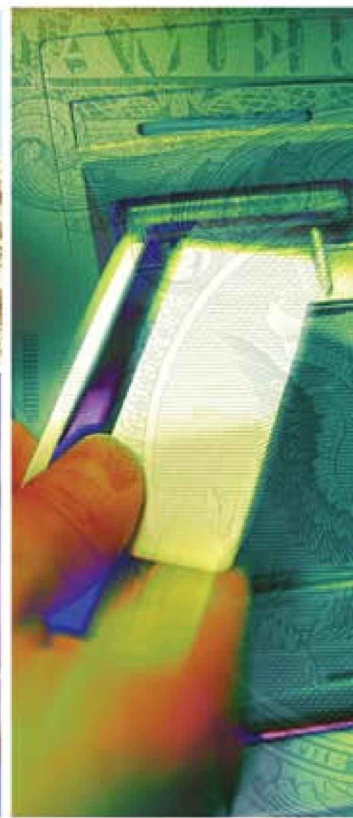
THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

The Blueprint for U.S. Financial Competitiveness

Principles-Based Regulation | *An Agenda For Reform* | *Modernized Charters*



RICHARD M. KOVACEVICH
JAMES DIMON
THOMAS A. JAMES
THOMAS A. RENYI

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Message from Commission Co-Chairs Richard M. Kovacevich and James Dimon

Effective regulation and the competitiveness of U.S. financial markets and firms are vital to consumers, capital formation, job creation, and sustained economic growth. Consumers of all kinds – small savers, first-time homebuyers, college students, small businesses and medium-size enterprises, large corporations, issuers, investors, pension funds, and even governments – benefit when markets are safe, stable, and secure as well as when they are vibrant and innovative, and financial services firms actively compete for their business. Today, financial services firms directly account for five percent of total U.S. employment, and 8 percent of U.S. gross domestic product (GDP).

Three recent studies, including a bipartisan study issued by New York Mayor Michael R. Bloomberg and U.S. Senator Charles E. Schumer (D-NY), have called for a legal and financial regulatory system that is more effective, balanced, and responsive to the needs of consumers and our economy. The Blue Ribbon Commission on Enhancing Competitiveness was formed to build upon the work of these earlier studies.
The Commission's mandate was threefold:

- To develop a set of Guiding Principles for a more balanced, consistent, and predictable legal and financial regulatory system
- To create a financial services reform agenda based upon the application of the Guiding Principles to eight legal and regulatory issues (prudential supervision, litigation reform, consumer credit and opportunities for long-term financial security, anti-money laundering, risk-based capital regulation, insurance regulation, Sarbanes-Oxley Act (Section 404), and U.S. and international accounting standards)
- To identify charter enhancements for existing depository institutions and propose new optional national charters for serving consumers more effectively and efficiently in the future.

The Blueprint for U.S. Financial Competitiveness is the product of the Commission's deliberations. Our goal is that this Blueprint—and its policy reforms and more than 60 specific recommendations—serve as a starting point for a broader dialogue and constructive engagement with policymakers, regulators, and all interested parties to improve our legal and financial regulatory system and thereby enhance our ability to compete and serve consumers in national and international markets.

We firmly believe that the United States would benefit from the adoption of a set of common Guiding Principles and better oversight by regulators across all financial markets. Our proposed Guiding Principles would not replace rules, but would provide regulators and firms with a common framework to guide policies and practices. We also believe it is

time to ensure that financial regulation across all financial markets is risk-based and cost-effective and that prudential supervision is the standard across these same financial markets. This is not a call for de-regulation; it is a call for more constructive engagement between regulators and firms that allows issues to be addressed in a timely and effective manner.

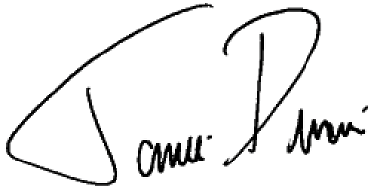
This Blueprint addresses eight specific policy areas where principles-based financial regulation could be implemented to achieve better policy and regulatory outcomes for financial services firms and the consumers they serve. These "case studies" include reform of our legal system that is needed to support a shift to a more principles-based approach to financial regulation. The Blueprint also calls for the modernization of existing financial services charters and the creation of three new optional financial charters: a national insurance charter, a national securities license, and a universal financial services charter.

We do not underestimate the effort involved to implement our recommendations, but we also strongly believe that these recommendations address some of the most fundamental issues facing the financial services sector, consumers, and our economy today. The United States needs to act now to maintain its leadership role in financial services globally.

On behalf of The Financial Services Roundtable and the Commission on Enhancing Competitiveness, we stand ready to work with all interested parties to achieve our common objectives and desired policy results. Better regulation and enhanced competitiveness are needed urgently to serve the dynamic and diverse needs of all consumers of financial services in the future.

Respectfully,

Richard M. Kovacevich
Chairman
Wells Fargo & Company
Co-Chair
Commission on Enhancing Competitiveness



James Dimon
Chairman and Chief Executive
JPMorgan Chase & Co.
Co-Chair
Commission on Enhancing Competitiveness

Thomas A. James
Chairman and CEO
Raymond James Financial, Inc.
Chairman, The Financial
Services Roundtable

Thomas A. Renyi
Chairman and CEO
The Bank of New York Mellon
Chairman-elect, The Financial
Services Roundtable

Acknowledgements

The Financial Services Roundtable is a unique trade association, limited to 100 of the largest financial services companies in the United States. Built on the legislative foundation created in the Gramm-Leach-Bliley Act of 1999, members are banking, securities, insurance, and other diversified financial services firms. The Roundtable believes that a competitive market is the best system for financing the economy, and that regulation should ensure safety and soundness and consumer protection without stifling innovation. The Roundtable is also committed to uniform national standards, a strong economy, and the active promotion of U.S.-based companies in the global economy.

The Roundtable's Blue Ribbon Commission on Enhancing Competitiveness was formed in response to several recent studies on the competitiveness of U.S. financial markets and firms, including the bipartisan Bloomberg-Schumer report. This Blueprint also builds upon two previous Roundtable studies: *Reconciliation of Regulatory Overlap for the Management and Supervision of Operational Risk in U.S. Financial Institutions* (May, 2005) and *The Compliance Function in Diversified Financial Institutions* (July, 2007). The Commission's mandate was to: (1) develop a set of guiding regulatory principles for more balanced, consistent and predictable regulation; (2) create a financial services reform agenda by applying those guiding principles to key legal and regulatory issues; and (3) propose enhancements for existing charters and new national chartering options to serve and protect consumers better. This Blueprint, and its over 60 general and specific recommendations, are the product of the Commission's deliberations.

The Roundtable is grateful to the members of the Commission and the many other individuals who lent their time, energy, and expertise to this project.

In particular, we owe deep gratitude to the Co-Chairmen of the Commission, Richard M. Kovacevich, the Chairman of Wells Fargo & Company, and James Dimon, the Chairman and Chief Executive Officer of JPMorgan Chase & Co. This Blueprint could not have been completed without their leadership.

The Blueprint also could not have been produced without the input provided by the 63 Commission members, who researched, considered, and discussed the issues in the Blueprint over the past several months. A complete list of the Commission members appears in Appendix C. Nor could the Blueprint have been possible without the subject matter experts who assisted in the preparation of the case studies.

The Roundtable is grateful for the outstanding guidance provided throughout this project by William A. Longbrake of Washington Mutual, Inc., who also is the Anthony T. Cluff Senior Policy Advisor to The Financial Services Roundtable. He also provided invaluable editorial assistance in drafting the Blueprint. The Roundtable staff and Connie Nelson in particular deserve our special thanks. Connie kept us organized, on schedule, and focused throughout the project.

The Roundtable also thanks Jim Sivon, a partner in the Washington, D.C. law firm of Barnett Sivon & Natter P.C., and Greg Wilson, President of Gregory P. Wilson Consulting, for serving as Co-Project Study Directors. They were responsible for drafting much of this Blueprint and incorporating the recommendations and insights of Commission members and subject matter experts. They performed these tasks in a professional and courteous manner.

Additionally, the following individuals provided expertise, and advice on various topics: Robert Barnett, Raymond Natter and Sujey Kallumadanda, Barnett Sivon & Natter, P.C.; Cheryl Evans, U.S. Chamber; Hal Scott, Harvard Law School; Ross Delston, GlobalAML.com; Adam Gilbert, JPMorgan Chase; John N Wright, Wells Fargo; Gary Parker, Washington Mutual; Tim Robison, The Bank of New York Mellon; Jeanne de Cervens, AEGON; Denise Ferguson, Ameriprise; Scott Rothstein, The New York Commission to Modernize the Regulation of Financial Services; and Bruce D. Wilson, Ernst & Young.

Finally, the Roundtable thanks the Cluff Fund and the member organizations of the Commission, which provided the financial support for this effort.

A copy of this report can be found at www.fsround.org.

Executive Summary

This Blueprint seeks to serve and protect American consumers with better regulation and enhanced competitiveness. The Blueprint is a call to action to the financial services industry, national and state legislators, regulators, and other policymakers. The Blueprint's recommendations are intended to serve and protect consumers, promote economic growth, job creation, and market stability through a combination of better regulation and the enhanced competitiveness of the financial services industry. Achieving a dynamic balance between enhanced competitiveness and better regulation will assure that both U.S. financial services firms and regulators adapt quickly to rapidly evolving domestic and global markets in a manner that promotes innovation, while simultaneously maintaining safety and soundness as well as financial system stability and security.

Better regulation can be achieved across U.S. financial markets by adopting Guiding Principles to govern existing and new regulations, improving regulatory oversight and coordination, and promoting more regular and open communication between firms and regulators through prudential supervision. Enhanced competition can be achieved by modernizing existing charters and creating new options for national charters to serve and protect consumers better in the future.

For decades, U.S. financial markets and financial firms have been the envy of the world. Our dynamic and innovative financial markets and financial firms have provided consumers, businesses, investors, governments, and other organizations with the means to invest, save, borrow, finance, and exchange funds. Likewise, our legal and regulatory system and regulators have played an important role in maintaining the stability and security of our financial system. This has helped the U.S. economy to grow and to produce record levels of employment. U.S. financial services firms directly account for 5 percent of all jobs nationwide and 8 percent of the U.S. gross domestic product (GDP).

However, with the accelerating expansion of global markets and competition, it appears that we may have reached a "tipping point," where the inability of our current legal and financial regulatory system to adapt to new global methods of regulation is putting the competitiveness of U.S. firms at risk. As demonstrated by recent events, it also appears to be increasingly less effective in adequately serving and protecting consumers of financial products as well as fully supporting the stability of financial markets.

Three major studies - the bipartisan report by New York Mayor Michael R. Bloomberg and New York Senator Charles E. Schumer (D-NY), the U.S. Chamber report, and the study by the Committee on Capital Markets - have concluded that the United States is losing its position as the world's leading financial marketplace.[1]

More recently, the liquidity crisis and ensuing credit crunch in several significant capital markets sectors has revealed weaknesses in the regulatory system. Many homeowners have been confronted with the prospect of foreclosure, and U.S. financial markets

[1] Michael R. Bloomberg and Charles E. Schumer, Sustaining New York's and the US' Global Financial Services Leadership, January 2007 at www.nyc.gov; hereafter, Bloomberg-Schumer Report. See also Michael R. Bloomberg and Charles E. Schumer, "To Save New York, Learn from London," Wall Street Journal, November 1, 2006, p. A-18; Committee on Capital Markets Regulation, Interim Report, November 2006 at www.capmktsreg.org; hereafter, Interim Report; Commission on the Regulation of U.S. Capital Markets in the 21st Century (U.S. Chamber of Commerce), Report and Recommendations, March 2007 at www.uschamber.com; hereafter, U.S. Chamber Report.

have been roiled by problems that can be traced to aggressive practices by some firms, gaps between national and state regulation of the U.S. mortgage industry, and opaqueness in some structured financial instruments innovations. Many of these problems also have impacted the broader credit and capital markets, both domestically and globally.

These market and regulatory challenges are the result of both external and internal factors. External factors threatening the competitive position of U.S. financial firms and the stability of financial markets include the relentless growth in international financial services competition, rapidly expanding foreign financial markets, and foreign regulatory regimes purposefully designed to adjust quickly to market developments. These factors are beyond our control.

On the other hand, issues raised by our legal and regulatory system are within our control. While our system of financial regulation has served as a source of strength in the past, it is not flexible or adaptive enough to accommodate growing global competition, respond rapidly to innovative market developments, or fully meet the dynamic financial needs of all consumers. The recent events in the mortgage market are the latest example of the inability of our current regulatory system to respond rapidly to market developments and technology changes. Policymakers at all levels of government have recognized the direct links among the health and stability of U.S. financial markets, job creation, and economic growth. U.S. Treasury Secretary Henry M. Paulson, Jr., has made this point clear:

> *Competitive capital markets are the lifeblood of the U.S. economy. They help entrepreneurs implement new ideas and businesses expand operations, creating new jobs. They give our citizens the confidence to invest, earn higher returns on their savings, and reduce the cost of borrowing.*[2]

The limitations of our existing legal and regulatory system also should be a concern to the multiple

national and state regulators who supervise financial markets and institutions doing business here and abroad, the thousands of executives who compete in the increasingly global financial marketplace, and – most importantly–the millions of consumers and companies who depend on competitive financial services to enhance their prosperity and make the conduct of their daily financial affairs more valuable, efficient, and convenient.

The Bloomberg-Schumer Report

In their January 2007 report, *Sustaining New York's and the US' Global Financial Services Leadership,* Mayor Bloomberg and Senator Schumer found that our regulatory system, and the legal environment upon which the system is based, is stifling innovation and reducing the ability of financial services firms to serve consumers effectively and efficiently. Accordingly, the Bloomberg-Schumer report recommended the development of a national vision for the regulation of financial markets and financial services firms in the United States based upon a set of regulatory principles that could guide the future development of our financial marketplace:

> *. . . (O)ur regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as is the case in the United Kingdom and elsewhere . . . The time has come . . . to undertake broader reforms, using a principles-based approach to eliminate duplication and inefficiencies in our regulatory system.*[3]

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[2] Opening Remarks of the Honorable Henry M. Paulson, Jr., U.S. Secretary of the Treasury, Capital Markets Competitiveness Conference, Georgetown University, March 13, 2007; hereafter, Paulson, Georgetown University Speech.

[3] Bloomberg-Schumer Report, p. 2.

Treasury Secretary Paulson's challenge

After the Bloomberg-Schumer report was issued, Treasury Secretary Paulson challenged all stakeholders to take a hard look at a more principles-based approach to financial regulation:

> *. . . (W)e should also consider whether it would be practically possible and beneficial to move to a more principles-based regulatory system as we see working in other parts of the world.*[4]

Other key financial policymakers also are pursuing, or have expressed interest in, a more principles-based regulatory system. Today, the Commodity Futures Trading Commission (CFTC) exercises its statutory responsibilities based on 18 core principles enacted into law by the Commodity Futures Modernization Act of 2000. As Acting CFTC Chairman Walter Lukken has stated: "a principles-based oversight regime – compared to the traditional rules-based one – provides a more effective regulatory approach for financial services in this global technological age."[5]

In February 2007, the President's Working Group on Financial Markets (PWG) adopted a principles-based approach to private pools of capital, including hedge funds, focusing on principles for investor protection and systemic risk.

More recently, the Chairman of the Federal Reserve Board, Ben S. Bernanke, also suggested that U.S. regulators look to the U.K.'s principles-based approach to regulation as a potential model for the United States: "We should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives."[6]

The Roundtable's response

To meet Secretary Paulson's challenge, and build upon the recommendations of the Bloomberg-Schumer report, the U.S. Chamber's report, and other recent studies, The Financial Services Roundtable established a Blue Ribbon Commission on Enhancing Financial Competitiveness, co-chaired by James Dimon, Chairman and Chief Executive Officer of JPMorgan Chase & Co., and Richard M. Kovacevich, Chairman of Wells Fargo & Company.[7]

The Roundtable is well positioned to take up Treasury Secretary Paulson's challenge and propose reforms for the regulation of our financial markets and financial institutions. In addition to two studies previously mentioned (on Regulatory Overlap and the Compliance Function), Roundtable member companies are active in all of the nation's major financial markets. Further, financial market competitiveness that serves consumers is a core belief of the Roundtable.[8]

The Commission's mission was threefold:

1. *Financial regulatory principles.* Develop a set of Guiding Principles for financial regulation that delivers more balanced, consistent, and predictable outcomes for financial institutions, consumers, and other market participants.

2. *Regulatory case studies.* Create a reform agenda based upon applying the Guiding Principles to key regulatory issues that have an impact on consumers and the competitiveness of the financial services industry, including: prudential supervision; litigation reform;

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[4] Paulson, Georgetown University Speech.

[5] Walter Lukken, "It's A Matter of Principles," University of Houston's Global Energy Management Institute, January 25, 2007.

[6] Chairman Ben S. Bernanke, Board of Governors, Federal Reserve System, "Regulation and Financial Innovation," remarks to the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, May 15, 2005; hereafter, Bernanke, Regulation and Financial Innovation. See also "Bernanke calls for UK-style regulation," Financial Times, May 16, 2007, p. 1.

[7] William A. Longbrake, Vice Chairman of Washington Mutual and senior policy advisor to the Roundtable, served as the Commission's project coordinator. James C. Sivon of Barnett, Sivon, & Natter, P.C., and Gregory P. Wilson, President of Gregory P. Wilson Consulting, served as project co-directors for the Commission.

[8] The Financial Services Roundtable (hereafter Roundtable) is a unique trade association limited to 100 of the nation's largest, integrated U.S. financial services firms. Roundtable members employ over 2.4 million people, have a market capitalization of $2.7 trillion, and manage over $65.8 trillion in financial assets. Among other things, the Roundtable's core beliefs include: "the competitive marketplace should largely govern the delivery of products and services, and regulation should provide safety and soundness, and consumer protection;" and "uniform national standards across state lines are critical for the efficient and effective delivery of products and services."

consumer credit and opportunities for long-term financial security; anti-money laundering; risk-based capital regulation; insurance regulation; Sarbanes-Oxley Act (Section 404); and U.S. and international accounting standards.

3. *Modernized charter and structural options for serving consumers.* Identify alternative ways in which U.S. financial services charters, organizing structures, and state and federal regulatory regimes can be modernized and enhanced to meet the challenges of global competition and better serve consumers.

The Blueprint for U.S. Financial Competitiveness is the product of the Commission's deliberations. The Blueprint and its recommendations are a collective call for better, more effective regulation based upon guiding regulatory principles and greater prudential supervision across the entire financial services industry. Our proposed Guiding Principles would not replace rules; they would provide regulators and firms with a common framework to guide policies and practices. Similarly, prudential supervision is not a call for de-regulation; it is a call for a more constructive engagement between regulators and firms that allows issues to be addressed in a timely and effective manner before they become serious problems. This approach to regulation will benefit consumers both individually and collectively.[9]

The Commission recognizes that a key issue for policymakers and financial regulators is how to structure a regulatory system that balances important societal objectives, such as consumer and investor protection, market integrity, financial stability, and risk mitigation, with competitive markets and firms. In this regard, we fully support Treasury Secretary Paulson's recent assessment that regulatory and competitive balance is a national imperative:

> *When it comes to regulation, balance is the key. And striking the right balance requires us to consider the economic implications of our actions. Excessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs. The right regulatory balance should marry high standards of integrity and accountability with a strong foundation for innovation, growth, and competitiveness.*[10]

Regulatory reforms to enhance the competitiveness of U.S. financial markets and firms do not have to conflict with the broader public policy goals of financial system stability and security. To the contrary, ensuring the competitiveness of U.S. financial markets and firms complements the systemic objectives of financial regulators. For example, securities regulators today are required by law not only to promote orderly markets and investor protection, but also to consider "efficiency, competition, and capital formation". A landmark court ruling recently affirmed this statutory mandate for a more balanced approach to financial regulation of our markets.[11]

The Commission's ten regulatory policy reforms are intended to strike the appropriate balance between the competitiveness of financial services firms, consumer protection, and a strong, stable, and secure financial system. Our policy reforms are unique to financial services, but they are not exhaustive. Important national policy issues such as tax reform, immigration reform, open trade, data security, and

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[9] For us, the term "consumers" captures not only all retail customers, but also small- and medium-sized businesses, larger national and international businesses, investors, issuers, governments, and others who rely upon financial services firms in the conduct of their business.

[10] Remarks by Treasury Secretary Henry M. Paulson, Jr., on the Competitiveness of U.S. Capital Markets at the Economic Club of New York, November 20, 2006; hereafter, Paulson, New York Economic Club Speech. See similar remarks by Mary L. Schapiro, Chairman and Chief Executive Officer, NASD, before the SIFMA Compliance & Legal Division's 38th Annual Seminar, March 26, 2007; and remarks by Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, on Principles to Guide the Future Evolution of Financial Supervision and Regulation, at the Bond Market Association's 2006 Annual Meeting, May 19, 2006.

[11] Chamber of Commerce v. Securities and Exchange Commission, 412 F.3d, pp. 133, 141 (D.C. Cir. 2005), Chamber v. SEC, April 2, 2006, slip opinion. See also Peter J. Wallison, "Landmark Ruling: Could the Court's Decision in Chamber v. SEC Be a Turning Point in Securities Regulation?" American Enterprise Institute for Public Policy Research, May 2006. Peter Wallison is the Arthur F. Burns Fellow in Financial Market Studies at the American Enterprise Institute (AEI) and a member of the Roundtable's Commission on Enhancing Competitiveness.

privacy also have implications for the U.S. economy, but are beyond the scope of this Blueprint.

THE COMMISSION'S POLICY REFORMS

The Commission's ten policy reforms for serving consumers with better regulation and enhanced competitiveness are summarized below. A complete list of the Commission's detailed recommendations appears in Appendix A.

***Policy Reform I** - Enact Principles-based Regulation.* Congress should enact Guiding Principles for Financial Regulation and authorize the President's Working Group on Financial Markets to oversee the implementation of the Guiding Principles.

The Commission proposes that Guiding Principles be blended with and guide a body of rules to interpret the principles in a policy and legal context. Our principles-based approach to U.S. financial regulation envisions a set of fundamental principles standing ahead of, and guiding, the application and review of policies, laws, and rules affecting the activities and behaviors of both financial market participants and their regulators. The Guiding Principles recommended by the Commission are designed to be a unified and cohesive response to the needs of consumers, financial services firms, and regulators. At their core, the Commission's six Guiding Principles are intended to ensure that the regulation of financial services and markets is more balanced, consistent, and predictable and therefore achieves three fundamental objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation.

Policy Reform I has three parts: Guiding Principles; greater oversight by the President's Working Group on Financial Markets; and Regulatory Action Plans.

Guiding Principles

First, the Commission recommends that Congress enact into law a set of overarching Guiding Principles for national and state financial regulators and firms. The Guiding Principles would not only enable regulators to focus on desired policy outcomes and material risks to markets, but also reduce the potential for consumers to fall through gaps between the national and state legal and regulatory systems. These Guiding Principles would not replace regulations. To the contrary, regulations will remain necessary, especially at the retail level for the protection of consumers. However, once enacted into law, the Guiding Principles would become a touchstone against which all existing and new national and state financial regulations would be evaluated in a policy and legal context. Regulations that are not consistent with these Guiding Principles would be identified, analyzed, and then revised or eliminated, with regulators recommending changes to existing national or state laws, if necessary to achieve the intent of the Guiding Principles. The Commission's Guiding Principles are highlighted below and discussed further in Chapter 2.

President's Working Group on Financial Markets

Second, the Commission recommends that Congress codify and expand the current President's Working Group on Financial Markets (PWG) to ensure greater accountability and transparency across financial market regulatory agencies. The PWG would continue to be chaired by the Secretary of the Treasury and would be composed of appropriate national financial regulators and representatives of state financial regulators. The PWG would have a two-part statutory mandate. The first part of the PWG's mission would be to oversee the implementation of the Guiding Principles by individual national and state regulators to ensure better regulatory outcomes in the future. It would pursue this mission through its oversight of the Regulatory Action Plans discussed below.

Since we have a complex regulatory system composed of multiple, functional, and holding company

regulators at both the national and state levels, the United States is often slow to respond to changing market forces, international competition, and the dynamic needs of consumers. One of the primary tasks of the Secretary of the Treasury, as Chairman of the PWG, will be to ensure that the national and state financial regulators balance the competitive needs of our economy with financial stability and security. This would occur through an open and transparent rule-review process based on the Guiding Principles and through systematic monitoring of market developments. Therefore, the second part of the PWG's mission would be to serve as a forum for regulatory coordination.

Today, neither the current PWG nor the Federal Financial Institutions Examination Council (FFIEC) performs that role. No single agency spans all financial markets or is accountable across the entire financial sector of our economy, not even the U.S. Treasury Department. Over the past three decades, when specific events in the financial markets have impacted the U.S. economy, both the Congress and the Administration have empowered the Secretary of the Treasury to assume a leadership role in convening and overseeing various aspects of financial regulation.[12] Based upon these precedents, we propose that the Secretary of the Treasury continue to preside over the enhanced PWG. The Secretary's role would be limited to the oversight of financial regulation and general coordination; the Secretary would have no role in supervision of any particular institution by a national or state financial regulatory authority or other aspects of an individual regulator's statutory mandate (e.g., prudential supervision by all agencies, monetary policy of the Federal Reserve).

The recent market volatility here at home and around the world underscores the urgent and critical need for better regulation and more effective coordination. It also highlights the growing imperative to better manage the complex structural and regulatory issues that challenge all of us – regulators and firms alike. Better coordination among all federal and state agencies based on fundamental principles, more balanced regulation and prudential supervision, should enable financial services firms and regulators to see issues sooner, understand complicated inter-market workings better, and resolve problems faster. While we may not have been able to avoid all of the fallout from the recent market volatility, the PWG would have been the point of first response for a more focused, accountable, and coordinated approach to market issues across all segments of the financial services industry.

Regulatory Action Plans

Third, under the oversight of the PWG, each financial regulator would be required to develop its own Regulatory Action Plan to implement the Guiding Principles. We would expect that all national and state financial regulatory agencies would design a multi-year plan to conduct a comprehensive and balanced review of all regulations that affect the ability of financial services firms to compete and serve consumers' financial needs. Our goal is that this individual agency review process would lead to better regulation - regulations that are consistent with their

[12] For example, the Secretary of the Treasury played a leading coordinating role for the deregulation of interest rates in the 1980's as the head of the Depository Institutions Deregulation Committee (DIDC), the resolution of failed assets during the savings and loan crisis as head of the Resolution Trust Corporation Oversight Board, and the response to the stock market crash of 1987 as head of the President's Working Group on Financial Markets, which still exists today.

policy objectives and desired regulatory outcomes. Good regulations should be proportionate, risk-based, cost-effective, and consistent with the Guiding Principles. The PWG would serve as the U.S. Government's review panel to monitor and measure the progress of each agency in implementing the Guiding Principles.

To ensure accountability and transparency, the PWG would report annually to the Congress and the President on its activities and progress in implementing the Guiding Principles through the Regulatory Action Plan. It is not our desire to have the PWG intrude on the mission of individual regulators or become an impediment to other needed regulatory reforms. To the contrary, because we do not have one single financial regulator, we expect the PWG to provide greater focus, accountability, and transparency to regulatory issues that cut across the financial services industry and affect broader national policy objectives.

The Commission recommends, therefore, that Congress and the Administration work together to enact into law the following Guiding Principles for financial regulation:

Guiding Principles for U.S. Financial Regulation

Preamble. These Guiding Principles are intended to ensure that the regulation of financial services and markets is more balanced, consistent, and predictable for consumers and firms, and therefore achieves three fundamental objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation. Consumers' needs include those of retail customers, small- and medium-sized businesses, larger national and international businesses, investors, issuers, governments, and others who rely upon financial services firms in the conduct of their business. These Guiding Principles should guide the supervisory and regulatory policies and practices of national and state financial regulatory authorities as well as the policies and practices of financial services firms, and they should be enforced by the firm's primary regulator. They are not intended as a complete substitute for rules, but should guide both the development of new rules and the review of existing rules.

1. *Fair treatment for consumers (customers, investors, and issuers).* Consumers should be treated fairly and, at a minimum, should have access to competitive pricing; fair, full, and easily understood disclosure of key terms and conditions; privacy; secure and efficient delivery of products and services; timely resolution of disputes; and appropriate guidance.

2. *Competitive and innovative financial markets.* Financial regulation should promote open, competitive, and innovative financial markets domestically and internationally. Financial regulation also must support the integrity, stability, and security of financial markets.

3. *Proportionate, risk-based regulation.* The costs and burdens of financial regulation, which ultimately are borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and consumers.

4. *Prudential supervision and enforcement.* Prudential guidance, examination, supervision, and enforcement should be based upon a constructive and cooperative dialogue between regulators and the management of financial services firms that promotes the establishment of best practices that benefit all consumers.

5. *Options for serving consumers.* Providers of financial services should have a wide choice of charters and organizational options for serving consumers, including the option to select a single national charter and a single national regulator. Uniform national standards should apply to each charter.

6. *Management responsibilities.* Management should have policies and effective practices in place to enable a financial services firm to operate successfully and maintain the trust of consumers. These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety, soundness, and financial stability, and appropriate conflict of interest management.

Policy Reform II – Apply prudential supervision to all financial services firms.

The Commission recommends that all financial services regulators, including self-regulatory organizations, adopt and apply a system of prudential supervision. A system of prudential supervision encourages constructive engagement between regulated firms and their regulators, thereby permitting firms and regulators to address and correct issues in a timely and effective manner.

Policy Reform III – Reform securities and other class-action litigation.

Our existing regulatory system is a reflection of our existing legal system. If we are to improve financial regulation and move toward a system of prudential supervision, then we must address securities and other class action litigation. The Commission recommends a series of litigation reforms essential to complement a principles-based approach to regulation and prudential supervision.

Policy Reform IV – Improve consumers' access to credit and opportunities for long-term financial security.

The Commission recommends that Congress, the Administration, financial regulators, and the industry take actions to meet the credit and long-term financial security needs of consumers. Such actions should include enhanced financial education programs in school curricula, more meaningful and simpler disclosure requirements, uniform national consumer protection laws, alternative mechanisms for resolving consumer disputes, and the creation of a centralized portal for filing consumer complaints. Consumer lending has become a vital part of the U.S. financial services industry and an engine for the entire economy. Our proposed reforms will enhance prudent consumer lending in the future.

Policy Reform V – Make anti-money laundering supervision more effective.

The Commission recommends that Congress and the Administration take statutory and administrative actions to make anti-money laundering supervision more effective through prudential, proportionate, and risk-based supervision. The financial services industry performs an important role in the fight against money laundering and terrorist financing. These crimes pose serious threats to the well-being of our society, and we seek to fulfill our obligations fully and faithfully. However, to do so, regulations need to be focused properly and resources need to be applied effectively.

Policy Reform VI – Expand the risk-based focus of capital regulation.

The Commission recommends that U.S. and international financial regulators build upon the Basel II Capital Accord, and apply a risk-based focus to capital regulation for all financial services firms. One of the underlying purposes of Basel II is to enhance the risk focus of capital regulation. We believe this approach to capital regulation should be extended to all financial services firms, including Solvency II for insurance companies.

Policy Reform VII – Ensure the effective implementation of Sarbanes-Oxley Act (Section 404) regulatory reforms.

The Commission recommends that the Securities and

Exchange Commission (SEC), the Public Companies Accounting Oversight Board (PCAOB), and the financial services industry take actions to ensure the prompt implementation of recent administrative reforms to Section 404 of the Sarbanes-Oxley Act. The SEC and PCAOB have taken several initiatives to reform the Section 404 process, including risk-based principles, which we applaud. We offer several recommendations to ensure that these reforms achieve their intended purposes and are implemented effectively with appropriate oversight to monitor and measure the benefits of the new reforms.

Policy Reform VIII – Accelerate U.S. accounting standards modernization.

The Commission recommends that the SEC, the Treasury, and the industry continue to improve financial reporting standards. The Commission endorses the full use of International Financial Reporting Standards (IFRS) without reconciliation to U.S. generally accepted accounting principles (GAAP) as soon as possible, and the accelerated convergence of global accounting standards. High-quality financial reporting, comprehensive standards, and effective audits are critical components of vibrant financial markets.

Policy Reform IX – Modernize existing charters.

The Commission recommends that Congress and the Administration adopt statutory and administrative changes to enhance the powers, authority, and flexibility of national and state banks, federal and state savings associations, and financial holding companies to better serve consumers in the future. Consistent with our proposed principles for financial regulation, the managers of U.S. financial institutions should have a choice of the most modern, competitive, and productive charters and legal structures possible. Modernizing charters and legal structures allows firms to innovate and serve consumers more effectively and efficiently in their local markets as well as in the global financial marketplace.

Policy Reform X – Enact new national charter options.

The Commission recommends that Congress and the Administration authorize three new national charter options for financial services firms: an optional national insurance charter, an optional national securities charter, and an optional universal financial services charter.

During the past 20 years, various proposals have been made to reform the existing regulatory system by merging regulatory bodies. None of those proposals has been successful. Accordingly, we have taken a different approach to regulatory reform. Rather than eliminate agencies, we recommend the creation of new charters and, where appropriate, new national regulators. These new national charter options would put U.S. financial services firms on a more equal competitive footing with their international competitors that operate globally with a single license supervised by a single prudential home regulator. More effective coordination of multiple regulators can be accomplished through an enhanced PWG.

MOVING FORWARD NOW

As demonstrated in this Blueprint and earlier studies, factors such as the fundamental complexity of our regulatory system, potential legal exposure, delays in serving consumers with innovative products and services, and rising legal and regulatory costs are having a direct impact on the ability of U.S.-based firms to compete and serve consumers domestically and globally and on the stability of U.S. financial markets. It is critical to move expeditiously to address these problems by reforming financial regulation to assure better regulation and enhancing the competitiveness of U.S. financial markets so they may better serve all kinds of consumers, create new jobs, and finance a growing U.S. economy.

The Commission anticipates that implementation of its recommendations will require a long-term commitment of effort and resources. The Commission's recommendations are ambitious but

necessary if the U.S. financial system is to remain healthy, stable, and competitive. Moreover, recent market events have demonstrated the current shortcomings of our financial regulatory system, notwithstanding the efforts of individual regulators to address immediate problems in the segment of the financial system for which they are responsible.

Reforming the regulation of our markets and firms will not only help to meet the financial needs of all consumers, but also help the health of our economy as well. We hope that our recommendations will be the starting point for bipartisan discussions by policymakers and the broader financial services industry. Those discussions need to start now and should be open to everyone.

STRUCTURE OF THE COMMISSION'S BLUEPRINT

Chapter 1, "Rules or Principles: Two Approaches to Financial Regulation," describes the two competing approaches to financial regulation – rules-based regulation that predominates in the United States and a more principles-based regulation approach such as the one evolving in the United Kingdom. Chapter 1 also discusses the strengths and weaknesses of these two approaches to regulation.

Chapter 2, "Guiding Principles to Enhance U.S. Financial Regulation and Competitiveness," proposes six Guiding Principles designed to improve financial regulation and provide greater direction and consistency to the regulation of U.S. financial markets and firms. It also supports the enhancement of the PWG to oversee the implementation of these principles through individual Regulatory Action Plans and to better coordinate national and state regulatory policy across the financial services industry.

Chapter 3, "Eight Case Studies Applying the Guiding Principles to Enhance Regulation and Competitiveness," presents eight case studies on financial services competitiveness, and makes a series of specific recommendations for both regulatory and legislative actions to enhance the U.S. competitive position for serving and protecting consumers better.

Chapter 4, "Enhancing Charters and Creating New Options for Serving and Protecting Consumers," examines the current U.S. regulatory system and its development over time. We propose initiatives to modernize current charters and create three new options for enhanced national charters for serving and protecting consumers domestically and internationally.

Chapter 5, "An Action Plan for Serving and Protecting Consumers Better in the Future," is a final call to action for policymakers, regulators, and the financial services industry to adopt reforms now for better regulation and enhanced competitiveness in the future.

Chapter I – Rules or Principles: Two Approaches to Financial Regulation

This chapter of *The Blueprint for U.S. Financial Competitiveness* provides a foundation for the remainder of the Blueprint. It describes the existing U.S. system of financial regulation and supervision, which is predominantly rules-based, and the U.K.'s more principles-based approach to regulation and supervision applied by the Financial Services Authority (FSA). It also evaluates both approaches to financial regulation and highlights the challenges associated with the implementation of a principles-based system in the United States.

THE U.S. RULES-BASED SYSTEM OF FINANCIAL REGULATION

A rules-based system of financial regulation is one in which a body of financial laws and regulations addresses many, if not most, aspects of financial activities and practices. This system is focused on compliance, and it leaves little margin for variations or subjective judgment on the part of financial firms or financial regulators. In contrast, a principles-based system of financial regulation (discussed in the next section of this chapter) is focused primarily on achieving desired policy goals – such as helping retail consumers get a fair deal from their financial services providers or ensuring efficient and orderly financial markets – that benefit consumers and overall economy activity.

In the United States, financial regulation has evolved toward a strong bias of rules over principles. This bias has developed in response to our complex regulatory structure, an ever-growing body of national and state laws and implementing regulations that address financial activities and practices in great detail, and the felt need for certainty in the face of an ever-present risk of litigation and enforcement actions.

Multiple, functional regulators

In the United States, the major sectors of the financial services industry – securities, insurance, and banking – are regulated separately, along functional lines at both the national and state levels. The result is a regulatory system that includes:

- Overlapping national and state systems for regulating banking and securities firms
- Separate regulators for different financial services providers
- More than 50 different state insurance and bank regulatory systems
- Multiple enforcement authorities (i.e., functional regulators, U.S. Justice Department, 50 state attorneys general, the U.S. Federal Trade Commission [FTC], and private litigants)
- Separate regulators for different types of holding companies (e.g., Federal Reserve Board [FRB] for bank holding companies, the Office of Thrift Supervision [OTS] for saving and loan holding companies, and the SEC for certain companies controlling broker-dealers)
- Federally-chartered firms that are subject to some state laws but not others
- State-chartered firms that are subject to a growing body of national laws (e.g., the FDIC Act, the Bank Holding Company Act [BHCA], the Bank Secrecy Act [BSA], Title V of the Gramm-Leach-Bliley Act [GLBA], Real Estate Settlement Procedures Act [RESPA], Community Reinvestment Act [CRA], and federal insurance statutes such as the Terrorist Risk Insurance Act of 2002 [TRIA])
- An ever-growing body of regulations as well as enforcement actions against specific institutions that become quasi-regulations in

practice for the rest of the industry.[13]

- Only one national regulator, the CFTC, that operates from a set of Congressionally-mandated principles, which encourages more prudential supervision.

This complex financial regulatory structure contributes to the U.S. bias for rules. Each of the various national and state agencies and authorities that regulate and supervise financial services firms has developed its own set of regulations. Federal rules governing the banking industry take over six volumes in the Code of Federal Regulations (CFR), while securities regulations take three volumes.

Further, each of these agencies and authorities has developed a core of professional examiners, accountants, economists, and lawyers who are responsible for supervising the operations of our nation's financial services firms. These professionals, naturally, are actively engaged in the interpretation and application of the body of national and state rules applicable to financial services firms. Each regulation, opinion letter, and decision made by these individuals contributes to the extensive list of rules and precedents binding upon the financial services industry.

