal coordination and information sharing. We further suggest that the agency would benefit from a comprehensive process for setting regulatory priorities and assessing progress.

Finally, if a new U.S. financial regulatory structure is to be successful in protecting the interests of our nation's savers and investors, there is a critical need for effective coordination and information sharing among the financial regulators, including in particular the Systemic Risk Regulator. Stronger links between regulators and an overriding sense of shared purpose would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community. ICI observes that the President's Working Group on Financial Markets, with certain modifications, may be the most logical mechanism through which to accomplish this purpose.

We strongly believe that the future of the fund industry depends upon the existence of strong, well-regulated financial institutions operating within a well-regulated financial marketplace that will promote investor confidence, attract global financial business, and enable our institutions to compete more effectively. ICI looks forward to working with other stakeholders and policymakers to strengthen the U.S. financial services regulatory system and to improve its ability to meet new challenges posed by the continuing evolution of the financial markets, market participants, and financial products.

ABOUT ICI

The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $9.88 trillion and serve over 93 million shareholders.

I. INTRODUCTION

Well before mainstream Americans felt the widespread effects of the current financial crisis, many policymakers and commentators were calling for financial services regulatory reform.[2] These efforts reflected general agreement that our current organization for oversight of financial institutions is insufficient to address modern financial markets. Recent market events have served to put into much sharper focus the many weaknesses of the current system and the many important linkages that exist between and among the U.S. financial markets and the markets of other developed nations.

Yet the current financial crisis also offers an important opportunity—the chance to have a frank and robust public dialogue about what works and what does not. It further affords policymakers with the public mandate necessary to take bold steps to strengthen and modernize regulatory oversight of the financial services industry.

The debate over financial services regulatory reform will require careful consideration of a multitude of complicated and interconnected issues, and there are many stakeholders in the eventual outcomes of this debate—most importantly, the nation's savers and investors. In this paper, the Investment Company Institute (ICI), the national association of U.S. investment companies,[3] offers its recommendations on how to achieve meaningful reform of financial services regulation. We give particular emphasis to reforms that most directly affect the functioning of the capital markets and the regulation of investment companies (also referred to as "funds").

Investment companies have a unique perspective on our regulatory system, as both issuers of securities and investors in domestic and international securities markets. It has been our experience that, in large measure, the needs of issuers and investors are aligned—that both will benefit from broad and efficient markets, transparency of information, strong investor protections, and within that context, the elimination of unnecessary regulatory impediments to innovation.

We strongly believe that the future of our industry depends upon the existence of strong, well-regulated financial institutions operating within a well-regulated financial marketplace that will promote investor confidence, attract global financial business and enable our institutions to compete more effectively. The reforms suggested in this paper should help to build and foster such a financial system.

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[2] *See, e.g.*, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (March 2008) ("Treasury Blueprint"), available at http://www.treas.gov/press/releases/reports/Blueprint.pdf; Report and Recommendations: Commission on the Regulation of U.S. Capital Markets in the 21st Century, U.S. Chamber of Commerce (March 2007), available at http://www.capitalmarketscommission.com/portal/capmarkets/default.htm; *Sustaining New York's and the US' Global Financial Services Leadership* (report by McKinsey & Co., Jan. 2007), at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf; Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006), available on the Committee's website at http://www.capmktsreg.org/research.html.

[3] ICI members include mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts (UITs).

Our recommendations and the benefits they are designed to achieve are summarized in Section II below. We elaborate on our recommendations in Section III (Establishment of a Systemic Risk Regulator), Section IV (Formation of a New Capital Markets Regulator), Section V (Regulatory Structure Affecting Other Financial Institutions), and Section VI (Enhanced Inter-agency Coordination and Information Sharing). In Section VII, we discuss in detail the expected benefits from these reforms.

A host of different reform proposals are being advanced—by the new Administration, members of Congress, industry groups, academics, and others. ICI will closely follow these developments and participate in this debate on behalf of the fund industry. We also may refine as appropriate the views expressed in this paper.

II. SUMMARY OF RECOMMENDATIONS AND EXPECTED BENEFITS

Recommendations for Reform

ICI recommends that Congress:

- Designate a new or existing agency or inter-agency body to act as a Systemic Risk Regulator.

