

Statement of
Arthur Levitt, former Chairman, Securities and Exchange Commission
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Thank you, Chairman Dodd and Ranking Member Shelby, for the opportunity to appear before the Committee at this critical moment facing our markets, our economy, and our nation.

When I last appeared before this committee, I focused my remarks on the main causes of the crisis we are in, and the significant role played by deregulation. Today, I would like to build upon that testimony and focus your attention on the prime victim of deregulation – investors. Because of failures at every level of our financial system, investors no longer feel that they receive correct information or enjoy meaningful protections. Their confidence in fair, open, and efficient markets has been badly damaged. And not surprisingly, our markets have suffered from this lack of investor confidence.

Above all the issues you now face, whether it is public anger over bonus payments or the excesses of companies receiving taxpayer assistance, there is none more important than investor confidence. The public may demand that you act over some momentary scandal, but you must not give in to bouts of populist activism. Your goal is to serve the public not by reacting to public anger, but by focusing on a system of regulation which treats all market actors the same under the law, without regard to their position or status.

In coming months, you will adopt specific regulatory and policy solutions to the problems we face, yet none of that work will matter much unless we find a way to restore investor confidence. If at the end of the process you don't place investor confidence at the heart of your efforts, no system of regulation and no amount of spending on regulatory agencies can be expected to succeed.

Core Principles

You are focusing now on the issue of systemic risk, and therefore whatever response you take must be systemic as well. Specifically, some have suggested that we should re-impose Glass-Steagall rules regarding the activities and regulation of banks. Those rules kept the nation's commercial banks away from the kinds of risky activities of investment banks. But by 1999, the law no longer had the same teeth – multiple workarounds had developed, and it no longer was practical to keep it in place. Perhaps we were too hasty in doing away with it, and should have held onto several key principles that made Glass-Steagall an effective bulwark against systemic risk in America's banking sector. That does not mean we should pursue “turn-back-the-clock” regulation reforms and re-impose Glass-Steagall. The world of finance has changed greatly since 1999 and we have to change with it. But we can borrow some important principles from Glass-Steagall, apply them to today's environment, as we address the serious weaknesses of our current system of financial regulation.

Those principles, in short, are:

Regulation needs to match the market action. If an entity is engaged in trading securities, it should be regulated as a securities firm. If an entity takes deposits and holds loans to maturity, it should be regulated as a depository bank. Moreover, regulation and regulatory agencies must be suited to the markets they seek to oversee. Regulation is not one size fits all.

Accounting standards serve a critical purpose by making information accessible and comprehensible in a consistent way. I understand that the mere mention of accounting can make the mind wander, but accounting is the foundation of our financial system. Under no circumstances should accounting standards be changed to suit the momentary needs of market participants. That principle supports mark-to-market accounting, which should not be suspended under any condition.

The proper role of a securities regulator is to be the guardian of capital markets. There is an inherent tension at times between securities regulators and banking supervisors. That tension is to be expected and even desired. But under no circumstance should the securities regulator be subsumed – if your goal is to restore investor confidence, you must embolden those who protect capital markets from abuse. You must fund them appropriately, give them the legal tools they need to protect investors, and, most of all, hold them accountable, so that they enforce the laws you write.

And finally, all regulatory reforms and improvements must be done in a coordinated and systemic way. The work of regulation is rarely done well in a piecemeal fashion. Rather, your focus should be to create a system of rules that comprise a complete approach, where each part complements the other, and to do it all at once.

Specific Reforms

Allow me to illustrate how these principles can be put to work, in specific regulatory and policy reforms:

First: Some have suggested that you create a single super-regulator. I would suggest that a more diverse approach should be adopted, taking advantage of the relative strengths of our existing regulatory agencies. For example, the Federal Reserve, as a banking supervisor, has a deep and ingrained culture that is oriented towards the safety and soundness of our banking system. But when banks – or any financial institution -- engage in securities transactions, either by making a market in securities, or by securitizing and selling loans, or by creating derivatives backed by equities or debt, they fundamentally require oversight from trained securities regulators.

What serves the health of banks may run exactly counter to the interests of investors – and we have seen situations where bank regulators have kept information about poorly performing assets from the public in order to give a bank time enough to dispose of them. In that case, banking regulators will work at cross-purposes with securities regulators.

Ultimately, the only solution to that tension is to live with it. When I was at the SEC, there was tension between banking regulators and securities regulators all the time. This creative tension served the ultimate goal of reducing overall risk to our economy, even if it occasionally was frustrating for the regulators and the financial institutions themselves. And so we should not be surprised if regulatory reforms yield a bit of regulatory overlap. That is both natural, considering the complexity of financial institutions, and even desirable.

