Testimony Concerning
Recent Developments in U.S. Financial Markets and Regulatory Responses

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Chairman Dodd, Senator Shelby, and Members of the Committee:

Thank you for this opportunity to describe the SEC's actions to deal with the recent developments in our financial markets.

Since the credit market crisis began with the deterioration of mortgage origination standards and a contagion of abusive lending practices, and then spread to the capital markets through securitization, the SEC has used its law enforcement and regulatory powers to contribute to orderly and liquid markets. We have acted in three main areas:

- Investigation and prosecution of violations of the securities laws;
- Regulation of problem areas in the markets, including credit rating agencies under recent authority granted us by Congress; and
- Accounting and disclosure standards to bring hidden risk into the light.

Our work in these areas has been both national and international.

First and foremost, the SEC is a law enforcement agency. Our enforcement actions to address the capital markets turmoil have involved not only our Division of Enforcement and each of the agency's 11 regional offices, but also nearly every major SEC division and office, and every area of professional emphasis, through our agency-wide Subprime Task Force. We are also working closely with other federal and state law enforcement agencies.

The SEC has over four dozen pending law enforcement investigations in the subprime area. They fall primarily into three broad categories: first, subprime lenders; second, investment banks, credit rating agencies, insurers and others involved in the securitization process; and third, banks and broker-dealers who sold mortgage-backed investments to the public.

We are investigating whether mortgage lenders properly accounted for the loans in their portfolios, and whether they established appropriate loan loss reserves. In connection with the sale of mortgage-backed securities and collateralized debt obligations, we are investigating the role of the various parties involved in the securitization process. Among other things, we are focused on whether lenders adequately disclosed the risk profiles of underlying loans, whether they valued their portfolios appropriately, and whether they made adequate risk disclosures to investors.

We are also investigating whether investment banks and broker-dealers defrauded retail customers by making false representations, or by putting investors into unsuitable mortgage-backed investments.

As one example of these initiatives, just a few weeks ago the Commission brought enforcement actions against two portfolio managers of Bear Stearns Asset Management, whose hedge funds collapsed in June of last year. We allege that they deceived their investors and institutional counterparties about the financial state of the hedge funds, and in particular the hedge funds' over-exposure to subprime mortgage-backed securities. The collapse of the funds caused investor losses of over $1.8 B. These cases, and others like them in the subprime area, are making it clear that vigorous investor protection extends to hedge funds, which are by no means unregulated when it comes to fraud. Those who commit fraud at the expense of investors will always be the target of a relentless SEC.

That same vigorous commitment to investors extends to our jealous protection of the integrity of public disclosure. Because the reliability of information about public companies in the marketplace is so important to market confidence, there have long been clear rules in place that prohibit market manipulation by knowingly spreading false rumors. But for the entirety of its 74-year history until 2008, the Commission had never brought an enforcement action of this kind.

It is probably because of the difficulty in tracing where a false rumor starts, and proving that it was knowingly false, that these cases haven't been brought in the past. But now the same technology that instantly spreads market rumors across the globe is also helping law enforcement track down the culprits. As a result, just a few weeks after the demise of Bear Stearns, we successfully sued a trader who used instant messages to other brokerage firms and hedge funds to spread fake information about a pending acquisition. The false rumors that he started caused the stock to drop by 17%, and wiped out $1 billion of market cap in the first 30 minutes. That caused the NYSE to halt trading in the company's securities. Following our enforcement action, the Commission not only hit the trader with penalties and other sanctions, but also banned him for life from the industry. If we are successful in bringing future cases like this, I believe the penalties should be commensurate with the enormous amount of shareholder value that is destroyed by this kind of wantonness toward other people's money.

For several months, we have had other active investigations underway concerning the possible manipulation of securities prices through various combinations of manufacturing false rumors and short selling in a number of cases that may have contributed to the increase in market volatility that is impacting so many ordinary investors. In addition, the Commission has joined with other securities regulators in undertaking industry-wide sweep examinations that will include hedge fund advisors, aimed at preventing the spread of intentionally false rumors to manipulate securities prices. Our examiners will focus on whether firms and advisers have proper controls in place, and whether those controls are reasonably designed to prevent the intentional creation or spreading of false information intended to affect securities prices, as well as other potentially manipulative conduct.

In addition to enforcing our existing regulations, the Commission is also using our authority to promulgate new rules to address serious issues that have arisen in the subprime crisis.

Today, the Commission will issue an order designed to enhance protections against “naked” short selling in the securities of primary dealers, Fannie Mae, and Freddie Mac. This emergency order will provide that all short sales in the securities of primary dealers, Fannie Mae, and Freddie Mac will be subject to a pre-borrow requirement. In addition to this emergency measure, we will undertake a rulemaking to address these same issues across the entire market.

We are using our new authority under the Credit Rating Agency Reform Act to write sweeping new regulations to deal with one of the most significant problem areas that led to the spread of the subprime crisis. Until the passage of this landmark legislation, the credit rating industry has been largely unregulated. Now, in the 10 months since the first firms became registered under the new law, they are subject to thorough-going regulation of everything from their public disclosures, to their management of conflicts of interest, to their ability to prevent unfair, abusive, or coercive behavior in the ratings process.