Prescriptive federal laws

While reforming our complex regulatory structure could help to alleviate some of the U.S. rules-based bias, detailed federal laws and implementing regulation reinforce this bias. During the past 40

Table 1-1

Selected Federal Financial Services Laws Enacted in Past 40 Years

Date	Statute
1968	Consumer Credit Protection Act (Truth-in-Lending)
1968	Fair Credit Reporting Act
1968	Fair Housing Act
1968	Fair Debt Collection Practices Act
1970	Bank Secrecy Act
1970	Investment Company Act Amendments
1970	Equal Credit Opportunity Act
1975	Securities Act Amendments
1977	Community Reinvestment Act
1978	Electronic Fund Transfer Act
1984	Insider Trading Sanctions Act
1986	Money Laundering Control Act
1987	Competitive Equality Banking Act
1988	Insider Trading and Securities Fraud Enforcement Act
1989	Financial Institutions Reform Recovery and Enforcement Act (FIRREA)
1990	Market Reform Act of 1990
1990	Securities Act Amendments

[13] The Federal Financial Institutions Examination Council (FFIEC) estimates that more than 800 regulations have been imposed on banks and other deposit-gathering institutions since 1989. Statement of Hon. John M. Reich, Vice Chairman, Federal Deposit Insurance Corporation, on the consideration of regulatory reform proposals before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 22, 2004, p. 1. The testimony also cites a Federal Reserve survey in 1998 that suggests that the total regulatory costs for banks at that time were estimated at 10 to 12 percent of their total noninterest expense.

years, the U.S. Congress has enacted a plethora of laws that have imposed a significant degree of detailed regulation on financial services firms. Table 1-1 is a partial list of federal financial services laws enacted since the late 1960s.

Three of the most recently passed federal laws – the Gramm-Leach-Bliley Act, the USA Patriot Act, and the Sarbanes-Oxley Act (SOX) – illustrate how federal laws result in detailed, prescriptive rules.

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act of 1999 (GLBA) was the culmination of a protracted effort to remove the restrictions on affiliations between various types of financial services firms.[14] GLBA permits banking, securities, and insurance firms to affiliate under a single financial holding company that is supervised by the Federal Reserve Board, but subjects each affiliate to regulation by functional regulators. It also includes detailed instructions on how functional regulators should operate.

GLBA also established complex privacy protection rules for consumer information.[15] These include a requirement that institutions annually disclose their privacy policies and practices to consumers. This statutory mandate is made even more burdensome by the implementing regulations. For example, the privacy regulations issued jointly by the federal banking agencies define "clear and conspicuous" to mean "reasonably understandable and designed to call attention to the nature and significance of the information in the notice."[16] This definition is then

1990	Penny Stock Reform Act
1991	Federal Deposit Insurance Corporation Improvement Act (FDICIA)
1992	Annunzio-Wylie Money Laundering Suppression Act
1994	Telemarketing and Consumer Fraud and Abuse Prevention Act
1994	Home Ownership and Equity Protection Act of 1994
1994	Riegle-Neal Interstate Banking and Branching Efficiency Act
1996	Investment Company Act Amendments
1996	Investor Advisors Supervision Coordination Act
1996	National Securities Markets Improvements Act
1999	Gramm-Leach-Bliley Act
2001	USA Patriot Act
2002	Sarbanes-Oxley Act
2002	Terrorism Risk Insurance Act (TRIA)
2004	Fair and Accurate Credit Transactions Act (FACT Act)

[14] P.L. 106-112.
[15] Title V of GLBA, 15 U.S.C. 6801 et seq.
[16] 12 C.F.R. 216.3(b)(1)

further complicated by examples of what constitutes "reasonably understandable" and "designed to call attention."

Similar detail accompanies the regulatory definition of the term "consumer" as it is used in the annual notice requirement.[17] The regulation includes over seven examples of who is, and who is not, a consumer for purposes of the regulation. For example, a person is a consumer if he or she provides the institution with nonpublic information in an application for a personal loan, even if the loan is not extended. On the other hand, a person is not a consumer solely because he or she has designated the institution as a trustee for a trust.

Compliance with these provisions, however, does not relieve compliance with state privacy laws. The statute provides that financial institutions must not only comply with the terms of GLBA and its implementing regulations, but also with any state privacy laws that provide "greater" protection.[18] Since many states have adopted privacy statutes, these notices must include not only the information required by GLBA, but also applicable state information. Compliance with state law is even more complicated for insurance firms because they are primarily regulated by the states.

Few would argue with the need for financial institutions to provide information on their collection and use of personal information. Yet, as the foregoing illustrates, the rules-based implementation of this seemingly straightforward goal is quite complex. To the extent that this complexity confuses consumers, the intended goal is not being achieved.

After six years of costly efforts to comply with these provisions, Congress recently directed the federal financial regulatory agencies to develop a simplified-model privacy notice that institutions could use to comply with the GLBA requirements.[19] Even this effort, however, has suffered from an excess of detail.[20] Moreover, as a state regulated industry, insurers would not be able to take advantage of any simplified privacy notice unless it is adopted uniformly by each state

One Roundtable firm has estimated that the new formatting requirements imposed by the model notice would increase its compliance costs by nearly 600 percent. Currently, that firm spends approximately $900,000 per year to deliver privacy notices. The company estimates that the costs to print and mail the proposed notice would be in excess of $6 million. When we extrapolate these costs to the entire financial services industry, the overall cost to the industry to provide the proposed model form could easily approach an estimated $400 million.[21] While the cost of compliance would be substantial, consumer benefits are unclear.

A principles-based approach would simply direct financial institutions to fully, fairly, and accurately inform prospective and existing consumers about the institution's collection and use of personal information, as well as other applicable privacy rights (e.g., do-not-call, recourse in the event of identity theft) and would authorize individual regulators to take appropriate corrective action in the event

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17 See 12 C.F.R. 216.3(e) (Federal Reserve Board rule applicable to state member banks).

18 15 U.S.C. 6807

19 Sec. 728 of the Financial Services Regulatory Relief Act of 2006, P.L. 109-351.

20 The proposed model form was issued for public comment in March 2007 (see 72 Fed. Reg. 14940, March 29, 2007).

21 Roundtable members have calculated that it will cost most firms approximately $0.38 to mail each notice. Assuming that over 1 billion notices would be mailed, the total cost to the financial services industry would be approximately $400 million.

a notice does not meet the intent and spirit of this principle.

USA PATRIOT Act

The USA PATRIOT Act of 2001 was enacted in response to the 9/11 terrorist attacks on the United States.[22] Under the Act, financial services firms must establish an anti-money laundering program that includes: 1) internal policies, procedures, and controls; 2) the designation of a compliance officer; 3) an ongoing employee training program; and 4) an independent audit function.

The Act also extended suspicious activity reporting (SAR) requirements and customer identification requirements to all financial services firms. SARs must be filed with the federal government whenever an institution discovers a possible violation of law or regulation, and the failure to do so can result in enforcement actions. Under the customer identification requirements, institutions must verify the identity of customers and determine if the customer is on a terrorist list.

Unfortunately, these requirements are not well suited for addressing terrorist financing, which means that the mandated, detailed, and costly compliance procedures on firms do not match the risks posed by terrorist activities.

In contrast, the U.K. has adopted an anti-money laundering program that is focused on results, not inputs. It imposes an obligation on management to be innovative and develop anti-money laundering policies and procedures that are used as "a means to an end." For example, while U.K. firms are required by law to identify new customers, the risk-based approach leaves it up to each institution to determine how much customer identification is appropriate above a basic minimum level. This approach permits firms to develop effective customer identification procedures that are consistent with their approaches to managing customer relationships and that are cost-efficient.

Sarbanes-Oxley Act (SOX)

The Sarbanes-Oxley Act of 2002 was Congress's response to shortcomings in management conduct and investor disclosure, epitomized by the failure of Enron, WorldCom, and other companies.[23] It imposed new accounting and financial reporting requirements on public companies, including a requirement that management assess the effectiveness of internal controls and public auditors attest to those assessments (Section 404). Other provisions mandate detailed requirements for audit committees, internal controls, financial disclosures, a code of ethics, and insider loans.

Table 1-2 lists the regulatory actions taken by the SEC in response to the enactment of SOX. These actions were extremely detailed and prescriptive in nature. Regulatory burden could have been ameliorated by more principles-based requirements that emphasized the use of a "top-down" approach, and afforded both management and auditors the discretion to concentrate on the most significant aspects of a company's internal control framework. Rather than specifying detailed procedures, implementing regulations could have stressed the goals of the requirement, and given more discretion to the accountants and company management in finding effective ways to achieve the goals.

[22] P.L. 107-56.
[23] P.L. 107-204.

Table 1-2

Regulatory Actions by SEC in Response to SOX[24]

Date	Subject	Status
August 2, 2002	Certification of disclosure in companies' quarterly and annual reports	Proposed rule
August 27, 2002	Ownership reports and trading by officers, directors, and principal security holders	Final rule
August 29, 2002	Certification of disclosure in companies' quarterly and annual reports	Final rule
October 18, 2002	Improper influence on conduct of audits	Proposed rule
October 22, 2002	Disclosure required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002	Proposed rule
November 4, 2002	Disclosure in management's discussion and analysis about off-balance-sheet arrangements, contractual obligations, and contingent liabilities and commitments	Proposed rule
November 5, 2002	Conditions for use of non-GAAP financial measures	Proposed rule
November 6, 2002	Insider trades during pension fund blackout periods	Proposed rule
November 21, 2002	Retention of records relevant to audits and reviews	Proposed rule
November 21, 2002	Implementation of standards of professional conduct for attorneys	Proposed rule
December 2, 2002	Strengthening the Commission's requirements regarding auditor independence	Proposed rule
December 20, 2002	Mandated electronic filing and Web site posting for Forms 3, 4, and 5	Proposed rule
January 8, 2003	Standards relating to listed company audit committees	Proposed rule
January 22, 2003	Insider trades during pension fund blackout periods	Final rule
January 22, 2003	Conditions for use of non-GAAP financial measures	Final rule
January 23, 2003	Disclosure required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002	Final rule
January 24, 2003	Retention of records relevant to audits and reviews	Final rule
January 27, 2003	Certification of management investment company shareholder reports and designation of certified shareholder reports as Exchange Act periodic reporting forms; disclosure required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002	Final rule
January 28, 2003	Strengthening the Commission's requirements regarding auditor independence	Final rule
January 28, 2003	Disclosure in management's discussion and analysis about off-balance sheet arrangements and aggregate contractual obligations	Final rule
January 29, 2003	Implementation of standards of professional conduct for attorneys	Proposed rule
January 29, 2003	Implementation of standards of professional conduct for attorneys	Final rule
March 21, 2003	Certification of disclosure in certain Exchange Act reports	Proposed rule
March 26, 2003	Strengthening the Commission's requirements regarding auditor independence	Final rule
March 8, 2005	Management's report on internal controls	Final rule and extension of compliance date
September 29, 2005	Management's report on internal controls, extension for nonaccelerated filers	Final rule and extension of compliance date
August 9, 2006	Internal control reports for foreign private issuers	Final rule and extension of comment period for smaller companies
December 15, 2006	Internal control reports for nonaccelerated filers and new public companies	Final rule and extension of comment period for smaller companies
June 20, 2007	Revised regulation on management responsibilities for report on internal controls	Final rule
June 20, 2007	Guidance on management responsibilities	Interpretive release
August 3, 2007	Definition of the term "significant deficiency"	Final rule

[24] SEC Web site – www.sec.gov/spotlight/sarbanes-oxley.htm.

Redundant Requirements

Overly prescriptive federal laws also can result in redundant requirements. In a 2005 study sponsored by the BITS Operational Risk Management Working Group, KPMG found significant redundancy in the requirements for banking institutions to manage operational risk.[25] That study focused on the internal control and audit requirements imposed by the Federal Deposit Insurance Corporation Improvement Act (FDICIA), GLBA, SOX, and the operational risk guidance associated with the Basel II framework. The BITS study found that large banking organizations faced significant compliance requirements and costs as a result of the overlapping internal control and audit requirement mandated by FDICIA, GLBA, SOX and Basel II:

> *… large U.S. banking organizations are being required to establish overlapping internal control reporting and compliance structures, as well as specific operational risk data collection, validation processes, and IT systems requirements. For example, the requirements of FDICIA and GLBA implicitly, and the requirements of SOX and [Basel II] explicitly, require a comprehensive system of "risk control self assessments" (RCSA) and related documentation. The cost of compliance with each of these regulatory requirements is significant, albeit difficult to quantify and segregate.*[26]

Further, prescriptive laws can take a significant amount of time to implement. The more complex the law, the longer it takes for agencies to write regulations, and the longer it takes for regulated firms to change policies and procedures.

Litigation concerns

Finally, in addition to multiple regulators and prescriptive laws, the rules-based bias in U.S. financial regulation is a logical reaction to the extensive litigation risks that financial services firms face. Detailed and prescriptive rules are viewed as a means to reduce this risk because they can provide operational certainty. In other words, compliance with prescriptive rules can serve as a shield against enforcement actions by regulators, as well as private actions by consumers, shareholders, and other parties, even if the rules do not represent best business practices.

The relationship between our existing rules-based system of regulation and litigation risk may be the greatest impediment to the implementation of a more principles-based approach in the United States. While the risk of litigation can serve to assure appropriate conduct and behavior, financial firms clearly would not benefit from the establishment of a principles-based system of regulation if that system increased litigation risk. Therefore, any system of principles-based regulation in the United States must blend principles and rules in a way that does not increase, and optimally would reduce, litigation risk.

Attempts to reduce the complexity and cost of regulation

From time to time, Congress and financial regulators have taken steps to attempt to reduce the complexity and cost of financial regulation. A variety of federal laws and executive orders requires federal regulatory agencies to assess the cost and impact of proposed rules. These laws and regulations include the Regulatory Flexibility Act, the Paperwork Reduction Act, and the Unfunded Mandates Reform Act. Table 1-3 lists some of these federal requirements and their purpose.

In practice, however, these assessments have had little practical effect on the regulatory process because federal agencies generally underestimate the cost of compliance. Recently, for example, the federal financial regulatory agencies jointly issued a proposal for a model privacy notice to satisfy the provisions of the Gramm-Leach-Bliley Act. The agencies concluded that the proposed notice would not result in a cost to the economy of more than $100 million, and thus would not trigger the requirement for a cost-benefit analysis. Yet, Roundtable members found that the costs of preparing and mailing the proposed notice would cost several times the $100 million threshold (see the discussion of GLBA privacy provisions above.)

[25] BITS, The Financial Services Roundtable, "Reconciliation of Regulatory Overlap for the Management and Supervision of Operational Risk in U.S. Financial Institutions," May 20, 2005.

[26] Ibid., p. 3.

Table 1-3

Federal Requirements to Assess the Impact of Regulations

Law/Order	Purpose
Regulatory Flexibility Act (5 USC 601-612)	Requires federal agencies to assess impact of rule on small businesses For purposes of this requirement: 1. Small banks are banks, thrifts, and credit unions with assets under $165 million (approximately 9,000 banks, thrifts, and credit unions in this category) 2. Small broker-dealers are broker-dealers with capital of less than $500,000 that are not affiliated with a large firm (approximately 900 broker-dealers in this category) 3. Small investment companies (plus related companies) have net assets of $50 million or less (approximately 200 investment companies in this category) 4. Small investment advisors manage less than $25 million in assets and are not controlled by a larger firm (approximately 700 investment advisors in this category)
Paperwork Reduction Act (44 USC 3501 et seq.)	Requires certain federal agencies to obtain approval from the Office of Management and Budget before collecting information from the public
Unfunded Mandates Reform Act (PL 104-4)	Federal agencies must assess the impact of rules that impose a federal mandate that will result in an expenditure of $100 million or more in any one year by state, local, and tribal governments (in the aggregate) or by the private sector
Section 23(a)(2) of the Securities Exchange Act	Requires the SEC to consider the impact of proposed rules on competition, and prohibits the adoption of any rule that would impose a burden on competition not necessary or appropriate
Executive Order 12866	Requires certain federal agencies to prepare a regulatory impact analysis of any "significant regulatory action" For purposes of this requirement, a significant regulatory action is an action that will: 1) have an annual effect of more than $100 million on the economy; or 2) adversely affect, in a material way, the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, of state, local, or tribal governments or communities

The federal banking agencies are also required, by law, to review existing regulations at least once every 10 years to identify any regulatory requirements that are outdated, unnecessary, or unduly burdensome.[27] The federal banking agencies have taken this mandate seriously, and several regulatory changes have resulted from this requirement. Nonetheless, as Table 1-4 indicates, these changes have been at the margin; they do not represent any fundamental realignment or reduction of regulatory burden imposed on providers of financial services and ultimately borne by consumers.

[27] P.L. 104-208.

Table 1-4
Efforts to Reduce Regulatory Burdens

Regulation	Action	Comment
CRA	Asset threshold for simplified compliance raised from $250 to $500 million	OTS effort to increase the threshold to $1 billion was not successful
Privacy Notices	Simplified notice issued after four years of review and consumer testing	Industry reaction largely negative; proposed "simple notice" viewed as too prescriptive and costly to implement
Customer Identification	Guidance on how to structure customer identification programs	A useful guidance, but basic requirements of KYC requirement remain unchanged
CTRs and SARs	Effort to streamline filing requirements	No meaningful change in compliance burden
Call Report Modernization	Creation of central database by regulators	Positive change for regulators, but no change in reporting requirements for institutions
Applications	Creation of interagency charter and deposit insurance application requirements	Positive change, but only applies to start-up operations

Summary

In summary, our highly complex regulatory system, combined with a prescriptive approach to writing federal laws and implementing regulations, and potential litigation risk have created a strong bias for rules over principles. As described below, the United Kingdom has decided to take a different path – with the intent of making its financial markets and financial firms more competitive and responsible to consumers.

THE U.K.'S PRINCIPLES-BASED SYSTEM OF FINANCIAL REGULATION

In contrast to the rules-based regulatory system in place in the United States, the United Kingdom has taken a different path to the regulation of its financial marketplace. This alternative path is guided in large measure by the U.K.'s determination to be the leading financial center in the world and to strengthen its domestic economy at the same time. In pursuit of this goal, the U.K. has adopted, over a period of several years, a regulatory model grounded in a set of clear objectives, guiding regulatory principles, and an explicitly defined "Better Regulation Action Plan" to implement its regulatory principles. The U.K. also has consolidated a variety of financial supervisory and regulatory authorities into a single agency, the Financial Services Authority.

This section of Chapter 1 begins by reviewing the creation of the FSA. It then sets forth the FSA's regulatory principles. Finally, it highlights the FSA's current efforts to put these principles into action to benefit the U.K. economy and all consumers of financial services in its economy.

Creating the FSA

A decade ago, the U.K.'s newly elected Labour government created the Financial Services Authority as a single financial regulator to replace the multiple self-regulatory organizations (SROs) that previously supervised the various segments of the financial services sector. In 1997, Gordon Brown, then the new Chancellor of the Exchequer (the U.K.'s equivalent to the U.S. Treasury Department) and current Prime Minister, called for a more independent and objective regulator not only to protect consumer interests better but also to facilitate the development of London as a global financial center. At that time, the SROs were viewed as too bureaucratic, too rules-based, and too slow to respond to both market demands and the protection of consumers.

Consequently, in May 1997 the Chancellor announced the merger of banking, securities, insurance, and investment services regulators into a single, unified, modern regulator – the FSA. In June 1998, the Bank of England transferred its bank supervision responsibilities to the FSA, and in May 2000 the FSA acquired the role of the U.K. listing authority from the London Stock Exchange (LSE). The FSA's sweeping new authority was codified in the Financial Services and Markets Act (FSMA) in 2001. Continuing the transition, the FSA assumed responsibility for the mortgage industry in 2004 and the insurance industry in 2005.

The FSMA contains four statutory mandates that the FSA must follow:

- Maintaining market confidence
- Promoting public understanding of the financial system
- Securing an appropriate degree of protection for consumers
- Fighting financial crime.

Since its inception, the FSA has followed a logical and methodical strategy for regulatory reform consistent with its statutory mandate. As part of its evolving strategy as a new modern regulator, the FSA adopted a set of objectives for what it wanted to achieve as a regulator.[28] It then developed a set of general principles to guide how both the FSA and regulated firms should behave; these principles focus on outcomes, consistent with the FSA's statutory mandate and its objectives as a regulator. To put its principles into practice to achieve desired outcomes, the FSA then designed the Better Regulation Action Plan, which it is now in the process of implementing.

Creating principles to guide the FSA and firms supervised by the FSA

The drafters of the FSMA understood that it would not be in the public interest to develop a set of rules to govern each and every aspect of the financial services industry. The FSA, therefore, adopted two separate but related sets of guiding regulatory principles. These principles are designed to govern the behavior of both the FSA, as a regulator, as well as the conduct of all firms supervised by the FSA. The FSA describes this general approach, and the subsequent behavior it demands for both the regulator and regulated institutions, as follows:

> *Principles-based regulation means placing greater reliance on principles and outcome-focused, high-level rules as a means to drive at the regulatory aim we want to achieve, and less reliance on prescriptive rules. Much of this rebalancing of our use of principles has been and will continue to be executed through changes to the FSA Handbook and related material.*
>
> *Principles-based regulation also means a different approach to how we deal with regulated entities, whether in the context of day-to-day supervisory contact, the information we request, or, when necessary, the way we use our enforcement powers. It also means different expectations of firms and how they engage with the regulatory issues they face. Our aim is to focus more clearly on the outcomes we as regulators want to achieve, leaving more of the judgment calls on the achievement of those outcomes to the senior management of the firms.*[29]

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[28] Since 2003, the three fundamental regulatory objectives that the FSA seeks to achieve are: 1) retail consumers achieve a fair deal; 2) markets are orderly, efficient, and fair; and 3) the FSA operates capably and effectively. See Dr. Thomas Huertas, Director, Wholesale Firms Division and Banking Sector Leader, Financial Services Authority, BBA 4th Annual Regulating Banking in Britain Conference, "The future of banking regulation and supervision," March 24, 2006.

[29] Financial Services Authority, Principles-based Regulation: Focusing on the Outcomes that Matter, April 2007, pp. 6-7; hereafter, FSA, Principles-based Regulation.

FSA's Principles of Good Regulation

Efficiency and economy – When addressing a specific risk, the FSA will aim to select the options that are most efficient and economic with respect to the allocation and deployment of its resources.

Role of management – A firm's senior management is responsible for its activities and for ensuring that its business is conducted in compliance with regulatory requirements.

Proportionality – The restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry.

Innovation – We should facilitate innovation, for example, by avoiding unreasonable barriers to entry or restrictions on existing market participants launching new financial products and services.

International character of financial services – The FSA will consider the impact on U.K. markets and consumers of the economic, industry, and regulatory situation overseas. The FSA must also take into account the international mobility of financial business and must avoid damaging the competitiveness of the U.K., which works to the advantage of consumers as well as markets.

Competition – The FSA must avoid unnecessarily distorting or impeding competition. This includes avoiding unnecessary barriers to entry or business expansion.[30]

Principles for the regulator

The FSA adopted six "Principles of Good Regulation." These overarching principles, which the FSA must consider while pursuing its statutory objectives, have the force of law.[31] They appear on the following page.

Principles for regulated firms

To ensure that the senior management teams of financial services firms fulfill their unique responsibilities for a more principles-based approach to regulation, the FSA also adopted a set of 11 principles to guide firms that are designed to work in tandem with its own six principles that guide its behavior as a regulator. Under the FSA's new regime adopted in 2001, a firm must conform to the principles on the following page.

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[30] Financial Services Authority, A New regulator for the New Millennium, January 2000, pp. 18-19; hereafter, FSA New Regulator.

[31] Ibid. With respect to the FSA's industry guidance to firms, it notes: "Firms are not legally obliged to act on everything we say; only Rules and Principles are binding. Where, however, firms reasonably rely on statements we have made – whether individual or generic and whether formal guidance or other material – in determining the approach they adopt, this will be a defence to any subsequent regulatory action we take. Firms' behavior and positive engagement with the regulatory outcomes will also be a factor that is taken into account in our regulatory action towards that firm." FSA, Principles-based Regulation, p. 14.

FSA's Principles for Firms

Integrity – Conduct its business with integrity

Business dealings – Conduct its business with due skill, care, and diligence

Risk management – Take reasonable care to organize and control its affairs responsibly with adequate risk management

Resources – Maintain adequate financial resources

Market conduct – Observe proper standards of market conduct

Consumers – Treat consumers fairly

Communications – Communicate appropriate information to clients in a clear and fair manner

Conflicts – Manage conflicts of interest fairly

Suitability – Take reasonable care to ensure the suitability of its advice to consumers entitled to rely on its judgment

Asset protection – Adequately protect clients' assets when responsible for them

Responsibilities to regulator – Deal with regulators in an open and cooperative way[32]

These principles do not eliminate rules. They are designed to guide rules – and lead to fewer, clearer rules connected to desired regulatory outcomes. As Sir Callum McCarthy, the Chairman of the FSA, has acknowledged, the FSA still has a handbook of rules that is 8,500 pages long.[33] However, as discussed below, the FSA has undertaken a systematic review of these rules to ensure that they are consistent with the foregoing principles, and plans to eliminate or revise rules that are inconsistent. Recently, for example, the FSA distilled its extensive anti-money laundering regulation down to two pages of rules.

[32] FSA, Principles-based Regulation, p. 9.

[33] Sir Callum McCarthy, "Financial Regulation: Myth and Reality," speech to the British-American Business – London Insight Series and Financial Services Forum, February, 13, 2007. See also Ben S. Bernanke, Chairman, Board of Governors, Federal Reserve System, "Regulation and Financial Innovation," remarks to the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, May 15, 2007.

Putting the FSA's principles to work

The FSA not only has put its principles in writing for all to see and judge, but it is also implementing its Better Regulation Action Plan consistent with its principles. In 2005, the FSA's former chief executive, John Tiner, announced this action plan to shift to an even more rigorous principles-based approach to produce even better outcomes in specific areas: "We are committed to promoting better regulation by ensuring that the overall benefits of our regulation outweigh the costs, and that we maximize those benefits."[34] He also said some rules would still have value and would be retained even if in modified form.

The FSA's action plan highlighted specific examples of its recent and ongoing efforts to improve regulation to benefit consumers, firms, and its marketplace. For example, to help retail consumers achieve a fair deal, the FSA removed barriers to providing retail advice and investing in personal pensions as well as facilitating the marketing of workplace pensions. To better promote efficient, orderly, and fair markets, it simplified listing rules, made shareholder notifications more proportionate, embraced industry solutions for soft commissions and bundled brokerage arrangements, and took a measured response to the potential risk of hedge funds. To improve its own business capabilities and effectiveness, the FSA launched a review of its own regulatory costs in three specific areas in conjunction with the Financial Services Practitioners Panel: 1) reviewing the cost burdens imposed by its own Handbook; 2) emphasizing senior management's responsibility for money laundering controls by transforming 57 pages of detailed rules into two pages of specific principles; and 3) lifting audit requirements on small firms, which make up 90 percent of the 27,000 institutions the FSA regulates.[35]

The FSA's 2007-2008 business plan affirms "a determination to seek market solutions where possible, and intervention by regulation only where the market does not provide a solution and when the benefits of intervention outweigh the costs…"[36] This forward-looking business plan outlines the significant benefits the FSA expects to accrue to firms, consumers, and markets from a more principles-based approach. This business plan has no comparable U.S. counterpart, with the exception of the former National Association of Securities Dealers (NASD).

To meet the goals of this business plan, the FSA expects to spend the current equivalent of $100 million to train its people over the next three years in an effort to support the move to a more principles-based approach to financial market regulation; the business plan then proceeds to outline specific actions under each one of its fundamental regulatory objectives on a quarter-by-quarter approach.

In April 2007, the FSA announced that it will review its Handbook (rules), to reassess rules that make up 80 percent of the administrative costs imposed on firms – and by extension their consumers – by the regulator. The FSA is especially sensitive to the disproportionate burden placed on smaller firms.

Finally, the FSA is taking the next step to embed a more principles-based approach into its overall regulatory strategy. As indicated in Table 1-5, it has defined nine new "outcome indicators" that will allow both firms and the FSA to measure their success against all three of the desired fundamental regulatory outcomes.[37]

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[34] Financial Services Authority Better Regulation Action Plan, December 2005, p. 5; hereafter, FSA, Better Regulation.
[35] FSA, Better Regulation, pp. 7-12.
[36] Financial Services Authority, Business Plan 2007-2008, p. 5.
[37] FSA, Principles-based regulation, p 15

Table 1-5

FSA's Principles-Based Regulatory Outcome Indicators

Strategic aim	Indicator Number	Definition (outcome indicator)
Help retail consumers achieve a fair deal	1	Consumers receive and use clear, simple, and relevant information from the industry and from us
	2	Consumers are capable and confident in exercising responsibility when dealing with the financial services industry
	3	Financial services firms treat their consumers fairly and so help them to meet their needs
Promote efficient, orderly, and fair markets	4	Firms are financially sound and well managed
	5	Firms and other stakeholders understand their respective responsibilities and mitigate risks relating to financial crimes and arising from market conduct
	6	Financial markets are efficient, resilient, and internationally attractive
Improve our business capability and effectiveness	7	The FSA is professional, fair, efficient, and easy to do business with
	8	The FSA is effective in identifying and managing risks to our statutory objectives
	9	The costs and benefits of regulation are proportionate

In summary, since 1997, the FSA has made significant strides to build its regulatory capabilities as an integrated financial services regulator that operates on a principles-based approach. Certainly, its clear statutory mandate, its focused and concise objectives and preferred principles-based regulatory outcomes, and its forward-looking, better regulation action and business plans have no comparable counterparts in the U.S. financial system. Arguably, this regulatory fact of life enhances the competitiveness of U.K. financial markets and its financial services industry to the detriment of ours, both directly and indirectly. In the final section of this chapter, the two distinct approaches to financial services regulation and supervision are examined in greater detail.

COMPARING THE U.S. AND THE U.K. FINANCIAL REGULATORY SYSTEMS

As described in the first two sections of this chapter, the U.S. rules-based approach to regulation and the U.K.'s principles-based approach are the result of two different legacy regulatory systems. This section examines the strengths and weaknesses of the two systems, and the current threats as well as the opportunities that confront the U.S. system of financial regulation.

As reflected in the preeminence of U.S. financial markets and firms, the strengths of the U.S. financial regulatory system have outweighed its weaknesses. The U.S. system of financial regulation has facilitated the development of world-class financial markets and financial institutions, and has served as a model for many foreign countries. However, it appears that the system may have reached a tipping point, especially given the challenges of rapidly expanding and evolving global financial markets and more adaptive regulatory regimes overseas. Increasingly, it appears that the high regulatory standards that have served U.S. markets and institutions so well in the past have difficulty adapting to new forms of global regulation and market changes. This is a consequence of the U.S. regulatory system's ad hoc design over time (i.e., multiple regulators at the national and state levels), the constant threat of litigation, and a growing body of confusing and sometimes conflicting national and state laws and implementing regulations aimed at governing the operations and practices of financial services firms in ever-increasing specificity.

Without significant reform, the current system threatens to impair the global competitiveness of U.S. financial markets and firms. This outcome, in turn, would negatively impact U.S. consumers of financial products and services as well as the U.S. economy.

Strengths

Like any system, the U.S. financial services regulatory system has strengths and weaknesses. The system's strengths include: 1) high regulatory standards and world-class regulators; 2) attention to consumer choice and protection; 3) transparency; and 4) legal certainty.

1. High regulatory standards and world-class regulators.

Despite periodic concerns that multiple financial regulators will lead to a "race to the bottom" in regulation at the national and/or state levels, the U.S. financial regulatory system generally has adhered to high regulatory standards. Regulators have focused supervisory attention on key indicia of solvency and liquidity in an effort to reduce failures, and have adopted risk-based supervisory systems and techniques in response to increasingly complex institutions and transactions.

One key to the quality of U.S. financial regulation has been the independence of U.S. financial regulators from political influence. Most federal regulators are independent agencies, not subject to the annual Congressional appropriations process. Several are managed by bipartisan boards with staggered terms (e.g., the Federal Deposit Insurance Corporation [FDIC] and the SEC). National regulators that are bureaus of the U.S. Treasury Department (the Office of the Comptroller of the Currency [OCC] and the Director of the Office of Thrift Supervision) have multi-year terms and can take supervisory, regulatory, and enforcement actions without notifying or seeking approval from the Treasury Secretary. Also, the federal civil service system has fostered a core of highly qualified, professional staff, who are dedicated to public service.

The FSA also enjoys a reputation for world class supervision and regulation. As noted in the Bloomberg-Schumer report, senior executives at financial services firms have a favorable view of the FSA's approach, including the fact that it is a single point of contact, authority, and accountability. They especially like the principles-based approach, including the last principle for firms that requires them to maintain an open and constructive dialogue with the FSA on a variety of issues. The FSA has assembled an organization of professionals, and many of the senior managers have previous experience in the private sector. The FSA's forward-looking efforts to implement its Better Regulation Action Plan is an example of the professional and mutual approach taken toward financial services firms doing business in the United Kingdom.

2. Consumer choice and protection.

The U.S. financial system has permitted the development of a wide range of competitively priced and convenient financial products and related services. Home mortgages, credit cards, annuities, and mutual funds are examples of financial products that have become ubiquitous for retail consumers. Online banking is now available from any home or remote computer on a 24/7 basis. Wholesale consumers have a wide array of innovative and increasingly global products available, whether they are derivatives to help them manage risks better or a variety of financing options through efficient capital markets.

The system also is attentive to consumer protection. A combination of full and fair disclosure requirements, laws, and regulations that address product terms and conditions and market conduct, examinations, federal and state enforcement actions, and private legal actions protect consumers of financial services from fraud and abuse. Furthermore, mechanisms exist to protect consumers in emergencies. Retail deposits are protected up to prescribed limits, by the FDIC and the National Credit Union Administration (NCUA). Insurance policy holders are protected by state guaranty funds, and securities holders are protected from fraud by the Securities Industry Protection Corporation (SIPC).

Consumer choice and protection also is a strength of the U.K. system. Both its statutory mandate as well as the FSA's regulatory objectives speak to the needs of consumers. Several of the U.K.'s regulatory principles

specifically address consumer needs. For example, the principles require a firm to:

- Conduct its business with integrity
- Conduct it business with due skill, care, and diligence
- Observe proper standards of market conduct
- Treat consumers fairly
- Manage conflicts of interest fairly
- Take reasonable care to ensure the suitability of its advice to consumers entitled to rely on its judgment
- Adequately protect clients' assets when responsible for them.

3. Transparency.

As a general rule, the U.S. financial services regulatory system is transparent to both regulated firms and their consumers.[38] Applicable rules and procedures are explicit and publicly available, and most regulators are accessible to both consumers and regulated companies. Furthermore, the mission statements of regulatory agencies are public, and agency heads are frequent speakers at industry meetings and witnesses at Congressional oversight hearings. This transparency not only helps to keep all stakeholders as informed as possible about current regulatory issues and concerns, but also helps to ensure greater compliance with applicable rules and regulations.

The U.K. system is perhaps even more transparent than the U.S. system. For example, everything that anyone needs to know about financial regulation in the United Kingdom – new releases, recent statements, regulatory opinions, regulations, reports – can be found at a single Web site. The FSA takes it statutory mandate to promote the public understanding of the financial system seriously; there is no similar legislative mandate for any of the U.S. regulators although many of them have recently taken up the cause of consumer financial education. Moreover, the FSA provides great clarity and transparency about its future actions through both the Better Regulation Action Plan and its annual business plans, neither of which has a counterpart at any of the U.S. financial regulators, with the exception of the former NASD.

4. Certainty.

Finally, one of the major strengths of the U.S. regulatory system is the certainty it provides financial firms and regulators. As a general matter, firms know that if they follow the rules then they face a reduced risk of supervisory actions or private litigation. In our highly legalistic society, this can be an important benefit for firms, especially when the cost of class-action suits can be significant.

In contrast, legal certainty is less of a goal in the U.K. where the potential for litigation or formal supervisory actions is not as great as it is in the U.S. This reflects not only some broader societal differences between the U.S. and the U.K., but, more importantly, the U.K.'s more prudential approach to financial supervision. Prudential supervision reduces the need for litigation and enforcement actions because it encourages firms and regulators to address areas of concern before they develop into significant problems. The U.K.'s approach to financial supervision is embedded in two of its guiding principles. The last principle for regulated firms requires all firms to "deal with regulators in an open and cooperative way." The third principle for the FSA is that "the restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry." A combination of our recommended principles and our specific proposals for securities and class-action reforms is intended to address this point from a unique U.S. perspective.

Structural regulatory weaknesses

Each of the three previous competitiveness reports cited serious structural problems embedded in the current U.S. system of financial regulation that

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[38] One exception to this general rule on transparency are so-called "desk drawer" rules applied by some state insurance regulatory authorities. Such rules are not published and consequently detract from the regulatory approach and transparency of many state insurance regulators.

need immediate attention by policymakers. The Committee on Capital Markets described the current system as "increasingly filled with friction and even dysfunctional."[39] The Bloomberg-Schumer report called upon the government and the financial regulators to be more sensitive to the business needs of firms so they can better serve their consumers.[40] The U.S. Chamber's conclusion was particularly strong: "quick and decisive adjustments to the U.S. legal and regulatory framework will significantly improve the health and competitiveness of the U.S. capital markets, creating greater wealth and prosperity for American businesses and investors."[41]

Three inter-related aspects of the U.S. financial regulatory system contribute to its structural weaknesses:

1. First, regulatory agencies have different objectives. Diverse regulatory agencies at the national and state levels lack a common vision that systematically balance issues such as competitiveness, serving consumers, and risk management. This can delay the implementation of needed policies and responses to market volatility.

2. Second, our rules-based system of regulation is overly prescriptive. This leads to a focus on compliance with rules rather than outcomes and makes it difficult for regulators to adjust policies in any kind of flexible manner, especially in response to rapidly changing global financial market developments. It also fosters a more compliance-based and confrontational relationship between firms and regulators that is costly. Only the CFTC operates under a set of principles enacted by Congress.

3. Third, our regulatory regime has been slow to react and adapt to the rapidly changing financial marketplace, especially in response to international trends, market opportunities, and financial crises. One of the major reasons for this is the absence of any formal overarching common set of objectives or mechanisms for regulators to take coordinated action, which is especially important in times of market volatility and financial crises.

1. Regulatory agencies have different objectives.

With multiple national and state regulators that have slightly different missions, there is a constant potential for regulatory conflict. When this potential is realized, it can delay the implementation of policy and place U.S. firms at a competitive disadvantage to foreign counterparts. The delay in the U.S. implementation of the Basel II Capital Accord is an example. In Europe, Basel II is already in effect, but the United States is at least two more years away from full implementation. This has put U.S. banks at a competitive disadvantage because they are forced to abide by different capital rules during the interim. The delay in the United States is attributable, in part, to the fact that we have multiple banking regulatory agencies at the national and state levels, which were unable to reach consensus as quickly as their U.K. and European counterparts.

The potential for conflict among regulators also can have serious ramifications for important national policy issues. For example, it took roughly one year to negotiate a common regulatory guidance for nontraditional mortgages, and even then the guidance applied only to federally-supervised lenders, not state-supervised lenders.

Moreover, there are international supervisory problems that arise because of our fractional and functional system of regulation. The regulation of holding companies is illustrative. At least three separate regulators exist for different types of financial holding companies – the Federal Reserve, the OTS, and the SEC for investment-company holding companies subject to consolidated supervision. Each has a different mandate, a different regulatory philosophy, and a different approach to regulation. As a result, U.S. financial services firms that compete internationally can have three different types of

[39] Interim Committee, p. 67.
[40] Bloomberg-Schumer Report, pp. 61-65.
[41] U.S Chamber Report, p. 146.

holding company structures with three different regulators and three different sets of rules. While this situation allows companies the freedom to pick and choose preferred structural options that best meet their business plans for serving consumers, it also complicates supervision internationally. For example, under the E.U. directive that requires U.S. firms doing business in Europe to have a comprehensive consolidated supervisor at home, an E.U. regulator is put in the position of potentially having to work with three separate and uncoordinated U.S. regulators for those U.S. firms doing business in their markets. While this situation may be acceptable during noncrisis periods – even if it complicates supervisory interaction and creates additional delays - it is unacceptable during periods of financial strain and crisis when time and the ability to execute actions expeditiously are a factor.