Second: Mark to market or fair value standards should not be suspended under any circumstance. Some have come forward and suggested that these are unusual times, and we need to make concessions in our accounting standards to help us through it. But if we obscure investor understanding of the value of assets currently held by banking institutions, we would exacerbate the crisis, and hurt investors in the bargain. Unfortunately, recent steps taken by the FASB, at the behest of some politicians, weaken fair value accounting.

Those who argue for a suspension of mark-to-market accounting argue this would punish risk-taking. I strongly disagree. Our goal should be to make sure risk can be priced accurately.

Failure to account for risk, and failure to present it in a consistent way, makes it impossible to price it, and therefore to manage it. And so any effort that seeks to shield investors from understanding risk profiles of individual banks would, I believe, be a mistake, and contribute to greater systemic risk.

I would add that mark-to-market accounting has important value for internal management of risk within a firm. Mark-to-market informs investment bank senior managers of trading performance, asset prices, and risk factor volatilities. It supports profit and loss processes and hedge performance analyses, facilitates the generation and validation of risk metrics, and enables a controlled environment for risk-taking. If treated seriously by management, mark-to-market is a force for internal discipline and risk management, not much different than a focus on internal controls. Yes, valuing illiquid or complex structured products is difficult. But that doesn't mean the work should not be done. I would argue that it has to be done, both inside the firm and by those outside it, to reduce risk throughout our system.

And so I agree with the Chairman of the Federal Reserve, and the heads of the major accounting firms, that the maintenance of mark-to-market standards is essential.

Third: As this committee and other policymakers seek to mitigate systemic risk, I would suggest taking a broad approach to the challenge. It would be a mistake, I believe, to designate only one agency to focus on systemic risk, because systemic risk emanates in multiple ways.

You may find the task best accomplished by enacting a series of complementary regulatory enhancements aimed at promoting transparency and information discovery across multiple markets.

Those remaining pockets of financial activity covered by self-regulation and protected from litigation should be brought in under a more vigorous regulatory structure with fully independent regulators and legal remedies. For years, credit ratings agencies have been able to use legal defenses to keep from the SEC from inspecting the way they do their ratings the way the PCAOB is empowered to examine the way audits are done, even though these agencies dispense investment advice and sit at a critical nexus of financial information and potential risk. In addition, these ratings agencies cannot be fined by the SEC and they operate with significant protections from private rights of action. These protections from regulatory review and legal remedies need to be reconsidered. The credit ratings agencies have an abysmal record of performance in recent years and their failure has had an outsized impact on the health of our entire financial system. They are not merely expressing views that would ordinarily receive legal protections. They are playing a much larger role, and their activities should be treated in the same way as other market actors who are subject to SEC review and regulation.

In the same manner, the SEC should have a far greater role in regulating the municipal bond market, which consists of state and local government securities. This is the market where Wall Street and Main Street collide. Since the New York City crisis of 1975, this market has grown to a size and complexity that few anticipated.

It now includes not-for-profit institutions and even for-profit business corporations who sell securities through government conduit entities. The debt and derivative products sold are substantially the same as those sold in the corporate market. Small investors make up a substantial part of this market and because of the Tower Amendment many participants – insurers, rating agencies, financial advisors to issuers, underwriters, hedge funds, money managers and even some issuers – have abused the protection granted by Congress from SEC regulation.

This market has shown that self-regulation by bankers and brokers through the Municipal Services Rulemaking Board all too often has come at the expense of the public interest. The New York City debacle in 1975, the San Diego pension fund fraud in 2006, the Orange County California derivatives crisis in 1994, the Washington Public Power System defaults in 1980, the auction securities settlements of 2008, and the current investigations into derivatives, bid rigging, pay to play and other scandals – this is an industry prone to scandal.

In recent months, we have even seen several well-documented scandals where small municipalities and public agencies were encouraged to float bonds even though the money was not to be spent on public purposes, but rather used as an investment pool. We may not want to treat municipals like we do other securities – but we do need to level the playing field between the corporate and municipal markets and address all risks to the financial system. Municipal issuers are ill-equipped and some are reluctant to do this on their own. We may have to develop ways protect small municipal issuers from over regulation just as we do for

small corporations, so long as we do not develop a double standard for principles of disclosure, transparency, finance and compliance with market rules. Former Chairman Cox has suggested granting the SEC authority to regulate the municipal bond industry to promote integrity, competition and efficiency, and I agree.

