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BEFORE THE UNITED STATES SENATE COMMITTEE

ON BANKING, HOUSING, AND URBAN AFFAIRS

HEARING ON "ENHANCING INVESTOR PROTECTION

AND THE REGULATION OF THE SECURITIES MARKETS – PART II"

26 MARCH 2009

Thank you very much, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for inviting me to appear today at your hearing. It is an honor and privilege for me to provide information for your deliberations on possible legislation regarding the U.S. financial markets. This Committee has a long history of careful study and analysis of matters relating to the financial markets and the financial services industry.

There are multiple, complex, and interrelated causes to the current situation in the global financial markets. These causes have been decades in the making. Those who would tell you otherwise are simply misguided, have ulterior motives, or are unaware of the intricacies of global finance. These causes are more than the competence or incompetence of individuals in particular roles, but have more to do with fundamental principles of organizational behavior and incentives.

Your topic for today is rather broad, so I would like to touch on a few specific items that go to the heart of an agency that I know very well – the Securities and Exchange Commission. I have been working in and around the SEC for all of my professional career. I have spent almost 10 years as a staff member and as a Commissioner. In 15 years of private practice I have applied the Commission's regulations in transactions and in real business situations. In the course of my work, I have interacted with every one of the SEC's divisions and offices in one way or another.

With respect to the subject of regulatory reform, I would suggest that you ask very hard questions in subsequent hearings: For example, why has the SEC in the course of the past dozen years or so experienced catastrophic failures in every one of its four core competencies – rulemaking, filing review, enforcement, and examinations? What led to failures at the SEC and other regulatory agencies – both in the United States and globally – to discern the increasing risk to financial institutions under their jurisdiction? What led to failures at financial institutions to recognise the inadequacy of their own risk management systems and strategy in time to avert a collapse? How did many investors get lulled into complacency and not adequately do their own due diligence? What is the proper role of credit rating agencies, and has regulation fostered an oligopoly by recognizing the opinions of a few as being more privileged than the rest?

Your challenge in formulating laws and regulations is that every action leads to a reaction, just as in physics. Just as investors should know that there is no riskless or easy way to make money, policymakers should know that there is no riskless or easy way to oversee the financial markets. I respectfully submit that changes to the securities laws should be made carefully and with the knowledge that modern financial services is a quickly evolving industry. Sooner or later the markets will stabilize, depending on what actions governments take. The goal should be a balance, using the facts as they best can be discerned, through a robust analysis of the costs and benefits of various potential actions and how those actions might affect human behavior. The current situation is certainly no time to "wing it" or act on "gut" instinct. The weighing of costs and benefits is vital, because investors ultimately pay for regulation. If regulations impose costs without commensurate benefits, investors suffer the costs of lack of effectiveness and efficiency, not only through higher prices but also through constrained investment opportunities. That ultimately hurts them in their investment performance, because it means less opportunity for diversification.

Why should we care about the capital markets? Despite all of the recent gloomy and tragic news of the past couple of years, we must not forget that one of the most important underlying purposes of our capital markets is to allow entrepreneurs with great new ideas to make their dreams possible by raising capital, thereby helping the economy grow by creating jobs, improving the lives of consumers through producing innovative products, and providing a return to investors who have risked their savings to help finance that entrepreneur's dream. This is the role – and genius – of the United States capital markets that has helped our economy to be the engine of the world's growth and made our standard of living the best in the world.

Notwithstanding the current economic conditions, I feel confident that the role of the United States capital markets will return to what it was, barring ill-advised legislation or regulatory actions. An example of legislation that had a detrimental effect on the attractiveness of U.S. markets was the so-called Interest Equalization Tax, a short-lived tax imposed in 1963 on borrowing by U.S. and foreign companies in the U.S. The goal was to encourage capital to stay in this country and to equalize the costs between selling debt and equity securities. It essentially backfired when U.S. companies found that they could issue dollar-denominated debt in London, avoiding the tax and increasing yields. The London markets, which had yet to fully recover after World War II, experienced a boom in size and credibility that eventually led them to eclipse the U.S. in some benchmarks by 2007.

