Testimony of David S. Ruder

Professor of Law, Northwestern University School of Law

Former Chairman, Securities and Exchange Commission (1987-1989)

The Regulatory Role of the Securities and Exchange Commission in Complex Global Financial Markets

Before the Senate Banking, Housing, and Urban Affairs Committee's

Subcommittee on Securities, Insurance, and Investment

United States Senate

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"The Regulatory Role of the Securities and Exchange Commission in Complex Global Financial Markets"

My testimony today will address the role of the Securities and Exchange Commission in regulating investment banks in today's complex global financial markets. I will discuss the SEC's regulatory obligations stemming from the recent credit crisis and its obligations relating to supervision of the securities markets, concluding that the SEC should have increased resources in order to fulfill its regulatory missions. I will argue that the SEC should not be required to substitute principles based regulation of investment banks for its current enforcement based regulation. I will urge the SEC to continue to communicate with investment banks regarding market innovations and risk positions. I will advocate giving the SEC new powers enabling it to improve its oversight of the financial stability of investment bank holding companies.

The Credit Crisis

As you know, the credit crisis arose from the so-called subprime housing market. In summary, mortgage originators loaned money to large numbers of home buyers, many of whom eventually were unable to meet their loan obligations. The mortgage originators sold these mortgages to others, including off balance sheet entities created by investment banks. Aided by investment banks, these entities issued debt instruments called structured notes whose obligations were secured by groups of home mortgage loans. These structured notes were divided into levels (or traunches) that had varying degrees of risk. Their notes were then sold by the investment banks on behalf of the investment entities to investors, primarily, sophisticated investors. In some cases, the structured notes received credit ratings from credit rating agencies, with the highest (AAA) ratings assigned to the safest debt levels. The structured notes were sometimes insured by firms specializing in insuring payment obligations for complicated structured products. In some cases as part of the selling process investment banks purchased structured notes in all risk categories and held them on their balance sheets. Additionally, many investment banks held some of the most highly rated structured notes on their balance sheets.

When home buyers began to default on loans, the market value of these notes, including Triple A rated notes, fell dramatically because buyers were unwilling to accept valuation risks. As the market for structured notes dried up, market participants became uneasy about the value of the notes and other assets, and about the financial stability of other market participants, some of whom were investment banks. As a result credit became unavailable in the broader markets. One consequence of the credit crisis was the collapse of the market for auction rate securities, in part because investment banks withdrew from their normal roles as buyers of these securities.

Securities and Exchange Commission Enforcement Activities Regarding Investment Banks

Any investigation of the role of investment banks in the credit crisis will probably evaluate the role and responsibilities of the Securities and Exchange Commission. At the first level the question will be whether the SEC's enforcement practices and other policies regarding investment banks have been and will be adequate.

Investment banks are broker dealers engaged in the business of buying, selling or otherwise dealing in securities for their own account or for the accounts of others. As broker dealers they are subject to regulation by the SEC. The SEC regulates all investment banks as broker dealers, whether or not they are owned by bank holding companies. Broker dealer regulation is conducted directly by the Commission through its rules and enforcement actions and indirectly through its oversight of self regulatory organizations (SROs), including the Financial Industry Regulatory Authority (FINRA) and the stock exchanges.

In the investment banking area, the SEC's regulation centers on the federal securities laws and SEC rules. Regulated broker dealer activities include distribution of securities, conduct relating to customers, securities trading activities, securities fraud, and other securities related areas, such as proxies and takeovers.

In my view the SEC's enforcement program is vital to its mission. The SEC has power to bring injunctive actions in federal court seeking restitution, fines, disgorgement of improper gains, and orders barring individuals from serving as officers or directors of public companies. It can impose similar sanctions in administrative proceedings. It also has power in its administrative proceedings to bar or suspend broker dealers from the securities industry. The SEC's enforcement activities are effective because they not only punish wrong doing, but also send strong messages of deterrence.