- Establish a new Capital Markets Regulator encompassing the combined functions of the Securities and Exchange Commission and the Commodity Futures Trading Commission. The Capital Markets Regulator should:

    - be the regulatory standard setter for all registered investment companies, including money market funds;

    - have explicit authority to regulate in certain areas where there are currently gaps in regulation and to harmonize the legal standards that apply to investment advisers and broker-dealers;

    - maintain a sharp focus on investor protection and law enforcement;

    - carefully consider as well the impact of its rulemaking activity on efficiency, competition and capital formation;

    - serve as the first line of defense with respect to risks across the capital markets as a whole; and

    - take proactive steps to maximize its continuing effectiveness, including: establishing the conditions necessary for ongoing dialogue with the regulated industry; establishing mechanisms to stay abreast of market/industry developments; and developing strong capability to conduct economic analysis to support sound rulemaking and oversight.

- Consider consolidation of the regulatory structure for the banking sector.

- Authorize an optional federal charter for insurance companies.

- Enhance inter-agency coordination and information sharing efforts, including by modernizing the Executive Order authorizing the President's Working Group on Financial Markets.

Expected Benefits of these Reforms

ICI believes the principal benefits of these reforms would be to:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system.

- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry.

- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products.

- Preserve specialized regulatory focus and expertise and avoid potential uneven attention to different industries or products.

- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern.

- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

III. ESTABLISHMENT OF A SYSTEMIC RISK REGULATOR

Over the past year, various policymakers and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks to the financial system as a whole. For example, in a March 2008 speech, House Financial Services Committee Chairman Barney Frank (D-MA) recommended that Congress consider establishing a "Financial Services Systemic Risk Regulator" that has the capacity and power to assess risk across financial markets and to intervene when appropriate.[4] Around the same time, then-Senator Barack Obama highlighted the need for a process that identifies systemic risks to the financial system.[5]

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[4] *See Frank Calls for Significant Changes in Financial Services Regulation*, Press Release (March 20, 2008), available at http://financialservices.house.gov/press110/press0320082.shtml. Likewise, the Treasury Blueprint issued shortly thereafter suggested that an optimal regulatory structure would include the designation of a market stability regulator responsible for overall issues of financial market stability.

[5] *See Remarks of Senator Barack Obama: Renewing the American Economy,* New York, NY (March 27, 2008), available at http://www.barackobama.com/2008/03/27/remarks_of_senator_barack_obam_54.php.

The deepening financial crisis has further exposed the vulnerability of our financial system to risks that have the potential to spread rapidly throughout the system and cause significant damage. It has led to a growing consensus that bold steps are needed to equip regulators to better anticipate and address such risks. Analyses of the causes of the current crisis suggest that systemic risks may be occasioned by, for example: (1) excessive leveraging by financial institutions; (2) a lack of transparency regarding risky practices; and (3) institutions or activities that fall through gaps in the regulatory framework. Systemic risks—whether they are attributable to excessive risk taking by some market participants or to other causes—can negatively impact investment companies, thereby making it more difficult for their shareholders to achieve important financial goals.

Subject to important cautions, ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." Broadly stated, the goal in establishing a Systemic Risk Regulator should be to provide greater overall stability to the financial system as a whole. The Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas markets; (3) evaluating the risks of practices as they evolve and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators.

Very careful consideration must be given to the specifics of how the Systemic Risk Regulator will be authorized to perform its functions. In particular, the legislation establishing the Systemic Risk Regulator should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies. By way of example, it has been suggested that a Systemic Risk Regulator could be given the authority to identify financial institutions that are "systemically significant" and to oversee those institutions directly. Despite its seeming appeal, such an approach could have very serious anticompetitive effects if the identified institutions were viewed as "too big to fail" and thus judged by the marketplace as safer bets than their smaller, "less significant" competitors.[6]

Additionally, the Systemic Risk Regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance. Legislation establishing the Systemic Risk Regulator thus should define the nature of the relationship between this new regulator and the primary regulator(s) for each industry sector. This should involve placing explicit limitations on the extent of the authority granted to the Systemic Risk Regulator, as well as identifying specific areas in which the Systemic Risk Regulator and primary regulator(s) should work together. We believe, for example, that the primary regulators have a critical role to play by acting as the first line of defense with regard to detecting potential risks within their spheres of expertise.

How these issues are resolved will have a very real impact on registered investment companies, as both issuers and investors in the capital markets. Money market funds, for example, are comprehensively regulated under the Investment Company Act of 1940 and subject to special requirements that limit

[6] *See, e.g.*, Peter J. Wallison, *Regulation Without Reason: The Group of Thirty Report*, AEI Financial Services Outlook (Jan. 2009), available at http://www.aei.org/publications/pubID.29285/pub_detail.asp.

the fund's exposure to credit risk and market risk.[7] These strong regulatory protections, administered by the SEC for nearly three decades, have made money market funds an effective cash management tool for retail and institutional investors and an important source of short-term financing for American business and municipalities. Given the size of this industry segment[8] and its important role in our nation's money markets, money market funds are likely to be on the radar screen of the Systemic Risk Regulator as it monitors the financial markets. The type of information about money market funds that the Systemic Risk Regulator may need to perform this function, and how the regulator will obtain that information, are just two of the specific issues that will need to be carefully considered. As a threshold matter, however, ICI firmly believes that regulation and oversight of money market funds must be the province of the Capital Markets Regulator.