Nor are the problems of a federal and fragmented regulatory system limited only to the banking industry. As noted above and later in Chapter 4, the state-based system of insurance complicates the ability of the United States to speak with one voice in international insurance and other forums, since there is no single national regulator that can speak or negotiate for the entire insurance regulatory structure at a systemic level. The National Association of Insurance Commissioners (NAIC) is an association of regulators, but it lacks any regulatory authority of its own. It sends representatives to international meetings, but functions primarily as an observer since it cannot promise or deliver any specific regulatory actions on its own. Insurance regulators can act, especially on issues of international interest, only when they have a green light from their state legislatures.

Moreover, this fragmented system of insurance regulation has led to the demise of the U.S.-based reinsurance industry. Even though U.S. insurance companies still play a major role in the reinsurance business, most of the business has moved off-shore to Bermuda, London, and other markets due to a combination of a more flexible, accommodating, and comprehensive regulatory environment, a more favorable tax regime, and greater ease in setting up an insurance business.[42]

Similar problems exist among securities regulators. For example, the former NASD had a strategy, a set of shared values, and a well-defined structure as a self-regulatory organization for the exchanges, firms, and brokers that it regulated. However, it is not clear if NASD's successor organization, the new Financial Institutions Regulatory Authority (FINRA),[43] has the same basic strategy and shared values that are aligned fully with those of either the SEC or the CFTC, let alone those of the various state securities regulators. U.S. financial regulators are not required to develop and publish robust business plans similar to the FSA, so it is difficult to tell if various regulatory strategies and programs are consistent and complimentary or conflicting and duplicative. Moreover, the CFTC operates under a set of Congressionally-mandated principles, while the SEC does not.

State regulators also can have different goals than federal regulators. For example, in the late 1970s and early 1980s, when interest rates reached record high levels, many consumers were unable to finance a home purchase at market interest rates, and homeowners had difficulty selling properties without significantly lowering the asking price. To protect consumers, California and other jurisdictions began to prohibit banks and savings associations from exercising "due on sale" clauses in mortgages. These clauses prevented a homeowner from selling a home and allowing the new owner to assume the mortgage with its old (lower) rate of interest. While benefiting consumers, the effect of these measures was to increase losses in the depository institutions, which were funding mortgages at market rates but receiving the lower rate of return specified in the older mortgages. The impact of the mismatch between deposit rates and mortgage rates was devastating

[42] Bloomberg-Schumer Report, pp. 33-34.

[43] The Financial Institutions Regulatory Authority (FINRA) was formed in July 2007 by the combination of NASD and member regulation, enforcement, and arbitration from the New York Stock Exchange (NYSE). FINRA is the largest non-governmental regulator for securities firms doing business in the United States, regulating more than 5,100 brokerage firms and 665,000 registered securities representatives.

to the savings and loan industry, and, due to this and other factors, a large portion of the industry technically was insolvent as early as 1981 under U.S. GAAP, even though the crisis did not fully erupt until the late 1980s. Ultimately, the "due on sale" issue was resolved by federal legislation that preempted state authority.

The existence of multiple regulators should be one of the strengths of our system. Multiple, specialized regulators can be more attentive to the differences between financial firms than a single regulator. The potential for conflict among regulators, however, has turned this strength into a weakness. Our recommended set of Guiding Principles is designed to address this weakness by giving all financial regulators – at both the national and state levels – a common vision for regulation that balances their systemic obligations (e.g., safety and soundness, solvency, investor protection) with other societal goals (e.g., serving consumers needs, competitiveness, capital formation). Our proposed expansion of the PWG also is intended to address this issue.

2. Our rules-based system of regulation is overly prescriptive.

While compliance with prescriptive rules can serve as a shield against enforcement actions and litigation,[44] prescriptive rules limit the ability of regulators to adapt to changes in global market forces because they focus primarily on compliance rather than outcomes. At a minimum, this can complicate the introduction of new products and services. The difficulty insurance firms face in licensing new products illustrates this weakness; it can take years for new products and services to be approved by the 50 states.

Further, our overly prescriptive system fosters a compliance-focused mentality by firms and regulators that can result in greater confrontation instead of cooperation. As we discuss further in Chapter 3, a prudential form of supervision that is based upon a constructive engagement between firms and regulators can protect consumers while accommodating the convergence and growth of the financial services sector. Our overly prescriptive regulatory system deprives both regulators and firms of this flexibility.

Finally, our prescriptive system is costly. The FSA has estimated that the direct cost of all U.S. financial services regulators in 2006 was $5.25 billion, almost nine times the direct cost of the FSA or $625 million (Exhibit 1-1).[45] The direct and indirect costs to the industry are sizeable as well. For the banking industry, estimated regulatory compliance costs by banks are roughly 10 percent to 12 percent of their noninterest expense (NIE), or from $33.5 billion to $40.2 billion at year-end 2006.[46] For the securities industry, the average cost of compliance per firm in 2005 is estimated at 13 percent of net revenue, or roughly $17.2 billion at year-end 2006 (Exhibit 1-2).[47] For the life insurance industry, the American Council of Life Insurers (ACLI) has estimated that the life insurance costs could be reduced by an estimated $5.7 billion annually if companies could be regulated by a single national regulator.[48] Ultimately, consumers bear the burden of excessive regulatory costs – in an increasingly global marketplace for financial services, this result conveys a competitive advantage to global firms not similarly impacted.

[44] See, for example, Robert Pozen, "Bernanke's False Dichotomy," Wall Street Journal, May 19, 2007, p. A-8.

[45] U.S. Financial Services Authority, Annual Report, 2006-2007, Appendix 1. Exchange rate conversion from sterling to dollars was calculated at 1:2.0063.

[46] Gregory Elliehausen, "The Cost of Bank Regulation: A Review of the Evidence," Federal Reserve Bulletin, April 1998, and staff paper; U.S. General Accounting Office, Regulatory Burdens: Recent Studies, Industry Issues, and Agency Initiatives (Washington, D.C., GAO/GGD-94-28, December 1993); Gregory P. Wilson, "Reg Burden Poses Risk to Nation's Dominance," American Banker, November 11, 2006, p. 11; SNL Financial.

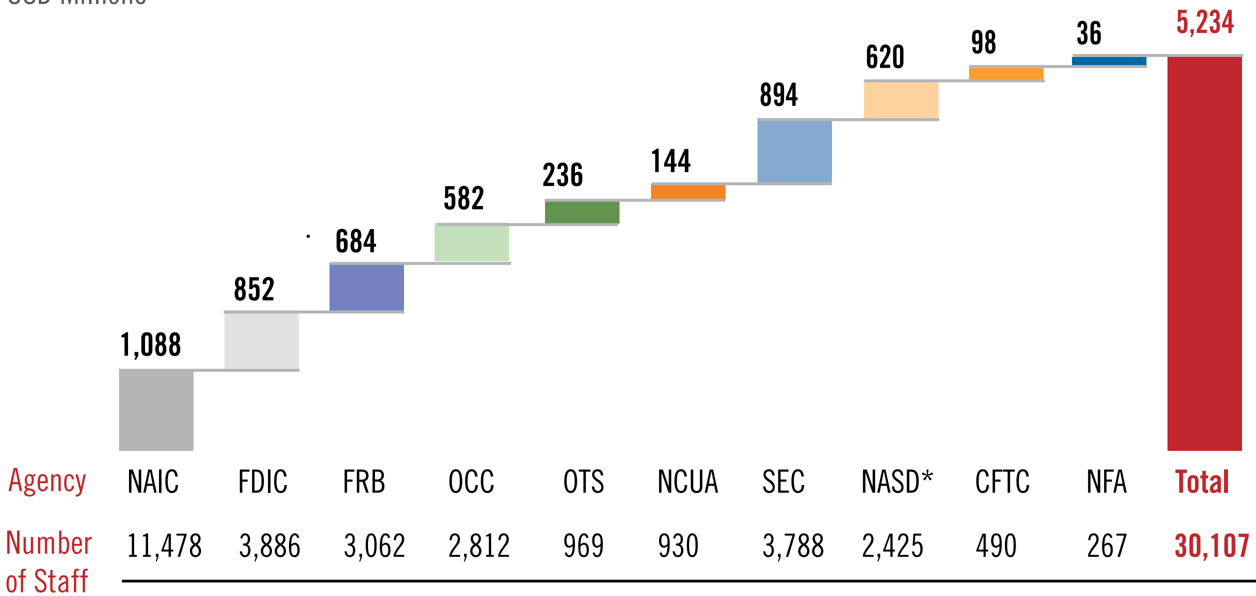
[47] "The Costs of Compliance in the U.S. Securities Industry – Survey Report," Securities Industry Association, February 22, 2006; Securities Industry and Financial Markets Association data.

[48] Steven W. Pottier, "State Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength," prepared for the American Council of Life Insurers, May 30, 2007, p. 1.

Exhibit 1-1

DIRECT COSTS OF U.S. FINANCIAL REGULATORS ARE HIGH

USD Millions



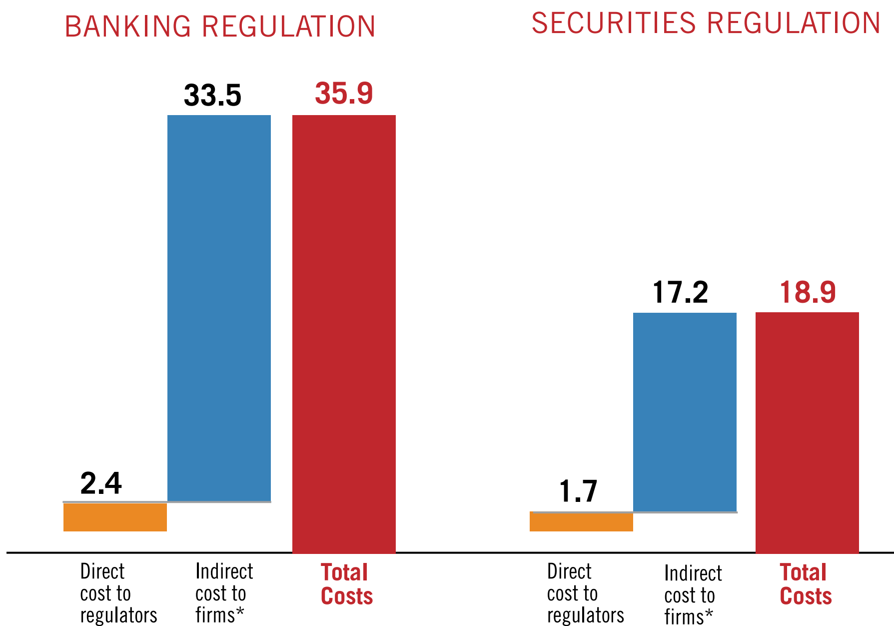
* Before NASD became FINRA

Source:Financial Services Authority (U.K.) Annual Report 2006-07

Exhibit 1-2

TOTAL COSTS OF COMPLIANCE TO U.S. CONSUMERS ARE SIGNIFICANTLY HIGHER THAN DIRECT COSTS OF REGULATORS

USD billion, 2006



* Estimated at 10% of noninterest expense (NIE) of all insured banks and thrifts

** Estimated at 13% of revenue

Source: Financial Services Authority (FSA), U.K.; Federal Reserve; FDIC; Securities Industry Association, SNL Financial

While it is difficult to weigh the full costs and benefits of financial regulation with any degree of precision to either consumers or the overall financial system, the costs alone are significant by any measure. In an increasingly competitive global financial marketplace, the questions are twofold. Are we getting the best kind of regulation possible for the total direct cost of regulation – $5.25 billion estimated in the United States last year – or would a more principles-based approach with more modern charters and structures and more efficient and coordinated regulation produce different and better results? Similarly, could we capture more benefits for consumers and the economy arising from the current cost of compliance – direct and indirect – by moving to a new model of financial regulation that is based upon guiding regulatory principles rather than prescriptive rules? Moreover, would not a principles-based approach to financial regulation give regulators – and firms – a greater ability to respond to the rapidly changing global marketplace, especially in times of market volatility and financial crises?

3. Our regulatory regime is slow to react and adapt to the rapidly changing financial marketplace, especially in response to international trends, crises, and opportunities.

In general, one of the clear lessons from the last round of financial crises in the late 1990s is the failure of national regulatory systems of all kinds to adapt quickly and sufficiently to the changing financial landscape domestically and internationally.[49] Crises have a way of revealing structural flaws that were apparent before a crisis hit but never addressed in any intentional and structured way prior to a crisis. Because the U.S. regulatory system is both fragmented in function and divided between national and state agencies, our regulatory system has been too slow as well to react to the diverse and dynamic needs of consumers and the rapidly changing financial landscape.

This fact is especially true when the rapidly changing and globally competitive financial markets are considered. The Bloomberg-Schumer report correctly noted that it was not just the market for global IPOs where the United States was losing ground competitively, but that other important and contestable markets in derivatives and debt financing are also at risk. In all three market segments, London is gaining ground relative to the United States.[50] While regulation and regulatory structure obviously are not the sole reason for these shifts, they are major contributing factors and cannot be ignored by policymakers or regulators.

One of the major impediments to timely actions by regulators is the absence of a formal mechanism for taking coordinated action in response to market developments. During times of financial turbulence and crisis, there is no single U.S. authority that can intervene across financial markets to take the necessary corrective action. Different financial regulators have different missions with varying responsibilities and tools at their disposal, and there is no clear leader in charge with an equally clear mandate. Crisis responses in the United States, therefore, become ad hoc efforts at best, without any formal and effective crisis prevention and cooperation agreements in place. Two examples are illustrative.

The first example is the U.S. stock market crash October 6, 1987, when the response to calm the markets effectively was made up on the spot by a variety of regulators coordinating with the Administration as best they could. In its role as the nation's central bank, the Federal Reserve had the responsibility for ensuring that there was sufficient liquidity in the markets and intervened expeditiously, but there was no formal way for the Federal Reserve to coordinate with the capital markets regulators, in this case the SEC for the cash markets and the CFTC for the futures markets. Moreover, given the market seizure and connectivity, there were no formal mechanisms for the SEC and the CFTC to coordinate their actions.

[49] Dominic Barton, Roberto Newell, and Gregory Wilson, Dangerous Markets: Managing in Financial Crises (New York: Wiley Finance, 2003). See especially Chapter 2 – "Recognizing New Global Market Realities."

[50] Bloomberg-Schumer Report, pp. 43-59.

Meanwhile, calls to the White House from Congress and elsewhere were referred to the Treasury Department, which seems logical except for the fact that the U.S. Treasury has no formal regulatory or supervisory role or powers over the financial markets. The Treasury Department can issue statements and encourage different actors to do different things, but it cannot command anyone to do anything differently when confronted with a crisis. Even though the OCC and the OTS formally are bureaus of the Treasury Department and the Secretary of the Treasury discusses broad policy issues from time to time with the heads of both of those bureaus, Treasury traditionally has followed a hands-off policy with respect to regulatory and supervisory actions.[51] Even if Treasury did lean on OCC and OTS to take specific actions, these agencies only supervise a portion of the banking system within the broader financial system.

Eventually, an effective crisis response was implemented in 1987 in the spirit of cooperation, given the need to "do the right thing at the right time." The various financial regulators, with Treasury in the middle, did take the necessary corrective action over time to restore market confidence in a coordinated manner in short order. The fact that there was no formal coordinating mechanism at the time of the crisis, however, led to the creation by Executive Order in 1988 of the President's Working Group on Financial Markets, with the Secretary of the Treasury as chairman and including the chairmen of the Federal Reserve, the SEC, and the CFTC. While the PWG exists today under the same Executive Order, it has limited authority as a discussion forum and cannot force any regulator to take any specific action.

The second, more recent example of weakness in the U.S. regulatory structure is the credit crunch that surfaced publicly in August 2007, initially in the U. S. mortgage markets. The problems soon spread to other credit markets, such as asset-backed commercial paper (ABCP), and around the world through the global capital markets affecting both debt and equities. Ultimately, massive and coordinated intervention by the leading central banks, including the Federal Reserve, was required to provide the necessary liquidity to calm the markets.

The developments that ultimately led to that crisis had their genesis in mortgage instruments and structured financial transactions, such as tranched asset-backed securities, collateralized debt obligations (CDOs), and derivatives. These innovations facilitated an explosion in activity in the U.S. housing market. While credit became more accessible, the development of the "originate-to-distribute" model led to an increased separation between those responsible for risk creation and those who ultimately bore the risk and thus led to a weakening of risk accountability. In short, governance of risk did not keep pace with innovation and market structural changes.

The OCC, OTS, Federal Reserve, and FDIC supervise state and national banks that are active in the mortgage markets, but our overly prescriptive system of financial regulation makes it difficult for these agencies to focus prospectively on the risks that market innovation and structural changes might pose. Nor is there a mandate for these agencies to coordinate on crisis prevention or crisis management

[51] Congress also has prohibited Treasury from interfering with the regulatory actions of the OCC and OTS. See, for example, 12 U.S.C. 1, which states "The Secretary of the Treasury may not delay or prevent the issuance of any rule or the promulgation of any regulation by the Comptroller of the Currency."

issues[52] and only the Federal Reserve is a member of the PWG. These national agencies oversee only a portion of the mortgage industry, and there is no formal mechanism for them to coordinate with state bank regulators. Furthermore, structural changes in the mortgage market include a much expanded role for mortgage bankers and, in particular, mortgage brokers, who were involved in 58 percent of the mortgage originations in 2006. These firms often are effectively unregulated at the state level, even though they may have state licenses to conduct business. Consequently, no single agency has a clear purview or supervisory authority over the entirety of the primary-mortgage market.

Secondary-mortgage market activity is split between regulatory agencies and government-sponsored enterprises as well, with Freddie Mac, Fannie Mae, and Ginnie Mae playing a role for conforming mortgages that get packaged into securities and the SEC overseeing the securities created from nonconforming loans (i.e., those over a certain dollar amount, currently $417,000), subprime, and Alt-A loans.[53] Many financial services firms regulated by federal and state bank regulators are also active in securitization and the secondary-mortgage market, but, again there is no single agency across the secondary markets, or the combined primary- and secondary-mortgage markets.

Having a single regulator may not have prevented the current credit crunch, but having different national and state regulators overseeing different parts of the marketplace, without coordination or clearly delineated accountability, increased the potential for excesses and ultimately crisis. When the crisis erupted, as in previous crises, an ad hoc response was required.

Many observers looked to the Treasury Department to play a leadership role, which is a natural response, but the Treasury has only hortatory powers at best. It can provide some information and its perspective to the markets, but it is dependant on a variety of other agencies to provide that information to it and it has no power to act beyond its auction of Treasury securities to fund the government's debt. To its credit, the Treasury, through the PWG, had taken the initiative prior to the current credit crunch to work through a variety of potential crisis scenarios and develop more prepared responses at the interagency level.[54] While this foresightedness hopefully helped with a rapid and more coordinated response to current market events than in the past, it is not a substitute for having an overall crisis management leader with clear authority.

Our proposed enhancement of the President's Working Group on Financial Markets (see Chapter 2, Recommendation 2) is designed, in part, to address the weaknesses of evolving appropriate regulatory responses to market innovation and structural change as well as to effectively coordinate crisis management. In addition to overseeing the implementation of the Guiding Principles for regulation, this improved PWG could serve as a coordinating body in times of crisis.

Potential threats to U.S. financial competitiveness

In light of the weaknesses noted above, the competitiveness of the U.S. financial system and its ability to serve consumers is subject to two major threats: 1) external threats that are global in nature and beyond our ability to control directly; and 2) internal threats that are mostly national in nature and are within our collective ability to influence directly, if not fully control.

External threats

External threats arising from increasing global financial competitiveness and integration need to be recognized since they will affect the collective U.S. competitive response over time. But they admittedly

[52] Traditionally, the FFIEC has not been used for crisis prevention or resolution issues, but simply for examination and supervision coordination.

[53] Jumbo nonconforming loans, subprime loans, and Alt-A loans collectively accounted for 53 percent of single-family mortgage originations in 2006. See Inside Mortgage Finance.

[54] Robert K. Steel, Under Secretary of the Treasury, "Testimony on Hedge Funds," Committee on Financial Services, U.S. House of Representatives, July 11, 2007, HP-486.

are largely beyond our ability to control directly, especially in the short-term. As Mayor Bloomberg and Senator Schumer indicated in their bipartisan report, these threats are real:

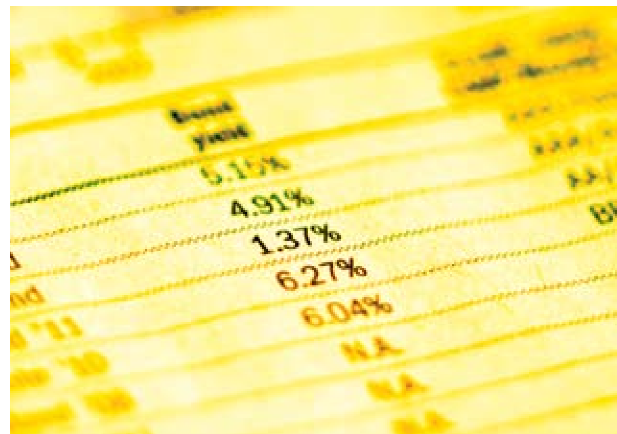
> *At some level, it is inevitable that other national markets will become more attractive to industry participants as they grow faster than those in the United States, albeit from a smaller base. . . . Continued economic liberalization and the introduction of new market-oriented regulations are working to stimulate this growth. Moreover, technology, trading markets, and communication infrastructures are evolving to make real-time interactions and transactions possible and affordable from virtually anywhere, thus reducing some of the benefits of physical co-location in major financial centers such as New York.*[55]

The U.S Chamber's Commission on the Regulation of Capital Markets in the 21st Century came to a similar, independent conclusion about the external threat of more competitive foreign markets.

More recently, there have been considerable advancements in foreign capital markets that have sharply increased their competitive position in relation to the traditionally dominant U.S. markets. The United States now faces stiff competition from capital markets in Europe and Asia. General economic growth throughout these foreign markets has driven advancements in technology, communication, and information management systems. Concurrently, lawmakers and regulatory bodies have collaborated in modernizing their internal legal frameworks while working to harmonize securities regulations on both regional and global levels to improve cross-border capital flows. Newly developed foreign infrastructure supports secondary trading markets and provides the requisite liquidity sought by issuers and investors.[56]

1. Faster country growth.

The economies of many countries are simply growing faster than the Untied States' economy. For example, countries with huge financing needs, such as China and India, have experienced annual growth rates in recent years in excess of 7 percent, more than twice the estimated average annual U.S. growth rate of approximately 3 percent. While the growth rates are lower in Europe, capital markets in the "Euro zone" are expected to grow at almost three times the U.S. rate (20 percent in Europe versus 7 percent in the United States).[57]



2. Faster product growth.

Just as other national markets are growing faster, many financial product markets are growing faster overseas as well. Initial public offerings (IPOs), over-the-counter (OTC) derivatives, and debt are three of the major contested investment banking markets where U.S. competitiveness is eroding rapidly in favor of overseas competitors. But changes in the U.S. legal and regulatory regime are part of the intrinsic factors that ultimately can enable us to control this erosion. As recent studies have indicated, companies that just a few years ago had to list in the United States if they wanted to raise capital internationally now have other viable options – they no longer have to come to New York to raise capital globally. Moreover, private equity offerings, which do not require formal listings as IPOs and thus escape many regulatory requirements imposed on publicly-traded securities, also are expanding in both the United States and Europe as companies either come to market or de-list from more heavily regulated markets.

[55] Bloomberg-Schumer Report, p. 11.
[56] U.S. Chamber Report, p. 21.
[57] Bloomberg-Schumer Report, p. 41.

3. More conducive regulatory regimes.

Many financial centers and other countries are moving to improve their own financial market regulatory regimes to enhance their countries' prospects for higher economic growth and development that can be expected from more market-oriented but well-regulated financial sectors. The continuous efforts of the FSA in London over the past 10 years were noted in the last section and are obvious; hardly a day goes by without some news article in the financial press describing what the U.K. is doing compared to the United States.

Other countries and smaller but growing financial centers such as Bermuda, Dubai, Switzerland, Liechtenstein, Luxemburg, Singapore, Hong Kong, and others are also working hard to maintain and improve their financial regulatory regimes and thus improve their chances for more sustained economic growth in the future. While not all of these markets compete directly with the United States, some do, most notably Bermuda in reinsurance and London in capital markets products. Growing centers like Dubai are relatively new and still developing, but they are making considerable strides to attract and retain international listings as well as domestic investors, and are keeping more capital within their region instead of letting it find its way to the United States as it once did historically at high levels, especially before 9/11.

Like it or not, external threats in the form of faster-growing national and product markets overseas, rapidly developing global and regional financial centers, and the widespread rise of more conducive policy and regulatory regimes are part of the ongoing global competitive landscape. How we respond to these external threats will affect our competitive position as a financial system, but since these threats are beyond the direct ability of the U.S. to control, a better understanding of those internal threats intrinsic to our policy and regulatory regime that we can control is required.

Internal threats

As noted in recent major studies, the most significant threats to U.S financial market competitiveness are of our own making, and thus are within our power to correct.[58] While the current U.S. legal and regulatory environment may have been part of our competitive advantage in financial markets in the past, what worked historically to our advantage may now have become a source of our potential competitive disadvantage within the global marketplace.

The internal threats center on legal and regulatory issues that not only have a long historical legacy, and thus may be difficult to change in the near future, but also are the most pressing immediate ones from a strategic competitiveness perspective.

1. Legal issues.

Chief among the internal threats facing financial market competitiveness in this country is the U.S. legal framework, including the litigious nature of our system in general and securities litigation and class actions in particular. While the Class Action Fairness Act of 2005 improved the class action system by facilitating the removal of national class action suits to federal court, additional class action reforms are warranted.

Perhaps the most instructive recent analysis of current business views of the U.S. legal, regulatory, and policy environment is the survey of 275 U.S. and international financial executives conducted as part of the Bloomberg-Schumer report. The survey found that when it comes to a fair and predictable legal environment, the United Kingdom and London's financial center have a remarkable competitive advantage over the United States. In addition to the high legal costs of doing business in the United States,[59] those executives surveyed indicated that the U.K. advantage is greatest across three dimensions: the propensity toward legal action; the predictability of legal outcomes; and the fairness of legal processes. For example, 63 percent of those surveyed preferred the U.K. legal system for its response to litigious actions, compared to only 17 percent who thought that the U.S. was less litigious. When CEOs are isolated in this survey, 85 percent preferred the U.K.

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[58] Bloomberg-Schumer Report; Interim Report; and U.S. Chamber Report.
[59] Bloomberg-Schumer Report, p. 74.

legal regime; not a single CEO preferred the U.S. legal system.[60]

One observable manifestation of the U.S. legal system that affects the competitiveness of our financial markets is increasing securities litigation. Since 1996, the U.S. Chamber notes that more than one-third of roughly 6,000 listed companies have been defendants in class-actions for federal securities fraud. While noting that there needs to be a balance between the right of private litigants under securities laws and reliance on federal, state, and SRO enforcement, the Chamber recommends that the SEC undertake a comprehensive review of federal and state securities enforcement mechanisms to determine whether they are making positive contributions to investor protection and capital formation relative to costs.[61]

2. Regulation.

According to the Bloomberg-Schumer findings, having regulators that are responsive to business needs and an attractive regulatory environment are critical to our international competitiveness. When asked to compare the regulatory environments in the two major financial markets, without hesitation leading business executives expressed growing appreciation for the U.K.'s more measured approach and predictable processes. The U.K. is viewed as more results-oriented and more effective, compared to the fragmented U.S. approach, which is seen as being more punitive and more costly.

In short, chief executive officers and other senior executives view London as having a significantly better regulatory environment.

Looking more closely at the drivers behind respondents' preference for London's regulatory regime, senior executives were asked to evaluate six different dimensions of the regulatory system.[62] Across all six factors identified, respondents indicated that they preferred the U.K. system. Ranked from highest to lowest degree of U.K. advantage, the six factors are:

1. *Cost of ongoing compliance* – 54 percent of respondents indicated that the U.K.'s regulatory regime is "somewhat better" or "much better" than that in the U.S. Only 15 percent give the same accolade to the U.S.

2. *Regulatory simplicity* – 48 percent prefer London for the simplicity of its regulatory system and structure, as compared with just 19 percent for the U.S.

3. *Uniformity* – 44 percent of respondents indicated that the uniformity of regulatory enforcement in the U.K. is "somewhat better" or "much better," as compared with only 14 percent for the U.S.

4. *Fairness* – 40 percent prefer London for the fairness of its regulatory rules, as compared with 15 percent for the U.S.

5. *Clarity* – 38 percent prefer London for the clarity of regulatory rules, as compared to 19 percent for the United States.

6. *Investor confidence* – 30 percent prefer the U.K. for rules that inspire investor confidence, as compared with 25 percent for the U.S.

This survey of executives represents the most current indication of business perceptions of critical dimensions of the U.K. and U.S. regulatory systems. Unless these regulatory perceptions are changed, more and more businesses and jobs likely will migrate to other regulatory venues – most notably London – that are viewed as more conducive to doing business while maintaining high, principles-based regulatory

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[60] Ibid., pp. 75-78.
[61] U.S. Chamber Report, pp. 28-31.
[62] Bloomberg-Schumer Report, p. 86.

standards that ensure fair and competitive markets, prudential risk management based on observable market principles, and high degrees of protection for consumers.

Opportunities

An assessment of the current strengths and weaknesses and the threats facing U.S. financial competitiveness brings us to the point of understanding what opportunities and challenges lay ahead for the industry, policymakers, and regulators. The good news is that many of the perceived weaknesses and real internal threats are manageable – assuming that the private and public sectors commit to a process of change. At this point in our financial history, where U.S. global financial competitiveness is being challenged seriously for the first time by other markets, both the financial services industry and the U.S. government have a unique opportunity to step back and assess our past, present, and future financial competitiveness and its impact on the ability of financial institutions to serve consumers.

The balance of this Blueprint sets forth the Commission's proposed reforms for better regulation and enhanced competitiveness.

Chapter 2 – Guiding Principles to Enhance U.S. Financial Regulation and Competitiveness

". . . [O]ur regulatory framework is a thicket of complicated rules rather than a streamlined set of commonly understood principles. . . . The time has come to undertake broader reforms, using a principles-based approach to eliminate duplication and efficiencies in our regulatory system. And we must do both while ensuring that we maintain our strong protection for investors and consumers."[63]

New York Mayor Michael R. Bloomberg and
Senator Charles E. Schumer (D-NY), January 2007

"We should assess how the current system works and where it can be improved. . . . And we should consider whether it would be practically possible and beneficial to move to a more principles-based regulatory system, as we see working in other parts of the world."[64]

Henry M. Paulson, Jr., Secretary of the Treasury,
March 13, 2007

". . . [C]entral banks and other regulators should resist the temptation to devise ad hoc rules for each new type of financial instrument or institution. Rather, we should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives."[65]

Ben S. Bernanke, Federal Reserve Board
Chairman, May 15, 2007

"At the same time [as the passage of the Commodity Future Modernization Act], the United Kingdom was capping off a similar exercise with the passage of the Financial Services and Modernization Act of 2000. Despite these two separate efforts from different sides of the Atlantic, both governments came to the same conclusion: a principles-based regulatory regime – compared to the traditional rules-based one – provides a more effective regulatory approach for financial services in this global technological age."[66]

Walter Lukken, Acting Chairman, Commodities Future
Trading Commission, January 25, 2007

The common theme in the foregoing statements is a call for the adoption of a principles-based approach to U.S. financial regulation to ensure that U.S. financial services firms are competitive, consumers of financial services are protected, and financial markets are stable and secure. Mayor Bloomberg, Senator Schumer, Treasury Secretary Paulson, Federal Reserve Chairman Bernanke, Acting CFTC Chairman Walter Lukken, and others[67] have recognized that a more principles-based approach to U.S. financial regulation will benefit financial firms, markets, and the economy. In fact, the CFTC has been using a principles-based approach to the regulation of the future industry since the enactment of the Commodity Futures Modernization Act of 2000, when Congress adopted 18 core principles for boards of trade to maintain their designation as a futures contract market.

More recently, the President's Working Group on Financial Markets adopted a principles-based approach to guide regulatory treatment of private pools of capital, including hedge funds. The PWG focused on principles for investor protection and systemic risk. As Treasury Secretary Paulson, who chairs the PWG, noted: "The President's Working Group believes that public policy toward private pools of capital should be governed by consistent principles that set out a uniform approach to specific

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[63] Bloomberg-Schumer Report, p. ii.
[64] Paulson, Georgetown University Speech.
[65] Bernanke, Regulation and Innovation Speech.
[66] Walter Lukken, op. cit.
[67] The U.S. Chamber also endorses a more principles-based approach to financial regulation; U.S. Chamber Report, pp. 117-118. See also Gregory P. Wilson, The Importance of Financial Market Regulation for the Competitiveness of the U.S. Economy, testimony to the National Commission on the Regulation of Capital Markets in the 21st Century, U.S. Chamber of Commerce, October 20, 2006, and Gregory P. Wilson, "A New U.S. Regulatory Strategy to Enhance Financial Competitiveness," American Enterprise Institute, January 24, 2007, on the AEI Web site at www.aei.org/docLIB/20070124_WilsonPaper.pdf.

policy objectives. These principles demonstrate that U.S. regulators and policymakers have a unified perspective and are committed to providing forward-leaning guidance for the industry and its participants."[68]

Principles can serve as a guide for financial laws, regulations, supervision, and enforcement actions. Further, principles have the flexibility to be applied in guiding responses to rapidly changing markets in contrast to rules, which simply cannot anticipate each and every contingency for each and every financial product and service offered to consumers.

Recently the liquidity crisis and ensuing credit crunch in several significant capital markets sectors revealed weaknesses in the regulatory system. Many homeowners have been confronted with the prospect of foreclosure, and U.S. financial markets have been roiled by problems that can be traced to aggressive practices by some firms, gaps between national and state regulation of the U.S. mortgage industry, and opaqueness in some structured financial instruments innovations. Many of these problems have also impacted the broader credit and capital markets, both domestically and globally. These developments may not have been avoided entirely by a principles-based approach to regulation, but there would have been greater opportunity within a principles-focused system to anticipate the potential effects of market changes and mitigate some of the consequences. The principle of prudential supervision would have encouraged a closer dialogue between firms and regulators, enabling both firms and regulators to earlier identify and manage practices that contributed to the problems. Similarly, the application of uniform national standards and fair treatment for consumers would have prevented gaps in different national and state regulatory standards and could have helped to ameliorate inappropriate practices.

This chapter addresses the development and application of a principles-based approach for U.S. financial regulation. The chapter is divided into two parts. First, we explain why a more principles-based approach to improving financial regulation is critical to the competitiveness of U.S. financial services firms, the protection of consumers, and the stability of financial markets. Second, we propose a comprehensive set of principles to guide U.S. financial policy and regulatory decisions – principles that span the spectrum of our financial services industry and are designed to enhance the competitiveness of the industry and guide U.S. financial regulation so it can better serve consumers and the economy.

UNDERSTANDING WHY MORE PRINCIPLES-BASED FINANCIAL REGULATION HELPS U.S. COMPETITIVENESS, CONSUMERS, AND THE ECONOMY

Recent studies, such as the Bloomberg-Schumer report and the U.S. Chamber report, have catalogued the challenges facing U.S. financial firms and U.S. financial markets. Those studies have cited our complex, prescriptive, and costly regulatory system as a major source of risk, especially when compared to the developments in other internationally competitive financial markets. Clearly, principles-based regulation is not a cure-all to these challenges. However, principles can contribute significantly toward balancing effective regulation with greater competitiveness and other policy goals, especially when combined with the other recommendations made in this Blueprint related to charter modernization, new optional national charters, and more effective regulatory coordination.
Adopting a more principles-based approach to

[68] "President's Working Group Releases Common Approach to Private Pools of Capital: Guidance on hedge fund issues focuses on systemic risk, investor protection," U.S. Treasury press release HP-272, February 22, 2007. This approach to private pools of capital was also endorsed by former Treasury Secretary Robert Rubin, now Chairman of the Executive Committee at Citigroup; see "Rubin rejects hedge fund regulation," Financial Times, September 27, 2007, p. 6.

financial regulation can have distinct substantive and procedural advantages for regulators, regulated firms, and the consumers of financial products and services. Adoption of principles-based financial regulation would have multiple benefits:

- *Adaptation of regulatory supervision.* As financial services firms develop innovative responses to changing consumer needs, evolving technology, structural changes in the marketplace, and increasing global competition, an outcomes-focused, principles-based approach will prompt regulators and financial firms to develop responses that encourage, facilitate, and govern positive change to meet the diverse financial needs of all consumers.

- *Common direction.* Common principles that apply to all financial regulators can guide regulators in the same general direction with greater clarity and balance. Guiding principles can facilitate a shared view of encouraging competition, sound risk management, and a fair deal for consumers.

- *Competitiveness.* The United States lacks a clear vision and strategy for the future development of the financial services sector as a critical economic sector. A principles-based approach to financial regulation can set a common direction for all financial regulators and position the U.S. to remain competitive with other financial centers (e.g., London, Zurich, Dubai, Hong Kong, Singapore), which have clear visions and robust strategies to enhance their financial markets' competitiveness as part of their national plans for economic growth and development.

- *Expected behavior.* Principles put both consumers and financial services firms on notice about the kind of behavior that is expected in everyday transactions and ongoing business relationships. Rules cannot be written to govern every conceivable new product or all potential conflicts of interest, but principles can guide the activities and conduct of firms and consumers as markets, products, and technology evolve.

- *Innovation.* Given the rapidly changing nature of financial services competition globally, a principles-based approach to U.S. financial regulation can encourage innovation for new products, services, strategies, delivery systems, and risk management without complicated and voluminous rules impeding or discouraging beneficial change.

- *Risk management.* A set of principles that is understood and embraced in advance can guide recognition of, and response to, developing problems and help to reduce or avoid unwanted outcomes.

- *Designing new rules.* A principles-based approach can provide a common platform to design new laws and regulations. This is especially important when principles such as competitiveness, a fair deal for consumers, and cost-effectiveness guide the drafting of new laws and regulations.

- *Evaluating existing rules.* These same principles can be applied on a regular basis to audit and assess existing laws and regulations as well.

While the benefits of a principles-based approach to regulation are many, the implementation of this approach in the U.S. raises several important practical and policy issues.

First, and foremost, the U.S. legal and regulatory environment differs substantially from that of the U.K. In other words, we cannot assume that a principles-based approach to regulation will work in the United States simply because it has been implemented and appears to be working well in the U.K. Our system of multiple national and state financial regulators is far more complex than the

regulatory structure that existed in the U.K. before the creation of the FSA. Similarly, the United States traditionally has relied more heavily on private litigation as a form of recourse than has the United Kingdom. Therefore, while we can look to the U.K. as a model for principles-based regulation, we need to refine that model to fit the U.S. legal and regulatory systems.

To address these differences, we propose a simple, unified set of six Guiding Principles for regulators and regulated firms, (in contrast to the two separate sets of U.K. principles, one for regulators and one for regulated firms). Also, our proposed enhanced President's Working Group on Financial Markets is designed to implement these Guiding Principles in a coordinated manner, since there is no single U.S. regulator to oversee their adoption and implementation across the financial services industry. Further, because of the unique U.S. legal and regulatory environment, we propose that these Guiding Principles be enforced by a firm's primary national or state financial regulator.