We should not forget that just prior to the recent problems in the credit markets, which began more or less in June 2007 when a small fund was closed to redemptions, setting off a world-wide reassessment of the creditworthiness of U.S. housing-related debt securities, public offerings of securities in the United States were on the decline, compared to offerings in the private markets. In fact, in 2006, the value of Rule 144A unregistered offerings in the U.S. for the first time exceeded the value of public offerings.

All of this is to suggest that Congress be especially deliberative and pragmatic in legislating in this area. The worrisome thing to me is that if care is not taken to have solid analysis, the wrong lessons may be gleaned from this latest crisis that hurt investors. It takes a long time to change legislation in this area. We still have not dug ourselves out of some of the mistakes and false premises that drove the decision making during the 1930s and 1940s. For example, it took 40 years for Congress and the SEC to end fixed commissions for brokerage services that were essentially imposed by law in the 1930s, and we still have many aspects of the so-called “managed competition” philosophy that led to that policy. We still have the alphabet soup of regulators and self-regulatory organizations in the financial services industry, with all of the distortions and inefficiencies that have contributed to the current crisis and become so painfully evident to the world. Many have complained about this situation for years, but others have opposed any restructuring as “dangerously deregulatory,” and ignored the inherent systemic risks, overlapping jurisdiction, turf wars, and wasted resources of the current structure.

In the wake of the stock market crash of 1929, over the next decade this Committee and others held many hearings and explored the abuses in the marketplace including conflicts of interest, shady transactions with affiliates, less-than-adequate disclosure, and squirrelly valuations. Congress responded by passing the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 (“PUHCA”), the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, among other laws.

Many provisions of these laws were helpful to the market and to investors and stood the test of time. But, as time passed, it became clear that some laws were counter-productive. For example, by the end of the 20th century, PUHCA was cited as a reason for a relative paucity of investment in the electric and gas utility industry. In fact, for the first 25 years of its existence, the SEC’s main task was to break up interstate investor-owned electric and gas utilities by using PUHCA. This was the investment management division’s primary job, and more people were devoted to this mission than any other at the SEC for more than 20 years. By the end of the 1950s, this mission was mostly accomplished. Finally, Congress repealed PUHCA in 2006.

What lesson can we draw from PUHCA? Congress passed the Act because of the self-dealing and manipulation concerning interstate utility holding companies in the1920s. Instead of focusing on the problematic practices and addressing them directly, Congress reshaped the entire industry. What were the unintended consequences? After repeal, for example, alternative energy technologies are easier to finance. In addition, What would our power industry be like today if a different legislative strategy had been pursued originally? What would our capital markets be like today if the SEC had spent more of its energy for those three decades focusing on more general problems of the capital markets?

FORTHRIGHT ANALYSIS NEEDED

Certainly, many mistakes were made by business people, investors, and regulators during the past decade, but too many these days are looking in hindsight to pass judgement or blame. What we need is an analysis to determine how we can efficiently and effectively promote honesty and transparency in our markets and ensure that criminality is not tolerated.

For example, some have claimed that “deregulation” over the past 4, 8, or 10 years has led to the current problems in the financial markets. One can hardly say that the past 8 to 10 years have been deregulatory. The enactment of the Sarbanes-Oxley Act in 2002 led to the promulgation by the SEC of more rules in a shorter amount of time than ever before. In addition, the last 7 years have seen many new SEC and self-regulatory organization rules regarding compliance and trading, which have certainly been very regulatory. The Financial Accounting Standards Board, the Public Company Accounting Oversight Board

("PCAOB"), and the Municipal Securities Rulemaking Board have promulgated a host of new rules, standards, and interpretations.

This attitude that blames our current problems on "deregulation" is not only completely wrong, but dangerous because it is off the mark. If that is what policy makers think is the reason for the current situation, then they will have learned the <u>wrong</u> lesson and their solutions will cause more problems than they will solve.