ICI will closely follow the debate over the establishment of a Systemic Risk Regulator, and will inform policymakers as to the fund industry's views of future proposals.

IV. FORMATION OF A NEW CAPITAL MARKETS REGULATOR

Currently, securities and futures are subject to separate regulatory regimes under different federal regulators. This system reflects historical circumstances that have changed significantly. As recently as the mid-1970s, for example, agricultural products accounted for most of the total U.S. futures exchange trading volume. By the late 1980s, a shift from the predominance of agricultural products to financial instruments and currencies was readily apparent in the volume of trading on U.S. futures exchanges. In addition, as new, innovative financial instruments were developed, the lines between securities and futures often became blurred. The existing, divided regulatory approach has resulted in jurisdictional disputes, regulatory inefficiency, and gaps in investor protection. With the increasing convergence of securities and futures products, markets, and market participants, the current system makes little sense. To bring a consistent policy focus to U.S. capital markets, we recommend the creation of a Capital Markets Regulator as a new agency that would encompass the combined functions of the SEC and the CFTC.

As the federal regulator responsible for overseeing all financial investment products, it is imperative that the Capital Markets Regulator—like the SEC and the CFTC—be established by Congress as an independent agency, with an express statutory mission and the rulemaking and enforcement powers necessary to carry out that mission.[9] A critical part of that mission should be for the new agency to maintain a sharp focus on investor protection and law enforcement. And Congress should ensure that the agency is given the resources it needs to fulfill its mission. Most notably, the Capital Markets Regulator must have the ability to attract personnel with the necessary market experience to fully grasp the complexities of today's global marketplace.

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[7] The term "credit risk" refers to the exposure of securities, through default or otherwise, to risks associated with the creditworthiness of the issuer. The term "market risk" refers to the exposure of securities to significant changes in value due to changes in prevailing interest rates.

[8] Money market funds had assets of approximately $3.9 trillion under management as of February 2009.

[9] Currently, regulatory oversight of both the securities and futures industries involves various self-regulatory organizations. In establishing the Capital Markets Regulator, Congress will need to determine the appropriate role for any such organization(s).

A. Scope of Authority

ICI recommends that the Capital Markets Regulator assume on an integrated basis the responsibilities currently handled by the SEC and the CFTC. For the SEC, those functions include requiring public companies to disclose financial and other information to the public; overseeing various market participants, including securities exchanges, broker-dealers, investment advisers, and investment companies; and enforcing the securities laws. The SEC also oversees the setting of accounting standards for public companies. For its part, the CFTC regulates the commodity futures and option markets. It oversees various entities including exchanges, clearing facilities, and market participants such as futures commission merchants, commodity pool operators, and commodity trading advisors. Through its oversight and enforcement powers, it seeks to protect market users and the public from fraud, manipulation, and abusive practices.

Of particular importance to the fund industry is to ensure that the Capital Markets Regulator is authorized: (1) to act as the regulatory standard setter for all registered investment companies, as is the case now with the SEC; (2) to regulate in certain areas where there are currently gaps that have the potential to impact the capital markets and market participants; and (3) to regulate broker-dealers and investment advisers in a consistent manner when they provide similar services to investors.

1. Regulation of Registered Investment Companies

In creating the new regulator, Congress should take note of the important benefits that have flowed from the shared system of federal-state oversight established by the National Securities Markets Improvement Act of 1996 (NSMIA). Under this system, federal law governs all substantive regulation of investment companies and states have concurrent authority to protect against fraud. NSMIA represented the judgment of Congress that "the system of dual federal and state securities regulation ha[d] resulted in a degree of duplicative and unnecessary regulation … that, in many instances, [was] redundant, costly, and ineffective."[10] In recognition of the national character of the market in which investment companies operate, and to secure the regulatory efficiencies Congress intended, Congress should affirm the role of the Capital Markets Regulator as the regulatory standard setter for registered investment companies. The Capital Markets Regulator's regulatory jurisdiction should include the authority to regulate money market funds.[11]

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[10] Joint Explanatory Statement of the Committee of Conference, Conference Report—National Securities Markets Improvement Act of 1996, H.R. 3005, H.R. CONF. REP. NO. 104-864 (1996).