The CFTC's principles-based approach to regulation of the futures market can serve as a practical model for other parts of U.S. financial markets. Moreover, the CFTC has demonstrated since 2000 that a principles-based regulatory regime can work. To increase the flexibility of compliance and reduce prescriptive regulation, the CFTC identifies acceptable practices for each principle that serve as safe-harbors for compliance, but it also permits the industry and SROs to develop their own acceptable practices for CFTC approval, so the futures exchanges have a choice. The CFTC's principles also are risk-focused, allowing the agency to prioritize its responsibilities while leveraging limited staff resources. By moving to a more principles-based regulatory regime, the CFTC is also more compatible globally and better able to work cooperatively with other regulators based on mutual recognition of comparable standards. Its principles have enabled the CFTC to become more of prudential supervisor, encouraging a more collaborative relationship with regulated entities while reserving its rights as an enforcer in the case of fraud, manipulation, or trade practices abuse, for example.[69]

Second, care must be taken to ensure that principles improve our regulatory system and do not become an additional layer of regulation that simply increases costs for regulated firms and consumers. Such a result, obviously, would defeat the goal of principles-based regulation. To address this concern, the PWG should be required to oversee, evaluate, and report to Congress and the President on the Regulatory Actions Plans of the individual financial regulatory agencies, similar to the Better Regulation Action Plan recently adopted by the FSA or the CFTC's recent review of its rule book under the Commodity Futures Modernization Act. The approach would address concerns that the adoption of a principles-based approach to regulation could detract from the urgent need to improve the existing body of rules and regulations already in effect.[70]

Third, since principles are, by nature, high-level statements of policy objectives, it can be difficult to envision how they should be applied on a real-time, day-to-day basis. Therefore, in any principles-based regulatory system some rules must remain as a supplement to principles. For example, if a principle calls for competition that is open, fair, and market-based, then the rules implementing that principle

[69] Walter Lukken, op. cit.
[70] Robert C. Pozen, "Bernanke's False Dichotomy," Wall Street Journal, May 19, 2007, p. A-8.

could be expected to provide clear guidance for entry requirements, minimum capital levels, and market conduct. Firms that meet the requirements of both the principle and the rules would be allowed to compete, and those that fail to meet the principle and rule would be subject to prudential supervision. This blend of principles and rules also would limit the potential for individual regulators to use the principles to subject firms to arbitrary actions.[71]

Fourth, there is a legitimate concern that the litigious nature of the U.S. legal system and multiple layers of enforcement, including private actions, are not conducive to a principles-based system. Indeed, if principles become a basis for even further litigation against financial services firms, they would have the unintended consequence of harming, not enhancing, competitiveness. Part of our solution to this concern is that these principles be enforced by a firm's primary regulator, and not through class-action lawsuits. Financial services firms are subject to extensive supervision and regulation, largely aimed at protecting consumers. Moreover, if regulators adopt a more prudential form of supervision, as we recommend, then potential problems will be addressed long before they impact consumers. Therefore, consumers should have no need to resort to class-action cases for redress of any violations of the principles.

Fifth, principles cannot be effective without full acceptance and meaningful support by policymakers, especially Congress. As we note in Chapter 1, highly prescriptive federal laws contribute to our existing rules-based system of regulation. To ensure that Congress is part of this process, we propose that these principles be enacted into federal law, similar to the approach of the Commodity Futures Modernization Act of 2000. Moreover, there is clear precedent for this beyond the CFTC. For example, Congress also gave the SEC a statutory mandate to promote efficiency, competition, and capital formation in the National Securities Market Improvement Act of 1996 (NSMIA).[72]

Finally, we acknowledge that the implementation of a U.S. principles-based regulation will be a process, not an event. It will take time to modify the highly prescriptive approach to regulation that dominates our current system. It also will require the establishment of a level of trust and constructive engagement between firms and regulators. A principles-based system of regulation places a significant amount of discretion on the management of financial services firms. It calls upon managers to determine how broad principles apply to specific products and practices. Firms will need to be comfortable assuming this responsibility, and regulators will need to be comfortable with the exercise of this responsibility by firms, even while assuring that management actions are consistent with the intent and spirit of the principles. Regulators also will need to recognize that adherence to the principles will not require every firm to apply them in exactly the same manner.

The challenges are great. Yet, the rewards can be significant for consumers and the economy. As former Federal Reserve Board Chairman Alan Greenspan noted over 15 years ago, excessive regulation can lead to "unnecessarily high transaction costs, distortions in asset prices, and a stifling of innovation."[73] Today, our current rules-based system of regulation does impose unnecessarily high transaction costs on firms and consumers; it distorts asset prices, as we have seen recently in the mortgage industry; and it can stifle the introduction of new products and services, especially for the consumers of insurance. Thus, it is our view that the establishment of a principles-based system of regulation will improve outcomes and is essential to maintain global competitiveness of U.S. financial firms and markets to serve and protect consumers better.

[71] Peter Wallison, "America will prefer to rely on rules, not principles," Financial Times, July 6, 2007, p. 9. See also Peter Wallison, "Fad or Reform: Can Principles-based Regulation Work in the United States," American Enterprise Institute for Public Policy Research (June 2007).

[72] P.L. 104-290.

[73] Remarks of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System, before the 16th Annual Conference of the International Organization of Securities Commissions, September 24, 1991.

DESIGNING GUIDING PRINCIPLES FOR U.S. FINANCIAL REGULATION

For the purposes of the Commission's Blueprint, a principles-based approach to financial regulation is defined as the development of an overarching code of conduct that governs the development, implementation, administration, and adjudication of laws, regulations, supervision, and enforcement affecting financial market intermediaries and their interactions with both consumers and regulators. In this context, the term "consumers" is used broadly to include all possible customers as well as issuers and investors.

We fully recognize that given the U.S. legacy regulatory system, a pure "principles-only" financial regulatory system cannot be a complete substitute for our existing rules-based system. As noted in Chapter 1, even the United Kingdom does not have a pure principles-based system of financial regulation. While the U.K. has adopted a principles-based approach to financial regulation, its rule book continues to total almost 8,500 pages, although the FSA's current Better Regulation Action Plan intends to reduce this volume significantly over several years.

The CFTC also uses a hybrid approach of principles and rules, and has completed its own regulatory review of its rules that can serve as a model for the Regulatory Action Plan we propose. It also gives regulated entities a choice of how they are supervised. As Acting Chairman Lukken stated earlier this year: "For those wanting absolute legal certainty, a principle's acceptable practices guarantee compliance. However, the [CFMA] specifies that acceptable practices are not the exclusive means for meeting a principle, giving regulated entities the choice of adopting alternative means for meeting a principle."[74]

Accordingly, we propose a blend of Guiding Principles along with a body of rules to interpret the principles in a policy and legal context. Our principles-based approach to U.S. financial regulation envisions a set of fundamental principles standing ahead of, and guiding, the application and review of policies, laws, and rules affecting the behaviors of both financial market participants and their regulators. The Commission's Guiding Principles are designed to be a unified and cohesive response to the needs of consumers, financial services firms, and regulators. At their core, the Commission's six principles are intended to ensure that the regulation of financial services and markets is more balanced, consistent, and predictable. Guiding Principles for financial regulation should also support basic national policy objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation.

As indicated earlier, the Commission believes that these Guiding Principles should have the force of law. As such, U.S. financial regulators and regulated financial services firms would be held accountable for compliance with them, provided, however, that compliance by financial firms is enforced solely by the firm's primary financial regulator.

Accordingly, the Commission's **Recommendation 1** proposes the following Guiding Principles for U.S. Financial Regulation to guide the development of laws, rules, supervision, and enforcement of the financial services industry in the future. In addition to being prospective, these same principles also should guide a comprehensive retrospective assessment of current laws, rules, and supervisory policies that directly affect the competitiveness of firms and how well consumers are served under the current regulatory regime.

[74] Walter Lukken, op. cit.

POLICY REFORM I. PRINCIPLES-BASED REGULATION.

Congress and the Administration should enact principles-based financial regulation. Specifically:

Recommendation 1. Principles. Congress and the Administration, with input from the private sector, should enact the following set of Guiding Principles into law in 2008.

Guiding Principles for U.S. Financial Regulation

Preamble. These Guiding Principles are intended to ensure that the regulation of financial services and markets is more balanced, consistent, and predictable for consumers and firms, and therefore achieves three fundamental objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation. Consumers includes those of retail customers, small- and medium-sized businesses, larger national and international businesses, investors, issuers, governments, and others who rely upon financial services firms in the conduct of their business. These Guiding Principles should guide the supervisory and regulatory policies and practices of financial regulatory authorities as well as the policies and practices of financial services firms, and they should be enforced by the firm's primary regulator. They are not intended as a complete substitute for rules, but should guide both the development of new rules and the review of existing rules.

1. Fair treatment for consumers (customers, investors, and issuers).

Consumers should be treated fairly and, at a minimum, should have access to competitive pricing; fair, full, and easily understood disclosure of key terms and conditions; privacy; secure and efficient delivery of products and services; timely resolution of disputes; and appropriate guidance.

Fair treatment of consumers in meeting their needs competitively to help them achieve all of their financial goals in life is a core principle. Treating consumers fairly is a stated objective for every responsible financial services firm today, and typically it is a critical component of a firm's strategy for doing business in all consumer segments. Fair treatment should occur throughout a financial transaction. At the beginning of a transaction it involves the meaningful disclosure of terms. Meaningful disclosure, especially to the retail consumer, goes hand in hand with effective competition. After a consumer relationship is established, fair treatment includes maintaining the privacy of consumers' confidential personal information and providing a safe and secure environment in which to conduct financial business. It also includes facilitating all consumer transactions – payments, transfers, credit applications, setting up new accounts, sales, and purchases – to ensure that they are conducted in the most efficient and timely manner possible given available technology. Further, fair treatment includes the establishment of transparent, effective, and timely mechanisms in place for consumers and firms to resolve potential disputes.

The phrase "appropriate guidance" is not intended to apply existing legal standards governing investment advice to all other forms of financial products and services. The sale of certain products, such as the purchase of securities, are subject to suitability standards that this principle does not propose to alter or extend to other types of financial products and services. Nonetheless, fair treatment of consumers does require a financial firm to consider the needs of a consumer in any interaction and to make sure that a consumer understands how the interaction will affect him or her. While effective disclosure often will constitute appropriate guidance, in some instances, it may be important to help a consumer to understand the purpose and function of a particular product or service by providing financial education training.

2. Competitive and innovative financial markets.

Financial regulation should promote open, competitive, and innovative financial markets domestically and internationally. Financial regulation also must support the integrity, stability, and security of financial markets.

U.S. financial markets must be competitive locally and globally to support sustained economic growth and meet all consumers' needs over time. Open, competitive, and innovative markets benefit consumers and are preferable to financial markets that are closed or restricted, where incumbents are protected from competition, and where new products and services are subject to unnecessary regulatory hurdles and delays. To ensure a competitive U.S. environment, domestic and international firms doing business here should compete equally and not be subject to any form of discrimination based upon national origin.

Unreasonable barriers to entry should be eliminated, but minimum capital levels, fit-and-proper tests for management, reasonable strategic plans, and appropriate internal controls should be required.

Innovations in financial products and services that are within the scope of the chartering authority should be encouraged and should comply with other principles, such as providing fair treatment for consumers.

Prices should be market-based and set by competitive forces. The current Congressional proposals to establish a new optional national insurance charter correctly incorporate competitive pricing requirements that are consistent with this principle.[75]

Principle 2 also articulates the importance of having a strong and healthy financial system comprised of strong and healthy institutions. A vigilant and forward-looking regulatory system that supports the integrity and security of our financial markets will help the U.S. maintain its competitive advantage as a productive and secure place to engage in the full spectrum of financial services. Market discipline has an important role to play, as does traditional financial supervision by regulatory authorities. This principle embraces the traditional public policy objectives of financial stability, investor protection, and market integrity for U.S. markets.[76] Moreover, this principle addresses the competitive need to have a healthy and profitable financial system, where investors can earn a reasonable return relative to other opportunities for their capital. In this context, both policymakers and regulators will need to ensure that the competitiveness of U.S. financial markets relative to other international markets is considered fully in their deliberations and rulemaking.

3. Proportionate, risk-based regulation.

The costs and burdens of financial regulation, which are ultimately borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and their consumers.

Financial regulation should be proportionate and risk-based. Regulatory efforts and resources should be targeted to the actual material risks of specific activities and material risks to the financial system as a whole. Market discipline should play a key role in helping to ensure that risk management is effective and proportionate. Government oversight should be risk-focused as well, with appropriate and proportionate responses to correct real deficiencies that inevitably occur from time to time as markets evolve, new products are introduced, and new players enter the markets.

4. Prudential supervision and enforcement.

Prudential guidance, examination, supervision, and enforcement should be based upon a constructive and cooperative dialogue between regulators and the management of financial services firms that promotes the establishment of best practices that benefit all consumers.

The foundation of prudential supervision is an open and professional dialogue between regulators and regulated firms. When corrective measures are required of regulated firms, prudential supervision is predicated on a spectrum of corrective measures that begins with voluntary remedial actions by management and then escalates progressively, culminating ultimately in formal enforcement action. Prudential supervision is not grounded in a black-and-

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[75] H.R. 3200, 110th Cong., 1st Sess (2007); S. 40, 110th Cong., 1st Sess (2007).
[76] Bernanke, Regulation and Financial Innovation.

white world of either compliance or noncompliance where noncompliance results in immediate penalties and public enforcement actions. Moreover, prudential supervision is not based on a predicate of a presumption of guilt prior to a discussion of facts and circumstances or an examination.

In a more principles-based approach to financial regulation, regulators and regulated firms focus primarily on results and how consumers are affected, rather than on technical compliance with regulations that may not be material to a transaction or consumer protection. A principles-based approach that values competitive firms serving the needs of consumers effectively, for example, encourages these same firms to engage in self-reporting and to voluntarily initiate corrective measures. It also encourages regulators to work with firms when they discover problems to resolve them quickly, while reserving authority to take harsher actions should voluntary responses prove inadequate.

Prudential supervision also includes swift regulatory action, public enforcement, and tough penalties for willful misconduct, fraud, and similar crimes that can lead to a firm's failure or seriously harm consumers.

5. Options for serving consumers.

Providers of financial services should have a wide choice of charters and organizational options for serving consumers, including the option to select a single national charter and a single national regulator. Uniform national standards should apply to each charter.

Managers of financial services firms use a variety of competitive strategies to meet all of the financial product and service needs of their consumers locally, regionally, and globally. Most corporate strategies are designed after a thoughtful and ongoing assessment of market forces, competitive threats and opportunities, demographic trends, consumer needs, institutional capabilities, and core competencies. While there is a wide range of national and state charters and organizing structures available to management today, many strategies require multiple charters and licenses and an equal if not greater number of regulators, at both the national and state levels. Requiring financial services firms to use multiple charters and multiple regulators increases operating costs for those firms, and some of those costs are ultimately borne by both consumers and investors.

In today's national and international financial marketplace, there actually is a competitive demand for new charters and more cost-effective organizing structures to replace the dated and often outmoded ones created decades or centuries ago. A good example is the proposal for a new national insurance charter to give those companies implementing a national or even international insurance business strategy a better, more efficient regulatory option than the current state-based system. Another example is the need for the option of a single universal financial services charter, under the oversight of a single national regulator, to permit those U.S. firms that choose this option to be able to compete effectively internationally with U.K., European, and other firms that operate from a similar regulatory structure.

Charter choice and uniform national standards are two different, but complementary, objectives. Charters establish the powers of an institution. They authorize an institution to engage in a specified range of activities. On the other hand, national standards are conditions placed on an institution's activities; they do not determine what activities are authorized for an institution. Standards may include supervisory conditions, such as capital requirements, and consumer protection conditions, such as loan disclosure requirements.

National standards should be applied when a product or activity is truly national in scope. Our consumer credit system, which includes products such as mortgages, credit cards, and auto loans, is a national one. Therefore, institutions that offer those products should be subject to uniform supervisory and consumer protection regulations.

6. Management responsibilities.

Management should have policies and effective practices in place to enable a financial services firm to operate successfully and maintain the trust of consumers. These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety, soundness, and financial stability, and appropriate conflict of interest management.

Capable and well qualified management is critical for financial services firms that aspire to serve their consumers effectively and efficiently. Discipline imposed by the marketplace and government supervision is also critical in assuring that consumers are well served.

Senior management is responsible for key elements of corporate success, including assuring adequate financial and human resources, appropriate and effective risk management and internal controls, accurate reporting, and consumer protection. An experienced management team with skilled personnel at all levels of the organization is important as is continuous training for all employees. Management should have in place a transparent code of conduct based on best practices observed through the industry to ensure ethical behavior of employees at all levels of the organization; education in ethics and good business conduct should be mandatory.

Recommendation 2. President's Working Group on Financial Markets. The President's Working Group on Financial Markets should be enacted into law to ensure greater accountability and transparency across financial markets. The PWG should have the following three responsibilities: 1) oversee implementation of the Guiding Principles; 2) oversee and evaluate the management of the Regulatory Action Plans in Recommendation 3 for existing and new regulations; and 3) provide greater communication, collaboration, and coordination on national policy issues across financial markets, including during times of market volatility and financial crises.

In the absence of a single financial regulator, the adoption of a more principles-based approach to financial institution regulation requires a mechanism to ensure that the agencies' rules and guidelines are consistent with the Guiding Principles. We recommend the codification and expansion of the current PWG to ensure the full implementation of principles-based regulation.

The PWG should consist of the head of each national financial regulatory authority as well as individuals with expertise in state banking, insurance, and securities regulation as appropriate. The PWG would continue to be chaired by the Secretary of the Treasury, consistent with other precedents affecting important financial market policy issues.

In addition to the PWG's oversight and reporting on the Regulatory Action Plans set forth in Recommendation 3, below, it also should serve as a convenient forum for closer collaboration and coordination among all financial regulators. Currently, the banking agencies utilize the Federal Financial Institutions Examination Council to discuss and attempt to coordinate supervisory policies and examination standards. The current President's Working Group provides a forum for the Treasury, the Federal Reserve, the SEC, and the CFTC to meet. However, there is no formal body to enhance communication, collaboration, and coordination among all of the national and state financial institution regulators, including the banking,

insurance, securities, and commodities industries. The enhanced PWG could serve this function, potentially replacing both the FFIEC and current PWG.

The recent market volatility both domestically and globally underscores the urgent and critical need for better regulation, more effective coordination, and greater accountability by the government. It also highlights the growing imperative to better manage the complex structural and regulatory issues that challenge all of us – regulators and firms alike. Better coordination among all federal and state agencies based on fundamental principles and more balanced regulation and prudential supervision should enable regulators to recognize emerging issues sooner, understand complicated inter-market workings better, and develop appropriate responses and resolve problems faster. While we may not have been able to avoid all of the consequences of the recent market volatility, a restructured PWG would have been the point of first response for a more focused, accountable, and coordinated approach to market issues across all segments of the financial services industry.

More effective communication, collaboration, and coordination are especially important in light of the development of complex financial conglomerates that are subject to functional regulation. It would also help to mitigate some of the jurisdictional disputes among the agencies as they begin to work together to solve common problems. Statutory impediments to information-sharing among federal and state regulators should be removed, to the extent necessary to facilitate such coordination.

There is statutory precedent for the Secretary of the Treasury to preside over the U.S. financial regulators in response to major national policy issues. When inflation and high interest rates became a national economic issue in the late 1970s, Congress created the Depository Institutions Deregulation Committee (DIDC) in 1980, chaired by the Secretary of the Treasury, to oversee the managed deregulation of interest rates at depository institutions over a set time period in response to growing disintermediation of insured deposits by mutual funds and other investment vehicles that increased financial pressures on depository institutions. After the stock market crash in 1987, an Executive Order created the President's Working Group on Financial Markets to better coordinate capital markets policy. The Secretary of the Treasury chairs the PWG today, even though the Treasury Department has no formal regulatory role beyond issuing federal government debt.

This recommendation is a natural extension of the Commission's endorsement for charter choice in Chapter 4. As long as the United States maintains multiple national and state financial regulators, there will be a need for some mechanism to promote coordination of regulation, especially in times of market stress. We have noted elsewhere in this Blueprint that the independence of our financial regulators has been one of the strengths of our financial regulatory system. At the same time, however, we have noted that overlapping and inconsistent missions are a significant weakness in our regulatory system, especially during times of market stress.

The solution to this tension is to give the enhanced PWG the power to exercise authority in limited circumstances. Specifically, the PWG should be expressly empowered to take collective action in periods of extreme market stress, and even then any actions taken by the PWG must be consistent with the Guiding Principles and must not infringe upon the statutory mandates of independent regulators.

Recommendation 3. Regulatory Action Plans. The President's Working Group on Financial Markets, with input from the private sector, should oversee

the Regulatory Action Plans of individual financial regulatory agencies to revise and align existing and proposed regulations are consistent with the Guiding Principles. The President's Working Group should report at least annually to Congress and the President on its evaluation of the Regulatory Action Plans of the financial regulatory agencies.

Under the oversight of the PWG, each financial regulator would be required to develop its own Regulatory Action Plan to implement the Guiding Principles. We would expect that all national and state financial regulatory agencies would design a multi-year plan to conduct a comprehensive and balanced review of all regulations that affect the ability of financial services firms to compete and serve consumers' financial needs. Our goal is that this individual agency review process would lead to better regulation at the end of the day - regulations that are consistent with these Guiding Principles, agency policy objectives, and desired regulatory outcomes. Good regulations should be proportionate, risk-based, and cost-effective. The newly enhanced PWG would serve as the U.S. Government's review panel to monitor and measure the progress of each agency in implementing these Guiding Principles.

The PWG would rely upon a system of public reporting and transparency to ensure the implementation of the Guiding Principles. Since regulations are based upon applicable federal and state laws, the PWG would have no independent authority to require changes in regulations that are found to be inconsistent. Instead, the PWG would be required to submit the results of its evaluation of the Regulatory Action Plans in annual or interim reports to the Congress and the President. Those evaluations could be performed by Treasury Department personnel in cooperation with relevant agency personnel. The reports would identify regulations deemed to be inconsistent with the Guiding Principles and recommend actions that should be taken to bring regulations into compliance with the Guiding Principles by the regulators, Congress, or states

It is not our desire to have the restructured PWG intrude on the statutory mission of individual regulators or become an impediment to other needed regulatory reforms. To the contrary, because we do not have one single financial regulator, we expect the new PWG to provide greater focus, accountability, and transparency to regulatory issues across the financial services industry that affect broader national policy concerns.

IMPLEMENTING THE GUIDING PRINCIPLES

Assuming that these principles, or something closely approximating these principles, are enacted ultimately into law, there are several high-level implications for senior management to consider. First, boards of directors will need to be briefed on the principles and understand the implications of them for the company. Next, senior management will need to ensure that all company policies and especially the corporate code of conduct are compatible with these new principles, particularly with respect to management's responsibilities for running the company effectively and treating consumers fairly.

To the extent that they do not already, senior managers will need to ensure that they have an open and professional two-way dialogue with their regulators and supervisors and are able to explain how these principles impact the way in which they conduct their business and serve their consumers, especially at the retail level. Legal counsel, chief risk officers, chief financial officers, and other members of senior

management will need to internalize the principles and adapt the company's procedures and practices accordingly. All employees will need to understand the impact of these principles on their areas of responsibilities and be trained on the implications of these principles for doing their job successfully, especially retail employees who will need to embrace the principle of treating consumers fairly in every interaction with every consumer.

Perhaps the biggest change for management during the transition to a principles-based regime will come when new regulations are promulgated and old rules are reassessed in light of these new principles. At that point, management will need to have a process in place to monitor rule changes based on the new principles and provide comments during the public comment period of the rulemaking process. Financial services firms, acting collectively through their trade associations, will need to engage as major rules are revised based on the new principles. If old rules are revised to enhance competition, provide for more cost-effective application, and consider greater proportionality in conformity with these new principles, then there is the potential for a major overhaul of old rules that could have a real impact on how financial services firms compete and serve their consumers.

Summary

A set of Guiding Principles to guide U.S. financial regulation in the future will lead to better regulation and the enhanced competitiveness of U.S. financial firms and markets. In turn, adoption of these Guiding Principles also should lead to demonstrable benefits for consumers and our economy. The Commission, therefore, recommends that these Guiding Principles, the enhanced President's Working Group on Financial Markets, and the Regulatory Action Plans be the starting point for a discussion on a more principles-based approach to financial regulation by all interested stakeholders, including policymakers in the Administration and the Congress, state and federal regulators, trade associations, consumer organizations, and other users of financial services.

Chapter 3 – Eight Case Studies Applying the Guiding Principles to Enhance Regulation and Competitiveness

In this chapter we examine the application of our proposed guiding principles to eight legal and regulatory issues. These issues have been selected because of their importance to the consumers of financial products and services, as well as their impact on the competitiveness of the U.S. financial services industry and the stability and security of our financial markets. These eight case studies are:

1. Prudential supervision
2. Litigation reform
3. Consumer credit and opportunities for long-term financial security
4. Anti-money laundering
5. Risk-based capital regulation
6. Insurance regulation
7. Sarbanes-Oxley Act (Section 404)
8. U.S. and international accounting standards.

Each of these case studies begins with a background discussion of the issue, which provides some historical context for the existing regulation of the issue. We then identify the guiding regulatory principles most applicable to the issue and explain how the application of those principles could serve consumers through better regulation and enhanced competitiveness. Each case study ends with a set of recommendations to implement the guiding principles.

While each of the case studies is important, the first two – prudential supervision and litigation reform – are integral to the system of better regulation that this Blueprint envisions. Prudential supervision and litigation reform are the pillars upon which our proposed guiding regulatory principles stand. Litigation reform allows principles to substitute for prescriptive regulations. As we note in Chapter 2, many of our highly prescriptive rules are designed to reduce or eliminate the potential for legal risk. Therefore, principles-based regulation must be paired with litigation reform; otherwise financial services firms and financial regulators will be reluctant to have principles replace rules. Prudential supervision, in turn, is linked to litigation reform because it creates a compliance environment that identifies and addresses industry practices before they become problems for individual consumers or the stability of financial markets. In other words, prudential supervision reduces the need for consumers, shareholders and other parties to resort to litigation.

CASE STUDY 1: PRUDENTIAL SUPERVISION

In this case study, we recommend that all financial regulators, including self-regulatory organizations, adopt a "prudential" form of supervision that is based upon Principle 4. This form of supervision not only can protect consumers, but also can better accommodate the ability of the financial services industry to grow and adapt to a dynamic environment and facilitate the efficient allocation of regulatory resources.[77]

Historical context and current issues

Prudential supervision is a form of supervision in which regulators and regulated entities maintain a constructive engagement to ensure an effective level

[77] Cornelius Hurley and John A. Beccia, III, "The Compliance Function in Diversified Financial Institutions" The Financial Services Roundtable in conjuction with the Morin Center for Banking and FInancial Law, Boston University School of Law, July 2007, hereafter Hurley-Beccia

of compliance with applicable laws and regulations. Prudential supervision relies upon regular and open communications between firms and regulators to discuss and address issues of mutual concern as soon as possible. Prudential supervision encourages regulated entities to bring matters of concern to the attention of regulators early and voluntarily. Prudential supervision promotes and acknowledges self-identification and self-correction of control weaknesses, thereby reinforcing continued focus and attention on sound internal controls. Industry-led solutions to identify weaknesses have proven to be both responsive and effective. Among existing financial services regulators, the federal banking agencies and the CFTC have the greatest experience with a prudential form of supervision.

The federal banking agencies rely upon regular examinations and robust internal compliance and audit functions to identify existing or potential violations of law or regulations as well as unsafe and unsound practices. The Comptroller of the Currency recently described this prudential supervisory approach to Congress:

> *[O]urs is not an "enforcement-only" compliance regime – far better to describe our approach as "supervisory first, enforcement if necessary," with supervision addressing many problems early that enforcement often is not necessary.* [78]

The nation's largest banking institutions have full-time examination teams on-site. Regular, informal exchanges between examiners and management allow both examiners and management to raise questions on matters of common concern. Examination reports routinely identify matters that require attention by management. Examiners and other supervisory staff, however, are given a significant amount of discretion, which permits firms to utilize resources to resolve issues, rather than expending them on defending a formal enforcement matter.

Banking agencies expect problems to be identified and corrected internally by insisting upon strong internal controls and audit functions. Sometimes, informal memorandums of understanding are used to identify concerns more specifically and set forth specific corrective actions, to which both the firm and the regulator agree. Less formal approaches to addressing problems usually are successful simply because the failure to take appropriate corrective actions can expose a firm to a range of more formal, and public, enforcement actions, including written agreements, cease and desist orders, removal orders, and civil money penalties. It is generally not necessary for banking agencies to take public enforcement actions, since serious problems should already have been identified with strong compliance and audit functions and corrected. More importantly, banks do not want to be exposed to the reputation risk of public enforcement actions.

Since the passage of the Commodity Futures Modernization Act in 2000, the CFTC also has followed a more prudential approach to supervision. For example, regulated entities that seek to pursue alternatives to the agency's accepted compliance practices are able to engage in a dialogue with CFTC staff, and that dialogue often leads to the implementation of a more tailored compliance regime.

Recently, the SEC has adopted a more prudential form of supervision for the nation's largest securities firms. The so-called consolidated supervised entity (CSE) program provides the SEC with real-time information regarding serious challenges facing the capital markets, including subprime lending, energy trading, and hedge fund derivative innovations.[79] The SEC's Derivatives Policy Group (DPG), which supervises firms active in the OTC derivatives business, also follows a form of prudential supervision. The DPG initiative has encouraged risk managers to craft risk reports to review and discuss with SEC staff.[80]

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[78] Statement of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, June 13, 2007.
[79] Speech of SEC Commissioner Annette Nazareth: Remarks before SIFMA Compliance and Legal Conference, March 26, 2007.
[80] Ibid.

The sheer number of brokers/dealers that are within the jurisdiction of the SEC's Office of Compliance Inspections and Examinations (OCIE) makes it difficult to apply prudential supervision on a widespread basis. In 2006, for example, 308 of the nation's 8,000 investment companies were examined, approximately 1,346 of the nation's 10,400 investment advisors were examined, and approximately 741 of the nation's 6,000 registered broker-dealers were examined. Thus, the current examination function provides limited opportunities for interaction between most regulated firms and the SEC.

Given these limitations, the SEC relies heavily upon enforcement actions. The SEC initiates an average of 600 enforcement actions a year. One consequence of this more enforcement-focused approach to supervision is that regulated firms are reluctant to consult with the agency on matters of mutual concern. This might also have the unintended consequence of inhibiting the resolution of issues before they become more serious problems. This environment also can leave the agency behind on market developments because industry participants are reluctant to approach the agency with concerns.

Constructive interactions between firms and the SEC also have been inhibited. As the U.S. Chamber of Commerce noted in its recent report on the regulation of U.S. capital markets, OCIE is more closely aligned with the SEC's enforcement division than the operating divisions and often refers findings directly to enforcement without consultation with the operating divisions.[81] Knowledge of this practice discourages firms from engaging in early and frank communications with examining staff.

The supervisory approach taken by state insurance authorities falls somewhere between the more prudential approach taken by banking regulators and the enforcement approach followed by the SEC. State insurance authorities have the authority to examine insurers but do so infrequently. New York State, for example, requires the examination of insurers only every five years.[82] Instead, state insurance authorities rely heavily upon the submission and review of financial statements and other regular reports. Much of the contact between insurers (and producers) and state insurance authorities relates to the licensing process. Such contacts, however, are largely compliance-oriented and do not provide an opportunity for insurers and insurance authorities to engage in a substantive dialogue on competition and meeting consumers' insurance needs. The quarterly meetings of the NAIC provide the best opportunity for interaction between firms and regulators, yet the effectiveness of these meetings is limited because the NAIC cannot take any action without further action by state commissioners or state legislatures. State insurance authorities rely heavily upon fines as a means to address violations of law or regulation, no matter how minor the matter. Small-dollar fines for licensing violations are not uncommon.

Applying principles to prudential supervision

The evolution of the financial services industry, including growing competition from foreign markets and firms, demands a regulatory approach that permits regulators to both protect consumers and foster competitive markets. Prudential supervision, as embodied in the Commission's Principle 4, is intended to accomplish this goal.

[81] U.S. Chamber Report, pp. 134 and 135.
[82] New York Consolidated Laws, Insurance, Article 3, Section 309.

Adherence to the principle of prudential supervision would allow the industry to be more competitive while providing the agencies with meaningful information to protect consumers and markets. A nonadversarial approach to supervision also would facilitate the establishment of an open dialogue and a constructive relationship between regulated firms and regulators. In the current financial marketplace, where complex products are becoming more common, a high degree of public and private sector cooperation will enable regulators to keep up with or even stay ahead of the curve on market innovation and industry developments. This cooperation would result in a higher quality of regulation and compliance over time and, in turn, greater investor confidence.

As noted above, the federal banking agencies have come the closest to employing a prudential supervision approach. Despite its law enforcement focus, the SEC is exploring utilizing a prudential supervision approach and is developing experience in this area.

In response to accelerating and dynamic change, the major sectors of the financial services industry are increasingly engaging in similar activities, and the industry is facing unprecedented competition from international markets. In response to these developments and to foster better regulation, we recommend below a series of actions that can facilitate the adoption of a more prudential form of supervision by all financial regulators, consistent with Principle 4.

All of the financial services regulators should develop and enhance a culture of prudential supervision. Agency personnel should be rewarded for learning about problems and working with firms to undertake informal corrective. Cooperation between examiners and firms should be encouraged and rewarded. Likewise, cooperation within and among agencies should be encouraged. However, enforcement actions would continue to be necessary and appropriate in cases of fraud, serious abuses, egregious behavior or ineffective voluntary compliance.

While we have highlighted federal banking regulation as the approach closest to prudential supervision, we are not calling for all agencies to simply adopt the practices of the banking regulators. Each agency will need to adjust its supervisory model based upon the specific nature of the operations of regulated firms and the agency's statutory authority.

Finally, successful implementation of prudential supervision should minimize the need for lawsuits, as problems can be identified and resolved more quickly through a cooperative approach that promotes self-identification and corrective actions. Thus, adoption of a prudential supervision approach to regulation and litigation reform go hand in hand.

POLICY REFORM II. PRUDENTIAL SUPERVISION.

Congress should enact laws to apply prudential supervision to all sectors of the financial services industry. Regulators and regulated entities should maintain a constructive engagement and open dialogue to ensure compliance with all applicable laws and rules. Prudential supervision should rely on regular communication between firms and regulators to discuss and address issues of mutual concern as soon as

possible. Prudential supervision also should encourage regulated entities to bring matters of concern promptly to the attention of regulators. Rather than respond to matters of concern with immediate enforcement actions, prudential supervision contemplates the regulator working with firms to correct practices, to address impacts of practices on consumers, and inform other firms of best practices developed from the process. Prudential supervision, however, should not be a means to avoid immediate enforcement in the case of serious abuse or fraud. Specifically:

Recommendation 4. Mitigating factors. Financial regulators should be required by federal law to consider mitigating factors when initiating enforcement decisions under a system of prudential supervision.

Under current law, the federal banking agencies are required to review various mitigation factors when considering the imposition of a civil money penalty. Specifically, regulators must consider: 1) the size of financial resources and good faith of the institution; 2) the gravity of the violation; 3) the history of previous violations; and 4) such other factors as justice may require.[83] Similarly, the New York Stock Exchange has published a list of factors it will consider in determining sanctions against NYSE member firms. Those factors include: 1) the nature of the misconduct; 2) the harm caused; 3) the extent of the misconduct; 4) the firm's prior disciplinary record; and 5) the firm's acceptance of responsibility.[84]

The application of mitigating factors would encourage cooperation between firms and regulators. The consideration of such factors also should limit enforcement actions to material matters. Appropriate factors should include intent, harm caused, enrichment, the extent of misconduct, prior disciplinary record, corrective measures, neglect, controls, reliance on professional advice, resources available, training, education programs provided with respect to the misconduct, and cooperation.

Recommendation 5. Continuum of prompt corrective actions. Congress should require financial regulators to pursue prompt corrective actions based upon a continuum of requirements, which begins with regulatory identification of an infraction and the opportunity for the institution to bring itself into compliance through voluntary actions, and eventually graduates to public cease-and-desist orders and civil money penalties.

Federal banking regulators have adopted a continuum of actions to address violations of law and regulation and unsafe and unsound practices. This continuum starts with examination recommendations and graduates to informal warnings to institutions, including informal memorandums of understanding, and ultimately to more serious, and public, sanctions. How far banking regulators proceed along this continuum depends upon how quickly and effectively a regulated bank corrects the violation or deficiency. In this way, problems can be addressed more quickly and efficiently. This approach to corrective actions also would promote more cooperation and communication between regulated firms and regulators.

Recommendation 6. Field examiners. The SEC and state insurance regulators

[83] 12 U.S.C 1818(i)(2)(G).

[84] NYSE Information Memo Number 05-77, October 7, 2005.

should train and utilize their field examination forces consistent with Principle 4 (Prudential supervision and enforcement).

Banking regulators are able to implement a prudential form of supervision because of their reliance upon regular examinations. The SEC and state insurance regulators could encourage a greater dialogue with regulated firms by placing examiners in the field, either their own or those of the SROs, who are trained in prudential supervision consistent with Principle 4. For example, the NYSE traditionally assigned a "finance coordinator" to each member organization, who was not present onsite but otherwise functioned in a somewhat comparable way to the on-site banking examiners. Any expansion of OCIE's examination force should be undertaken only in connection with a shift by the SEC to a more prudential form of supervision and should be linked to Recommendation 7, below. Otherwise, an increase in the number of examiners could lead to more enforcement actions and further impede development of the kind of constructive engagement we believe is essential to enhancing competitiveness and serving consumers better.

Recommendation 7. SEC communication and coordination. Building on the progress the SEC has made on prudential supervision for the nation's largest securities firms, the SEC should establish better lines of communication and coordination between the Office of Compliance, Inspections and Examinations (OCIE), and its nonenforcement divisions. Moreover, OCIE should be subject to greater oversight by the Commissioners to ensure that its investigations are resolved in a timely fashion consistent with the principle of prudential supervision and with a better balance between its responsibilities, including its mandate for competitive markets and capital formation.

The SEC can take steps to establish better lines of communication and coordination internally, especially between OCIE and the operating divisions of the agency. OCIE should be required to consult with the operating divisions before referring any matter for enforcement to the Commission.

Recommendation 8. Attorney-client waivers. Congress should enact the Attorney-Client Privilege Protection Act to reverse government policies requiring companies to waive their attorney-client privilege to be deemed cooperative in a government investigation or prosecution. However, after enactment of this legislation and consistent with a system of prudential supervision, Congress should establish a limited waiver for attorney-client privilege and work product protections for materials provided by the regulated firms to the SEC and insurance regulators.

As this Blueprint was being prepared, Congress was actively considering legislation to limit government policies requiring firms to waive their attorney-client privilege. We recommend the passage of this legislation. Additionally, Congress has provided a limited waiver for banking institutions that share information with banking regulators.[85] After enactment of the broader Attorney-Client Privilege Protection Act, Congress should extend a similar waiver to information shared with the SEC and other financial regulators. The SEC has supported such a waiver in the past.

Recommendation 9. Fair Notice.

Before authorizing an enforcement action, financial regulators should be required to find that an institution had "fair notice" of the requirement upon which the action is based.

As a matter of fundamental fairness, firms should have prior notice from regulators, regulations, statutes or principles that particular actions may be the subject of an enforcement action.

CASE STUDY 2: LITIGATION REFORM

The U.S. legal system has contributed to the strength of our economy. It has enabled individuals and institutions to conduct business affairs with confidence and trust. Yet, the growth in class-action lawsuits, especially securities class-action cases, imposes substantial uncertainties and costs and presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk.

This case study highlights the impact of securities class-action litigation on U.S. financial services firms. Consistent with Principle 1 (fair treatment for consumers), Principle 2 (open, competitive markets), and Principle 4 (prudential supervision), we propose a series of specific statutory changes to federal securities laws that would better align the risk of securities litigation with investor protection.[86] This case study also includes other recommendations for reforming class-action cases.

Historical context and current concerns

Excessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses. Thus, fundamental reform in this area is needed.