In the wake of the credit crisis, the SEC is undertaking investigations. Once it has gathered sufficient evidence it will undoubtedly bring regulatory actions. Possible areas of inquiry regarding investment banks include failures to disclose the poor quality of structured securities when selling them to investors, sales of high risk structured securities to investors for whom they were unsuitable, sales of auction rate securities without revealing possible market illiquidity, and failures to reveal known investment bank holding company low asset valuations to purchasers of holding company securities.

Securities and Exchange Commission Resources

"The mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[1] In today's world, the SEC's regulatory tasks are increasingly more complicated. It must deal with interconnected global futures and securities markets, the growth of hedge fund and

[1] U.S. Securities and Exchange Commission, In Brief FY 2009 Congressional Justification, p.7 (February 2008).

private equity investing, and the existence of complicated derivative financial instruments.

One of the SEC's unique advantages as an enforcement agency is that it has its own enforcement staff. It does not have to persuade other government regulators to provide the staff and other resources necessary to perform is enforcement functions. Nevertheless, the SEC's ability to bring enforcement actions is dependent upon the size of its enforcement staff.

Despite the ever increasing need for SEC enforcement activity, the size of the Commission's enforcement staff has not grown markedly in recent years. During the fiscal year 2007 the SEC had 1,111 staff members devoted to enforcement. During the fiscal year 2008 staff levels increased slightly to 1,124, but for fiscal year 2009 the predicted enforcement staff level is expected to decrease to 1,093.[2] Although these staff levels are large compared to those in other countries, I believe the SEC needs substantial increases in its budget for enforcement in order to meet its credit crisis enforcement staffing needs.

In addition to increased SEC resources for enforcement activities related to the credit crisis I believe the additional communication and monitoring responsibilities that I will discuss in the remainder of my testimony will also require additional resources.

[2] *Id*., p.35.

The SEC's actual budget for FY 2007 was $875.5 million. Its FY 2008 estimated budge was $906 million and its FY 2009 request if $913 million.[3] I believe these relatively small increases do not meet the SEC's real needs in regulating today's global market place.

The U.S. Treasury Principles Based Regulatory Proposals

In March of 2008, the U.S. Treasury released a Blueprint for Reform of the Financial Regulatory System containing both near term and long term proposals for financial system regulatory reform.[4] Although the Blueprint was published following the emergence of the credit crisis, it was developed during a period of a year or more, and followed four substantial study projects supporting various reforms in the financial regulatory system.[5] Each of the study projects emphasized the need for the U.S. to maintain its competitive position in the world's financial markets. These projects and the Treasury Blueprint raise important questions regarding the future of the SEC's regulatory function.

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[3] *Id.*, p.3.

[4] United States Treasury: Blueprint for a Stronger Regulatory Structure http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf (hereinafter "Treasury Blueprint").

[5] Interim Report of the Committee on Capital Markets Regulation http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ;U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century – Report and Recommendations http://www.uschamber.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf); Michael R. Bloomberg and Charles E. Schumer Sustaining New York's and the US' Global Financial Services Leadership http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf

The Treasury Department Blueprint contains proposals that would change the SEC's oversight of stock exchanges and investment banks from an enforcement system to a principles based system. The Blueprint seeks this change in a number of ways. First it urges that the Commodity Futures Trading Commission operation under the Commodity Futures Modernization Act (CFMA) serve as a model for the SEC's oversight of securities clearing agencies and exchanges. Under that Act core principles are utilized for regulation of futures exchanges and clearing organizations by the CFTC. [6] The idea is that the CFTC will perform is regulatory mission by applying a guiding principles approach involving discussions with the clearing agencies and exchanges about appropriate means of achieving compliance with the principles. The Blueprint then urges the SEC to use its current exemptive authority now to adopt core principles for securities clearing agencies and securities exchanges, in part to facilitate a smoother merger of the CFTC and SEC.[7]

The Blueprint lists the CFMA core principles for exchanges:

> The CFMA required contract markets to comply with eighteen core principles relating to: having reasonable discretion in establishing their compliance with the core principles; rule compliance and enforcement; listing of contracts not readily susceptible to market manipulation; trade monitoring system; position limits; emergency authority; information availability; daily publication of trading information; contract execution; procedures for recording and safe storage of trade information; financial integrity; market participant protections; dispute resolution; fitness standards; conflict of interest management; governing board composition; recordkeeping; and antitrust considerations.[8]

[6] Treasury Blueprint, p.111.
[7] *Id*.
[8] *Id*., p.110.