[11] ICI has formed a Money Market Working Group that is developing recommendations to improve the functioning of the money market and the operation and regulation of funds investing in that market. The group will identify needed improvements in market and industry practices; regulatory reforms, including improvements to SEC rules governing money market funds; and possibly legislative proposals. The Working Group expects to report its recommendations in the first quarter of 2009.

2. Regulatory Gaps

The Capital Markets Regulator should have express regulatory authority in the following areas:

- ***Hedge funds and other unregulated private pools of capital.*** The Capital Markets Regulator should be authorized to provide oversight over hedge funds and other unregulated pooled products with respect to, at a minimum, their potential impact on the capital markets (*e.g.*, require nonpublic reporting of information such as investment positions and strategies that could bear on systemic risk and adversely impact other market participants).

- ***Derivatives.*** The Capital Markets Regulator should have clear authority to adopt measures to increase transparency and reduce counterparty risk of certain over-the-counter derivatives, while not unduly stifling innovation.

- ***Municipal Securities.*** The Capital Markets Regulator should be granted expanded authority over the municipal securities market, and use this authority to ensure that investors have timely access to relevant and reliable information about municipal securities offerings. Currently, the SEC and the Municipal Securities Rulemaking Board are prohibited from requiring issuers of municipal securities to file disclosure documents before the securities are sold. As a result, existing disclosures are limited, non-standardized and often stale, and there are numerous disparities from the corporate issuer disclosure regime.

3. Regulation of Investment Advisers and Broker-Dealers

The Capital Markets Regulator also should have explicit authority to harmonize the regulatory regimes governing investment advisers and broker-dealers. What once were real distinctions in the businesses of advisers and broker-dealers are no longer so clear, to the point that retail investors are largely unable to distinguish the services of an adviser from those of a broker-dealer. These two types of financial intermediaries, and their customers and clients, deserve a coherent regulatory structure that provides adequate investor protections—including, in particular, a consistent standard of care—without overlapping or unnecessary regulation.

B. Mission

The SEC describes its mission as "to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation." For its part, the CFTC states that its mission is "to protect market users and the public from fraud, manipulation and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and options markets." The differing focus expressed in these two mission statements is reflective of historical distinctions in the securities and futures industries, including with regard to the purposes of their respective markets and the participants in those markets. As growing convergence within these two industries suggests the creation of a unified regulator for the capital markets, it is important to consider how the mission statement for the new regulator can best reflect this convergence.

From the perspective of the fund industry, the mission of the Capital Markets Regulator must involve maintaining a sharp focus on investor protection, supported by a comprehensive enforcement program. This core feature of the SEC's mission has consistently distinguished the agency from the banking regulators, who are principally concerned with the safety and soundness of the financial institutions they regulate, and it has generally served investors well over the years.

At the same time, the SEC is required by NSMIA to consider, in determining whether a proposed regulation is consistent with the public interest, both the protection of investors *and* whether the regulation would promote efficiency, competition and capital formation. This NSMIA requirement suggests that Congress did not view investor protection and efficiency, competition, and capital formation as being competing considerations, but rather determined that each is relevant to the development of sound capital markets regulation. We strongly believe that the Capital Markets Regulator should be subject to the same requirements.[12] Investors are not well served, for example, by rulemaking actions that create significant inefficiencies or have anti-competitive effects in the marketplace, which ultimately result in increased costs for investors.

Combining the market-related missions of the SEC and CFTC should be more straightforward. Generally speaking, each agency is called upon to maintain the integrity of the markets under its jurisdiction. The same must be true for the new Capital Markets Regulator. As the ongoing financial crisis demonstrates, it is imperative that the task of maintaining market integrity be viewed broadly to include monitoring and addressing risks across the markets as a whole. Formally assigning some level of responsibility to the Capital Markets Regulator in this area makes sense. Given its expertise and its position as the primary regulator of these markets, the Capital Markets Regulator can serve as the first line of defense with regard to detecting problems in the capital markets. While this approach could result in some potential overlap with the responsibilities of the Systemic Risk Regulator, we believe that any inefficiencies may be minimized through effective coordination and information sharing.

C. Agency Management and Organization

It is axiomatic in the private sector that a company's success is directly related to the soundness of its management. The same principle holds true for public sector entities. But management improvements take time and serious attention, not to mention allocation of resources. Given that they often experience frequent turnovers in leadership and strained resources, it is not surprising that government agencies can find it particularly difficult to undertake and sustain significant management reforms. Establishing a new agency presents a very valuable opportunity to "get it right" as part of that process.