This issue significantly impacts U.S. financial services firms as well as other businesses across the United States. For example, a survey conducted jointly by the U.S. Chamber of Commerce and its European counterpart, Eurochambre, found that European companies cited the fear of liability as one of the three biggest barriers to investing in or trading with the United States.[87] Also, the Organization for International Investment (OFII) conducted a member survey of 65 CEOs of U.S. subsidiaries of foreign companies. It was generally reported that the CEOs were somewhat less optimistic about the attractiveness of the United States as a competitive location for investment, and they pointed to the cost of health care and the cost of our legal system, especially class action lawsuits, as the main drawbacks to doing business in the U.S.[88] By most accounts and market indicators, this trend will likely continue to worsen with fewer companies wishing to trade here or otherwise do business in the U.S. due, at least in large part, to our litigation environment.

Class actions and securities class actions, in particular, create some of the most significant problems because

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[85] 12 U.S.C. 1828.

[86] The discussion of securities litigation and the recommendations related to the PSLRA and SLUSA that are set forth in this case study are substantially extracted from a white paper entitled Securities Class Action Litigation Reform that was prepared by the U.S. Chamber Institute for Legal Reform. Copies of that entire paper and other studies on this topic prepared by the Institute may be found at www.instituteforlegalreform.com/issues.

[87] Exchange rate fluctuation and customs procedures were the other two factors mentioned in the survey.

[88] Robert E. Litan, "Through Their Eyes: How Foreign Investors View and React to the U.S. Legal System".

of their size and scope and how they are managed. Further, their utility is also in question.

The problem of our growing litigation climate has been discussed by the Secretary of the Treasury. Secretary Paulson has called the costs of abusive litigation "an Achilles heel for our economy."[89]

The three previous studies of the U.S. capital markets unanimously identify securities litigation as a major issue that policymakers must address to enhance U.S. competitiveness. Senator Schumer and Mayor Bloomberg observed that "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation" and "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business – and driven away potential investors."[90] The U.S. Chamber report states that there is a "strong need to investigate the accuracy of the widely held global perception that the U.S. securities litigation and regulatory environment makes it dangerous to participate in our capital markets."[91]

Furthermore, in a recent letter to SEC Chairman Christopher Cox, a group of six, ideologically diverse, law professors stated that issues regarding the current securities class action system merit careful consideration.[92] The law professors suggested that the Commission "take a leadership role in studying this issue." They expounded upon potential problems with the system and posed a list of fundamental issues and questions that the SEC should consider. We agree with the professors' outline of fundamental issues and concerns. The professors noted that they "have doubts that the current system is the best the United States can do."

It seems clear that the securities class-action system merely shifts money from one group of shareholders to another, instead of truly serving to compensate those who lost money because of a securities fraud. If this is so, we are left to consider whether this system can be changed in order to provide meaningful compensation. In this regard, the law professors note that "investors themselves fund the settlements, directly or indirectly, so there is an immense amount of "pocket shifting" that occurs."

We need to think about where the money goes in theses cases. We are left to consider whether investors receive anything more than pennies on the dollar while lawyers receive huge fees. The law professors ask a number of questions on this topic: "What percentage of eligible losses do investors receive in recovery?" "How often are large diversified investors the beneficiaries of a distorted stock price (selling at an inflated price or buying at a depressed one) compared to suffering from such distortion? And what is the net effect?" "How realistic is compensation as a goal in securities fraud class actions?"

It also seems clear that this system does not deter bad conduct, given that most actions are brought after the SEC has begun an enforcement action or another government entity has acted. The law professors focus on this issue as well. They ask: "How well do securities class actions deter misbehavior, as opposed to the other legal and marketplace penalties that come from the discovery of fraud?"

Below we focus upon the U.S. securities class action system. The system simply does not work as intended and, indeed, many argue that it is broken. The system does not serve its intended functions – to provide compensation to injured parties and to deter wrongdoing. Instead, it has become a means of cost-shifting from one group of shareholders to another, with a large share of settlements allocated to legal fees rather than to injured parties. Overall, the system harms U.S. competitiveness in the global business and financial markets due to the huge potential costs and exposure for market participants. It also has a negative economic effect on all companies, not just financial

[89] John Engler, "Washington's Biggest Decision," Washington Post, July 2, 2007.

[90] Bloomberg-Schumer Report, p. ii.

[91] U.S. Chamber Report, p. 31.

[92] Letter to The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, August 2, 2007 from professors Donald C. Langevoort, James D. Cox, Jill Fisch, Michael A. Perino, Adam C. Pritchard and Hilary A. Sale.

services providers, as well as the economy.

Competitiveness and litigation costs

One of the unique aspects of the U.S. capital markets is the availability of private lawsuits to recover damages based upon conduct that violates federal securities laws. Although many countries authorize private parties to institute lawsuits to recover damages relating to capital markets activities, no country permits claims that approach the size and scale of those that may be filed under U.S. law. Furthermore, while a few European countries have "group actions," the U.S. class-action structure is more costly and voluminous.[93]

A common criticism of the U.S. capital markets is that our highly litigious legal environment imposes unnecessary costs on companies doing business here. Many companies now must carefully weigh the risks associated with listing stock or doing business in the United States – the risk of being sued and the particular risk of facing a securities class-action lawsuit. These lawsuits can be significant for companies and their investors. The expense has several components.

The settlements paid to resolve these cases – and virtually every case that survives a motion to dismiss is settled – are very large. In 2004 and 2005, nine cases settled for $100 million or more, compared to four in 2002; 30 cases settled for more than $20 million in 2005 compared to 23 cases in 2004.[94] Even excluding the Enron and WorldCom settlements, five cases settled in 2006 for more than $500 million; four of those were for more than $1 billion.[95] Cornerstone's analysis of the size of these claims filed in 2004 found that the average settlement size was $883 million, with eight cases of $5 billion or more and three cases of $15 billion or more.[96] Seven cases filed in 2005-2006 involved $5 billion or more.[97]

The average size of settlement is increasing in dollar value. The average settlement in 2006 was $34 million, excluding the four $1 billion settlements.[98] That is a 37 percent increase over the 2005 figure, which itself was 25 percent greater than the average in 2004.[99] If the billion-dollar settlements are included, the average jumps to $86.7 million – a record.[100] The dramatic change in the cost of these cases is shown by comparing the average settlement value for 1996-2001 with the average for 2002-2006, when the amount more than doubled, from $11.5 million to $24.3 million. An increasing percentage of settlement costs involve large mega-settlements.[101]

While these sums are large viewed in isolation, the total amount of money diverted to securities class-action settlements has no equal globally. Settlements of 755 of the cases resolved between December 1995 and August 2005 totaled $25.4 billion dollars.[102] The total for 2004 and 2005 alone was $6.5 billion (not including the $6 billion WorldCom settlement).[103]

The settlements are only part of the cost of this litigation. Although fees for plaintiffs' attorneys are awarded out of the settlement amounts, the fees paid to defense lawyers, experts, and other consultants are additional, material costs. No data is collected regarding these defense costs, but they are likely to at least equal – and probably exceed – the $4.56 billion in fees awarded to plaintiffs' attorneys in the 755 cases just discussed.[104] This would amount to a surcharge

93 U.S. Chamber Report.
94 PricewaterhouseCoopers, 2005 Securities Litigation Study 16 (2006).
95 NERA, Recent Trends in Securities Class Action Litigation 5 (January 2007).
96 Cornerstone Research, Securities Class Action Case Filings, 2004: A Year in Review 10 & 11 (2005).
97 Cornerstone Research, Securities Class Action Case Filings, 2005: A Year in Review 11 (2006); Cornerstone Research, Securities Class Action Case Filings, 2006: A Year in Review 12 (2007). These size estimates are not damages projections, but they still provide a reasonable indication of the order of magnitude of these lawsuits.
98 Ibid.
99 Ibid., p. 6.
100 Ibid., p. 5.
101 Ibid.
102 Anjan V. Thakor with Navigant Consulting, The Economic Reality of Securities Class Action Litigation (2005).
103 Cornerstone Research, Post-Reform Act Securities Settlements: 2005 Review and Analysis 1 (2006).

for defense costs of at least 18 percent on each settlement. In addition, those companies that succeed in having a case dismissed do so at significant expense.

Separate from the class-action costs are costs associated with government lawsuits. Companies doing business here are also subject to significant costs and time required to gather information in administrative and enforcement actions. The U.S. Chamber report outlines civil penalties paid in securities litigation. It notes that civil penalties amounted to $4.7 billion in the United States during 2004 alone compared to $40.5 million in penalties imposed in the United Kingdom.

Thus, if the United States wants to remain competitive in the global marketplace, then it must take action now to decrease unproductive litigation costs. The "costs" are monetary costs, competitive costs (loss of business), as well as the cost of management time and energy. These costs are a substantial factor in decision-making regarding where to raise capital and where to do business. If we are to retain our global leadership, then we must eliminate – or at least significantly reduce – this legal competitive disadvantage.

Compensation and deterrence do not work

Private litigation is supposed to provide compensation for injured investors and deter wrongdoing. Unfortunately, it is accomplishing neither goal. Far from compensating the most vulnerable investors, private litigation provides a windfall for sophisticated investors while often shortchanging individual investors.

Many observers of securities litigation have noted that diversified investors suffer little or no economic harm from fraud – they are often beneficiaries of fraud (by selling shares at an artificially inflated price) as often as they are harmed by fraud (by buying at an inflated price and holding the shares until the fraud is discovered and the price drops). But in the U.S. litigation system, these investors are entitled to recover damages in the latter situation while retaining the benefits gained from fraud in the former situation. Perhaps most important is the fact that unsophisticated investors, who are often individual investors, often receive pennies on the dollar in securities class actions.[105]

Deterrence is provided by the threat of enforcement action by the SEC and prosecutors, not by private lawsuits that piggyback on government enforcement efforts. Enforcement resources have skyrocketed compared to 20 years ago. Where once the SEC used to follow the plaintiffs' lawyers, now many observers believe that the plaintiffs' lawyers are following the SEC. Further, state law enforcement officers as well as SROs are also involved in investigations for violations of the securities laws.

In sum, the billions of dollars that flow through securities class-actions do not compensate the most vulnerable investors or provide any real deterrence – they impose economic burdens on all investors without producing any real benefit to the U.S. economy in return.

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[104] Because each case typically involves numerous defendants, many of whom retain separate counsel, defense costs probably exceed the fees received by plaintiffs' lawyers in these cases.

[105] Thakor, op. cit. See also Donald C. Langevoort, Capping Damages for Open-market Securities Fraud, 38 Ariz. L. Rev. (1996), pp. 639, 648; Richard Booth, Who Should Recover What in a Securities Fraud Class Action? (December 2005); Frank H. Easterbrook and Daniel R. Fischel, "Optimal Damages in Securities Cases," 52 U. Chi. L. Rev. 611 (1985).

Burden on investors/cost-shifting

Securities class-actions impose a burden on investors. The structure of this system is fundamentally flawed and amounts to no more than a cost-shifting process with the addition of a "tax," which is the legal fees paid in such actions. This system is unique in that one group of shareholders is generally paying another group of shareholders – amounting to cost-shifting. Even if the company has insurance, the adverse effects in terms of higher insurance rates will be borne by the company's shareholders.

The actual wrongdoers are not paying in these actions because the claims are against the existing company, and the company, in fact, is the shareholders. This circularity problem affects all cases – even those in which the claim is legitimate. Securities litigation thus involves a transfer of wealth from one set of investors to another, with a very substantial percentage – approximately one-third according to the data discussed above – going to plaintiff and defense lawyers. Of the 755 cases studied in *The Economic Reality of Securities Class Action Litigation,* plaintiffs' legal fees amounted to over $4.5 billion. Rather than reliably providing compensation to investors, the actual economic benefits to injured investors with legitimate claims are unclear.

This circular problem has been discussed extensively in the academic community. For example, Professor Jack Coffee, of Columbia School of Law, has written that securities class-actions "impose costs on public shareholders in order to compensate public shareholders," characterizing these lawsuits as a "circular process" with "perverse effects." Also, Professor Donald Langevoort, of Georgetown University Law School, has noted that "[b]y all accounts, nearly all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves. Little if any of the sum is contributed by those who were the primary authors of the fraud; a recent study puts the figure at less than half of one percent."[106]

New theories

Private liability should not be broadly expanded based upon a new "scheme liability" theory.[107] This issue currently is pending before the U.S. Supreme Court in a case, Stoneridge v. Scientific-Atlanta, which some observers have called the most important securities case to come before the Supreme Court in decades.

Permitting scheme liability lawsuits will open the door to a huge new category of abusive claims that will harm investors. Under scheme liability, any business that enters into any sort of transaction with a public company may be sued based on an allegation that the business had the "principal purpose and effect of creating a false appearance of fact" as opposed to a "principal legitimate business purpose."

Moreover, scheme liability is not needed to punish wrongdoers and obtain compensation for injured investors. The SEC has clear enforcement authority, including the power to obtain compensation for investors, over any defendant that would be covered by a scheme liability claim.

Permitting scheme liability claims will harm the competitiveness of U.S. capital markets and the entire U.S. economy. Scheme liability would mean that entering into a transaction with a company listed on U.S. capital markets would carry special risks - risks not present in doing business with private companies or companies listed in Europe or Asia. That risk inevitably would translate into an increased cost to U.S. companies, a "litigation risk surcharge" that ultimately would be borne by investors in those companies, in the form of increased cost and lower returns. These additional burdens would drive companies away from U.S. capital markets, and that would hurt U.S. investors and our economy.

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[106] John Engler, "Washington's Biggest Decision," Washington Post, July 7, 2007.

[107] Trial lawyers have created the theory of "scheme liability," which imposes liability whenever any person has "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." Every federal court of appeals to consider the issue has rejected the "scheme" theory – except the Court of Appeals for the Ninth Circuit, which agreed with the trial lawyers. The Supreme Court granted review in Stoneridge to resolve this disagreement.

Applying principles to litigation reform

Three of our proposed principles apply to securities litigation and other class-action reform.

Principle 2 calls for competitive and innovative financial markets. Excessive litigation harms competition and innovation. Litigation risk can make firms overly cautious and unwilling to enter markets or offer particular products and services because of the potential for incurring large legal costs. Our recommendations to amend federal laws and procedures to limit excessive litigation risk are designed to preserve open and competitive markets.

The application of Principle 1 (fair treatment for consumers) and Principle 4 (prudential supervision) should reduce the need for consumers to resort to litigation. Both prudential supervision and fair treatment – if effectively applied and followed – should reduce actions that give rise to litigation.

POLICY REFORM III. LITIGATION REFORM.

In response to the foregoing concerns, Congress should pursue the following reforms to securities and other class action cases.

Recommendation 10. SEC shareholder review litigation process. Congress should establish a shareholder litigation review process under which shareholders present potential Section 10b-5 cases to the SEC prior to filing. Such cases would not be filed and would have no standing if the SEC determines to pursue an investigation and review of the matter.

The growth in securities class action cases is linked directly to private actions based upon alleged violations of the 10b-5 fraud rule. Actions under this rule, however, were never authorized by Congress; they have been created by the courts. While Congress and the Supreme Court have made repeated attempts to place some limits on these cases, those attempts have not succeeded. Our proposal would provide shareholders with appropriate recourse through the SEC, rather than the courts, in those instances in which the SEC pursues an investigation. Should the SEC not pursue an investigation, private litigation would remain possible.

Recommendation 11. Joint and several liability. Congress should limit joint and several liability in securities litigation cases to the most egregious cases.

The potential for defendants to be subject to joint and several liability effectively forces firms to settle cases because the costs of not settling can be enormous. This situation tilts the process of litigation to the advantage of the complaining party. Congress should narrow the scope of violations subject to such potential penalties.

Recommendation 12. Removal. Congress should expand opportunities for the removal of securities class action cases from state to federal court.

The 1996 National Securities Markets Improvement Act and the Class Action Fairness Act of 2005 expanded the ability for firms to remove actions from state to federal court. Nonetheless, it remains possible for cases against national firms to be framed under state law and filed in state court. We urge Congress to complete the process it started in 1996 and facilitate removal of these cases to federal court.

Recommendation 13. Interlocutory appeals. Congress should amend the PSLRA to permit interlocutory appeals of dispositive motions (e.g., motions to dismiss and summary judgments).

In virtually every case, the district court's ruling on the motion to dismiss and/or motion for summary judgment is the only judicial evaluation of the merits of the plaintiff's claim. If the motion is denied, the defendant often will settle before trial due to

substantial costs of discovery and the size of damage claims. Plaintiffs can appeal a decision granting a dispositive motion, but defendants have no such right to obtain appellate review to correct an erroneous denial of a motion to dismiss and/or motion for summary judgment. If the district court erroneously denies a dispositive motion, the defendants will be forced to pay a substantial settlement in a case that never should have been brought. This imbalance should be corrected. A discovery stay would remain in effect until the appeal is resolved.

Recommendation 14. Loss causation.
Congress should amend the PSLRA to require that loss causation be pleaded with particularity.

Recently, the U.S. Supreme Court established a national pleading standard for cases brought under the PSLRA.[108] Yet, under current law a complaint can survive dismissal even though it alleges that link in very general terms. Extending the PSLRA's specific pleading requirement to require that a plaintiff show a clear link between the challenged conduct and the defendant's loss would give courts an additional tool to screen out unjustified claims.

Recommendation 15. Discovery stays.
Congress should amend the PSLRA to eliminate gaps in discovery stay.

The PSLRA – with very limited exceptions – imposes a stay on discovery while a court considers a defendant's motion to dismiss. Some courts have expanded the exceptions, thereby defeating the purpose of the discovery stay, which is to prevent plaintiffs from using discovery as a "fishing expedition." For example, some courts have required defendants to turn over to plaintiffs information provided to government agencies or permitted discovery from third parties. Congress should reaffirm its decision to preclude discovery until after a complaint is upheld by closing these loopholes in the discovery stay.

Recommendation 16. Pay-to-play.
Congress should amend the PSLRA to eliminate "pay-to-play."

At times, the law firm selected to represent a pension fund in class-action litigation has been the source of campaign contributions to the public officials running the fund. Several years ago, to address a similar problem in the selection of underwriters for government bond offerings, the SEC adopted a rule prohibiting "pay-to-play" by banning such contributions. Congress should enact a similar prohibition, barring a law firm from becoming lead counsel if any lawyer at the firm has contributed to the campaign of any public official who in any way oversees the fund (for example, by serving on the fund's board, selecting those who serve on the board, supervising those who serve on the fund's board).

Recommendation 17. Aggregation.
Congress should amend the PSLRA to bar aggregation of plaintiffs for purpose of determining the lead plaintiff.

The PSLRA permits either a "person or group of persons" to act as the "most adequate" plaintiff. Some courts allow large numbers of unrelated plaintiffs to aggregate themselves into a lead plaintiff "group" while others define the word "group" narrowly to allow only small coalitions that have common characteristics (such as membership in a partnership). The larger the group the more diffuse the responsibility and the more likely that the attorney will retain practical control of the litigation with little or no effective oversight. This reform would prohibit such aggregations of unrelated "persons."

Recommendation 18. Refunds.
Congress should amend the PSLRA to require refunds of uncollected amounts of settlement funds, thus allowing each class member to take only his or her pro rata

[108] Tellabs Inc. v Makor Issues & Rights Ltd., 127 S.Ct. 2499 (June 21, 2007).

share of the settlement.

Settlements today invariably provide that the entire settlement fund will be divided among the class members who file claims: if only relatively few class members file, each receives a larger settlement than would have been the case if more class members filed claims. This can lead to excess recoveries. Each class member should be limited to his or her proportionate share, with uncollected funds returned to the defendant.

Recommendation 19. Coordination. Congress should amend the PSLRA to better coordinate SEC Fair Funds and litigation distributions.

In 2002 the SEC obtained statutory authority to create "fair funds" to distribute to injured investors payments obtained by the Commission in enforcement actions through use of its civil penalty and disgorgement authority. Today, there is no coordination between the fair funds process and the litigation process – either with respect to investor recoveries or distribution mechanisms.

Recommendation 20. Lead counsel. Congress should amend the PSLRA to authorize auctions for lead counsel.

The PSLRA was intended to transfer control of securities class-actions from plaintiffs' lawyers to investors. Despite the PSLRA's reforms, there is significant evidence that cases are still lawyer-driven. Chief Judge Vaughn Walker of the Northern District of California has pioneered use of an auction to choose a lead counsel. Under Judge Walker's original process, firms submitted sealed bids, which then were used both to select the attorney and set the fee. Other courts, however, have prohibited use of the mechanism. Auctions for lead counsel can offer advantages: courts will often choose the lawyer with the lowest fee, thus securing a larger share of any potential settlement for investors.

Recommendation 21. Certifications. Congress should amend the PSLRA to require certifications by lead plaintiffs.

Requiring that complaints contain a certification (modeled on SOX) by the plaintiff and lawyer stating that the plaintiff has not received and will not receive any extra compensation for serving as a plaintiff would be useful. The certification would list every other case in which the plaintiff has served as lead plaintiff in any form of class-action. These reforms would force increased public disclosure to try to stop the use of professional plaintiffs.

Recommendation 22. Arbitration. Congress should preserve the current securities industry arbitration system.

Arbitration is widely used by broker-dealers and has proven to be a fair and efficient means of resolving disputes in the broker-dealer context. Virtually all brokers include arbitration clauses in their customer agreements. The SEC has statutory authority to ensure that SRO arbitration procedures are adequate and consistent with the Securities and Exchange Act of 1934. The SEC's OCIE routinely looks at the SRO arbitration procedures administered by the NASD and NYSE (now FINRA). Moreover, an internal audit conducted by the SEC's Inspector General found the Commission's oversight operations to be "effective and efficient."[109]

Also, Professor Michael Perino concluded in a seminal 2002 SEC-commissioned report that "[a]vailable empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair."[110] A recent report by the Congressional Research Service (CRS) determined that despite allegations by certain

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[109] Office of the Inspector General, Securities and Exchange Commission, Oversight of SRO Arbitration, Audit 289, August 24, 1999.

[110] Michael A. Perino, Report to the Securities Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, November 4, 2002, p. 48.

critics of pro-industry bias, "research on the issue has not substantiated the bias claims," and that in fact "there appears to be little concrete evidence of a pro-industry bias."[111] Independent analysis shows that arbitration participants are overwhelmingly satisfied with the fairness of the forum, with 93.49 percent believing that their dispute "appears to have been handled fairly and without bias."[112] In 2006, the average turnaround time for NASD arbitration was 13.9 months (17.1 months for hearing decisions, and 5.3 months for simplified decisions).[113] By contrast, a civil case filed in a federal district court today faces, on average, a delay of nearly two years (23.2 months) before even reaching trial.[114]

Recommendation 23. Appellate review. Congress should amend SLUSA to permit appellate review of remand orders.

The Supreme Court held in the Kircher case that a defendant may not appeal district court orders holding the SLUSA inapplicable and remanding a case to state court.[115] Congress should correct that decision to allow defendants to obtain appellate review of district court orders.

Recommendation 24. Discovery stay. Congress should amend SLUSA to fix holes in discovery stay.

Some plaintiffs' lawyers have used state law claims not subject to removal under the SLUSA to circumvent the PSLRA's discovery stay. Congress should close that loophole.

Recommendation 25. Spin-off cases. Congress should amend SLUSA to preclude "spin-off" cases by institutional investors (or require that they be stayed until the resolution of federal class-actions).

Some plaintiffs' lawyers have adopted a strategy of urging pension funds with large potential claims or groups of individuals to opt out of securities class-actions and instead file separate cases, usually in state court (because these state court claims are not class-actions, they are not prohibited by SLUSA). These multiple claims impose huge costs on defendants and can be used to circumvent the protections enacted in the PSLRA and impose burdens on investors. Congress needs to amend SLUSA to require state courts to stay such cases until the final resolution of federal class-actions raising the same claims.

Recommendation 26. Interlocutory appeals. Congress should permit interlocutory appeals in all consumer class-action cases, consistent with the rationale set forth in Recommendation 13 above.

Recommendation 27. Settlement. The Advisory Committee on Civil Rules of the Federal Judicial Conference should endorse the appointment of special masters or interim class counsels to facilitate early settlements in consumer class-action cases.

The complexity of our consumer lending laws has led to the filing of class-actions that are often based on technical, nonmaterial violations. Obviously, such violations should not be condoned, but the full-scale litigation that usually ensues when a class-action is filed does not ensure prompt compliance and does

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[111] Gary Shorter, Securities Arbitration: Background and Questions of Fairness," CRS Report RS22127, pp. 1, 3 (April 26, 2005)

[112] Gary Tidwell, Kevin Foster, and Michael Hummel, Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations, Presentation to Academy of Legal Studies in Business (August 5, 1999), p. 3.

[113] NASD Dispute Resolution Statistics, available at www.nasd.com (last visited June 11, 2007).

[114] U.S. District Court – Judicial Caseload Profile, available at www.uscourts.gov (last visited June 11, 2007).

[115] Carl Kircher v. Putnam funds Trust, 126 S.Ct. 2145 (June 15, 2006).

not otherwise benefit consumers.

Frequently, the defendant in such actions would be willing to take actions to resolve the dispute immediately, but the lawyers who brought the action are unwilling to entertain such efforts because of their primary interest in securing substantial fees (and the need to "run the meter" for a period in order to justify such fees). To avoid this waste, federal courts should be encouraged to welcome early resolution proposals from defendants and to address them promptly, even if they have not been endorsed by the counsel who brought the action. When such proposals are made, a federal court could itself evaluate the appropriateness of the contemplated relief. However, given the potential need for substantial factual investigation to properly assess a resolution proposal at that early stage of the litigation, the court could appoint a special master to recommend whether the proposal should be accepted. In some cases, that may be the preferred approach. In most instances, however, the court may wish to appoint an independent attorney (that is, an attorney not previously involved in the litigation) as "interim class counsel" for the purpose of evaluating the resolution proposal.

Under Fed. R. Civ. P. 23(g), as adopted in 2003, a trial court is supposed to appoint interim class counsel to oversee the litigation through the class certification process, and the court is not obliged to appoint the counsel who filed the litigation to fill this role. If that interim class counsel concludes that the proposed resolution is in the best interests of the putative class, he or she may proceed to implement the settlement, subject to the trial court's approval under Fed. R. Civ. P. 23(e). If the counsel who brought the action does not concur in the recommended settlement, he or she may make appropriate arguments to the trial court during the settlement approval process, but he or she would not have any right to "veto" unilaterally the proposed class settlement.

We believe that all of these actions are already authorized by the Federal Rules of Civil Procedure. However, the Advisory Committee on Civil Rules of the Federal Judicial Conference should consider highlighting this procedure as a best practice by explicitly including it in Rule 23.

Recommendation 28. Shared costs. Congress should amend the Federal Rules of Civil Procedure to require that costs of discovery be shared by the parties.

The costs of discovery in class action cases may be disproportionately large for the defending party. Courts should have the ability to require cost sharing when discovery requests are deemed to be excessive.

Recommendation 29. Deference to regulatory determinations. Congress should require trial judges in class-action cases to give appropriate deference to regulatory determinations.

In those instances in which a party has based an action upon a ruling, interpretation or other determination by a regulator and then is subject to a class action lawsuit based upon that action, the trial judge should have an obligation to acknowledge the authority of the regulator and defer to that authority.

CASE STUDY 3: CONSUMER CREDIT AND OPPORTUNITIES FOR LONG-TERM FINANCIAL SECURITY

Consumer lending has become a vital part of the U.S. financial services industry. Broad access to efficiently priced credit has benefited consumers and promoted economic growth. In this case study we explore the growth and importance of consumer lending and propose some reforms to maintain the vitality of this market for consumers based upon Guiding Principles 1 (fair treatment), 2 (competitive and innovative markets), and 5 (uniform national standards).

Historical context and current issues

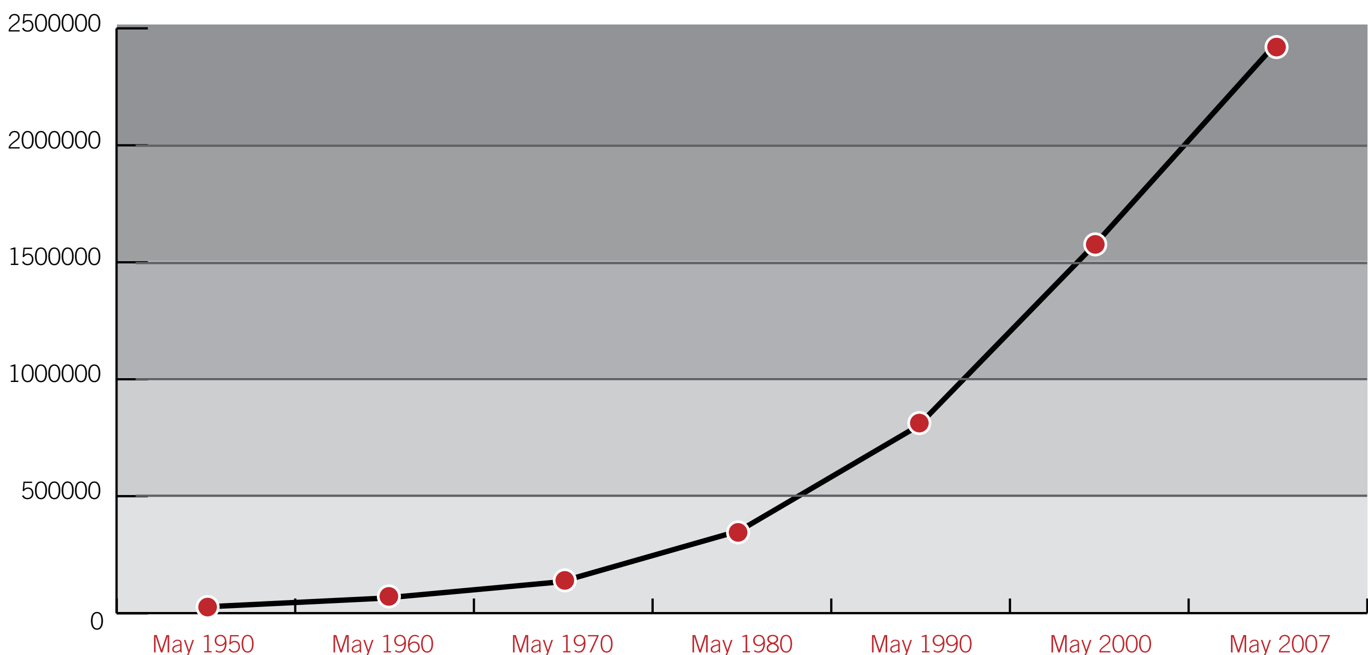
Consumer lending has expanded steadily over the past few decades to meet the diverse and dynamic needs of all categories of consumers. It has evolved from a second-tier business line for some lenders into a major business line for many. Exhibit 3-1 shows the absolute growth in consumer credit outstanding since 1950. As of the latest available data (2004), consumer debt was held by 76 percent of all families, and of those families 44 percent had credit card debt outstanding and almost 52 percent had home mortgages or home equity lines-of-credit.[116] In recent years access to credit has reached consumers at lower-income levels with over 50 percent of families in the lowest-income categories now holding some form of consumer debt.

As consumer lending has grown, the range of products and services available to consumers has grown to meet their changing needs and keep pace with demographic trends. Today, consumers can choose from an array of short-term and long-term, fixed- and variable-rate forms of credit, including credit cards with revolving-credit features and home

Exhibit 3-1

Consumer Credit Outstanding

(in millions)



Source: Federal Reserve Board

[116] Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," Federal Reserve Bulletin, Vol. 92 (February 2006), p. A28.

Table 3-2
Amount of Consumer Debt in Percentage Terms Distributed by Type of Lender as of 2004

Type of Institution	2004
Commecial bank	35.1
Thrift institution	7.3
Credit union	3.6
Finance or loan company	4.1
Brokerage	2.5
Mortgage or real estate lender	39.4
Individual lender	1.7
Other nonfinancial	2
Government	0.7
Credit card issuer	3
Pension	0.3
Other	0.2

Source: Federal Reserve Board

Consumer lending also is no longer a local business as it once was. Consumers are willing to consider offers from national and international lenders who are not located in their immediate vicinity, and loan terms have become more uniform as lenders have adopted sophisticated risk-based pricing techniques. Similarly, through securitization of pools of consumer loans, funding for consumer lending is available from a broad array of domestic and global sources.

Consumers have been the beneficiaries of these developments. Today, consumers have access to a dynamic array of products and services from a range of lenders on competitive terms to enhance their economic well-being over time in ways of their own choosing. Nonetheless, our consumer lending system faces several challenges.

First, as opportunities for borrowers have increased, so has the need for consumers to have a clear understanding of the increasingly complex array of financial products and services available to them. For example, variable rate mortgages are appropriate products for many consumers, but may not be appropriate for some consumers who expect little, if any, appreciation in income or home values. Consumers need to be able to understand and appreciate these distinctions and select the products and services more appropriate for their needs and circumstances. Proper consumer appreciation of the differences between products and services also is a competitive issue for firms. Educated and informed consumers can better appreciate product distinctions and innovations.

Greater financial literacy is one key to this challenge. The members of the Financial Services Roundtable already have done a significant amount of work in promoting greater financial literacy for consumers at their institutions. A variety of national and state financial regulators and various industry trade organizations also have engaged actively in providing educational materials, such as the FDIC's Money Smart program, but none of these programs is coordinated or uniform in either their content or application.

Financial literacy surveys by the Jump$tart Coalition for Personal Financial Literacy indicate that much more needs to be done. The Coalition has tested the financial literacy of high-school students annually since 1997. Throughout that period, test scores have hovered in the low- to mid-50 percent range out of a maximum possible 100 percent. These surveys also show a gap in financial literacy between minority and non-minority students. In the most recent survey, white students scored an average of 55 percent on the test, while African-American students scored 44.7 percent, and Hispanics scored 46.8 percent.

Second, most of our federal consumer lending laws and regulations are highly prescriptive and have given rise to a body of litigation based upon technical, nonsubstantive violations. Table 3-3 lists several of the major federal consumer lending laws enacted within the past few decades. Some of the detail in these consumer lending laws, and accompanying regulations, was supported by the financial services industry because strict compliance with prescriptive rules can serve as a legal shield of sorts against enforcement actions by regulators, as well as private

actions by consumers, shareholders, and other parties. On the other hand, technical and nonsubstantive violations of prescriptive laws and regulations can generate lawsuits, including massive class-action suits. The civil liability provision in the Truth-in-Lending Act, for example, has often been cited as a significant source of litigation that is based upon technical and nonmaterial violations of law.[117]

Third, there is evidence that existing consumer disclosure requirements are not always effective. A recent GAO report on credit card disclosures found that existing disclosure requirements can be confusing to consumers.[118] Similarly, a study by the American Bankruptcy Institute and the Ford Foundation found that credit card disclosures designed to prevent overspending may have the opposite effect on some consumers.[119] Moreover, an unintended consequence of extensive disclosure often is that consumers are overwhelmed with information, and unable to fully appreciate the key terms and conditions of a transaction.

The federal banking agencies have started to make use of consumer testing and focus groups in the development of model disclosure forms, but additional reforms are needed.[120] Existing disclosure requirements that are no longer necessary or productive should be eliminated. Congress also needs to resist the temptation to mandate specific disclosure terms. Detailed statutes typically result in lengthy regulations. More general statutory guidance gives regulators the flexibility to craft and revise disclosures to address new products and the changing needs of consumers.

Finally, the rules governing different lenders are not uniform across the country and confuse consumers, making it even more difficult for them to make informed financial choices.[121] Rules for state-licensed firms often are substantially different than those

Table 3-3
Major Federal Consumer Lending Laws

Consumer lending law (date)	Number of pages in law	Number of pages in CFR
1. Consumer Credit Protection Act (Truth-in-Lending)	52	248
2. Fair Credit Reporting Act	28	66
3. Equal Credit Opportunity Act	9	57
4. Home Mortgage Disclosure Act	9	25
5. Community Reinvestment Act	6	21
6. Telemarketing and Consumer Fraud and Abuse Prevention Act	5	12

[117] Section 130 of the Truth-in-Lending Act, 15 USC 1640.

[118] Credit Cards, Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers, GAO Report, September 2006.

[119] Psychology and BAPCPA: Does Disclosure Affect Consumer Behavior? A summary of an Empirical Investigation, American Bankruptcy Institute Journal, July/August 2007.

[120] In its recently proposed revisions to the open-end credit provisions of Regulation Z, the Federal Reserve Board relied heavily upon input from focus groups and other consumer testing methods. Fed. Reg. 32948 (June 14, 2007).

[121] Testimony of James C. Sivon, Partner, Barnett, Sivon, & Natter, P.C., before the Committee on Financial Services, U.S. House of Representatives, July 25, 2007.

for federally-licensed lenders for the same kinds of consumer loans. The recent federal agency response to hybrid adjustable-rate mortgages (ARMs) for subprime borrowers illustrates this lack of uniformity. As the case study on hybrid ARMs (below) indicates, federal attempts to adopt standards for such mortgages applied only to federally-regulated lenders. This has prompted calls from Congress for the Federal Reserve Board to adopt a regulation applicable to all lenders.

Case study: Subprime hybrid ARMs

Hybrid ARMs are mortgage loans that contain a fixed rate for an introductory period and then reset to an adjustable rate for the balance of the loan. These loans became popular, particularly for subprime borrowers, in the expanding housing market of 2002-2006. While they varied from lender to lender, many of the hybrid ARMs had a fixed payment for the first two years and then the payment reset every six months based on an adjustable rate for the remaining 28 years, or a fixed payment for three years and an adjustable payment for 27 years. These loans became known as 2/28s and 3/27s.

As housing price increases began to slow down and even turned down in some markets, some borrowers have found that they are unable to meet the monthly payments due under hybrid ARMs when the payment resets. It is now apparent that a large percentage of 2/28s and 3/27s will default in coming months.

Reaction to the increased defaults in these products

As defaults of hybrid ARMs have increased, some lenders have been pressed by investors to take back those loans under securitization contracts. Lenders with weak capital positions have not been able to meet such calls and have gone out of business. Media stories have caused even greater concern about firms specializing in those loans, and bankruptcies of such firms have increased. The plight of borrowers has attracted the concern of Congress, which has pressured the Federal Reserve Board to draft regulations to remedy practices that led to the current problems.

Reaction of the regulators

The federal banking agencies issued a Statement on Subprime Lending on June 29, 2007, to address this issue.[122] The Statement is guidance to examiners and covered institutions; it is not a regulation. Nonetheless, it is fairly detailed. For example:

> *Lenders are required, among other things, to include in their underwriting of subprime loans consideration of all credit factors, including the capacity of the borrower to adequately service the debt. A lender's analysis of repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also states that a lender's debt-to-income analysis should include an assessment of a borrower's total monthly housing-related payments (including principal, interest, taxes, and insurance) as a percentage of gross monthly income.*
>
> *Lenders are required to have clear policies governing the use of risk-layering features, and when risk-layering features are combined with a mortgage loan, a lender should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.*

[122] 72 Fed. Reg. 37569 (2007).

Lenders also should verify and document the borrower's income, and stated income and reduced documentation loans should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity.

State-regulated lenders

Significantly, the Statement only covers federally-regulated lenders. Lenders regulated only by states are unaffected by the Statement and, absent any action by the states in which they do business, such lenders may continue to engage in activities that would be prohibited by the Statement. While many states have followed the action of the federal regulators, not all have done so. Furthermore, in some states, legislative action is needed, which may or may not occur. As a result, some members of Congress have urged the Federal Reserve Board to use the authority under the Home Owners Equity Protection Act (HOEPA) to adopt regulations rather than guidance, thereby prohibiting all mortgage lenders from engaging in acts that are deemed to be abusive or unfair or deceptive and to establish a uniform national standard for all lenders.

Under HOEPA, the Board could extend the Statement to all lenders, or it could promulgate a formal regulation covering all lenders. What it will do is not clear, but there are differences in the two approaches. A violation of a regulation would permit private rights-of-action and class-actions. In addition, the violation of a regulation would permit the state attorneys general to bring actions against federal institutions. On the other hand, a violation of the Statement could serve as a basis for an enforcement action, but not a private action. The Board of Governors held a public meeting on this matter and has invited public comments on how to proceed. It is expected to publish its proposal in the fall of 2007.