The Blueprint indicates that futures exchanges are expected to comply with these core principles, but will have "reasonable discretion" in doing so.[9]

As a second step, the Treasury recommends a merger between the CFTC and the SEC and urges legislation that will "merge regulatory philosophies, in a sense, to continue and enhance the modernization in the aforementioned pre-merger steps, and to harmonize futures and securities statues and regulations."[10]

It notes the differences in CFTC and SEC rules involving "margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, the SRO rulemaking approval process, and the new agency's funding mechanism"[11] and recommends "harmonization" of the differences between futures and securities regulation.[12]

The Blueprint describes the benefits of the core principles approach to futures industry market participants as "flexibility to adapt to market changes, outcome-focused, acknowledgement of the possibility of more than one path of regulatory compliance, allowing for creativity and innovation, and facilitation of global regulatory

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[9] *Id*., Appendix F.
[10] *Id*., p.115.
[11] *Id*., p.116.
[12] *Id*., p.118.

cooperation."[13] It would apply this regulatory approach to securities industry participants.

Treasury support for a principles based system may come in part from a comparison with recent changes in the financial services regulatory system in the United Kingdom. In the U.K., regulation of banking, securities, insurance and investments including supervision of the listing practices on the London Stock Exchange, has recently been merged into a single, unified regulator, the Financial Services Authority (FSA),[14] utilizing a principles based regulatory system. The system has been described by the FSA as follows:

> Principles-based regulation means, where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified. We will increasingly shift the balance of our activity towards setting out desirable regulatory outcomes in principles and outcome-focused rules, enabling our people to engage with firms' senior management in pursuit of these outcomes. We expect firms' behaviour, in turn, to change to adjust to this shift in emphasis. We will also measure and evaluate our own performance against identified regulatory outcomes.[15]

The Treasury proposal that the SEC and the CFTC be merged is not new. I sought legislation calling for the combination of the SEC and the CFTC following the market crash of 1987, but to no avail. I welcome and support the Treasury proposal as properly seeking to solve important problems stemming from the existence of two

[13] *Id*., p.110.
[14] Financial Services Roundtable, "The Blueprint for U.S. Financial Competitiveness", p.26 (Nov. 7, 2007).
[15] Financial Services Authority (United Kingdom) "Principles Based Regulation" (April 2007).

agencies that are both regulating increasingly similar products and regulating markets that are engaged in active competition with each other, but I do not believe the merger should be the vehicle for imposing a principles based regulatory system in the securities markets.

Enforcement Based Regulation Should Not Be Abandoned

My concern is that the “principles based regulation” would result in the abandonment of an SEC enforcement based regulatory system that has been essential to preserving the integrity and honesty of the U.S. securities markets.

A principles based system relying upon market participants to police themselves is not likely to prevent the kind of misconduct engaged in by broker dealers and other participants in the securities industry. When I arrived at the Commission in 1987 the staff had just finished its Ivan Boesky insider trading case. It later successfully pursued Michael Milken and Drexel, Burnham for market manipulation. Subsequent successful SEC enforcement actions have been brought based upon price fixing in the Nasdaq Stock Market, false analyst recommendations, trading ahead by stock exchange specialists, laddering in the IPO market, and market timing and late trading. As I have indicated the SEC is now investigating probable misconduct in the credit markets.

The SEC Should Continue To Communicate With Investment Banks and Regulators Regarding Market Innovations

Although I do not believe the SEC enforcement based system should be abandoned, I am sensitive to the fact that the SEC is regulating U.S. investment banks and stock exchanges that are competing in a complicated and constantly changing world environment.