More regulation, for regulation's sake, is not the answer. We need <u>smarter</u> regulation. Some say that we need to trust less in the marketplace and more in the capabilities of regulators, including a putative ability to foresee bubbles and intervene to stop them. That is much easier said than done. This assertion ignores the reality that what may seem to be a bubble to one person may be another person's honest livelihood. What if the regulator is wrong? How will you ever know the opportunity cost to individuals or to society as a whole for curtailing some particular activity? It is always easier in hindsight to say what should have been done. How can you build public policy for years in the future on hoped-for brilliance or luck of individual, fallible human beings, especially if they are independent, non-elected, and essentially unaccountable?

This global crisis has primarily affected regulated (versus non-regulated) entities all around the world, not just in the supposedly deregulatory United States. How did so many regulators operating under vastly different regimes with differing powers and requirements all get it wrong? Indeed, how did so many firms with some of the best minds in the business get it wrong? The housing bubble occurred in the US as well as the United Kingdom, Ireland, and Spain. Heavily regulated financial institutions had problems with their housing-related investments not only in the US but also in Germany, Switzerland, France, Belgium, Netherlands, Ireland, the United Kingdom, and many others.

We must recognize that businesses ultimately are better than governments at business, because both can and do make mistakes. In addition, by removing risk management from firms and placing it in the hands of government, there is a danger that firms will become careless and take on additional risk, believing regulators are protecting them. If they believe that the government is backstopping their losses, then they may take greater risks, reap the rewards of taking those risks, and avoid the consequences if things go awry. This is the moral hazard that we all try to avoid. Regulators have a legitimate interest in setting capital standards to control this risk taking, but the ultimate risk management function must remain in the hands of the firms that face the risk.

WHAT CAUSED THE SEC'S OPERATIONAL FAILURES?

During the past dozen years, the SEC has experienced catastrophic operational failures in its four core functions of filing review, rulemaking, enforcement, and examinations. Enron's corporate filings were not reviewed for years in the late 1990s; Congress addressed this issue in Sarbanes-Oxley by mandating that the SEC review each issuer's filings on a periodic basis. In enforcement and examinations, tips were not pursued regarding Bernard Madoff and late trading of mutual funds. In rulemaking, the Commission proposed in December 1997 and again in April 2005 regulations regarding credit rating agencies, but never adopted any. This Committee led the effort to reform the SEC's approach to nationally recognized statistical rating organizations ("NRSROs") that culminated in the Credit Agency Reform Act of 2006, but unfortunately this statute came too late to affect the crisis in the financial markets and the 30-year history of NRSRO regulation.

The SEC to its credit and benefit has attracted many hard-working, bright, energetic staff members over its history. But, these mistakes were caused by failures of senior management, rather than by staff members. First, management applied faulty motivational and review criteria. Second, since resources are always limited, there is an opportunity cost in choosing to spend time and resources on one thing, because there is less time and fewer resources to spend on other things. Unfortunately, the SEC suffered from poor prioritization decisions during the critical years of 2003-2005 when the market for collateralized debt obligations and credit default swaps started to explode and its trajectory could have been diverted.

Some argue that low pay or poor morale contributed to these failures. Thanks to this Committee through the Sarbanes-Oxley Act, pay caps were removed from SEC staff pay in 2002. When I left the SEC, more than half of the 3,500 employees earned more than I did as a commissioner and many earn more than the chairman. Today, a staff attorney or accountant (SK-14) earns nearly $168,000 in Washington, D.C. ($177,000 in New York), and senior managers earn well in excess of $200,000.

As with anyone else, I am sure that SEC employees would like more pay, but how much should they be paid? As much as PCAOB board members, who earn more than the President? As with most government employees, the vast majority of SEC employees go to work because they like their job and they are committed to the agency's mission. In addition, they have job security and other benefits that cannot be duplicated in the private sector.