Applying principles to consumer lending

Several of our proposed guiding regulatory principles should govern consumer lending regulation in the future.

Principle 1 calls for fair treatment for consumers. Effective disclosures, as discussed above, are a key aspect of fair treatment. They protect consumers on the front-end of a transaction. After consumers have acquired a product or service, fair treatment includes the resolution of disputes. Consumers should have appropriate recourse if problems arise. Therefore, consistent with this aspect of fair treatment, we recommend the creation of an alternative resolution mechanism for consumer disputes. This mechanism could apply not only to consumer lending disputes but also disputes involving other financial products and services.

Aside from clearly disclosing the terms and conditions of loans and resolving disputes, fair treatment requires lenders (as well as other financial services firms) to provide products and services securely and efficiently as well as to protect the privacy of consumers. Fair treatment also requires that financial products and services provide a benefit to consumers and not simply serve as a source of revenue for firms. The provision of financial products and services consistent with this principle will enhance the lives of consumers by enabling them to obtain things they need in the present – a new car to drive to work, a new home, a college education, a small loan to start a new small business – as well as financial security for the future.

Fair treatment also is complemented and enhanced by greater financial literacy. Knowledgeable consumers are better prepared to handle financial matters that are critical to their long-term financial security. Likewise, knowledgeable consumers drive product innovation and industry accountability.

From credit cards and mortgages to 401(k) s and IRAs, financial services play an integral role in the daily life of a consumer. Consumers need to have a clear understanding of the increasingly complex array of financial products and services available to them. Consumers also need to be able to understand and appreciate the distinctions between products and select the products and services most appropriate for their needs and circumstances.

Principle 2 calls for competitive and innovative financial markets. As a general rule, our national consumer credit system has been able to evolve and reach consumers at all economic levels because firms have been able to innovate and compete. Instead of strict product and price regulation, we have relied upon disclosure requirements that inform and educate consumers about product choices. For consumer credit markets to remain competitive, however, it appears that more needs to be done to both educate and inform consumers.

Therefore, consistent with Principle 2, we recommend a national initiative on financial literacy. Educated consumers who understand products and services options will not be confused and will be better able to make informed choices that clearly benefit them. This action would minimize the potential for subsequent disputes.

To facilitate better consumer understanding, we recommend improvements to disclosure requirements. The purpose of disclosures is to inform consumers of the key terms of the loans they are considering so they can make informed choices. As such, disclosures must be understandable to the average consumer. Key disclosure metrics about the consumer loan should be summarized for the average borrower at the top of every disclosure statement. Too much information can defeat the purpose of the disclosure and confuse the borrower.

Principle 5 calls for charter options and the application of uniform national standards. The opportunity to select between alternative charters allows managers to select the charter best suited for their business model. In this way, managers can ensure that they can serve consumers effectively and efficiently. Uniform national standards complement charter choice. They ensure that, regardless of the specific charter a firm may select, the basic financial products and services offered by that firm will be subject to the same prudential and market conduct rules. This ensures consistency of protections for consumers, regardless of where they may reside. Accordingly, we recommend the application of uniform consumer protection standards by all lenders.

POLICY REFORM IV. OPPORTUNITIES FOR CONSUMERS.

Financial services opportunities for all consumers should be enhanced through a combination of policy, regulatory, and industry initiatives. Specifically:

Recommendation 30. National financial literacy plan. National and state educational authorities, working in conjunction with financial regulators and the financial services industry, should develop a national financial literacy program that includes the incorporation of financial literacy training in school curricula. Such a program should address not only the use of credit, but also long-term retirement savings and financial security.

As noted above, individual financial institutions and financial regulators are actively engaged in efforts to expand the financial literacy of consumers. The Treasury Department's Office of Financial Education and its Financial Literacy and Education Commission also have made great strides in coordinating these activities. However, we believe that financial literacy needs to be a key component of our national education agenda. Policymakers should make financial literacy classes part of the core curriculum in schools, incorporate financial education programs

into other federal programs, such as Teach for America, and encourage financial services SROs to become more aggressively involved in financial literacy outreach programs. This is an issue that applies not just to consumer lending, but all facets of financial products and services.

The financial services industry also can play a vital role in this effort by sponsoring workplace financial education programs. In-depth presentations on employee benefit programs and management of family finances can help employees build their financial confidence. With the significant shift to defined contribution plans and the scope of employer-provided health insurance programs, worksite financial education programs can provide employees with a better understanding of their specific benefit choices.

Recommendation 31. Alternative dispute resolution mechanism. Congress, with input from the financial services industry and its consumers, should create alterative dispute resolution mechanisms for consumer disputes.

Litigation is an expensive, time-consuming way to resolve disputes among consumers and financial services firms. Nonetheless, some parties favor litigation as the only way that the imbalance between the expertise, experience, and resources available to a firm compared to a consumer can be addressed. We believe it should be possible to design an alternative system that minimizes any imbalance between consumers and firms, yet allows disputes to be resolved separate from the courts. If structured with sufficient procedural safeguards for consumers, firms should be permitted to mandate the use of the system in contracts with consumers.

Recommendation 32. Model disclosure forms. Congress should authorize the federal financial regulators to develop simplified model disclosure forms for consumer lending and other financial activities based upon extensive consumer testing and interaction with the financial services industry, and shield firms from class-action lawsuits when they follow the forms in good faith. To be most effective, disclosures should be provided at the beginning of a transaction, not the end. Moreover, Congress also should resist mandating specific disclosure terms, type, size, or other details in favor of a more general principles-based approach to consumer disclosure.

For disclosures to work properly, they must be clear and understandable. As financial products and services have become more complex, disclosure requirements may have reached a point where consumers are more overwhelmed than informed. The volume of paper in a typical residential real estate closing, for example, is daunting and could be simplified to help the consumer make the most informed judgment possible when shopping for the best offer that meets his or her financial needs.

Ensuring that disclosures are informative, and not overwhelming, is a challenge. The federal banking agencies have started to make use of consumer testing and focus groups in the development of new model disclosure forms. Such testing should continue, and disclosures that are ineffective, duplicative, or even counter-productive should be eliminated. Detailed statutes typically result in lengthy detailed regulations and intense lawyering. More general statutory guidance would give regulators the flexibility to craft and revise disclosures to address new products and meet the changing needs of consumers.

Recommendation 33. Uniform application. Congress should ensure that national consumer protection laws are applied uniformly throughout the United States.

We have a national consumer credit system, but all consumers do not enjoy the same level of protection. The recent problems in the mortgage market illustrate the limitations of the current system. The federal banking agencies have responded to the problems in the mortgage market with two separate interagency advisories on appropriate lending practices and policies. These advisories, however, apply only to lenders that are subject to federal supervision and regulation, not to state-licensed lenders. While efforts are underway within the states to impose similar requirements on state-licensed lenders, nothing guarantees that all states will adopt the same or even similar requirements. As a result, consumers who obtain a loan from a federally-regulated lender receive one level of protection, and consumers who obtain a loan from a state lender receive a different level of protection and sometimes no protection at all. This not only deprives consumers of comparable protections, but allows institutions to engage in regulatory arbitrage based upon different consumer protection requirements.

Consumers of a financial product or service should receive the same protection, regardless of the type of lender that provides the product or service or the jurisdiction in which the product or service is delivered. Uniform, national laws that protect consumers would meet this goal.

Recommendation 34. Consumer complaint portal. Federal and state financial regulators should establish a uniform consumer complaint form and single point of contact for consumer complaints related to financial products and services.

Consumers do not appreciate the distinctions between various types of financial firms, and often do not know where to file a complaint. Under the auspices of the FFIEC or our proposed enhanced PWG, a uniform consumer complaint form should be developed along with a single point of contact created for filing consumer complaints.

CASE STUDY 4: ANTI-MONEY LAUNDERING

The financial services industry recognizes the important role financial services firms perform in the fight against money laundering and terrorist financing. These crimes pose serious threats to the well-being of our society, and we seek to fulfill our obligations to detect and deter these crimes. However, to do so, anti-money laundering regulations need to be focused properly and resources need to be applied effectively. This case study concludes that the current effectiveness of our anti-money laundering rules can be enhanced significantly through reforms based upon Principle 3 (proportionate, risk-based regulation) and Principle 4 (prudential supervision).

Historical context and current issues

The statutory foundation for enlisting the U.S. financial services industry in the fight against money laundering and, more recently, terrorist financing is the Bank Secrecy Act (BSA).[123] Enacted in 1970, the BSA initially required, among other things, financial institutions to file reports on large currency transactions (CTRs). The BSA subsequently was amended to require financial institutions to file reports on suspicious activities (SARs) as well and to implement anti-money laundering compliance programs.

Following the 9/11 terrorist attacks, key provisions

[123] 31 U.S.C. 3311 et seq.

of the BSA were revised by the USA PATRIOT Act to criminalize the financing of terrorism, strengthen customer identification procedures, prohibit financial institutions from engaging in business with foreign shell banks, and require financial institutions to have effective due diligence procedures, among other requirements.[124] The USA PATRIOT Act also extended the anti-money laundering compliance program requirements to all financial institutions, including securities firms and insurance companies.

Increasingly, the International Emergency Economic Powers Act, which authorizes the Treasury's Office of Foreign Assets Control (OFAC) to administer terrorist-related blocking orders, also plays an important role in the fight against money laundering and terrorist financing.[125] OFAC regulations prohibit financial institutions from providing services or processing transactions in which identified parties have an interest. These prohibitions have been used to sever terrorists and their supporters and international narcotics traffickers from economic resources.

Today, in addition to the basic CTR and SAR reporting requirements, the basic features of an effective anti-money laundering compliance program for U.S. financial services firms are fourfold:

1. The establishment and implementation of a system of internal controls to ensure ongoing compliance
2. Independent testing of BSA compliance
3. The designation of a specific person or persons responsible for managing BSA compliance
4. The training of appropriate personnel.

Regulations promulgated by the Secretary of the Treasury, in consultation with federal financial institution regulators, were intended to permit the anti-money laundering programs of covered financial institutions to be "risk-based." Increasingly, however, Roundtable member companies find that they are required to adopt detailed policies and procedures that involve comprehensive auditing of individual transactions, which more often than not pose little to no substantive risk. For example, extensive and expensive monitoring for transactions involving foreign politically exposed persons (PEPs) may be appropriate for one institution, but less appropriate for another engaged in different business activities and offering different products and services to different kinds of consumers. Similarly, securities firms have been repeatedly cited by NASD and SEC examiners for failing to develop written policies and procedures to address anti-money laundering regulations for activities in which the firms are not currently engaged (e.g., establishing, administering, and maintaining private banking accounts and correspondent accounts for non-US persons or accepting foreign currency), under the theory that they may some day engage in such activities and will then need to have procedures in place.

If all institutions are held to the same comprehensive standards, many will be required to needlessly employ resources that could have been employed to monitor and address areas of greater potential or actual risk. Selecting and implementing appropriate controls should be based on a meaningful understanding of the risk and efficacy of the control, not on the availability of a particular control methodology or the adoption of that methodology by another institution.

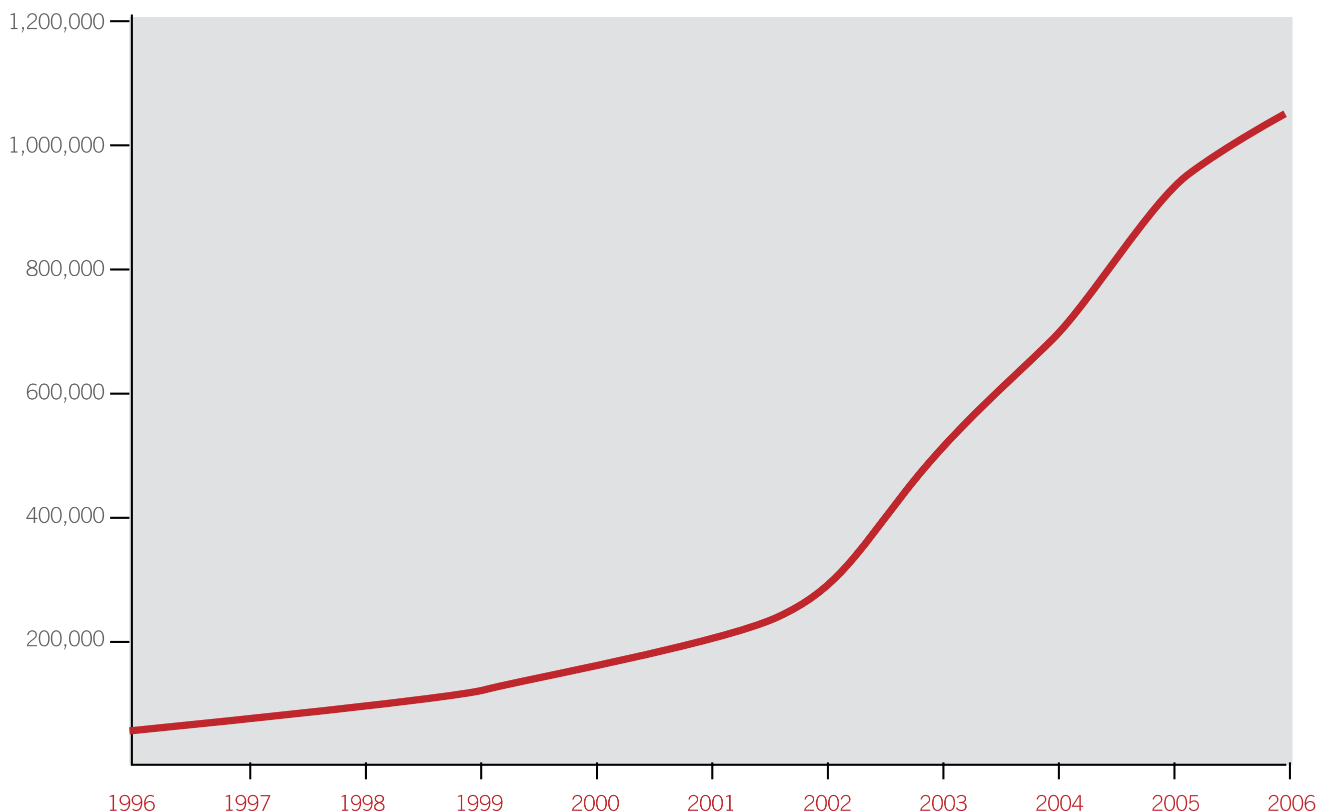
Additionally, CTR and SAR filing requirements have evolved into a costly compliance exercise. In the past decade, the volume of such filings has grown exponentially. Exhibit 3-4 shows the annual volume of SAR filings between 1996 and 2006. Most of the spike in SAR filings after 2002 is attributable to the extension of the SAR filing requirement to money service businesses (MSBs). In fact, SAR filings by MSBs constitute approximately one-half of the total amount of SAR filings. Some of the growth in filings, however, is attributable to "defensive" filings by institutions seeking to insulate themselves from potential examiner criticism or even enforcement actions and civil money penalties based upon

[124] USA PATRIOT Act, PL 107-56.

[125] 50 U.S.C. 1701 et seq.

Exhibit 3-4

Number of Suspicious Activity Report Filings by Year



Source: The SAR Activity Review: By the Numbers, Issue 6, May 2006

noncompliance with the filing requirements. The value of these filing requirements is clouded by the lack of data surrounding their use. While law enforcement agencies are able to cite examples of the value of CTR and SAR filings in individual cases, no aggregate data are available to measure the overall cost-effectiveness of filing requirements.

More fundamentally, our existing anti-money laundering rules are not well suited to prevent terrorist financing. After reviewing the financial transactions of the terrorists involved in the 9/11 attacks, the 9/11 Commission concluded that the SAR filing requirement "does not work very well to detect or prevent terrorist financing."[126] The Commission found that the amount of money involved in terrorist financing typically is below applicable SAR reporting thresholds because the transactions are usually routine and unsuspicious. As an alternative to SARs, the 9/11 Commission favorably cited the so-called Section 314(a) process under which law enforcement authorities provide the names of suspected terrorists to financial institutions.[127] When used, this process has permitted institutions to assist law enforcement in matters that have identifiable outcomes.[128] This process is an example of an efficient approach that is risk-focused.

The asserted linkage between terrorism and anti-money laundering controls has driven the development of more robust anti-money laundering programs across the financial industry since 9/11,

[126] "Monograph on Terrorist Financing," National Commission on Terrorist Attacks upon the United States, p. 54.

[127] The Section 314(a) process is a reference to Section 314(a) of the USA PATRIOT Act, which encouraged law enforcement authorities to share information on suspects with financial institutions.

[128] In the five years in which this process has been in effect, law enforcement initiatives have resulted in 118 arrests, 133 indictments, and 13 convictions. Law enforcement authorities also have used the process to locate over $28 million in funds. While all financial institutions are subject to mandatory SAR requirements, not all are required to develop anti-money laundering programs receive inquiries from law enforcement agencies through the Section 314(a) process.

making our financial system more secure than ever. On the other hand, this linkage also has resulted in placing undue emphasis on compliance for the sake of compliance, as regulators and firms adopt more and more controls to avoid the legal and reputation risks associated with handling terrorist financing. Moreover, a "zero tolerance" approach to compliance has driven financial institutions to invest ever-increasing resources in controls that are not particularly effective in identifying or preventing the underlying risks of terrorist financing or money laundering.

The limitations of the existing system are recognized by both financial firms and policymakers. Treasury Secretary Paulson, for example, recently announced a joint initiative between FinCEN, the office within the Treasury Department responsible for administering the BSA, and the federal banking agencies to match risk-based examinations with risk-based obligations. This initiative is designed to "ensure that financial institutions and regulators treat compliance obligations in a manner that helps to avoid expenditures that are not commensurate with actual risk."[129] The Commission welcomes this initiative and invites the Secretary, FinCEN, and the banking agencies to consider our proposed reforms (listed below in Recommendation 5) in the course of that review.

We also encourage the Secretary, FinCEN and the federal banking agencies to review the U.K.'s experience with a risk-based approach to anti-money laundering. In September 2006 the FSA adopted a new risk-based approach to anti-money laundering. The FSA eliminated its detailed money-laundering rules and replaced them with a set of high-level rules. For example, those rules simply require a firm to establish systems and controls to identify, assess, monitor, and manage money-laundering risk, and to ensure that such systems and controls are "comprehensive and proportionate to the nature, scale, and complexity of its activities."[130]

The FSA has emphasized that this approach does not mean that the agency has gone soft on money-laundering. Nor does the agency view a risk-based approach as a cheap or easy option for institutions. On the other hand, the FSA does believe that a risk-based approach to anti-money laundering designed by management rather than the regulator will be cost-effective, flexible, and proportionate.

The FSA's risk-based approach is focused on results, not inputs. Therefore, the approach imposes an obligation on management to be innovative and to develop anti-money laundering policies and procedures that are used as a means to an end. This permits firms to develop systems and controls that are fit for their consumer base, and not unnecessarily burdensome or costly.

Key to the FSA's action was the release of a money-laundering guidance developed by the Joint Money Laundering Steering Group (JMLSG), an industry group.[131] That guidance is detailed, yet risk-based. It emphasizes the responsibility of senior management to manage a firm's money laundering and terrorist-financing risks.

Applying principles to anti-money laundering

Principle 3, which calls for proportionate, risk-based regulation, should guide U.S. anti-money laundering and anti-terrorist financing requirements. More proportionate, risk-based supervision of anti-money laundering regulations would allow institutions and regulators to focus resources more effectively on areas of greatest potential risk. The changes in our anti-money laundering rules since 9/11 are neither proportionate nor risk-based. Institutions are required to adopt policies and procedures that have not been proven to be effective. This results in a misallocation of resources and detracts from the intended goals of the BSA.

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[129] Bank Secrecy Effectiveness and Efficiency Fact Sheet, www.fincen.gov/bsa_fact_sheet.pdf.

[130] Provision 3.2.6A

[131] Prevention of money laundering/combating the financing of terrorism, Guidance for the UK Financial Sector, The Joint Money Laundering Steering Group (January 2006).

These requirements should be applied with more proportionate, risk-based evaluations and examinations that place a greater obligation on financial services firms to identify areas of greatest risk and to allocate adequate resources to those areas. True risk-based examination policies also would require flexibility on the part of regulators to accept differences in compliance regimes adopted by different institutions, and base examination policies on the efficacy of those regimes, rather than on adherence to a single set of specific rules. Our recommended revisions to the FFIEC BSA/AML Examination Manual (the FFIEC Manual) to make customer due diligence review more risk-based and to modify existing CTR filing requirements are consistent with this principle.

Principle 4, prudential supervision, also should apply to U.S. anti-money laundering and terrorist-financing requirements. The foundation of prudential supervision is an open dialogue between firms and regulators. To some extent, such a dialogue exists today through the use of the Section 314(a) process. However, in the absence of the development of any new typologies and technologies to identify potential terrorists, the best solution is an ongoing exchange between firms and regulators to identify effective detection procedures. Our recommendations for information-sharing between firms and regulators are based upon this principle and the need for ongoing constructive engagement between regulators and regulated firms.

Our proposed guidelines for examinations also are based upon the principle of prudential supervision. Prudential supervision does not value compliance for the sake of compliance. It focuses on results and outcomes. Therefore, we recommend guidelines for examiners that encourage examination findings to be placed into the context of an institution's overall risk-based program. While institutions should be held accountable for effective programs, they should not be forced to adopt policies and procedures that bear little relationship to the institution's operations or the risk profile of its customers.

POLICY REFORM V. ANTI-MONEY LAUNDERING.

Policymakers and regulators should make anti-money laundering supervision more proportionate, risk-based, and prudential.

Recommendation 35. New guidelines for examinations. The Director of FinCEN and the heads of financial regulatory agencies should adopt a revised approach to examinations – throughout all levels of their agencies – that is based upon the following factors:

- *Consistency* – The agencies should continue to strive toward consistency in examination approaches and interpretation of anti-money laundering laws and regulations

- *Context* – Examination findings should be placed in the context of an institution's overall risk-based program and profile

- *Collaboration* – Examiners and management should share information to find more effective ways to detect significant risks

- *Coordination* – Examinations should be coordinated among regulators to eliminate supervisory or regulatory duplication.

Recommendation 36. Information sharing. Regulators and law enforcement agencies should enhance confidential information sharing between governmental authorities and financial institutions to prevent money-laundering.

There should be formal recognition of the distinctions between controls aimed at detecting money-laundering and those aimed at detecting the financing of terrorism. This distinction will begin to remove the incentive to bolster anti-money laundering controls beyond their utility in identifying money-laundering.

The linchpin in this strategy continues to be the need for enhanced information sharing from the government to the financial industry. Providing financial institutions with information on those suspected of supporting or engaging in terrorism, whether shared discretely or widely, would allow the government to tap the vast pools of information contained in financial institutions. Such sharing should be done with the controls necessary to assure confidentiality. Combining financial data and other intelligence held by the government with the account and transaction data held by the financial industry would boost government successes and further protect our financial system.

The following actions would facilitate this exchange:

Recommendation 37. Security clearance. Regulators and law enforcement agencies should provide appropriate security clearances to select financial institution personnel, beginning with money center banks.

Recommendation 38. Selective information sharing. Regulators and law enforcement agencies should promote more selective information and targeted sharing based on financial and other intelligence.

Recommendation 39. Greater use of Section 314(a) process. Regulators and law enforcement agencies should reduce the burden of conducting unfocused information searches for most financial institutions by making greater use of the Section 314(a) process.

Recommendation 40. Regular meetings. Regulators and law enforcement agencies should organize periodic meetings between industry and regional SAR review teams in local US attorneys' offices to discuss trends, and patterns of activities, and share examples of effective SAR filings.

Recommendation 41. Customer due diligence. The current guidance and direction by regulatory authorities for financial institutions to collect and document "usual and expected" activity should be reviewed to determine if it should be subject to public comment.

The examination process has increasingly led to an expectation that financial institutions collect and document "usual and expected" activity for customers, as detailed in the FFIEC Manual. This regulatory guidance and direction has driven the collection of customer due diligence information in a manner that is arguably beyond the requirements established in the BSA and its implementing regulations.

The BSA and its implementing regulations direct the collection of consumer due diligence information with particularity. The consumer identification program regulations and Section 312 of the USA PATRIOT Act are examples of this. While financial institutions have recognized the need to understand expected account activity in connection with customers posing a higher risk of money laundering to identify and report suspicious activity, directing the general collection of customer information without specific reason to do so and beyond the direct regulatory requirements raises both privacy and

burden concerns.

As the current guidance is applied across all accounts, financial institutions can be required to collect and maintain extensive personal financial information on customers who pose no demonstrable reason to obtain such information. A regulatory requirement to collect and maintain information on the usual and expected activity of all customers was proposed in 1998 by the federal banking agencies, but withdrawn after public comment because of privacy and burden concerns. Using the requirement for institutions to identify and report suspicious activity as the authority for the collection and documentation of due diligence information across all accounts does not seem appropriate.

Recommendation 42. Training of examiners. Treasury and the financial regulators should develop a training program designed to give both compliance staff and examiners a better understanding of the operations and business of financial institutions.

As financial institutions become increasingly complex, so too does the work of examiners. Industry concerns with consistency and proportionality through the examination process often derive from a perception that examiners do not thoroughly understand the business practices and operational aspects of the financial institutions they examine. For example, insurance company anti-money laundering programs are currently examined by IRS staff, who also are responsible for examining the programs of MSBs. These individuals have had limited training on insurance products and the insurance industry. Developing and maintaining an appropriate business perspective, grounded in an understanding of the nature and scope of an institution's business operations, is critical to an effective compliance examination.

Such training would not be specific to any one institution, but would rather offer a more generalized discussion on various banking business models, and operational support functions. To succeed, however, the active support of the regulatory agencies is a prerequisite, both to help develop appropriate programs and to ensure that examiners attend.

Recommendation 43. CTR filings. Regulators should reform the CTR filing process to reduce the compliance burden associated with this filing requirement, while preserving the goals of anti-money laundering enforcement. Specifically:

Recommendation 44. SAR filings. Regulators should substitute SAR filings for the CTR report and Form 8300 (cash equivalent reports) on multiple transactions under $10,000.

Much of the CTR filing burden is associated with reporting multiple transactions below the $10,000 threshold. A more effective, risk-focused approach to finding illegal activity would be to require institutions to submit SARs for those transactions under the $10,000 level that are suspicious. This action will enable institutions to focus resources on the transactions that pose the greatest risk for money laundering or terrorist financing.

Recommendation 45. GAO study. Regulators and the GAO should meet with representatives of the financial services industry prior to the release of the GAO's report on CTRs to discuss the GAO's pending recommendations.

This action would provide the financial services industry with an opportunity to share additional valuable insights on the CTR issue before the agencies implement any potential GAO recommendations.

Recommendation 46. Title 31 enforcement. To encourage the

use of CTR exemptions, the Title 31 enforcement doctrine for CTR exemption violations should be evaluated by law enforcement agencies and financial regulators.

Recommendation 47. Guidance. Law enforcement agencies and regulators should provide guidance to the industry on stored value cards and domestic political persons.

Director Freis has stated publicly that FinCEN is working with regulatory partners and law enforcement partners to craft new examination materials and guidance for money service bureaus. This program can be expanded to include guidance in other important anti-money laundering areas, including the use of stored value cards and treatment of domestic political persons.

Recommendation 48. Outcomes-based SARs. FinCEN, in conjunction with feedback from the industry, should develop outcomes-based SARs.

FinCEN currently releases information on individual cases in which SAR filings have been useful to law enforcement. Reports on individual cases, however, do not permit law enforcement or the industry to draw any conclusions about the effectiveness of the current filing requirements. In contrast, FinCEN does release data on the number of cases initiated, the indictments obtained, and the arrests and convictions associated with the Section 314(a) process.

Recommendation 49. Affiliates SAR sharing. Regulators should allow the sharing of SARs with affiliates.

Enterprise-wide risk management is appropriate in an anti-money laundering compliance program. While FinCEN and the regulators have issued guidance allowing the sharing of SARs from a U.S. institution to its foreign parent, there still is a prohibition on sharing of SARs among subsidiaries and affiliates, whether inside or outside the United States. There does not appear to be any prohibition in law or regulation that would prevent the sharing of SARs among subsidiaries and affiliates, and there is certainly no increased risk between this sharing and the sharing that already is permitted.

Recommendation 50. Standardized training. Regulators should develop a standardized training program for agents and brokers. Insurance companies should be given a safe harbor for compliance when they use agents or brokers who have successfully passed such a training program.

Currently, insurance agents and brokers are not directly responsible for establishing and implementing anti-money laundering compliance programs. That responsibility rests with the insurance companies. In practice, however, this allocation of responsibility has proven to be somewhat confusing and uneven. Particularly troublesome is the requirement that insurance companies develop policies and procedures to provide ongoing anti-money laundering training to insurance agents and brokers selling the company's products or verify that these agents and brokers receive ongoing training from some third-party provider. This requirement has resulted in: agents having to take training from multiple insurance companies; multiple insurance companies having to request evidence from agents and brokers that they have received training; and multiple insurance companies having to obtain copies of training materials from vendors to verify the substance of training programs. A more limited alternative to a standardized training program would be to allow companies to rely upon training provided to agents who are employees of other financial institutions and not require additional due diligence or review by the company.

Recommendation 51. International compliance guidance. U.S. regulators should provide financial services firms with guidance on compliance with privacy and anti-money laundering requirements imposed by other countries that conflict with U.S. requirements.

As more nations adopt their own privacy and anti-money laundering compliance regimes, there is a growing potential for conflict between U.S. and foreign requirements. For example, U.S. rules that prevent a U.S. financial services firm from providing services to certain individuals or entities may conflict with foreign rules that make it illegal to deny such services. Guidance on how to address such conflicts is needed.

CASE STUDY 5: RISK-BASED CAPITAL REGULATION

This case study discusses the implementation of the Basel II Accord in the United States and calls for U.S. and international regulators to apply risk-based capital requirements for all financial firms, consistent with Principle 2 (competitiveness), Principle 3 (risk-based regulation), and Principle 6 (management responsibility).

Historical context and current issues

The role of capital

Capital serves important purposes. In normal periods of economic activity, losses on loans simply reduce profits, but, in extreme periods capital is available to absorb unexpected losses. Thus, capital provides a buffer to protect creditors and ultimately the insurance funds and other mechanisms that protect depositors, investors, and insurance policyholders. Capital also helps maintain public confidence in the particular financial services firms and the financial system and is used by the market (and the rating agencies) in determining whether to lend to the firm and at what interest rate. Required capital ratios also serve to temper growth, since the financial services firm must support asset growth with additional capital to maintain the same capital ratio.[132]

However, capital is not without cost, both to the institution and to society. Because capital bears the risk of loss it is expensive to acquire, with respect to both transaction costs and tax treatment of dividends.[133] But, more significantly, the amount of capital required must be enough to absorb reasonable amounts of unexpected losses, but not so much that the financial services firm's return on equity becomes unattractive to investors. In addition, from the standpoint of society, required capital ratios serve as a constraint on growth and overall risk-taking, but higher than necessary regulatory capital mandates can result in periods of "tight money" and "credit crunches." If institutions performing similar economic functions have different minimum capital requirements, then the institutions with the lower regulatory capital requirements will have a competitive advantage over the institutions with the higher requirements, everything else being equal. Further, financial institutions are in business to earn a profit, and profits are the first line of defense against losses. Thus, establishing the right balance is critical for both the safety of our financial system and the health of our economy.

Economists studying this issue have developed the concept of "economic capital" and differentiate it from "regulatory capital." The term economic capital refers to the amount of capital a company allocates for each segment of its assets to protect the company (up to some predetermined level of assurance) from unexpected losses.[134] For example, a bank may determine, with respect to a segment of secured new car loans, that a capital charge equal to 3 percent of the outstanding balance on those loans will protect the bank against unexpected losses with a 99.9 percent probability. On the other hand, the bank might determine that a capital allocation of 12 percent is

[132] C. Matten, *Managing Bank Capital,* (1996) pp.7-9.

[133] Interest paid on debt is tax deductible, while dividends paid to shareholders are not.

[134] D. Hancock, A. Lehnert, W. Passmore and S. Sherlund, "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitizations," (Federal Reserve Board Staff Study 2005) pp. 14-18.

necessary to protect it to the same extent against unsecured loans to college students.

Traditional bank regulatory capital requirements, on the other hand, mandated a minimum capital ratio without tying the requirement to the actual risk posed by the different assets held by the company.[135] In some cases, the regulatory capital requirements may be lower than the economic capital allocations, in which cases a well-managed institution will hold more capital than required by the regulations not only to protect the institution from unexpected losses, but also to meet the demands of the capital markets. If, however, the regulatory capital requirements are higher than the economic capital allocations, the government regulations could be viewed as counter-productive. Regulated institutions will have an incentive to use the excess capital required by regulations by increasing the risk of their asset base, thereby better aligning aggregate regulatory and economic capital.[136] Alternatively, institutions may decide to meet the excess capital requirements by slowing growth or even shrinking their asset base, which will result in slower economic growth for the economy. In either case, requiring more regulatory capital than necessary can be deleterious both to the institution and to our economy. [137]

The development of bank capital regulations

The modern era of bank capital regulation can be traced to 1981, when the federal banking agencies proposed a uniform definition of regulatory capital (the "leverage ratio") and issued a policy statement explaining that the agencies will review the capital adequacy of each bank based on that bank's particular structure and activities.[138] The policy statement explained that a "bank's capital base can be considered adequate when it enables the bank to intermediate funds responsibly and provide related services while protecting against future uncertainties."[139] The policy statement contained guidelines for what the agencies would consider adequate, by describing capital "zones," based on the size and financial condition of the bank and its managerial expertise.

In June 1983 the agencies established explicit minimum capital requirements for the largest multinational banks and bank holding companies.[140] A few months later, in November 1983, Congress enacted the International Lending Supervision Act,[141] which directed the banking agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital." In response, the agencies issued enforceable uniform minimum capital levels – the leverage ratio – for all federally-supervised banking organizations – but not thrifts – including bank holding companies, regardless of size, type of charter, or primary supervisor. [142]

International concern about the health of the world's financial system also began to build in the 1980s. It became clear that many banks had overextended their lending to heavily indebted nations, particularly in Latin America. These concerns were magnified by the Mexican debt crisis, which resulted in significant losses for international banks. The "Cooke Committee" was established under the Bank for International Settlements (BIS), and in 1987 it published its proposal for a new risk-based capital requirement applicable to internationally active institutions, the Basel Capital Accord (Basel I).[143] The banking regulators of the major developed nations agreed to the Basel I Accord in 1988.

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[135] Remarks of Randall Kroszner, Member, Federal Reserve Board, Before the New York Bankers Association, July 12, 2007; General Accountability Office, "Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework," (February 2007).

[136] Berger, Jerring and Szego, "The Role of Capital in Financial Institutions," Wharton Financial Institutions Center Working Paper 95-01 (January 1995); Remarks of Alan Greenspan, Chairman of the Federal Reserve Board, Before the Conference on Capital Regulation, New York (February 26, 1998).

[137] Id.

[138] See 45 Fed. Reg. 49276 (1980); 46 Fed. Reg. 40520 (1981); FFIEC Recommendation, November 9, 1981.

[139] OCC Proposed Policy Statement, August 14, 1981.

[140] 49 Fed. Reg. 749 (1983).

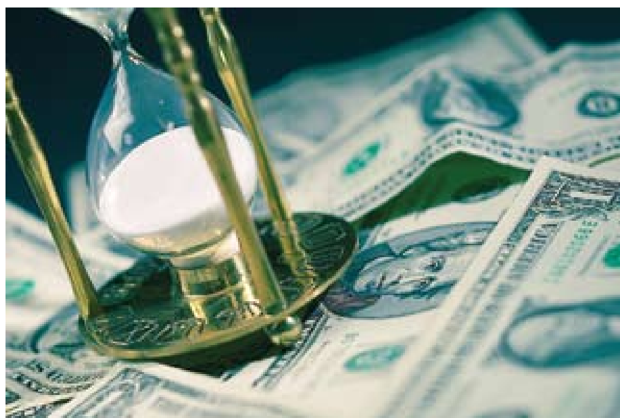
[141] P.L. 98-181, Title IX (1983).

[142] See Federal Reserve Board Release, December 1, 1983.

[143] C. Matten, "Managing Bank Capital," (1996), pp. 4-5.

Basel I has two main purposes: 1) to strengthen the stability of the international banking system; and 2) to reduce competitive inequalities by establishing an internationally uniform capital requirement. U.S. regulators began to implement Basel I in 1989, and applied it to all insured depository institutions and bank holding companies, regardless of whether they were active internationally.[144]

Unlike the leverage ratio, the Basel I Accord attempts to adjust for risk by assigning credit exposures to one of five regulatory baskets and requiring a different amount of capital to support assets based on the basket to which it has been assigned. However, the baskets are very broad. For example, all commercial loans made to private parties (without government backing) are assigned to the same basket, regardless of the creditworthiness of the borrower. Thus, loans to highly leveraged, speculative projects without a confirmed source of repayment have the same capital charge as loans to investment grade borrowers.



Shortcomings of Basel I

The shortcomings of the Basel I Accord soon became obvious. Since that Accord did not differentiate between borrowers based on credit risk, loans to riskier borrowers became more attractive since they yielded a higher return for the same capital charge.[145] Basel I provided a powerful incentive to sell off, through securitizations, the most creditworthy assets, and retain the riskier, higher yielding assets. Federal Reserve Board Governor Laurence Meyer explained the situation as follows:

> *Today, our capital regulation encourages banks to withdraw from low-risk credit markets… It has become increasingly difficult for supervisors to assess the residual capital adequacy of large, complex, banking organizations as relatively low-risk assets have been removed from the banking book. Indeed, I am concerned that regulatory capital is, as a result, becoming a safety and soundness irrelevancy and simply a compliance requirement.*[146]

Alan Greenspan, then-Chairman of the Federal Reserve Board, similarly explained that Basel I "has distorted risk-management practices and encouraged massive regulatory capital arbitrage. That is, our rules have induced bank transactions that have the effect of reducing regulatory capital requirements more than they reduce a bank's risk position."[147]

In addition, Basel I does not take into account certain off balance sheet risks and fails to acknowledge the benefits of many credit risk mitigation techniques, for example, requiring collateral for commercial loans.

Faced with these and other criticisms of Basel I, the international bank regulatory community determined to develop a new regulatory standard, incorporating the new risk management techniques that banking organizations began to use internally in the 1990s. In June 2004 the new framework was agreed to by the regulators and published as the Basel II Accord.

Basel II Accord

The Basel II Accord builds on the risk measurement and risk management practices of the most sophisticated banking organizations and provides incentives for further risk-based improvements. The Basel II framework encompasses three pillars (Pillars 1, 2, and 3).

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[144] 54 Fed. Reg. 4177 (January 27, 1989).
[145] C. Matten, Managing Bank Capital, (1996), p. 6.
[146] Laurence Meyer, Remarks at the Risk Management Planning Conference, Chicago, Illinois, June 1, 2000.
[147] Alan Greenspan, Remarks before the American Banker's Association, October 11, 1999.

Pillar 1 is risk-focused minimum regulatory capital requirements. Under Pillar 1, the risk sensitivity of minimum risk-based capital requirements is much greater than under Basel I. This greater sensitivity is achieved by linking each banking organization's capital requirement to empirically-based measures of credit and operational risk; these measures are determined, in part, by factors estimated by the banks based on their historical experience, such as a loan's probability of default and its expected loss given default. The methods used for these estimates will be subject to regulatory requirements and supervisory guidance and review. The Pillar 1 treatment of credit risk also reflects more accurately the risk-reducing effects of credit risk mitigation, such as guarantees and collateralization, thereby providing regulatory capital incentives for banks to use these techniques.