There is also an opportunity to make sound decisions up-front about how to organize the new agency. In so doing, it is important not to simply use the current structure of the SEC and/or the CFTC as a starting point. In the case of the SEC, for example, its current organizational structure largely took shape in the early 1970s and reflects the operation of the securities markets of that day. Rather, the objective should be to build an organization that not only is more reflective of today's markets, market participants and investment products, but also will be flexible enough to regulate the markets and products of tomorrow.

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[12] Curiously, the SEC's description of its own mission (*see* http://www.sec.gov/about/whatwedo.shtml) omits any reference to promoting competition—notwithstanding the specific requirement under NSMIA to consider this factor.

We offer the following thoughts with regard to management and organization of the Capital Markets Regulator:

- ***Ensure high-level focus on agency management.*** One approach would be to designate a Chief Operating Officer for this purpose.

- ***Implement a comprehensive process for setting regulatory priorities and assessing progress.*** It may be helpful to draw upon the experience of the United Kingdom's Financial Services Authority, which seeks to follow a methodical approach that includes developing a detailed annual business plan establishing agency priorities and then reporting annually the agency's progress in meeting prescribed benchmarks.

- ***Promote open and effective lines of communication among the regulator's Commissioners and between its Commissioners and staff.*** Such communication is critical to fostering awareness of issues and problems as they arise, thus increasing the likelihood that the regulator will be able to act promptly and effectively. A range of approaches may be appropriate to consider in meeting this goal, including whether sufficient flexibility is provided under the Government in the Sunshine Act, and whether the number of Commissioners should be greater than the current number at the SEC and at the CFTC (currently, each agency has five).

- ***Align the inspections and examinations functions and the policymaking divisions.*** This approach would have the benefit of keeping staff in the policymaking divisions updated on current market and industry developments, as well as precluding any *de facto* rulemaking by the regulator's inspections staff.

- ***Develop mechanisms to facilitate coordination and information sharing among the policymaking divisions.*** These mechanisms would help to ensure that the regulator speaks with one voice.

D. Additional Steps To Maximize Effectiveness

ICI believes that the following proactive steps will greatly enhance the ability of the Capital Markets Regulator to fulfill its mission successfully when carrying out its regulatory responsibilities and should be priorities for the new agency.

1. Establish the conditions necessary for constructive, ongoing dialogue with the regulated industry

The Capital Markets Regulator should seek to facilitate closer, cooperative interaction with the entities it regulates to identify and resolve problems, to determine the impact of problems or practices on investors and the market, and to cooperatively develop best practices that can be shared broadly with market participants. Incorporating a more preventative approach would likely encourage firms to step forward with self-identified problems and proposed resolutions. The net result is that the Capital Markets Regulator would pursue its investor protection responsibilities through various means not always involving enforcement measures, although strong enforcement must remain an important weapon in the regulator's arsenal.

2. Establish mechanisms to stay abreast of market and industry developments

The Capital Markets Regulator would benefit from the establishment of one or more external mechanisms designed to help the agency stay abreast of market and industry issues and developments, including developments and practices in non-U.S. jurisdictions as appropriate. For example, several federal agencies—including both the SEC and CFTC—utilize a range of advisory committees. Such committees, which generally have significant private sector representation, may be established to provide recommendations on a discrete set of issues facing the agency (*e.g.*, the SEC's Advisory Committee on Improvements to Financial Reporting) or to provide regular information and guidance to the agency (*e.g.*, the CFTC's Agricultural Advisory Committee).

ICI believes that a multidisciplinary "Capital Markets Advisory Committee" could be a very effective mechanism for providing the Capital Markets Regulator with "real world" perspectives and insights on an ongoing basis. We recommend that such a committee be comprised primarily of private sector representatives from all major sectors of the capital markets, and include one or more members representing funds and asset managers. Additionally, the Capital Markets Advisory Committee should be specifically established in, and required by, the legislation creating the Capital Markets Regulator. Such a statutory mandate would emphasize the importance of this advisory committee to the agency's successful fulfillment of its mission.

The establishment of an advisory committee would complement other efforts by the Capital Markets Regulator to monitor developments affecting the capital markets and market participants. These efforts should include, first and foremost, hiring more staff members with significant prior industry experience. Their practical perspective would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy.

3. Apply reasonably comparable regulation to like products and services

Different investment products often are subject to different regulatory requirements, often with good reason. At times, however, heavier regulatory burdens have been placed on funds than on other investment products that share similar features and are sold to the same customer base. It does not serve investors well if the regulatory requirements placed on funds—however well-intentioned—end up discouraging investment advisers from entering or remaining in the fund business, dissuading portfolio managers from managing funds as opposed to other investment products, or creating disincentives for brokers and other intermediaries to sell fund shares. It is critically important for the Capital Markets Regulator to be sensitive to this dynamic in its rulemakings. Among other things, in analyzing potential new regulatory requirements for funds, the Capital Markets Regulator should consider whether other investment products raise similar policy concerns and thus should be subject to comparable requirements.