Management Failures. Management philosophies like Total Quality Management and Six Sigma teach that in any organization, measurement drives human behavior because the incentive is to try to meet the measurement criteria ("You get what you measure").

Essentially, Enron was not reviewed for years because review personnel were judged by how many filings they reviewed, not necessarily by the quality of their review. The incentive was to postpone review of the complicated Enron filing because one could review many others in the time it would take to review Enron. By the late 1990s, this focus on numbers more than quality had decreased staff morale so much that employees began to organize to form a union. Despite management's campaign to thwart it, in July 2000 SEC employees voted overwhelmingly to unionize the workforce.

The emphasis on numbers over quality also affects behavior in the enforcement division and examination office. Every enforcement attorney knows that statistics (or "stats") help to determine perception and promotion potential. The statistics sought are cases either brought and settled or litigated to a successful conclusion, and amount of fines collected. These statistics do not necessarily measure quality (such as an investigation performed well and efficiently, but the evidence ultimately adduced did not indicate a securities violation). Thus, the stats system does not encourage sensitivity to due process.

In addition, the stats system tends to discourage the pursuit of penny stock manipulations and Ponzi schemes, which ravage mostly retail investors. These frauds generally take a long time and much effort to prove – the perpetrators tend to be true criminals who use every effort to fight, rather than the typical white-collar corporate violator of a relatively minor corporate reporting requirement who has an incentive to negotiate a settlement to put the matter behind him and preserve his reputation and career. Thus, over the years several staff attorneys have told me that their superiors actively discourage them from pursuing Ponzi schemes and stock manipulations, because of the difficulty in bringing the case to a successful conclusion and the lack of publicity in the press when these cases are brought (with the exception of Madoff, these sorts of cases tend to be small). Some senior enforcement officers openly refer to these sorts of cases as "slip-and-fall" cases, which disparages the real effect that these cases have on individuals, who can lose their life savings in them. Because of the interstate and international aspect of many of these cases, if the SEC does not go after them, no one can or will.

During my tenure as commissioner, I emphasized the need to focus from an enforcement perspective on microcap fraud, including Ponzi schemes, pump-and-dump schemes, and other stock manipulations. I was a strong advocate for the formation of the Microcap Fraud Group in the Enforcement Division, which as finally formed in 2008. I also strongly support the good efforts of the Office of Internet Enforcement, established under Chairman Levitt in the late 1990s, which works closely with other law enforcement agencies to tackle internet and other electronic fraud.

There are many intelligent, competent, dedicated, hard-working people at the SEC. It is the management system and how it determined priorities over the past decade that has let them down. Last year in an article published in the Fordham Journal of Corporate and Financial Law,[1] I called for the SEC to follow the example from 1972 of Chairman William Casey, who formed a committee to review the enforcement division – its strategy, priorities, organization, management, and due-process protections. Thirty-seven years later, and especially after the Madoff incident, this sort of review is long overdue.

The Opportunity Cost of Misplaced Priorities. I believe that the SEC was distracted by controversial, divisive rulemaking that lacked any grounding in cost-benefit analysis during a critical period. In 2003-2005, the agency pushed through three controversial rules regarding mutual fund governance, hedge fund registration, and the so-called National Market System rules. In these cases, the SEC did not conduct an adequate analysis of the costs versus the benefits of these proposed rules. The hedge fund and mutual fund rules were invalidated by the courts after long litigation and much distraction for the agency and the industry. In each of these cases, former Commissioner Cynthia A. Glassman

[1] *See* Paul S. Atkins and Bradley J. Bondi, "*Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program,"* 8 Fordham Journal of Corp. & Fin. Law 367 (2008).

and I offered alternatives and compromises, but we were presented with a take-it-or-leave-it choice that left no alternative but dissent.