Pillar 2 provides for supervisory review of each bank's capital adequacy and requires that banks have a process for assessing their overall capital adequacy for risks, such as liquidity risk, interest rate risk, and concentration risk, which are not captured in Pillar 1, and have a strategy for maintaining capital levels to reflect these risks.

Under Pillar 3, banks will be required to disclose to the public information about their business strategies, the new risk-based capital ratios, more-extensive information about the credit quality of their portfolios, and their practices in measuring and managing all types of risks. Such disclosures should make banks more transparent to financial markets and thereby improve market discipline.

Market risk rule

In addition to Pillars 1, 2 and 3, U.S. and international regulators have established a requirement for banks to measure and hold capital to cover their exposure to the market risks associated with foreign exchange and commodities holdings and positions in the bank's trading account, the "market risk rule." Market risk is defined as the risk of loss resulting from movement in market prices, whether due to broad market movements such as changes in interest rates or due to the market reaction to specific events relevant to a particular position. In the United States, the market risk amendment was implemented in 1997.

On September 25, 2006, the U.S. banking agencies published a proposed amendment to the market risk rule to include traded credit products, such as credit default swaps and other structured instruments, and to capture liquidity risk and concentration risk in the value-at-risk computation. The proposed amendment restricts the ability of a bank to include certain assets under the market risk rule and adds a number of mandates with respect to the design of a bank's internal models. Finally, the proposed amendment would require enhanced public disclosure including a specific list of new information that would have to be disclosed.

Differences between U.S. and international implementation of Basel II

As the Basel II framework was being developed, several quantitative impact studies (QIS) were performed to aid in assessing how the proposed system would work and to calibrate certain formulas prescribed under the framework. The U.S. banking regulators conducted one of these analyses involving the nation's largest banks in late 2004, during a period when risk measures were at historic lows. The QIS-4 survey found an average aggregate decline, from the Basel I base, of 15.5 percent in minimum risk-based capital for the large banks that participated in the survey.

Based upon the results of the QIS-4 survey and some concerns over the ability of empirical models to determine appropriate capital levels, the agencies proposed modifications to the U.S. version of the Basel II framework. Specifically, the agencies proposed a slower implementation schedule in the U.S. (three years instead of two), higher capital requirements for several types of assets, the retention of the leverage ratio, and a review of the framework, if minimum required capital computed with the Basel II rules dropped more than 10 percent for the industry as a whole from Basel I minimum requirements.

Additionally, to minimize differences in capital levels between Basel II banks and Basel I banks, the agencies

proposed an alternative to Basel I for the segment of the industry not using Basel II. This new option, "Basel IA," would have expanded the number of risk categories and risk weights based upon external credit ratings.

Both the Basel II and Basel IA proposals were subject to significant industry comment. Large U.S. banks noted that the Basel II rule, as modified by the federal banking agencies after the QIS-4 survey, reduced the risk sensitivity of the rule and significantly increased the cost of compliance.

The competitive impact of the proposed rule also was a major concern of large U.S. banks. One of the key objectives of the Basel Committee was to establish a uniform international capital framework that would reduce, if not eliminate, competitive advantages based on different capital rules. The reason for this objective is clear: higher regulatory required capital ratios can support fewer assets than lower capital requirements. An institution with a 5 percent capital requirement can hold twice as many assets as a bank with a 10 percent capital requirement. From a shareholder's perspective, a dollar invested in the first bank can produce twice the income as a dollar invested in the second bank. A bank with a lower capital requirement will be able to underprice the bank with the higher requirement and yet retain the same or even better return on equity. If the U.S. capital standards are significantly higher, the result will be to disadvantage our institutions competitively in the global marketplace.

The concerns raised by large U.S. banks over the proposed modifications to the Basel II framework were echoed by the Financial Services Roundtable, the American Bankers Association, Americas' Community Bankers, and the Finance Ministers of the 27 members of the European Union.[148]

Conversely, smaller U.S. banks voiced concerns over the potential competitive consequences of a capital reduction for large banks under the Basel II regime and urged the regulators to retain the leverage ratio as a safeguard. The Shadow Financial Regulatory Committee also joined in the call for the retention of the leverage ratio, based upon its concerns over the ability of models to accurately determine appropriate capital levels.

The recent turmoil in the credit markets has left some to question the adequacy of models to assess and quantify risk. Certainly, it is difficult for models, which are customarily based on historical experience, to always capture fully extreme events. Recent events undoubtedly will be taken into consideration when the regulators conduct their ongoing assessment of the effectiveness of capital models used under Basel II for the three transitional years. The regulators will publish a study in 2011 and will certainly highlight any model deficiencies that they find.

In late July 2007, the federal banking agencies announced that they had reached agreement to resolve major outstanding issues on the Basel II rules, and were prepared to finalize "a rule implementing the advanced approaches for computing large banks' risk-based capital requirements." The agreement harmonizes the U.S. approach with the international accord, reduces competitive disparities, both internationally and domestically, and addresses concerns over the reliance on models by retaining the leverage ratio. The key features of that agreement are as follows:

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[148] The E.U. Finance Ministers noted, "The European Commission is commenting on the notice of proposed rulemaking (NPR) since the differences between the proposed rules and the revised framework may lead to additional, and unnecessary, regulatory burden for E.U. banks that are active in the U.S. and U.S. firms that are active in the E.U."

- The Basel II rule should be "technically consistent in most respects with international approaches"

- The parallel run for Basel II banks would start in 2008 followed by three transitional years – 2009, 2010, and 2011

- Transitional floors for maximum cumulative reductions in capital – 5 percent in 2009; 10 percent in 2010; and 15 percent in 2011; thereafter, no floors

- Agencies will publish a study in 2011 that evaluates the new framework to determine if there are any material deficiencies. If there are material deficiencies, banks will not be permitted to exit the third transitional period unless the deficiencies are addressed by changes to the regulation; however, if the primary supervisor disagrees with the finding of material deficiency, it may authorize banks it supervises to exit the third transitional period, but only after it first provides a public report explaining its reasoning;

- The 10 percent limitation in aggregate reductions in risk-based capital is eliminated;

- The agencies will conduct an annual review of the performance of the new capital rules;

- The agencies will propose a rule covering non-core banks (other than mandatory large banks) with the option to adopt a standardized approach. This standardized approach would replace the proposed Basel IA option and would be finalized prior to 2009.

Capital regulation for securities firms

The SEC imposes capital requirements on registered brokers and dealers. Beginning in 2004, the SEC utilizes two different approaches. For a broker/dealer that elects to become subject to SEC "comprehensive supervision," the firm will be subject to the Basel II capital standard, as described in the International Accord. The SEC indicates that it may amend these frameworks after the banking agencies issue their version of the Basel II Accord in the near future. Today, there are five broker/dealers subject to this rule.

For the rest of the industry, the SEC applies a "net capital rule" that requires a broker-dealer to maintain specified minimum levels of liquid assets, or net capital. The rule is designed to protect the customers of a broker-dealer from losses upon the firm's failure. It requires different minimum levels of capital based upon the nature of the firm's business and whether a broker-dealer handles customer funds or securities. In calculating the capital requirement, the rule requires a broker-dealer to deduct from its net worth certain percentages, known as haircuts, of the value of the securities and commodities positions in the firm's portfolio. The applicable percentage haircut is designed to provide protection from the market risk, credit risk, and other risks inherent in particular positions.

A broker-dealer computes its haircuts by multiplying the market value of its securities positions by prescribed percentages. For example, as a general matter, a broker-dealer's haircut for equity securities is equal to 15 percent of market value. The haircut for interest rate sensitive securities, such as government bonds, is related to the time remaining to maturity.

Capital regulation for insurance firms

Minimum capital requirements for insurance companies are set by state law. However, almost all of the states follow the model risk-based capital framework developed by the National Association of Insurance Commissioners in the early 1990s. Under the NAIC model, capital is adjusted based on the amount and type of risks held by the insurance company, and thus the amount of required capital varies by the particular line of insurance offered by the company, and the company's risk profile. The standards capture the risk that the company's assets will decline, the risk that insurance claims will exceed expectations, interest rate risk, and operations risk. Operations risk includes the risk that another company will fail and the state guarantee fund will make an assessment against the surviving companies. For property and casualty companies, the

risks examined also include the risk that reinsurance companies will not be able to perform and the risk that reserves are inadequate to cover claims.

More recently, the International Association of Insurance Supervisors has urged the adoption of a more "principles based" capital framework. Under this approach, capital requirements would be established by the insurance company to assure that sufficient capital is held to satisfy insurance obligations in the event of financial adversity, with a specified level of safety over a defined time horizon. Different companies could use different methods for determining appropriate capital levels, but supervisors would establish "control levels" to safeguard policyholders from loss and as triggers for corrective action.

Applying principles to capital regulation

The Basel II rulemaking process illustrates the challenges of joint rulemaking. Each agency brought a slightly different mission and objective into the rulemaking process, and these differences were reflected in the range of changes proposed to the framework after the QIS-4 survey.

The competitive impact of the rule was a particular stumbling block for regulators and the industry. Most institutions felt that the U.S. banking agencies did not give sufficient consideration to the competitive impact of the Basel II rule. Large banks were concerned that they would be greatly disadvantaged by the rule in competing with foreign firms. Small U.S. banks were concerned about competition from large U.S. banks. The application of a common set of guiding regulatory principles could have facilitated the development and implementation of the Basel II Accord in the U.S. by minimizing the differences among the agencies. If, for example, all agencies were required to consider the competitive impact of regulations (as proposed in Principle 2), then the agencies might have reached agreement on the rule at an earlier point in the process. In the final analysis, it does appear, however, that the agencies developed a rule that maintains appropriate capital levels and ensures that U.S. institutions, both large and small, remain competitive.

The application of Principle 4 (prudential supervision) and Principle 6 (management responsibility) also might have helped to address concerns over the empirical models upon which Pillar 1 of the Accord is based. As noted above, Pillar 1 is just one segment of the Accord. Pillars 2 and 3 provide the agencies with additional tools to ensure that individual institutions maintain an appropriate level of minimum requirement capital. The on-going engagement between regulated institutions and regulators that is envisioned in Principle 4 could help to give regulators sufficient understanding and comfort with capital levels at individual institutions. Likewise, the obligation that Principle 6 imposes on management to manage their institutions properly would give regulators some assurance that they are exercising appropriate judgment in the establishment of capital levels.

One of the fundamental goals of the Basel II framework is to enhance the risk-sensitivity of capital requirements. This goal is consistent with our proposed Principle 3 (proportionate, risk-sensitive regulation). Below, we recommend a series of actions by U.S. and international regulators related to capital regulation that builds upon this principle for all financial services firms. Aligning capital with risk is good for our economy. It ensures that adequate capital exists to cover risk, but does not result in excess capital, which is then unavailable to support lending and investment activities.

POLICY REFORM VI. RISK-BASED CAPITAL REGULATION.

The U.S. and international financial regulators should build upon the approach taken in the Basel II Capital Accord and apply a consistent risk-based focus to capital regulation for all financial services firms. U.S. financial regulators should review the leverage ratio as well as the definition of capital to determine their impact on the international competitiveness of U.S financial services firms and report to Congress on their findings. More specifically:

Recommendation 52. Competitiveness. As U.S. financial regulators implement the new Basel II Capital Accord, they should adhere to Principle 2 (open and competitive markets) to ensure that the Accord does not place either smaller U.S. banks at a competitive disadvantage to larger banks or larger U.S. banks at a competitive disadvantage to their foreign competitors. To meet this objective, regulators should implement the international standardized approach as an option for non mandatory banks.

By proposing to harmonize the U.S. version of Basel II with the original Accord, U.S. financial regulators have diminished any competitive advantage foreign banks would have over large U.S. banks based upon capital requirements. Similarly, the continuation of the leverage ratio should minimize differences between large U.S. banks and smaller U.S. banks. The extension of the standardized option for non-mandatory banks would further ensure that smaller U.S. banks are subject to capital requirements comparable to larger U.S. banks.

Recommendation 53. Capital components. U.S. financial regulators should review all components of capital, with the active participation of the financial services industry, to make sure they are fully aligned internationally. The regulators should report their findings publicly.

Now that the Basel II Accord is in the process of being implemented internationally, we recommend that the U.S. financial regulators and their international counterparts undertake a joint review of the components of Tier 1 and Tier 2 capital to make sure that all instruments that provide capital-like support to an institution are recognized and treated consistently. Definitions of components of capital have not been reviewed for some time. In the meantime, accounting rules have continued to evolve. The migration to fair-value accounting is an example of a fundamental change in accounting practices that should be reflected in capital definitions. Furthermore, the end product will be better if regulators engage in an open and transparent assessment process within the industry.

Recommendation 54. Leverage ratio. The U.S. financial regulators should undertake a review of the continued role of the leverage ratio within the Basel II framework in the context of international competitiveness. The regulators should report their findings publicly.

While the leverage ratio ensures that every institution will maintain a certain, specific minimum level of capital, it can have unintended consequences. It can, for example, encourage institutions to acquire riskier assets because that greater risk does not carry any increased cost when the leverage ratio is the binding constraint. Moreover, the United States is one of the few countries that imposes a leverage ratio on financial institutions. We recommend that the federal banking agencies conduct an analysis of the continued need for a leverage ratio under the Basel II system. As Basel II is phased-in, regulators also will gain some additional insights into the empirical models used in Pillar 1 and will gain experience with the application of Pillars 2 and 3.

Recommendation 55. Comparable capital rules. The U.S. and international financial regulators should harmonize capital requirements across industry lines. Moreover, the Secretary of the Treasury, in the absence of a national insurance regulator, should begin a dialogue with U.S. insurers and the NAIC on the Solvency II process to ensure that the

requirements for U.S. and E.U. firms are comparable.[149]

With the convergence of many of the activities of financial services firms both in the United States and around the world, it is appropriate that capital rules for all financial firms be comparable. In this regard, we note that such a process is already underway in the E.U. for insurance firms.

The International Association of Insurance Supervisors (IAIS) is developing common principles and standards on solvency requirements to promote global transparency and harmonization. The Solvency II project at the European level also is promoting an economic risk-based approach with the goal of promoting efficient risk management by establishing a much closer link between an insurer's risk profile and the amount of capital it must set aside to cover those risks. The Treasury Department is in a good position to monitor these developments on behalf of the U.S. insurance industry and take the appropriate actions.

CASE STUDY 6: INSURANCE REGULATION

State-based regulation of the business of insurance has been in effect for almost 200 years. However, in today's national and global marketplace, state variations in insurance regulations - and how they are interpreted - inhibit the competitiveness of insurance firms and their ability to serve consumers. In this case study, we call upon the Congress to create a national insurance chartering system for insurers and producers (i.e., agents and brokers) as an optional alternative to state-based insurance regulation. Such a reform is consistent with Principles 1 (fair treatment for consumers), Principle 2 (open, competitive markets), Principle 3 (proportionate, risk-based regulation), Principle 4 (prudential supervision), and Principle 5 (charter options).

Historical context and current issues

The business of insurance has grown significantly since the state-based system of insurance regulation was established. It is no longer a local business, bounded by state borders. It is a national and international business. The U.S. insurance market is the largest in the world with $1.15 trillion in premium volume as of 2005. Japan and the U.K. trail the U.S. with $467 billion and $300 billion in premiums respectively.[150] Additionally, as of 2005, the total financial assets of U.S. property and casualty insurers exceeded $1.2 trillion, and the total financial assets of U.S. life and health insurers were almost $4.4 trillion.[151] In 2005, U.S. insurance firms (including reinsurers and producers) employed over 2.2 million individuals, or approximately 2.1 percent of total U.S. employment in private industry.[152]

The first state to charter an insurance company was Pennsylvania in 1792, and several other states soon followed.[153] Initially, state regulation of insurance was limited to required filings of financial reports with the state legislature or a state official. The first separate state insurance department was established in Massachusetts in 1853, and the first full-time insurance commissioner was appointed in New York in 1859. Within a decade, 35 states established their own insurance regulatory agency or assigned that responsibility to an existing state body.[154] In 1869, the Supreme Court ruled *(Paul v. Virginia)* that insurance was not part of interstate commerce.

In 1944 the Supreme Court overturned the *Paul* case and held that insurance was part of interstate commerce.[155] In response, Congress enacted the McCarran-Ferguson Act [156] to preserve the traditional role of the states as the sole regulatory authority over

149 Our proposed restructured President's Working Group on Financial Markets, if enacted into law, would be a logical place to monitor and report on Solvency II issues as they develop.

150 The Financial Services Fact Book, 2007, published by the Insurance Information Institute and the Financial Services Roundtable, p. 68.

151 Ibid., pp. 69 and 85

152 Ibid., p. 65.

153 H. Scott, Optional Federal Chartering of Insurance: Design of a Regulatory Structure 5 (Networks Financial Institution at Indiana University, March 2007).

154 A. Gart, Regulation, Deregulation and Regulation, (1994) pp. 103, 106.

155 United States v. South Eastern Underwriters Assn., 322 U.S. 533 (1944).

156 15 U.S.C. § 1011 et seq.

the insurance industry, unless a federal law specifically relates to the business of insurance.

Under the framework of the National Association of Insurance Commissioners, state insurance regulators have attempted to make the state-based system of regulation more uniform. However, insurance regulation continues to vary widely among the states. Even when the NAIC adopts a uniform proposed rule or law, individual states are not compelled to implement such proposals. Furthermore, even states that adopt the same uniform rule or law may administer or implement such rule or law differently. Varying, and potentially conflicting, state regulations not only complicate the operations of larger, multi-state insurers and producers and raise their costs for consumers, but also impede their ability to meet the needs of those same consumers.

Life insurers, which operate in multiple states, are increasingly frustrated with the costs and inefficiencies associated with this system:

> *Life insurers today operate under a patchwork system of state laws and regulations that lack uniformity and are applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that hinder companies and disadvantage their consumers.*[157]

Similarly, many property and casualty insurers have concluded that state rate regulation is often anti-competitive and disadvantages consumers:

> *. . . [T]he current system relies on outdated, discredited government price and product controls, which are rationalized by regulators in the name of 'protecting consumers,' but which, in truth, serve merely to interfere with the proper functioning of the private market – to the detriment of consumers. These controls are imposed in virtually every state, often in different and inconsistent ways. Even within each jurisdiction, there are often differing systems for different lines of business, making the process incredibly inefficient and ultimately unresponsive to consumer needs.*[158]

The state-based system of insurance regulation also has an impact on global competition. Because U.S. insurers lack a national regulator who can negotiate international agreements, the industry is not adequately represented in trade negotiations, and this fact limits the industry's access to foreign markets and its ability to meet the needs of consumers globally. While the NAIC and individual state regulators have been involved in some aspects of international trade negotiations, U.S. trade negotiators have a uniquely difficult challenge. Our trade negotiators must try to obtain concessions from other countries when they know that the United States cannot commit on a reciprocal basis. This challenge results from two fundamental aspects of the current U.S. insurance regulatory system: 1) the state-based regulatory system cannot be subject to commitments made at the negotiating table; and 2) the state-based regulatory system is characterized by anti-competitive features, such as price and product controls, which would be deemed unjustified barriers to trade if they existed in other countries. Thus, the state-based system of insurance regulation undermines the negotiating position of U.S. trade negotiators because the system is viewed by U.S. trading partners as a trade barrier that discourages entry into our market.

Similar challenges have arisen within other international regulatory settings. The International Association of Insurance Supervisors (IAIS) currently is working on several proposals regarding worldwide industry standards, including standards for solvency, accounting, collateral, and regulatory transparency. The United States, through the NAIC, participates in IAIS meetings. However, it is understood that no one representative from the United States can make any decision or commitment that is binding on the entire U.S. market. Therefore, despite participation by the NAIC, U.S. firms simply do not have an adequate

[157] Statement of John D. Johns, Chairman, President and CEO, Protective Life Corporation, on behalf of the American Council of Life Insurers before the Committee on Banking, Housing & Urban Affairs of the U.S. Senate on The Insurance Regulatory Structure, July 11, 2006, p. 3.

[158] Statement of Joseph J. Beneducci, President and Chief Operating Officer, Fireman's Fund Insurance Company, on behalf of the American Insurance Association, before the Committee on Banking, Housing & Urban Affairs of the U.S. Senate on The Insurance Regulatory Structure, July 11, 2006, p. 7.

representative at IAIS discussions. The result is that foreign, national-level regulators often support positions that are directly beneficial to their domestic firms, and U.S. firms have no effective advocate to represent their interests.

Given the limitations of state-based regulation, many insurers and producers have endorsed federal bills that provide for an optional national insurance chartering and supervisory alternative to state regulation.[159]

Applying principles to insurance regulation

The creation of an optional national insurance chartering system is consistent with several of the Commission's proposed principles for financial regulation. Principle 1 calls for the fair treatment of consumers. While state-based insurance regulation has been attentive to consumer protection, it does not serve all the interests of consumers. Overly prescriptive and inflexible product approval rules limit the availability of new products for consumers and stifles innovation. Rate regulations limit competition and the consumer benefits that flow from an open, competitive, and innovative market. The pending Congressional bills would replace strict product limitations and price controls with competitive pricing, disclosure requirements, and comprehensive market conduct rules.

Principle 2 calls for open, competitive, and innovative financial markets. While the business of insurance is open to new entrants, the state-based system of regulation is both cumbersome and costly for insurers and producers that operate in multiple states. Product approval requirements and price controls frustrate market innovations, and work to the disadvantage of consumers. In addition, the cost and complexity of obtaining multiple state licenses and complying with multiple state laws makes entry into the national markets significantly more difficult than entry into one state. Therefore, the current state regulatory system alone presents barriers to entry

and works to reduce competition in the insurance industry. Conversely, one national license and one uniform set of rules and interpretations will facilitate the entry of new insurers and producers. An optional national insurance regulatory system, structured along the lines of pending Congressional bills, would promote open, competitive, and innovative financial markets.

Principle 3 calls for proportionate, risk-based regulation. The existing state-based system of insurance regulation, with its overlapping and potentially conflicting requirements, is neither proportionate nor risk-based. Prices are regulated and often are not adequately responsive to underlying risks. An optional national chartering system, patterned after pending Congressional proposals, would be both proportionate and risk-based.

Principle 4 calls for a system of prudential supervision. The current system does not encourage a cooperative dialogue between insurers and regulators because it is overly prescriptive and often results in fines and penalties based upon nonsubstantive violations of minor rules and regulations. Differing administration and enforcement of existing rules and regulations, both from state to state, and often within a particular state, results in inconsistent consumer protection. Pending Congressional proposals to create an optional, national insurance chartering system would encourage a constructive engagement between insurance firms and the national insurance regulator

[159] H.R. 3200, 110th Cong. 1st Sess (2007); S. 40, 110th Cong. 1st Sess (2007).

that would promote compliance with applicable laws and regulations.

Principle 5 calls for the providers of financial products and services to have charter options. An optional national system would give insurers and producers a choice between state or national regulation and supervision. To provide a true option, continued efforts to modernize and improve the efficiency of the state regulatory system should be supported. Modeled after the dual banking system, a system of dual insurance regulation of comparable strength would promote the flexibility needed to respond to a changing market, promote product innovation, promote competition, and ensure consistent consumer protection. In other words, the creation of this option would not spell the end of state regulation. State regulation would continue to be a preferred option for the many insurers and producers that would continue to operate on a local basis, and under the pending Congressional bills, state regulation would remain in place for certain mandatory coverage, such as workers' compensation.

Proposed reforms

Optional national insurance charter (Recommendation 66). Congress should provide for the optional chartering, regulation, supervision and enforcement of national insurers, agencies, and individual insurance producers by a bureau of the Treasury Department. Nationally-chartered insurance firms, agencies and producers would be permitted to operate in any state with full competitive pricing, subject to one license and one set of prudential and market conduct rules.

The proposed National Insurance Act of 2007 provides for an optional national chartering and supervisory system for insurers and producers that is patterned after the dual banking system. Research by the Perryman Group has found that the impact of this proposal on the economy would drive growth in GDP and retail sales and create jobs in virtually every economic sector. The benefits of the proposal include regulatory and administrative cost savings, reduced delays in product introduction, and lower prices and greater mobility for insurance products. The Perryman Group's analysis estimates the magnitude of these potential gains, under baseline conditions, would be $38.4 billion in annual GDP and 362,015 individuals for permanent job creation.[160] For the insurance industry alone, another study found that the savings associated with the establishment of a national chartering option would exceed $5.7 billion annually.[161]

Insurers and producers that voluntarily select a national charter still would be subject to solvency and market conduct regulations, many of which would be based upon NAIC model laws. Further, no insurer could obtain a national charter without demonstrating sufficient managerial and financial resources to ensure successful operations. Nationally-chartered insurers and producers would be subject to a comprehensive system of regulation, examination, and enforcement. Indeed, the enforcement provisions of the bill are patterned after those Congress imposed on the banking industry after the thrift and banking crises of the late 1980s and early 1990s. Those provisions include civil money penalties that can be up to $1 million a day for intentional violations of law. Under the bill, nationally-chartered insurers could underwrite any form of insurance, including property and casualty insurance, life insurance, long-term care insurance, and disability insurance, and could engage in activities incidental to the business of insurance. The underwriting of health insurance is not authorized by the bill. The Commission calls upon the Congress to clarify that supplemental lines of insurance, such as supplemental health insurance, are

[160] "The Potential Impact of More Efficient Regulation of the Property/Casualty and Life Insurance Sectors on U.S. Business Activity," The Perryman Group (December 2006).
[161] "State Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength," Dr. Steve W. Pottier, Terry College of Business of the University of Georgia.

permissible for national insurers. Such lines provide income protection similar to other life insurance products and are typically offered by life insurers. The principle of open and competitive markets dictates that supplemental lines of insurance be authorized for national insurers.

Property and casualty insurance could not be written by the same company that writes life or annuity insurance. However, a holding company that registers with the Commissioner could own both a nationally-chartered life insurer and a nationally-chartered property and casualty insurer. Nationally-chartered agencies and producers could solicit or sell insurance for any insurer, federal or state, in any location.

The bill provides for the establishment of an Office of National Insurance within the Treasury Department, and for the appointment of a National Insurance Commissioner. It also provides for the establishment of a Division of Consumer Affairs within the Office to oversee the market conduct of national insurers and producers. The National Insurance Commissioner would have the same executive-level status as the OCC and the OTS. Also, like the OCC and OTS, the Secretary of the Treasury would be prohibited from interfering with the regulatory and supervisory activities of the Office. The costs of establishing and maintaining the Office of National Insurance would not fall upon taxpayers, but upon the insurance industry, which would fund the operations of the Office through annual assessments and fees.

Nationally-chartered insurers, agencies, and producers would be subject to exclusive national regulation for all of their insurance-related activities. On the other hand, nationally-chartered firms would be subject to various nondiscriminatory state laws, such as state tort and criminal laws. Nationally-chartered firms also would be subject to state tax laws, including state premium taxes. Therefore, no state would lose revenue based upon the enactment of this proposal, and the bill actually could benefit states by reducing tax-shifting strategies employed by some insurers.

Additionally, nationally-chartered insurers would be required to participate in state residual market programs and state guaranty associations. The residual market programs serve as an insurer of last resort for consumers who cannot obtain insurance in the normal market. The state guaranty associations protect policyholders in the event of the failure of a firm. The bill provides for the creation of a national guaranty association that would step in to protect policyholders if any state association fails to meet minimum protection standards within four years of the enactment of the bill.

Nationally-chartered insurers would not be subject to price controls. Price controls may be justified in markets with few competitors or in which participants may be inclined to engage in anti-competitive behavior. The insurance market does not fall into these categories, however. Instead, the insurance market consists of thousands of companies that actively compete on various levels, including price, where permitted. Globally, price controls in financial services are a relic of the past. Insurance is the last segment of the U.S. financial services market to be subject to this kind of competitive impediment. Moreover, the experience with state price controls indicates that they do not work nearly as well as free market competition to meet the needs of consumers. It is instructive to examine the experience of the state with the most competitive approach to auto insurance – Illinois. In 1969 Illinois instituted an open rating law. Under this law, prices for insurance products, including auto and homeowners insurance, are set by competitive market forces, rather than by the government. The Illinois Department of Insurance focuses on issues that are truly significant to consumers, such as ensuring that they receive fair treatment in the handling of claims and that insurers have the financial strength to pay their obligations. As a result, Illinois has a vibrant insurance market. More than 274 companies write private passenger auto insurance in the state of Illinois. Another indicator of the market's health is that it has one of the smallest residual markets of any state.[162] The current residual market is only 0.06 percent of total premiums written in Illinois. In place of price controls, nationally-

[162] The residual market is a market of last resort where those who cannot find insurance from the private market may purchase insurance policies.

chartered insurers would be subject to federal anti-trust laws.

While the bill could reduce the number of institutions subject to state regulation, the history of the dual banking system indicates that a strong system of state insurance regulation will remain necessary. Since the dual banking system was established in the mid-1860s, most commercial banks have continued to be state-chartered. In fact, today approximately two-thirds of all commercial banks are state-chartered. Nationally-chartered banks tend to be larger in asset size than state banks and collectively they control more than one-half of all commercial banking assets. Presumably, the enactment of the National Insurance Act of 2007 would have a similar impact on the insurance industry. That is, many of the nation's larger insurers and agencies would select a national charter to achieve uniform regulation, whereas smaller insurers and agencies that operate within a single state likely would choose to continue to be regulated by state insurance authorities.

The bill's reliance on state guaranty systems also should help to preserve state insurance systems. As we note elsewhere in this Blueprint, the vitality of the dual banking system has been eroded through limitations imposed on state banks under the banner of federal deposit insurance. The National Insurance Act of 2007 is structured to make the insurance industry, not the federal government or taxpayers, responsible for failures. This should prevent any unnecessary intrusion by the federal government on state regulation of insurers that remain state-chartered and state-regulated.

State insurance authorities view consumer protection as the paramount objective of state insurance supervision.[163] While the bill provides for regulation by a centralized, national authority, consumers would be well protected. National insurers and producers would be subject to comprehensive market conduct regulations, which would prohibit unfair methods of competition and unfair and deceptive acts and practices in the advertising, sale, issuance, distribution, and administration of insurance, including claims. These rules would be overseen by a special consumer division within the national insurance office. Moreover, the bill adopts a form of prudential regulation that is designed to minimize practices that may be harmful to consumers by subjecting firms to a regular examination cycle (every three years for insurers), and significant civil money fines for failure to comply with all applicable laws and regulations. Furthermore, the bill provides for the establishment of a minimum of six regional offices and places no limit on sub-regional offices.

The bill includes a number of provisions for producers, which have been endorsed by over 4,000 insurance agents nationwide.[164] Most significantly, the bill authorizes a national licensing option for producers. A key feature of this license is that it may be used on behalf of any insurer. In other words, a nationally-licensed producer may sell insurance not only on behalf of a new nationally-chartered insurance company, but also on behalf of an existing state licensed insurer. Moreover, the bill does not require a state-licensed producer to obtain a national license to sell insurance for a new nationally-chartered insurance company. State-licensed producers can use their existing state license to sell insurance for a nationally-chartered insurer as well as state-licensed insurers.

[163] Statement of Alessandro Iuppa, Maine Superintendent of Insurance and President of the National Association of Insurance Commissioners to the U.S. Senate Banking Committee, July 11, 2006.

[164] The National Insurance Act of 2007 has been endorsed by Agents for Change, a national association of insurance agents and brokers formed to promote optional national insurance chartering. See www.Agents4Change.net.

The major appeal of this national producer's license is that it authorizes an agent to sell insurance in any state. Today, a producer must obtain separate licenses in each state in which the producer sells insurance. Thus, the national license eliminates the administrative burdens and costs associated with maintaining licenses in multiple states.

To obtain a national producer license, a producer must meet educational and examination standards established by the new national insurance commissioner. Once licensed, a producer may be subject to periodic reporting requirements on activities, but would only be examined in response to a complaint or evidence that the producer has violated, or is about to violate, a law or regulation or agreement with the Commissioner.

The bill also establishes a national chartering option for agencies. A national agency may engage in the sale, solicitation, and negotiation of insurance for any insurer in any state, and may exercise all incidental powers necessary to carry out such activities, including claims adjustment and settlement, risk management, employee benefits advice, and retirement planning. National agencies also may own subsidiaries, provided the subsidiaries engage only in activities permissible for the parent agency.

The bill permits an existing state-licensed insurance agency to become a national agency (or vice versa), and permits mergers between national agencies and state agencies. Any entity that seeks to acquire control of a national agency must obtain approval from the Commissioner. Like nationally-licensed producers, national agencies would be subject to examination only in response to a complaint or evidence that the agency has violated a law or a regulation, or an agreement with the Commissioner.

In sum, the National Insurance Act seeks to provide insurance firms and producers with a national alternative to state regulation that builds upon the best of state regulation. It would permit insurance firms and producers to determine which chartering structure is best for their business plans and their customers.

CASE STUDY 7: SARBANES-OXLEY ACT, SECTION 404

In 2002, following the collapse of the Enron Corporation, WorldCom, and other newsworthy examples of corporate improprieties, Congress passed the Sarbanes-Oxley Act[165] to provide comprehensive changes in the area of corporate governance practices. While many provisions in the 2002 legislation were controversial, Section 404, in particular, was problematic for many public companies. Section 404 mandates both a management assessment on the effectiveness of internal controls and requires a registered public accounting firm to attest to and report on management's assessment. This case study notes recent initiatives by the SEC and PCAOB to modify compliance procedures to address the competitive impact of Section 404, and proposes methods for monitoring the implementation of those initiatives, consistent with Principle 2 (competitiveness), Principle 3 (proportionate and risk-based regulation), and Principle 4 (prudential supervision).

Historical context and current issues

It is highly unlikely that the Congressional authors of Section 404 anticipated that this provision would have created significant compliance concerns. In fact, the language in Section 404 was taken, almost word for word, from a provision in the 1991 Federal Deposit Insurance Corporation Improvement Act

[165] P.L. 107-204.

(FDICIA) that was applicable to insured banks.[166] For over ten years FDIC-insured banks complied with FDICIA requirements without significant objection. The different reaction to the same statutory provision resulted largely from its regulatory implementation, not from Congressional direction or intent.

Section 404, as enacted by Congress, is straightforward, and as written by Congress, would seem unlikely to impose a significant regulatory burden. It contains two mandates, one relating to the responsibilities of corporate managers, and the second relating to the responsibilities of public auditors.

With respect to corporate managers, Section 404 requires the SEC to issue regulations under the Securities Exchange Act of 1934 requiring each annual report filed under that Act to contain an internal control report. Under Section 404, the report is required to state the responsibility of management for establishing and maintaining adequate internal control structure and procedures for financial reporting, and to contain an assessment, as of the end of the fiscal year, of the effectiveness of the internal control structure and procedures for financial reporting.

For public auditors, Section 404 provides that with respect to the internal control report prepared by corporate management, the public accounting firm that issues the public audit for the company shall attest to and report on the management assessment of the effectiveness of the company's internal control structure and procedures for financial reporting. The attestation must be made in accordance with standards for attestation engagements issued by the PCAOB.

Section 404 is complemented by Section 302 of the Sarbanes-Oxley Act. Section 302 directs the SEC to issue regulations that, among other things, require the principal executive officer and the principal financial officer of a public company to certify that he or she is responsible for establishing and maintaining internal controls, and that all significant deficiencies in the design or operations of the internal controls have been reported to the public auditor. These officers also have to report on any "significant changes" in internal controls or other factors that could significantly affect internal controls.

The original SEC implementing regulations and interpretive releases did not provide guidance to corporate managers with respect to their evaluation of the effectiveness of their company's internal controls. Given the absence of such guidance, management sought to conduct their internal control evaluation consistent with the audit standards issued by the PCAOB on internal controls.[167] The initial PCAOB Audit Standard (AS 2) took an overly prescriptive approach to the requirements of Section 404. As a result, public companies were saddled with excessive and expensive regulatory burden that had a direct and adverse impact on the competitive position of U.S. markets.

Excessive regulatory costs

The most fundamental problem with the original implementing rules and accounting standards was that compliance with these regulatory mandates burdened the U.S. economy with excessive costs that were out of proportion to actual benefits. The initial regulations were expected to require five hours of work per quarterly report, and $91,000 per company.[168] Aggregate costs for the economy initially were estimated to be $1.6 billion. By 2004, estimates of the actual compliance costs incurred by the accelerated filers then subject to the rule reached $4.36 million per company, with an aggregate cost to the economy of $35 billion.[169] In addition to these quantitative costs, companies also experienced costs in the form of the diversion of management time and attention away from running the business and performing other strategic and governance activities.

[166] FDICIA § 203, codified at 12 USC § 1831m.

[167] Auditing Standard No. 2, March 9, 2004, effective pursuant to SEC Release 34-49884, June 17, 2004.

[168] SEC Release Numbers 33-8238 and 34-47986, January 27, 2003.

[169] Chairman Miller's "Memorandum to Members of the Government Reform Subcommittee," March 29, 2006.

Regulatory response

The SEC and the PCAOB were made aware of these concerns during a public roundtable meeting on internal controls, held on April 13, 2005. As a result, the SEC issued a "Staff Statement" on internal controls on May 16, 2005,[170] and the PCAOB issued a Policy Statement and Question and Answer Document on the same date.[171] These issuances recognized that legitimate concerns had been raised about the implementation of Section 404, and suggested a more flexible approach for both public auditing companies and corporate management. Following the releases, it was predicted that compliance costs would be significantly reduced.[172] However, the actual reduction in costs was much less than anticipated,[173] and the industry criticisms of the requirements continued unabated.[174]

The SEC and PCAOB responded by holding another public roundtable discussion on May 10, 2006. In December 2006 the SEC proposed new interpretive guidance for corporate management's use in conducting the annual evaluation of internal control over financial reporting that is required under Section 404. At the same time, the PCAOB proposed a new auditing standard (Auditing Standard No. 5). However, the PCAOB proposal and the SEC proposal were not entirely consistent, and concerns were raised that the accounting standards did not fully deal with the problems identified in AS 2. In light of these comments, the SEC embarked on a more coordinated effort with the PCAOB to provide consistent rules for both management and the accounting profession.

On May 23, 2007, the SEC issued final interpretive guidance and regulations.[175] A few days later, the PCAOB published a revised version of AS 5,[176] which was ratified by the SEC on July 25, 2007. The SEC also finalized a new definition of the term "significant deficiency" on that date.[177]

The SEC and the PCAOB have addressed the most significant concerns

The response of both the SEC and the PCAOB may be viewed as a casebook example of how regulatory agencies can modify regulatory policies in light of public comments and persuasive evidence that the original regulatory mandates were producing unintended consequences that are harmful to the competitive position of U.S. companies.

The new rules and interpretive guidance should help to promote greater cost efficiency and scalability. They allow company management and the outside auditing firm to concentrate on material risks to financial reporting and the controls for addressing those risks. The use of professional judgment is encouraged, while the prescriptive nature of the regulatory mandates and accounting standards are reduced. Regulatory inconsistencies are eliminated, and documentation requirements are more reasonable.[178]

Applying principles to Section 404

The implementation of Section 404 of Sarbanes-Oxley should be guided by Principle 3 (proportionate, risk-based regulation) and Principle 4 (prudential supervision). The costs of 404 compliance alone indicate that this requirement has been out of proportion to actual benefits. Similarly, until recently, neither the SEC nor the PCAOB has pursued what we would consider a prudential form of supervision. Section 404 was enacted over five years ago, and only within the past year have these agencies engaged the

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[170] SEC Division of Corporate Finance, Office of Chief Accountant, "Staff Statement on Management's Report on Internal Control over Financial Reporting," May 16, 2005.

[171] PCAOB, Release No. 2005-009, May 16, 2005.

[172] Section 404 costs were expected to decline by approximately 40 percent.

[173] According to a March 2006 study conducted by Financial Executives International, the cost of compliance with Section 404 for the average public company was reduced, but still remains excessive at $3.7 million per company. FEI, "FEI Survey on Sarbanes-Oxley Section 404 Implementation," March 2006.