4. Develop strong capability to conduct economic analysis to support sound rulemaking and oversight

The Capital Markets Regulator will be best positioned to accomplish its mission if it conducts economic analysis in various aspects of the agency's work, including rulemaking, examinations, and enforcement. Building strong economic research and analytical capabilities is an important way to enhance the mix of disciplines that will inform the agency's activities. From helping the agency look at broad trends that shed light on how markets or individual firms are operating to enabling it to demonstrate that specific policy initiatives are well-grounded, developing the agency's capability to conduct economic analysis will be well worth the long-term effort required. The agency should consider having economists resident in each division to bring additional, important perspectives to bear on regulatory challenges.

It is important that economic analysis play an integral role in the rulemaking process, because many regulatory costs ultimately are borne by investors. When new regulations are required, or existing regulations are amended, the Capital Markets Regulator should thoroughly examine all possible options and choose the alternative that reflects the best trade-off between costs to, and benefits for, investors. Effective cost-benefit analysis does not mean compromising protections for investors or the capital markets. Rather, it challenges the regulator to consider alternative proposals and think creatively to achieve appropriate protections while minimizing regulatory burdens, or to demonstrate that a proposal's costs and burdens are justified in light of the nature and extent of the benefits that will be achieved.[13]

5. Modernize regulations that no longer reflect current market structures and practices

Financial markets and related services are constantly evolving, frequently at a pace that can make the regulations governing them (or the rationale behind those regulations) become less than optimal, if not entirely obsolete. Requiring industry participants to comply with outmoded regulations imposes unnecessary costs on both firms and investors, may impede innovation, and, most troubling of all, could result in inadequate protection of investors. It is thus important that the Capital Markets Regulator engage in periodic reviews of its existing regulations to determine whether any such regulations should be modernized or eliminated.

6. Give heightened attention to investor education

During the course of their lives, investors are called upon to make a variety of investment decisions as their personal circumstances change. These decisions may involve saving to buy a home or to finance a child's education, building an adequate nest egg for retirement, or investing an inheritance, to name a few. Whether they make their investment decisions individually or with the help of a financial adviser, investors need to be able to make *informed* decisions based upon their individual needs.

[13] *See, e.g.*, *Special Report on Regulatory Reform*, Congressional Oversight Panel (submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008) (Jan. 2009) ("In tailoring regulatory responses ... the goal should always be to strike a reasonable balance between the costs of regulation and its benefits. Just as speed limits are more stringent on busy city streets than on open highways, financial regulation should be strictest where the threats—especially the threats to other citizens—are greatest, and it should be more moderate elsewhere.").

The recent turmoil in the financial markets has underscored how important it is that investors be knowledgeable and understand their investments. Well-informed investors are more likely to develop realistic expectations, take a long-term perspective, and understand the trade-off between risk and reward. They are less likely to panic and make mistakes.

To better equip investors to make good decisions about their investments, the Capital Markets Regulator should assign a high priority to pursuing regulatory initiatives that will help educate investors. The SEC's new rule allowing mutual funds and exchange-traded funds to provide a "summary prospectus" containing key fund information to investors—while making additional information available online or by mail or email upon request—is an excellent example of a forward-thinking approach to better informing investors. It should serve as a model for future disclosure improvement efforts, such as reform of fund shareholder reports. Regulatory efforts to promote investor education also should extend beyond funds. Investors who purchase other types of investment products or services, such as separately managed accounts, likewise would benefit from clear, concise, understandable disclosure. In addition, appropriately fashioned point of sale disclosure would help investors in all types of retail investment products assess and evaluate broker recommendations.

The SEC has an Office of Investor Education and Advocacy and provides some investor education resources on its website. These types of efforts should be expanded, possibly in partnership with other governmental or private entities, and better publicized. Many industry participants, too, have developed materials and other tools to help educate investors; additional investor outreach efforts should be encouraged.

E. Process of Merging the SEC and CFTC

Legislation to merge the SEC and CFTC should outline a process by which to harmonize the very different regulatory philosophies of the two agencies, as well as to rationalize their governing statutes and current regulations. We note that there is potential peril in leaving open-ended the process of merging the two agencies. We accordingly recommend that the legislation creating the Capital Markets Regulator set forth a specific timetable, with periodic benchmarks and accountability requirements, so as to ensure that the merger of the SEC and CFTC is completed as expeditiously as possible.