These controversies now sound rather trivial in light of the current situation in the financial markets. However, important legal principles were involved, including lack of authority to promulgate the hedge fund rule and lack of observing a legislative mandate for analyzing costs and benefits in connection with the mutual fund governance rule. Hedge funds ultimately were not the problem in the current financial crisis; risk management at regulated entities was the problem. Moreover, Regulation NMS cost the securities industry more than $1.5 billion to try to implement a rule to address a theoretical problem that did not exist. Ultimately, after much effort and distraction, many exemptions and exceptions have been issued by the SEC staff that effectively have gutted the rule.

Because life is full of choices, if you devote resources to one thing, you have less to devote to another. And, the one risk that you have not focused on just may blow up in your face.

That, in fact, is just what happened to the SEC. During this critical 2003-2005 time period when so much effort was wasted on these quixotic detours, the market for collateralized debt obligations (CDOs) and credit default swaps (CDSs) was taking off.

What might the SEC have done, had it not been so distracted by other false priorities? Sometimes the issues are a lot more basic than we think. With respect to CDOs and CDSs, the SEC did not have jurisdiction to regulate them as instruments. But, one of the critical factors that developed as market interest in them grew was the inadequate documentation for these OTC derivatives. While the SEC was trying to devise complex solutions to non-existent problems, it neglected a real risk management issue in the fundamental infrastructure that enables the markets to work smoothly. For example, in the failure of the hedge fund Amaranth in 2006, I was told that it took a couple of hundred people several weeks to sort through the OTC derivatives documentation issues and figure out valuation. One of the primary difficulties has been the lack of standardized documentation, which has often resulted in lengthy confirmations. At the time, I and others had called for this to be addressed. I am happy that the industry and regulators are making progress in this area.

The incomplete and inaccurate documentation in this area was a legitimate risk management issue, especially since no centralized, automated trade processing existed for these instruments. As we have witnessed over the past year, valuation is a challenge, because these instruments are complicated and not standardized. Novations create a huge challenge to follow the chain of ownership.

PROPOSALS FOR FINANCIAL SERVICES REFORM

Several general proposals have been made recently for structural reforms to the financial services regulatory framework. Since these have not yet become concrete proposals, I have a few general comments in this regard.

Systemic Risk Regulator: This concept was raised last year in the Treasury Department’s Blueprint for a Modernized Regulatory Structure. As a theory, it has some general appeal, but as a practical matter it raises many questions. Just who would be the systemic risk regulator? The Treasury, the Federal Reserve, some newly created entity, or a council of regulators (such as the President’s Working Group)? What would its powers be? Would it be a merit regulator of new products? If it is the Treasury, what would its role be with respect to other independent agencies?

Issues of systemic risk can be raised in many different contexts. For example, in the 1990s, the Federal Reserve and the SEC disagreed over the levels of loan loss reserves taken by certain banks. The Fed argued on the basis of safety and soundness concerns, and the SEC was worried about earnings management and disclosure.

Merit regulation of new products is always problematic, because a government agency is making determinations for investors as to appropriateness. What standards would the systemic regulator use to vet the new products? The time for review adds to the cost of the new products and adds to uncertainty

Although the federal rules with respect to public offerings of securities are based on disclosure, some states have a merit-regulatory regime. An illustrative example of how government officials can make incorrect determinations, with the best intentions of investor protection, is the initial public offering of Apple Computer. The SEC approved Apple's registration statement under the federal Securities Act, but Massachusetts prohibited the offering of Apple shares because they were "too risky." Texas approved the sale after an extensive review, but its securities regulator called his decision "a close call," and Apple did not even bother to offer its shares in Illinois due to strict state laws on new issues. The subsequent performance of Apple stock is a matter of history.

With respect to CDOs and CDSs, would a systemic regulator have identified the potential problems of documentation and trading?

Merger of the SEC and CFTC: If this merger is to be effected, it should be done with care. The statutes and rules governing the securities and futures markets are different, and the approaches that the two agencies take are different. The futures markets are mostly dealer markets, while the securities markets have a large retail investor component. A merger cannot simply be the combining of two agencies under one roof; it would be a complicated task.