The new law also gave us the authority to examine these firms, and we have been aggressively using it. Our examinations have focused on the rating agencies’ processes for rating subprime residential mortgage-backed securities and collateralized debt obligations. We've looked at whether they followed impartial procedures for determining credit ratings, or instead diverged from their stated methodologies in order to publish higher ratings. As you know, we recently provided to the Committee a complete report of our staff’s findings in these examinations. The report describes serious shortcomings in the three largest credit ratings agencies, including a lack of disclosure to investors and the public, inadequate policies and procedures to manage the rating process, and insufficient attention to conflicts of interest.

All of the issues that we identified in these examinations are being squarely addressed through real-time supervision, and through new rulemaking. Our proposed new rules directly address concerns about the integrity of the firms' ratings procedures and methodologies. They also address conflicts of interest and require disclosures that are specifically designed to increase the transparency and accountability of the firms and their ratings. Our proposed rules also require that a rating agency differentiate the ratings it issues on structured products from those it issues on corporate bonds through the use of different symbols, or by issuing a report explaining the differences. The new rules would also clarify for investors the limits of credit ratings, and the purposes for which they're suited.

Even before these new rules take effect, the firms themselves have committed to the SEC that they will make changes in their own procedures. Each of the firms we recently examined has agreed to take remedial measures as recommended in our report. In addition to following up with these firms to evaluate whether they have in fact complied, we will also initiate examinations of each of the other credit rating agencies registered with the SEC in the coming months.

The subprime crisis was also deepened by problems with disclosure and accounting. In recent months our Division of Corporation Finance has asked financial institutions to provide additional disclosure regarding both off-balance sheet arrangements and the application of fair value to financial instruments. The Division also provided suggestions to improve the transparency and content of this disclosure to investors. It encouraged disclosure about the types of events that could require consolidation of off-balance sheet arrangements, as well as the implications of consolidating if it were to occur. And it encouraged disclosures that would help an investor understand the significance of fair value measurements, including how they were determined by management and the judgments used by management. Financial institutions have improved their disclosures in subsequent public filings by taking into consideration these suggestions.

A related set of issues concerns the application of accounting rules to balance sheet consolidation and fair value accounting. The Commission's Chief Accountant has asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether the subprime experience points to the need for changes. This review by the FASB is currently underway.

Yet another pathology of the subprime crisis has been the difficulty of applying fair value accounting rules to assets for which there is no current market. Last Wednesday, the Commission hosted a Roundtable to hear from market participants and regulators about the challenges of the current fair value accounting and auditing regime. While the consensus of the panelists was that fair value standards provide important discipline for market participants and important information to investors, there were calls for additional information on how best to implement these standards at the margin, and especially in today's challenging market conditions. We are now working with both FASB and the PCAOB to tackle that challenge.

Since the events of mid-March that culminated in the Bear Stearns acquisition, the SEC has broadly engaged with other regulators on issues related to capital and liquidity. The lessons from recent market events were clear when it came to both securities regulators' and bank regulators' analysis of the adequate levels of both capital and liquidity. The SEC has broadly strengthened liquidity requirements for the largest investment banks. We are closely scrutinizing the secured funding activities of each CSE firm, to encourage the establishment of additional term funding arrangements and to reduce their dependency on "open" transactions.

Working together with the Federal Reserve, we have developed additional stress scenarios in light of the Bear experience that are focused on shorter duration but more extreme events. These scenarios entail a substantial loss of not only unsecured funding, but secured funding as well. They also assume no access to the Fed's liquidity facilities. And we are continually discussing with CSE senior management their longer-term funding plans, including specifically their plans for selling risky assets and raising new capital -- both equity and long-term debt.

Our recently concluded Memorandum of Understanding with the Federal Reserve Board is facilitating this cooperation as well as our joint work in a number of other important areas, including anti-money laundering, bank brokerage activities under the Gramm-Leach-Bliley Act, the regulation of transfer agents, and clearance and settlement in the banking and securities industries.

This cooperative focus on clearance and settlement is especially important when it comes to the over-the-counter derivatives markets, where the investment banks the SEC supervises are some of the most active participants. To enhance their operational capacity, we are encouraging the firms to reduce their gross exposures by tearing up, or netting, offsetting positions. And they are doing this -- both bilaterally with trading partners, and multilaterally through vendor-provided solutions. The SEC, the Fed, and other regulators are also discussing whether and how the market for OTC derivatives contracts might benefit from a central clearing party for the credit default swaps market. In our view, this could serve to handle spikes in transaction volume, and promote certainty of contract settlement. It would also reduce the negative effects of misinformation and rumors that can occur during high volume periods.

The subprime crisis has affected markets all over the world, and so for months we have been working with our international regulatory counterparts to ensure that our solutions to these problems work across national boundaries. As Chairman of the Subprime Task Force of IOSCO, I have had an exceptional opportunity to coordinate with other national regulators both on diagnosing the problems that led to the current distressed market conditions, and on the best regulatory solutions. Since March we have been working with the Basel Committee to amend the capital adequacy standards to deal explicitly with liquidity risk. And because the American credit rating agencies are relied on around the world, we have worked closely with our overseas counterparts to revise the international code of conduct for rating agencies.

The SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than it has ever been. We will continue to work not only within the SEC but in close cooperation with our regulatory counterparts to promote the continued health and vibrancy of our markets. Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.