The process of merging the two agencies will be lengthy, complex, and have the potential to disrupt the functioning of the SEC, CFTC, and their regulated industries. We suggest that, in anticipation of the merger, the SEC and CFTC undertake detailed consultation on all relevant issues and take all steps possible toward greater harmonization of the agencies. This work should be facilitated by the Memorandum of Understanding the two agencies signed last year regarding coordination in areas of common regulatory interest.[14] ICI believes that its recommendations with respect to the Capital Markets Regulator may provide a helpful framework for these efforts.

[14] *See SEC, CFTC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products* (SEC press release dated March 11, 2008), available at http://www.sec.gov/news/press/2008/2008-40.htm.

V. REGULATORY STRUCTURE AFFECTING OTHER FINANCIAL INSTITUTIONS

Earlier in this paper, we have recommended the establishment of a Systemic Risk Regulator, and we have discussed at length the need for a new Capital Markets Regulator to oversee markets and market participants in the securities and futures industries. In this section and the one immediately following, we comment briefly on reforms affecting the regulators overseeing other sectors of the U.S. financial system (specifically, banking and insurance) and how all regulators within the system can work together more effectively.

Regulation of the banking and insurance industries is, quite obviously, not ICI's primary area of focus. That said, regulation of these industries greatly affects the performance of the U.S. financial system as a whole and the ability of investment companies to function within that system.

ICI believes it is important, therefore, for policymakers to carefully consider how to achieve a more rational regulatory structure for the banking sector that consolidates duplicative regulatory agencies and clarifies regulatory missions. Any such analysis would no doubt need to address difficult issues concerning the future role of state banking regulators if we are to have a more rational regulatory system at the national level.

With regard to the insurance industry, ICI supports in concept the idea of creating a regulator at the federal level, a reform that has been sought by some insurance companies as a means of providing a streamlined and efficient alternative to the current system of state regulation. Authorizing an optional federal charter for insurers appears to be a logical way to bridge the gap between what exists today and the more comprehensive approach that is required for all financial institutions operating in truly national and often international markets. We also believe that a federal insurance regulator would provide an important and practical enhancement to federal inter-agency coordination and information sharing efforts, as discussed below.

VI. ENHANCED INTER-AGENCY COORDINATION AND INFORMATION SHARING

A recent report examined the benefits and shortcomings of the four primary approaches to regulatory supervision currently used in jurisdictions around the world.[15] The report observed that, regardless of the type of supervisory system in place, virtually all financial supervisors emphasized the importance of inter-agency coordination and information sharing for successful oversight of the financial system as a whole and for mitigation of systemic risk.

Effective inter-agency coordination also plays a critical role when there is a need to engage on financial services regulatory issues at an international level. The variety of supervisory systems around the world

[15] *See* Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (Oct. 6, 2008), available at http://www.deloitte.com/dtt/cda/doc/content/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf.

and the increasing globalization of financial markets make coordination among U.S. regulatory agencies all the more important.

In the United States at present, a variety of mechanisms are used to promote coordination and information sharing within our complex regulatory system, including arrangements at both the federal and state levels and arrangements among federal and state agencies. These arrangements may be specifically mandated by Congress, such as the inter-agency Federal Financial Institutions Examination Council, or may be initiated by the regulators themselves, such as the July 2008 Memorandum of Understanding between the Federal Reserve and the SEC to foster greater coordination and information sharing.[16] One particularly important mechanism for the past two decades has been the President's Working Group on Financial Markets, whose members are the heads of the Treasury Department, Federal Reserve, SEC and CFTC. As described in the Treasury Blueprint, the role of the PWG has evolved beyond the scope of the 1988 Executive Order creating it, so that the PWG has become a key communication and coordination mechanism for financial policy.

If efforts to streamline the U.S. financial regulatory structure are to be successful, some of these coordination mechanisms would almost certainly require modification or perhaps would no longer be necessary. There would, however, still be a very critical need for coordination and information sharing among the remaining regulatory bodies, presumably with involvement in particular by the Systemic Risk Regulator. The President's Working Group, with necessary modifications, would appear to be the easiest way to achieve this end.

ICI concurs with the recommendation in the Treasury Blueprint that the Executive Order authorizing the PWG should be modernized "to reinforce the group's mission and purpose … as an ongoing mechanism for coordination and communication on financial policy matters including systemic risk, market integrity, investor and consumer protection, and capital markets competitiveness." We suggest that any new Executive Order also discuss the following additional areas where inter-agency coordination and information sharing are critically important: (1) the regular exchange of information about the latest market and industry developments, including international trends and developments; (2) the discussion of policy initiatives that extend across jurisdictional lines; (3) the minimization of regulatory disparities for like financial products and services; and (4) the need to balance financial innovation with appropriate market and investor protection safeguards.