Thus, despite my concerns that principles based regulation would lead to abandonment of tried and true enforcement based regulation, I believe the SEC should embrace the communications objectives of principles based regulation. Dramatic innovation and technological change in the world's securities markets have created a need for the SEC to communicate constantly with the leaders of our investment banks, securities exchanges, and futures exchanges, as well as with domestic and foreign regulators.

I believe the SEC is currently highly aware of the need to communicate on all levels. It regularly meets with leaders of the U.S. securities industry. It participates in the President's Working Group on the Financial Markets, which is composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission. It has established strong contracts with securities regulators in other countries and with the International Organization of Securities Commissions (IOSCO).

The SEC Should Continue Its Oversight of the Financial Stability of Investment Bank Holding Companies

In one area, I believe the Commission should actively pursue principles based regulation. It should engage in "prudential regulation" with regard to the solvency, liquidity, and financial stability of investment banks, and related aspects of systemic risk. The Commission should play an active role in monitoring the overall risk management practices of investment banks. When possible it should obtain information about the risk positions of unregulated entities such as hedge funds, private equity, and off balance sheet entities.

Regulation of the financial stability of investment bank holding companies in the U.S. currently is bifurcated. Investment banks that are part of bank holding companies are subject to prudential supervision by the Federal Reserve Board. Investment bank holding companies not regulated as part of bank holding companies are subject to risk based supervision by the SEC through its Consolidated Supervised Entity (CSE) program. On July 8, 2004, the SEC adopted rules allowing it to supervise on a voluntary basis investment bank holding companies not subject to Federal Reserve oversight of bank holding companies. [16] The regulatory framework was established in part in order "to provide a basis for non-U.S. financial regulators to treat the Commission as the

[16] Final Rule: Supervised Investment Bank Holding Companies, Rel. 34-49831 (July 8, 2004).

principal U.S. consolidated home-country supervisor" for supervised investment bank holding companies.[17] The voluntary supervisory program was accepted by five holding companies: Bear Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.[18]

The CSE program requires the supervised entities to provide the SEC on a regular basis with extensive information regarding its group wide "capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk."[19] The aim of the program is to monitor both the regulated and unregulated entities within the holding company for financial or operational weaknesses. In practice the operation of the program is "prudential" because it involves attention to the affairs of the supervised investment bank holding companies on an individual basis, with close and regular contact between the SEC staff and the supervised entity.

I believe the prudential supervision of investment bank holding companies by the SEC should continue and be expanded. It is extremely important that the risk positions of investment bank holding companies, including their unregulated affiliates, be known, so that the SEC can confer with other regulators regarding systemic risk. This risk assessment regulatory function should remain in the SEC because it is the agency that best understands the risk activities engaged in by investment banks. Indeed, using its

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[17] SEC Rel. 34-49831, p.4 (July 8, 2004).
[18] SEC Holding Company Supervision Program Description www.secgov/divisions/marketreg/hcsupervision.htm, p.3.
[19] SEC Holding Company Supervision With Regard to Capital Standards and Liquidity Planning, www.sec.gov/divisions/marketreg/hcliquidity,htm.

expertise, the SEC might well cooperate with the Federal Reserve Board regarding the risk assessment of investment banks that are part of bank holding companies. I further believe that the CSE voluntary program for SEC oversight of investment bank risk activities should be made mandatory through legislation, so that the non-bank holding company investment banks will not have the power to withdraw from the supervisory system when they are dissatisfied with the SEC's supervision or unwilling to provide information.

In conclusion, I urge that the SEC be given additional resources to fulfill its regulatory mission, that it should not be required to substitute principles based regulation for its current enforcement based regulation, that it should continue and expand its communication with investment banks and regulators regarding market innovations and risk positions, and that it should be given new power enabling it to improve its oversight of the financial stability of investment bank holding companies.