Short of merger, Congress could help by laying out guidelines for the two agencies to resolve conflicts regarding products that have indicia of both securities and futures. This issue has existed since the 1980s, and the two agencies have periodically tried to address the conflicts. In fact, this issue would still exist even if the agencies were combined, just as issues exist between SEC divisions.

Credit Rating Agencies: Thanks to the hard work of this Committee, Congress passed the Credit Rating Agency Reform Act of 2006, which set out a regulatory regime for the SEC's staff-designated NRSROs through a frustratingly slow process that had the effect of limiting competition in issuing credit ratings. The 2006 legislation made the application process speedier and more transparent.

The subprime problems made it clear that many investors relied on credit ratings without performing their own due diligence. Government agencies relied on credit ratings to their detriment as well. Even if conflicts of interest are addressed and fully disclosed, we still have the problem that <u>opinions</u> of certain institutions are given great regulatory weight. Thus, few realized the great systemic risk inherent in the holdings of CDOs by financial institutions, because they were deemed to be the highest-rated instruments. Over the past 30 years or so, references to NRSRO ratings have become embedded in many federal and state statutes and SEC and other agency rules. Has this created a perception that the government endorses the process by which NRSROs produce their ratings? That would be an incorrect perception; the SEC or any government agency can never be equipped to assess the <u>quality</u> of NRSRO ratings or the procedures by which they are devised. I would argue that it would be a mistake to ask any government agency to attempt to do so. Is it time to remove these ratings from our statutes and rulebooks? Can we create alternatives to this flawed system that accords undue weight to informed, albeit potentially flawed, opinions?

The rating agency industry over the years had become an oligopoly – three large firms control 90% of the market, and two of them control 80%. This concentration was a direct result of a non-transparent, arcane SEC oversight system.

The consequence was a lack of competition and lack of new entrants. For example, a non-US rating agency waited 16 years before its application was finally approved. The 2006 enactment of the Credit Rating Agency Reform Act directed the SEC to open up the process, encourage competition, and increase transparency and oversight of the credit rating firms to protect against conflicts of interest. Would more voices in the rating industry have averted the problems with ratings of structured products?

SEC Strategic and Risk Assessment: Congress should encourage Chairman Schapiro to engage in a thorough strategic and risk assessment, especially if the agency is to receive more resources and authority. In the past ten years, the agency's budget has more than doubled and its staffing has increased commensurately. However, the internal organization and management structure is essentially the same.

Would today's crisis have occurred if the SEC had had a real risk evaluation capability? Former Chairman Harvey Pitt undertook an extensive review of the SEC's organization and functionality in 2001 with a view to modernize it. He conceived of a risk assessment office that would work closely with the operating divisions. The plan was to give it its own personnel, but also to have personnel seconded to it in order to generate buy-in from the operating divisions. Unfortunately, when his successor established the office, it did not have adequate resources and it did not have any secondments. Thus, the group was not integrated into the flow of the agency's operations and became an orphaned group filling a niche role with very limited effectiveness.

In addition, should the examination function continue in its current form? In the aftermath of the Madoff affair, the structure and function of the Office of Compliance Inspections and Examinations should be reviewed. If Congress chooses to require that hedge funds and private equity firms register as advisors under SEC oversight, the burden added to the agency's examiners would be enormous. The current paradigm of periodic inspections of funds by government examiners cannot endure, unless the agency increases tremendously in size, inevitably leading to more managerial problems. One solution could be to re-integrate the examination function into the operating divisions and to establish the opportunity for registered advisors to submit to independent reviews, which would be overseen by the SEC.

In conclusion, regulation of financial markets needs to be modernized and rationalized. But, it must be done in an informed way, taking into account costs and benefits and being mindful of potential unintended consequences. Financial markets are global, integrated, and quickly changing, and the legislative process is not as responsive. I stand ready to assist the Committee going forward as you deliberate these issues and if you develop any legislation.

Thank you again for extending me the privilege of appearing before you today. You have a momentous task before you. I wish you all the best in your work.