Equally important, in ICI's view, is the role of the PWG in fostering a culture of close consultation and dialogue among senior officials within each regulatory sector that will carry over into each regulator's dealings with one another. Stronger links between regulators and an overriding sense of shared purpose would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community.

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[16] *See, e.g., SEC, FRB Sign Agreement to Enhance Collaboration, Coordination and Information Sharing* (SEC press release dated July 7, 2008), available at http://www.sec.gov/news/press/2008/2008-134.htm.

VII. EXPECTED BENEFITS FROM THESE REFORMS

If implemented, the recommended reforms outlined above would help to establish a more effective and efficient regulatory structure for the U.S. financial services industry. Most significantly, these reforms would:

- Improve the U.S. government's capability to monitor and mitigate risks across our nation's financial system.

- Create a regulatory framework that enhances regulatory efficiency, limits duplication, and emphasizes the national character of the financial services industry.

- Close regulatory gaps to ensure appropriate oversight of all market participants and investment products.

- Preserve specialized regulatory focus and expertise and avoid potential uneven attention to different industries or products.

- Foster a culture of close consultation and dialogue among U.S. financial regulators to facilitate collaboration on issues of common concern.

- Facilitate coordinated interaction with regulators in other jurisdictions, including with regard to risks affecting global capital markets.

Of significant import to registered investment companies, creation of a consolidated Capital Markets Regulator would provide a single point of regulatory authority and consistent rulemaking and oversight for investment products, the capital markets, and market participants. It would create regulatory efficiencies by eliminating areas where responsibilities overlap and by ensuring against regulatory gaps and potential inconsistencies. A strong, integrated regulator for the capital markets that can see "the whole picture" will be better equipped to face the challenges of these rapidly evolving markets, and thus to protect the interests of investors.

More generally, increased consolidation of financial services regulators, combined with the establishment of a Systemic Risk Regulator and more robust inter-agency coordination and information sharing, should facilitate monitoring and mitigation of risks across the financial system. It also should result in increased regulatory efficiency, including less duplication, and help to eliminate regulatory gaps.

Consolidation of regulatory agencies also may further the competitive posture of the U.S. financial markets. It may make it easier to harmonize U.S. regulations with regulations in other jurisdictions when that is appropriate. And reducing the number of U.S. regulatory agencies, while also strengthening the culture of cooperation and dialogue among senior officials of the agencies, will likely facilitate coordinated interaction with regulators around the world.

By providing for one or more dedicated regulators to oversee each major financial services sector, the proposed structure would maintain the specialized focus and expertise that is a hallmark of effective regulation. This structure also would allow appropriate tailoring of regulation to accommodate fundamental differences in regulated entities, products and activities. Additionally, it would avoid the potential for one industry sector to take precedence over the others in terms of regulatory priorities or approaches or the allocation of regulatory resources.

ICI recognizes that some have criticized sector-based regulation because it may not provide any one regulator with a full view of a financial institution's overall business, and does not give any single regulator authority to mandate actions designed to mitigate systemic risks across financial markets as a whole. Our proposed approach would address those concerns through the establishment of the Systemic Risk Regulator and specific measures to strengthen inter-agency coordination and information sharing.

We further believe that retaining some elements of the current multi-agency structure likely would offer advantages over a single, integrated regulator approach. Even though a single regulator could be organized with separate units or departments focusing on different financial services sectors, it is our understanding that, in practice, there can be a tendency for agency staff to "gravitate" to certain areas and devote insufficient attention to financial sectors perceived to be less high profile or prone to fewer problems. Such a result has the potential to stifle innovation valuable to consumers and produce regulatory disparities.

Finally, we believe that a streamlining of the current regulatory structure may be more effective and workable than an approach that assigns regulatory responsibilities to separate agencies based on broad regulatory objectives (*e.g.*, market stability, safety and soundness, and business conduct). These functions often are highly interrelated. Not only could separating them prove quite challenging, but it would force regulators to view institutions in a less integrated way and to operate with a narrower, less-informed knowledge base. For example, a Capital Markets Regulator is likely to be more effective in protecting investors if its responsibilities require it to maintain a thorough understanding of capital market operations and market participants. And while an objective-based structure could be one way to promote consistent regulation of similar financial products and services, it is not the only way. Under our proposed approach, minimizing regulatory disparities for like products and services would be an express purpose of enhanced inter-agency coordination and information-sharing efforts.