In addition, I would also recommend amending the Investment Advisers Act to give the SEC the right to oversee specific areas of the hedge fund industry and other pockets of what some have called the “shadow markets” – those areas of finance beyond the oversight of regulators. In particular, I would urge that you require banks and hedge funds create an audit trail and clearinghouse for all trades, to create a better awareness of investment products that could pose risks to overall markets. I would also recommend placing hedge funds under SEC regulation in the context of their role as money managers and investment advisors.

There will be some who argue that SEC oversight of some aspects of hedge funds will come at the expense of financial market innovation. In fact, such regulation could help improve the environment for financial innovation. For example, we know that new investment vehicles can be a source for risk even as they supply investors with a desired financial product. How do we balance those competing qualities? Perhaps the SEC could increase the margin requirement for the purchase of new products, until those products are road-tested and have developed a strong history of performance in different economic conditions.

Nor are all forms of regulation going to simply involve more disclosure requirements. I could see a greater focus on better disclosure, so that investors and regulators receive information that has more value. For example, a system that allows financial institutions to make their own risk assessments, or relies on credit rating agencies for purposes of determining how much capital they should have, lacks adequate independence and credibility. At the same time, adopting a one size fits all approach is likely to be shortsighted and ineffective.

As SEC Chairman, I favored risk-based principles for regulation, and think greater application of those principles is needed. Such a system should be forward-looking, independent and free of bias in its assessment of risks and liquidity needs within an entity, overseen by a regulator with a mission, culture and necessary resources to do the job, and finally, be fully transparent not only to regulators but also to investors, taxpayers and Congress. Such a system would be far more useful than our current system. And it would contribute greatly to our awareness of potential sources of systemic risk.

These steps would require OTC derivative market reform, the outcome of which would be the regulation by the SEC of all credit and securities derivatives. To make this regulation possible and efficient, it would make sense to combine the resources and responsibilities of the SEC and CFTC. In today's financial markets, the kinds of financial instruments regulated by these two agencies share much in common as economic substitutes, and this change would allow regulators to share their skillsets, coordinate their activities, and share more information, thus providing a deeper level of understanding about risk.

Supporting all these activities will require an appropriately funded, staffed and empowered SEC. Under the previous administration, SEC funding and staffing either stayed flat or dropped in significant areas – enforcement staff dropped 11 percent from 2005 to 2008, for example. We have seen that regulators are often overmatched, both in staffing and in their capacity to use and deploy technology, and they can't even meet even a modest calendar of regular inspections of securities firms. Clearly, if we are to empower the SEC to oversee the activities of municipal bond firms and hedge funds, we will need to create not only a stronger agency, but one which has an adequate and dedicated revenue stream, just as the Federal Reserve does.

My final recommendation relates to something you must not do. Under no condition should the SEC lose any of its current regulatory responsibilities. As the primary guardian of capital markets, the SEC is considered the leading investor representative and advocate. Any regulatory change you make that reduces the responsibility or authority of the SEC will be viewed as a reduction in investor protections. That view will be correct, because no agency has the culture, institutional knowledge, staff, and mission as the SEC to protect investors.

Conclusion

These actions would affirm the core principles which served the nation's financial markets so well, from 1933 to 1999 – regulation meeting the realities of the market, accounting standards upheld and strengthened, regulators charged with serving as the guardians of capital markets,

and a systemic approach to regulation. The resulting regulatory structure would be flexible enough to meet the needs of today's market, and would create a far more effective screen for potential systemic risks throughout the marketplace. Financial innovations would continue to be developed, but under a more watchful eye from regulators, who would be able to track their growth and follow potential exposure. Whole swaths of the shadow markets would be exposed to the sunlight of oversight, without compromising the freedom investors have in choosing their financial managers and the risks they are willing to bear.

Most importantly, these measures would help restore investor confidence by putting in place a strong regulatory structure, enforcing rules equally and consistently, and making sure those rules serve to protect investors from fraud, misinformation, and outright abuse.

These outcomes won't come without a price to those who think only of their own self-interest. As we have seen in the debate over mark-to-market accounting rules, there will be strong critics of strong, consistent regulatory structure. The self-interested have reasons of their own to void mark-to-market accounting, but that does not make them good reasons for all of us. Someone must be the guardian of the capital market structure, and someone must think of the greater good. That is why this committee must draw on its heritage of setting aside partisanship and the concerns of those with single interests, and maintain a common front to favor the rights of the investor, whose confidence will determine the health of our markets, our economy, and ultimately, our nation.