[174] Testimony of Grace Hinchman, Senior Vice President, FEI, before the U.S. House of Representatives Subcommittee on Regulatory Affairs, April 5, 2006.

[175] 72 Fed. Reg. 35310 (2007).

[176] Auditing Standard No. 5, June 12, 2007, effective pursuant to SEC Release No. 34-56152, July 27, 2007.

[177] 72 Fed. Reg. 44924 (2007).

[178] This is not to say that there is no room for improvement. For example, AS 5 could provide additional clarity with respect to the definition of what should be considered a "material" misstatement in a financial report.

industry in a serious dialogue over its operation.

The recommendations offered below are intended to ensure that the SEC and PCAOB apply the internal control requirement in a proportionate, prudential fashion going forward. Measuring and monitoring performance of all parties and reporting on the results are critical to this ongoing effort.

POLICY REFORM VII. SOX IMPLEMENTATION.

Policymakers, regulators, and the financial services industry should monitor the implementation of recent regulatory initiatives to enhance the implementation of Sarbanes-Oxley Section 404 and, based on the results of this monitoring, take appropriate actions as necessary. Specifically:

Recommendation 56. Methodology. Both the regulatory agencies and the industry should establish a methodology for monitoring and measuring the impact of recent initiatives to enhance the implementation of Sarbanes-Oxley Section 404. Specifically, they should jointly establish benchmark levels for the time and cost involved in Section 404 compliance, (e.g., the number and type of process and entity-level controls examined, and the number of deficiencies identified). Public companies, the regulatory agencies, and the accounting industry should compare the actual implementation burden with the benchmarks and if the benchmarks are exceeded, further study and modification should be undertaken.

The new SEC and PCAOB guidance and accounting standards are a considerable improvement and address most of the concerns raised by the prior implementation standards. However, it is important for the regulators and the industry to jointly monitor the use of these standards by the public accounting firms and quantitatively determine if the revised regulatory compliance requirements are cost-effective.

There should also be continued focus on transitioning to a rotational testing standard and thus, for example, instead of testing all key controls each year, one-third of a company's key controls would be tested on an annual basis, while continuing to annually update process risk assessments. This approach would reduce costs while keeping companies focused on maintaining current internal control design assessments. More emphasis and reliance should be placed upon company-wide controls. If strong company-wide controls are identified and tested to be operating effectively, then there should be a reduction in the necessary work performed at the process level.

Further, the SEC and PCAOB should better define the information technology (IT) scope of Section 404 audit applicability and focus. The IT emphasis has been interpreted by the external auditors far too broadly, and, in fact, their IT scope appears to be expanding every year. External auditors are struggling to clearly define for their clients the appropriate level of IT controls documentation to achieve the intended scope and focus of Section 404. A company's IT approach should, for SOX 404 purposes, remain primarily focused on significant applications truly critical to the accurate reporting and presentation of financial data. The SEC should work through the Committee of Sponsoring

Organizations (COSO)[179] and other organizations to ensure that additional management-focused guidance on SOX 404 compliance is developed and made available, particularly in areas of IT controls (e.g., access, application, change, and security), testing (e.g., requirements, plans, methodologies and sample size), scoping (e.g., risk assessment, relationship to other controls, process and sub-processes), and various definitions (e.g., key controls, application, general controls).

Recommendation 57. SEC supervision of the PCAOB. The SEC should take a more active supervisory role with the PCAOB to ensure the PCAOB takes a more balanced role in executing its responsibilities and in the furtherance of the SEC's mandate for competitiveness, efficiency, and capital formation.

The SEC has the statutory responsibility to supervise the PCAOB and to approve its regulations. The SEC should be an active participant not only in the development of PCAOB policies and regulatory standards but also in the assessment of the implementation of PCAOB policies and regulatory standards to ensure that the PCAOB standards, and the implementation of those standards, are consistent with SEC policies and goals, especially with respect to its mandate to enhance competitiveness, market efficiency, and capital formation in the United States.

Recommendation 58. Roundtable survey. The Financial Services Roundtable should take a leading role in monitoring the implementation of the new SEC and PCAOB Section 404 guidance.

The Financial Services Roundtable can play a leading role in monitoring the implementation of Section 404, including compliance by the accounting industry. As part of this effort, the Roundtable can undertake a periodic survey of member companies to determine if the new standards are, in fact, being implemented as intended by the accounting profession in a cost-effective way and to determine if additional regulatory modifications are necessary. The aggregate results of these surveys, as well as any additional recommendations, should be shared with the SEC and PCAOB.

Recommendation 59. PCAOB industry participation. The PCAOB should be expanded to include a representative of the public reporting companies.

The PCAOB currently is composed of five members, appointed by the SEC, after consulting with the Chairman of the Federal Reserve Board and the Secretary of the Treasury. There is no PCAOB seat specifically designated as representing the interests of public companies. We recommend that either one of the five seats be so designated or that the PCAOB should be expanded to include an additional seat.

Recommendation 60. Periodic public reporting. The PCAOB should be required to make both annual and quarterly public reports. These reports should include information on the Board's proposed regulatory agenda, the status of the implementation of PCAOB policies, the existence of identified problem areas and explanation of the cause of these problems, and a summary of significant comments raised to the PCAOB by the public, public reporting companies, or the accounting industry.

The PCAOB currently is required to submit an annual report to the SEC, which is then required to forward

[179] The Committee of Sponsoring Organizations (COSO, also known as the Treadway Committee) was formed in 1985 to combat fraud in financial reporting.

that report to Congress. However, the statute does not specify the matters to be discussed in the annual report that are of greatest interest to public companies and the accounting industry.

CASE STUDY 8: U.S. AND INTERNATIONAL ACCOUNTING

High-quality financial reporting, comprehensible accounting standards, and effective audits are critical components of vibrant financial markets. Companies rely on all three to manage their businesses and attract and retain capital. Investors rely on them to make decisions about where to place their capital to earn an attractive return relative to competing investments – domestically as well as globally – based on collective information they can trust. Creditors and credit rating agencies also need to understand the true economic performance and health of businesses to fulfill their roles in financial markets.

In this case study, we recommend reforms to maintain the quality of accounting standards, but improve comparability and efficiency of financial reporting across global markets, consistent with Principle 1 (fair treatment for consumers) and Principle 2 (open and competitive markets). Our recommendations to accelerate needed reforms in U.S. accounting and reporting standards flow from our preference for more principles-based accounting regulation in general.

Historical context and current issues

There has been increased attention on the important role that accounting standards play in the global competitiveness of financial markets. Moreover, there has been a growing debate about the international use and acceptance of U.S. generally accepted accounting principles (GAAP) compared to International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board (IASB), and whether IFRS[180] will eventually become the global standard.[181]

In the past few years, there has been an increasing interest in a single set of high-quality, global accounting standards that can be applied consistently and recognized universally and, hence, would lower the cost of capital by eliminating the complexity of multiple financial reporting regimes with varying standards. IFRS is more principles-based than U.S. GAAP, which is more rules-based. IFRS is being used in over 100 countries and rapidly expanding. Given the growth in global financial markets, it is reasonable to assume that investors relying on IFRS are receiving the information they need to make informed economic decisions.

In 2002, the European Union decided to require that E.U. listed companies comply with IFRS for their consolidated financial statements as of January 1, 2005. Further, other non-E.U. countries such as Australia and many others began to base their local accounting standards on IFRS. Given the rapidly expanding usage of IFRS, former SEC Chief Accountant, Donald Nicolaisen, published his landmark "Roadmap" article in 2005 that proposed a plan whereby foreign companies listed in the United States that prepared their financial statements based on IFRS would not have to go to the trouble and expense of reconciling them to GAAP.[182]

Beyond discussions at the working technical level, policy officials have taken note of those issues as they affect the competitiveness of U.S. financial markets.

[180] The IASB is an independent, privately-funded accounting standard-setter based in London. The IASB is committed, in the public interest, to developing a single set of high quality, understandable, and enforceable global accounting standards that require transparent and comparable information in financial statements.
[181] PriceWaterhouseCoopers, "Viewpoint: Convergence of IFRS and US GAAP," April 2007 (www.pwc.com/viewpoint).
[182] Donald T. Nicolaisen, "Statement of SEC Staff: A Securities Regulator Looks at Convergence," Northwestern University Journal of International Law and Business (April 2005).

New York Mayor Bloomberg and Senator Schumer were among the first public officials to question "incompatible [U.S.] accounting standards" as the national policy debate on U.S. competitiveness in financial services moved into high gear last year.[183] The U.S. Chamber addressed the issue of the need for accounting reforms extensively in its report. U.S. Treasury Secretary Paulson describes our accounting system as "the lifeblood of our capital markets,"[184] and notes that, while setting a high bar historically, U.S. accounting standards were involved in recent corporate scandals related to the manipulation and the smoothing of earnings. "Capital markets rely on trust, which is based on financial information presumed to be accurate and reflect economic reality," Secretary Paulson stated: "The ultimate responsibility for accurate and transparent financial statements must rest with management."[185]

Increasingly, U.S. GAAP is viewed as being out of sync with the global trend in favor of the more principles-based IFRS. The adoption of IFRS by more than 100 countries in the past two years has been described as "one of the biggest revolutions in financial reporting in living memory," according to a recent KPMG report.[186] Continuing, the KPMG study acknowledges: "The financial reporting community globally – standards setters, regulators, accounting firms, preparers, and users – needs to find a way of stripping back this complexity, and of ensuring that sound accounting principles are allowed to drive reporting, without the need for dense disclosure notes or a narrow rules-driven approach."[187] This situation puts the United States in the position of being at odds with the global financial marketplace where IFRS has become the preferred standard across the vast number of national borders.

There are a variety of issues related to relying on different and divergent accounting standards for both domestic and global investors and companies. First, differences in accounting standards across markets add complexity for investors, who have to first understand and then be able to compare complex financial statements presented with varying standards for information and transparency; they also increase costs for companies that must file different and sometimes reconciled statements in multiple jurisdictions. Historically, the U.S., through the SEC, has required reconciliation of all foreign firms' financial statements prepared on a non-GAAP basis to U.S. GAAP, an issue cited in the Bloomberg-Schumer and the U.S. Chamber reports as an additional factor that detracts from the competitiveness of U.S. financial markets. As previously stated, IFRS is a set of high quality accounting standards that produce high quality information for companies, investors, creditors, and others to make informed economic decisions; thus a reconciliation to U.S. GAAP provides no benefit for investors. Indeed, investors have stated publicly that the U.S. GAAP reconciliation is not used for making economic decisions and, therefore, is superfluous. As noted below, the SEC is considering this issue.

Second, if reputable foreign firms do not list here, in part because of U.S. accounting issues that are not in harmony with other mature and emerging markets, then U.S. investors are at a competitive disadvantage. They are disadvantaged not only in terms of their choice of options for investments but also in the ability to better diversify their portfolios across world markets without the additional complexity and costs of setting up foreign accounts with brokers in other countries. Forcing companies to reconcile financial statements across markets, in lieu of mutually recognizing the increasingly accepted standard of IFRS, also can slow the delivery of timely information to investors.

183 Bloomberg-Schumer, Wall Street Journal, November 1, 2006 at A18.

184 Henry M. Paulson, Secretary of the Treasury, "Paulson Announces First Stage of Capital Markets Action Plan," press release HP-408, Washington, D.C., May 17. 2007.

185 Paulson, New York Economic Speech.

186 "Accountants in the world uniting in IFRS revolution," Financial Times, June 21, 2007, at 18. KPMG, International Financial Reporting Standards: The Quest for a Global Language (KPMG UK, LLC, 2007) p. 2; www.kpmg.co.uk.

187 KPMG, ibid.

Third, efforts to promote the convergence of GAAP and IFRS are currently underway at the appropriate policy level internationally, but they have a long way to go before convergence is achieved. Discussions by the SEC and the Financial Accounting Standards Board (FASB) and their international counterparts at the IASB are ongoing, but there is no public timetable for achieving the resolution of an acceptable system of converged accounting standards.

Applying Principles to U.S. and International Accounting

Consistent with the desire for a set of general guiding principles that cut across the financial services marketplace, the Commission believes specifically that Principle 1 (fair treatment for consumers) and Principle 2 (open, competitive markets) apply directly to the issue of competing accounting standards globally. The next section describes three driving reasons why policymakers should apply these two principles when they design changes to financial reporting policies, principles, and practices in the future.

Investors, companies, and financial markets benefit from the widely accepted use of high-quality global accounting standards. Financial markets work best when they receive accurate, timely, and transparent information that allows all participants – investors, companies, and regulators – to make informed investment, business, and regulatory decisions. High-quality financial information should flow naturally from equally high quality accounting standards, regardless of whether they are U.S. GAAP or the English language version of IFRS as published by the IASB (not IFRS as promulgated by a multitude of specific jurisdictions).[188] As Treasury Secretary Paulson noted in announcing the first stage of the Administration's Capital Markets Action Plan: "A transparent financial reporting system and vibrant auditing profession form the backbone of a marketplace investors can trust. Any plan to strengthen our capital markets must be based on this principle."[189] Moving towards a more principles-based

approach to accounting, while admittedly requiring more judgment and a more open dialogue between companies, auditors and regulators, should help to simplify the current system and facilitate eventual convergence of accounting standards.

Two recent announcements that support Principle 2 are noteworthy and should help to enhance the quality and effectiveness of U.S. financial reporting. First, on May 17, 2007, Treasury Secretary Paulson announced the formation of a new nonpartisan committee to develop recommendations to consider options for strengthening the industry's financial soundness and its ability to attract and retain qualified people. Former SEC Chairman Arthur Levitt, Jr., and former SEC Chief Accountant Donald T. Nicolaisen will serve as co-chairs.

Second, on June 27, 2007, the SEC announced the formation of a new Advisory Committee on Improvements to Financial Reporting, chaired by Robert C. Pozen, chairman of MFS Investment Management. The purpose of the advisory committee is two-fold: 1) reduce unnecessary complexity in the U.S. financial reporting system; and 2) make information more useful and understandable for investors. SEC Chairman Cox indicated that the committee would conduct its work with a

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[188] Roel C. Campos, Commissioner, Securities and Exchange Commission, "Remarks at the SEC Open Meeting: IFRS/U.S. GAAP Reconciliation," Washington, D.C., June 20, 2007.

[189] Henry M. Paulson, Secretary of the Treasury, "Paulson Announces First Stage of Capital Markets Action Plan," press release HP-408, Washington, D.C., May 17. 2007.

view toward removing practical and structural impediments that reduce transparency and/or unnecessarily increase the cost of financial reporting to the detriment of investors.[190] This SEC Advisory Committee held its first meeting in August to review a white paper and identify five issues to review further (substantive complexity, standard setting process, audit process and compliance, delivering financial information, and international coordination).[191]

Convergence of GAAP and IFRS should improve the quality of information to investors, companies, and financial markets globally. Convergence of GAAP and IFRS should be encouraged and pursued as rapidly as possible, consistent with Principles 1 and 2 as recommended by the Commission. As Treasury Secretary Paulson has stated: "The increasing globalization of our markets means that we must enhance the comparability of foreign company financial statements."[192]

Recognizing that the ultimate convergence into a single set of global accounting standards embraced by all financial markets may take considerable time, reaching a point of "reasonable convergence" along the way - where different but compatible high-quality standards allow the investor or the business executive to arrive at the same fundamental understanding when reviewing a financial statement in either GAAP or IFRS – will be a critically important milestone in the journey to perfect convergence of competing standards.

Mutual recognition of GAAP and IFRS with full disclosure is an acceptable interim arrangement to reduce complexity and lower costs on both investors and companies before full convergence is achieved. The Bloomberg-Schumer report also was one of the first major policy statements to support the mutual recognition of GAAP and IFRS by the SEC as a reasonable and important interim step.[193] The U.S. Chamber's report also endorsed the concept of convergence and mutual recognition, and recommended eliminating immediately the reconciliation requirement from companies in those IFRS countries that were in "substantial compliance" with SEC requirements through their own-home requirements. The U.S. Chamber recommended that this be done on a case-by-case basis, and reconciliation would not be required where a country is found to be in substantial compliance with U.S. rules. The U.S. Chamber also recommended that the foreign country provide reciprocity for U.S. companies in its home market.

Since these reports were issued, the SEC announced two major efforts to accomplish the goal of mutual recognition and eliminate the need for reconciliation. First, on July 3, 2007, the SEC issued a proposal to eliminate the need for reconciliation to GAAP by foreign private issuers filing their financial statements using the English language version of IFRS as published by the IASB. In issuing the proposal, the SEC stated that this proposal "represents another significant action to tailor the regulatory environment for foreign companies in the U.S. public capital markets."[194] Second, on July 25, 2007, the SEC agreed to publish a Concept Release for 90-days' public comment, which would allow U.S. issuers, including investment companies, to prepare financial statements using IFRS as published by the IASB.[195] The Treasury Department also supports these SEC initiatives.[196]

POLICY REFORM VIII. MODERN ACCOUNTING STANDARDS.

Reforms in U.S. accounting and reporting standards need to be accelerated to improve comparability and

[190] U.S. Securities and Exchange Commission, "SEC Establishes Advisory Committee to Make U.S. Financial Reporting System More User-Friendly for Investors," SEC press release 2007-123, Washington, D.C., June 27, 2007.

[191] See SEC website (http://www.sec.gov/about/offices/oca/acifr.shtml)

[192] Ibid.

[193] Bloomberg-Schumer Report.

[194] U.S. Securities and Exchange Commission, "SEC Soliciting Public Comment on Eliminating Reconciliation Requirements for IFRS Financial Statements," press release 2007-128, Washington, D.C., July 3, 2007. The SEC proposal includes a 75-day public comment period

[195] "SEC Solicits Public Comments on Role of IFRS in the U.S.," SEC press release 2007-145, July 25, 2007.

[196] Paulson, op. cit.

efficiency of financial reporting across global markets. Policymakers, regulators, and public companies including financial services firms should continue to advocate improving U.S. accounting standards. Specifically:

Recommendation 61. Current initiatives. Policymakers, regulators, and public companies including financial services firms should support current policy efforts by the Treasury Department, the SEC, FASB and the IASB to improve financial reporting and accounting.

Current efforts to improve financial reporting and accounting should continue as rapidly as possible, with a full opportunity for public comment by the private sector to help structure practical, cost-effective solutions. These efforts include the current work of the Treasury Department, the SEC, and the FASB to improve financial reporting and reduce unnecessary costs of reporting and compliance without negatively affecting investors.

Recommendation 62. IFRS. Policymakers and regulators should permit the full use of IFRS now without reconciliation to GAAP. Both the Roundtable and individual member companies should participate in the current public comment period and any future considerations.

The SEC's current initiative announced in June 2007 to push for mutual recognition of other high quality reporting regimes, most notably the English language version of IFRS as endorsed by the IASB, including the elimination for reconciliation of IFRS with GAAP, should proceed on schedule and without delay.[197] Moreover, equal treatment and management choice of either standard should be provided to all companies under this policy; namely, both foreign and domestic companies should be able to choose either GAAP or IFRS for financial reporting purposes, based solely on what management believes is in the best interests of its shareholders, depending on the mix of its business strategies, consumers served, and geographic reach.

Recommendation 63. Convergence. Policymakers and regulators, with support from public companies including financial services firms, should accelerate the convergence of IFRS and U.S. GAAP.

Current efforts directed at promoting greater accounting convergence, and reaching an interim point of "reasonable convergence" as soon as possible, should proceed over a defined, transparent time-line agreed to by the SEC, FASB, and IASB. The opportunity for public comment should be included at regular intervals for meaningful private sector input as the work continues. Efforts to converge U.S. GAAP and IFRS, which are achieving results, are already underway and overseen by the appropriate authorities and should be continued with deliberate speed and ongoing input from the private sector. As the Bloomberg-Schumer report noted: "The accelerated convergence of two high-quality standards will

[197] Securities and Exchange Commission, Proposed Rule: Acceptance from foreign private issuers of financial statements prepared in accordance with international financial reporting standards without reconciliation to U.S. GAAP (Release Nos. 33-8818, 34-55998, 17 C.F.R. Parts 210, 230, 239, and 249), July 2, 2007. Comments are due by September 24, 2007.

reduce regulatory compliance costs without undermining investor protection or impairing market information."[198]

Recommendation 64. Transition. Policymakers and the regulators should allow an appropriate transition period to educate issuers, investors, accountants, and others on IFRS.

A structured transition to a new set of accounting standards is important to give all market participants an opportunity to adjust the manner in which they conduct their financial reporting. The move to greater use of IFRS in the United States, including permitting U.S. companies to use IFRS without reconciliation to GAAP, will require just such a structured transition period. A transition period is necessary to educate preparers, investors, and regulators. The E.U., for example, used a 3-year transition period to allow companies, accounting firms, and others sufficient time to prepare for full IFRS. However, given the quality of information being produced under IFRS and given that U.S. investors are familiar with the information prepared by IFRS filers registered in the U.S., we recommend that IFRS filers registered in the U.S. be exempted from the requirement to reconcile their IFRS financial statements to GAAP as soon as possible.

[198] Bloomberg-Schumer Report, p. 23.

Chapter 4 – Enhancing Charters and Creating New Options for Serving and Protecting Consumers

It often is noted that no one intentionally would design our system of regulation for financial services firms. Our existing system consists of a range of organizational options for firms to serve their consumers, including a variety of charters and financial holding company structures through which a single organization may engage in banking, securities, and insurance activities through subsidiaries and affiliates. It also consists of an array of state and national agencies as well as self-regulatory organizations that have overlapping, and sometimes conflicting, missions and responsibilities.

While complex, this system of multiple charters, organizing structures, and regulators has contributed in the past to the vitality of the U.S. financial services industry. Supervisory attention to the solvency of firms, consumer protection, and investor protection has generated public confidence in U.S. financial services firms. A general reliance on market forces in lieu of price regulation has facilitated the growth of U.S. financial services firms and markets.[199]

Organizational options for firms have allowed managers to select structures suited for a wide variety of corporate strategies for serving consumers.

At the same time, the costs and inefficiencies inherent in this complex system impact the competitiveness of U.S. financial services firms and their ability to serve their consumers. Insurance firms find that it can take years to gain regulatory approval for new products and services. Banking and securities firms may be subject to examination by multiple state and national agencies and self-regulatory organizations. State-licensed lenders are often not subject to the same standards as federally-regulated lenders. The formulation and adoption of important regulatory policies are sometimes subject to protracted delays because of differences in regulatory missions.

Most recently, Treasury Secretary Paulson launched a new examination of regulatory structure as part of his comprehensive review of the U.S. competitive position.[200] During the past 50 years, however, there have been numerous proposals to reform the U.S. financial regulatory system. Many of these past proposals have called for the consolidation of national financial regulatory agencies or the realignment of existing supervisory powers.[201] All have failed

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[199] Rate regulation for insurance products is an exception to this general approach.

[200] Henry M. Paulson, Jr., "Paulson Announces Next Steps to Bolster U.S. Markets Global Competitiveness," June 27, 2007, HP-476.

[201] In 1961 the Commission on Money and Credit recommended that the supervisory and regulatory functions of the OCC and FDIC be transferred to the Federal Reserve Board. (Report of the Commission on Money and Credit 174 [1961]). Later, in the 1960s, the Federal Reserve Board took a different approach, suggesting that its bank regulatory responsibilities, along with those of the OCC and FDIC, be transferred to a new agency, the Federal Banking Agency. (J. Robertson, "Federal Regulation of Banking: A Plea for Unification," 31 Law and Contemporary Problems 673-695 [1966]). In 1971, the President's Commission on Financial Structure and Regulation (the Hunt Commission) supported the creation of two new agencies: the Administrator of National Banks, to take over the functions of the OCC, and an Administrator of State Banks, to take over the supervisory functions of the Federal Reserve and the FDIC. In 1975 the House Banking Committee issued a report entitled "Financial Institutions and the Nation's Economy (FINE)," which recommended the establishment of a Federal Depository Institutions Committee as the sole safety and soundness regulator for all depository institutions. (R. Kushmeider, "The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation," 17 FDIC Review 25 [2005]). More recent proposals include "Blueprint for Reform," issued in 1984 by then-Vice President Bush (Task Group on Regulation of Financial Services, Blueprint for Reform [1984]). The "Blueprint" called for the establishment of a Federal Banking Agency that would replace the OCC and would have the authority to regulate, supervise, and examine all national banks and all holding companies in which the national bank was the largest bank. It further proposed that the Federal Reserve would have the corresponding authority for state banks and their holding companies, as well as for approximately 50 "international-class" holding companies regardless of the charter of the lead bank. In 1991 the Treasury Department issued a report entitled "Modernizing the Financial System," which again called for the establishment of a Federal Banking Agency to regulate all national banks and all savings associations, and the OCC and OTS would be abolished. That report also proposed that the Federal Reserve would take over the supervisory functions of the FDIC for state banks, and that holding company regulation would be a joint responsibility of the new agency and the Federal Reserve. In 1993 President Clinton proposed consolidating the federal bank and thrift regulatory agencies into a new Federal Banking Commission, and limiting the FDIC's role to deposit insurance and the resolution of failed institutions. Under President Clinton's plan, the Federal Reserve's function would have been limited to monetary policy, but it also would have been permitted to participate in a number of depository institution examinations for all holding companies above a certain size. Most recently, an early version of the bill that eventually became the Gramm-Leach-Bliley Act called for the establishment of the National Council on Financial Services, composed of the Secretary of the Treasury, Chairman of the Federal Reserve, the FDIC, the SEC, the CFTC, the Comptroller of the Currency, a state securities regulator and a state banking regulator, and two Presidential appointees.

because of a combination of industry, agency, and Congressional opposition. Existing regulatory agencies naturally are reluctant to cede regulatory authority to another existing or newly created agency. Industry participants naturally worry about the potential for negative consequences. Recent calls within the banking industry for the preservation of both the OCC and the OTS as separate entities are illustrative of the inherent resistance to regulatory restructuring, despite the overlapping missions of these agencies. Finally, Congressional committees naturally resist changes that would deprive them of jurisdictional authority.[202]

Given this history, the Commission on Enhancing Competitiveness has taken a different approach to regulatory reform. Rather than restructure existing regulatory agencies, the Commission proposes to: 1) enhance existing depository institution charters so they may better serve consumers now; and 2) create new optional national charters that would enable financial services firms to serve and protect consumers better in the future.

State and national banks and thrifts are subject to a number of requirements that have been imposed in response to market conditions that no longer exist or that are no longer of concern for policy reasons. Geographic constraints on interstate and intrastate operations are an example. Such requirements are outmoded in an environment in which banking operations can be conducted over the Internet. Eliminating out-dated or redundant requirements on existing depository institution charters would enhance the competitiveness of these institutions and enable them to serve and protect consumers better.

Likewise, new optional national charters for insurance, securities, and universal financial services would enable financial services to serve and protect consumers better in the future. Such charters would give financial firms, especially those that serve consumers nationally and globally, a more modern platform and a single regulatory agency to oversee their operations. These new charters would supplement and complement the existing financial regulatory system.

This chapter begins with a discussion of the history of the regulation of the banking, securities, and insurance industries in the United States. That discussion provides context for the specific reform recommendations set forth in the second half of the chapter.

BACKGROUND ON U.S. FINANCIAL REGULATORY SYSTEM

Functional regulation and supervision

The U.S. system provides for the regulation and supervision of specific financial institutions and financial activities by separate, specialized agencies.[203] This approach to regulation and supervision, commonly called "functional" regulation and supervision, was recognized formally by Congress

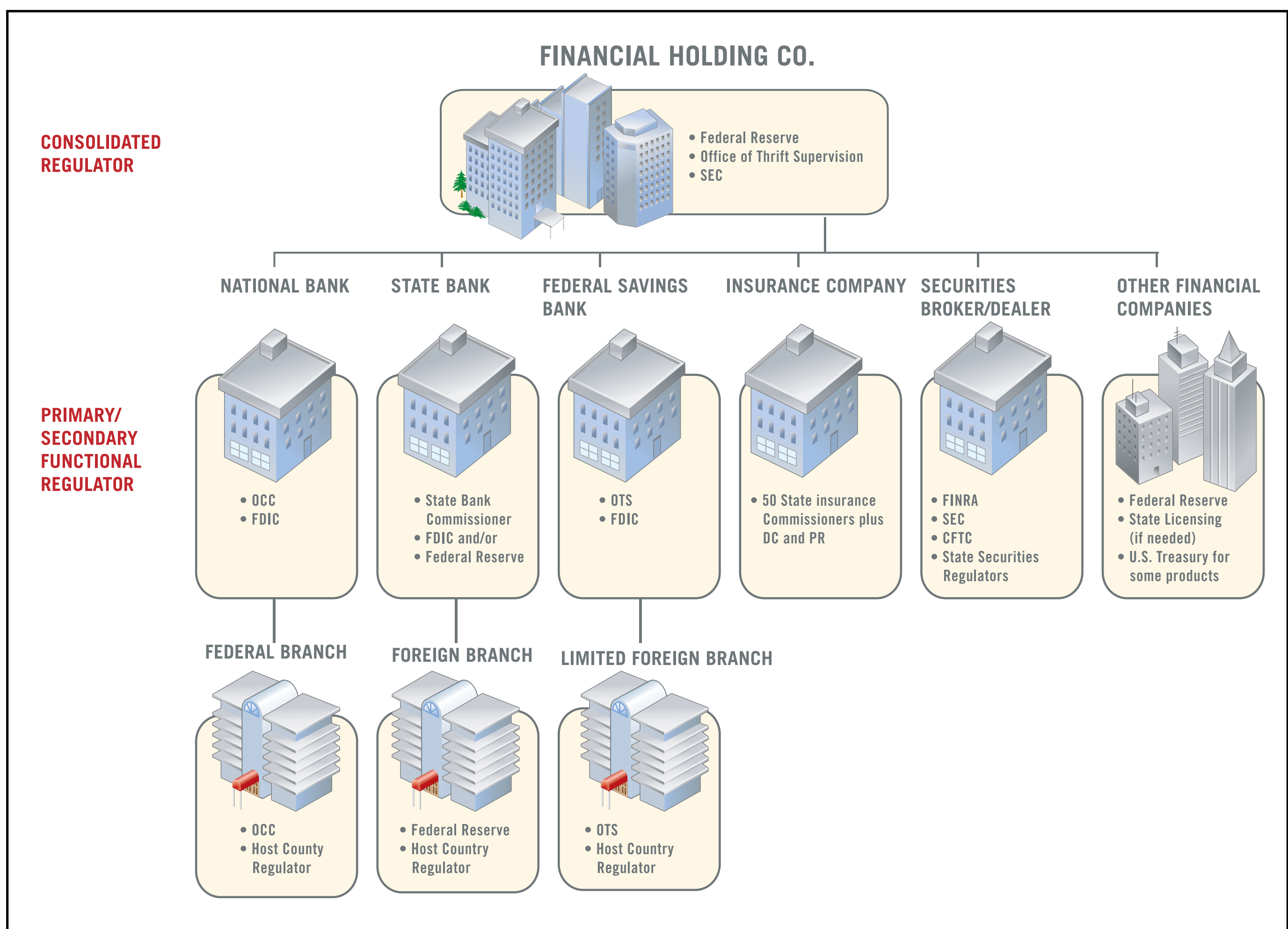
[202] This particular impediment to regulatory restructuring was reduced by the creation of the Financial Services Committee in the U.S. House of Representatives. Today, both the House Financial Services Committee and the Senate Committee on Banking, Housing and Urban Affairs have jurisdiction over banking, securities, and insurance matters. On the other hand, the House and Senate Agriculture Committees retain jurisdiction over the CFTC. Therefore, a merger of the SEC and CFTC could raise jurisdictional concerns in the Congress.

[203] Regulation refers to the promulgation of rules and other agency guidance that set forth actions that may or may not be taken by regulated institutions, such as limits on investments or loans or the prohibition of certain sales practices. Supervision refers to the examination process and the tailoring of directives to an individual institution based upon the results of that process.

in the Gramm-Leach-Bliley Act.[204] That Act permits a financial holding company to engage in banking, securities, and insurance activities, but requires (with certain exceptions) each of those activities to be regulated and supervised by separate agencies.[205] For example, the Gramm-Leach-Bliley Act provides that the insurance activities of any entity, including a national bank, shall be "functionally regulated by the States," subject only to certain anti-discrimination provisions.[206] The U.S. system of financial regulation and supervision also adheres to the policy of national treatment. Under this policy, foreign financial firms operating in the U.S. are subject, generally, to the same type of regulatory and supervisory requirements that apply to U.S. financial firms. Exhibit 4-1 below illustrates the complexity of the current U.S. regulatory system.

Exhibit 4-1

THE U.S. REGULATORY REGIME IS COMPLEX AND FRAGMENTED



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[204] P.L. 106-102.

[205] The Federal Reserve Board serves as the "umbrella" regulator and supervisor for the holding company.

[206] Implementation of functional regulation and supervision is a bit more complex. While it applies to insurance activities wherever conducted, it only applies to securities activities and commodities activities when conducted in a subsidiary or affiliate of a bank, not when the activity is conducted within the depository institution itself. In addition, the question of which activities may be conducted directly in the depository institution, and which activities must be "pushed out" into a functionally regulated company, is not entirely resolved. Also, the ability of a functional regulator to examine the activities of a subsidiary or affiliate regulated by a different functional regulator is limited, as is a bank regulator's ability to demand financial support for a troubled bank from a functionally regulated affiliate.

This system of regulation and supervision is an outgrowth of the separate development and unique historical legacy of banking, securities, and insurance regulation in the United States.

Banking regulation

The regulation of the banking industry began in the early 1800s when individual states began to charter commercial banks. Our system of national banks was not authorized until the 1860s.[207] During the Civil War, President Lincoln and his Secretary of the Treasury, Salomon P. Chase, proposed the creation of a system of national banks to replace state banks and facilitate a national system of credit to fund the war and rebuild the economy. The passage of the National Currency Act in 1863 and the National Bank Act in 1864 resulted in the national banking system, but it did not lead to the demise of the state banking system.[208] Instead, the "dual" banking system developed, under which commercial banks could choose either a national or state charter, and national or state regulation.[209]

Today, the dual banking system is far more complex. While national banks are governed primarily by the terms of the National Bank Act, they are subject to a variety of state laws, such as state tax, criminal, zoning, and contract laws. Further, in exchange for federal deposit insurance, Congress has subjected state banks to a growing body of national law. This policy reached a peak in the early 1990s, when Congress barred state banks from engaging in any activities, as a principal, unless the activities are authorized for national banks or found not to pose a significant risk to the deposit insurance fund.[210] Therefore, instead of having two truly independent banking systems, the dual banking system may be described more accurately as two interrelated and overlapping systems.

The doctrine of federal preemption of state law is an essential feature of the dual banking system.[211] Federal preemption ensures that national banks may engage in banking activities, primarily subject only to federal law. As such, federal preemption preserves the distinctive character of national banks. While this helps to ensure a meaningful choice between national and state regulatory systems, it also creates some tension between those two systems.

The Commission's call for enhancing both national and state banking charters is intended to ease these tensions by reversing the erosion of the dual banking system that has occurred over the years.

Savings associations

Prior to 1933 all savings and loan associations were chartered by the states, either as mutual or stock corporations. In 1933 Congress enacted the Home Owners' Loan Act, which provided for the national chartering of savings associations supervised by the Federal Home Loan Bank Board. Shortly thereafter, Congress established the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits in federal- and state-chartered savings associations, and established the regional Federal Home Loan Bank System to provide liquidity to savings associations through advances secured by mortgage loans.

Beginning in the late 1970s federal and state savings associations began to suffer significant losses due to the interest-rate mismatch between long-term assets (primarily home mortgages) and short-term funding (deposits and other liabilities). Most savings

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[207] Redford, "Dual Banking: A Case Study in Federalism," 31 Law and Contemporary Problems 749 (1966).

[208] The National Bank Act included a tax on state bank notes that was intended to lead to the conversion of state banks into national banks. However, the development of transaction accounts (checking accounts) by state banks reduced the need for state bank notes and permitted state banks to thrive in the face of competition from national banks.

[209] The national banking charter has become a charter of choice for many large banking institutions because it provides for national regulation and supervision by a single agency, the OCC. State banks, however, continue to outnumber national banks three to one, and each year a majority of de novo banks are state-chartered.

[210] 12 U.S.C. 1831a.

[211] Federal preemption is based upon Article VI, Clause 2 of the U.S. Constitution. That clause, which is commonly known as the Supremacy Clause, provides that the laws of the federal government are superior to the laws of the states. In other words, laws passed by Congress, such as the National Bank Act, can override state laws. The application of the doctrine of federal preemption to national banks (as well as federal thrifts) has been settled by a series of decisions by the U.S. Supreme Court, including the recent Watters v. Wachovia case, 550 U.S. 127 S.Ct. 1559 (2007).

associations found themselves in the position of paying more to their depositors when short-term rates skyrocketed than they were receiving in interest from their mortgage assets. It is now recognized that a significant portion of the industry was technically insolvent on a mark-to-market basis by 1981, as interest rates rose in response to inflationary pressures and depositors switched to alternative, higher-yielding investments (e.g., mutual funds). In response to high interest rates and disintermediation of depository institutions, Congress created the Depository Institutions Deregulation Committee, chaired by the Secretary of the Treasury, to deregulate interest rates and phase out Regulation Q over time.[212]

The response by several states, and to a lesser extent by Congress, was to broaden the lending and investment powers of savings associations to permit them to diversify sources of income and reduce the risks inherent in holding long-term, fixed-interest mortgage loans. Unfortunately, many savings institutions used these new powers to engage in speculative investments, many of which soured by the late 1980s and resulted in even greater losses and numerous failures.

In 1987, and then again in 1989, Congress passed legislation to provide funds to the FSLIC to resolve a significant number of failing thrifts. The 1989 legislation also made significant changes in the regulation of the industry. The Federal Home Loan Bank Board was abolished, and in its place the Office of Thrift Supervision (OTS) was established as a bureau in the Department of the Treasury. Further, the FSLIC was replaced by a new deposit insurance fund for thrifts – the Savings Association Insurance Fund (SAIF) – and administration of the thrift industry's deposit insurance function was transferred to the FDIC.

As the industry returned to health, Congress expanded the authority of savings associations to

engage in activities beyond traditional mortgage-lending. For example, federal savings associations may now engage in unlimited unsecured consumer lending (i.e., credit cards). Up until now, this gradual expansion of powers has enabled savings associations to remain competitive, without giving rise to the speculative excesses of the late 1980s. However, additional reforms are needed to allow the industry to remain competitive in the future.

Credit unions

Credit unions are mutually-owned thrift institutions, chartered by either the state or federal government. Prior to 1998, all members of a credit union were required to share a single common bond, such as having the same employer, belonging to the same labor or social organization, or living within the same well-defined community, neighborhood or rural district. In that year Congress also authorized multiple-common bond credit unions. Because of the cooperative focus flowing from the common bond principle and their mutual form of incorporation, credit unions are exempt from federal income taxes.

Federal credit unions are regulated by the National Credit Union Administration (NCUA), an independent federal agency. Deposit insurance is provided by the National Credit Union Share Insurance Fund. In addition, a credit union may borrow from a Central Liquidity Fund, which is established within the NCUA.

[212]Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221. Regulation Q was the popular nomenclature for the regulatory authority of the Federal Reserve to establish deposit rate limitations for banks that were members of the Federal Reserve System, for the FDIC to do the same for nonmember insured banks, and for the Federal Home Loan Bank Board to do the same for savings associations. To promote homeownership, Regulation Q also provided for a one-quarter point differential in deposit rates favoring savings and loan associations over commercial banks.

Credit unions have traditionally specialized in short-term personal loans for their members, but increasingly have provided other types of loans as well. Today, credit unions are authorized to provide a wide variety of loans, including real estate mortgages for members, automobile loans, and even business loans.

Because of their common-bond consumer focus and mutual form of organization, credit unions traditionally have been regulated as specialized entities. This specialized status has often served as a basis for differential regulatory treatment. For example, credit unions are not subject to the requirements of the Community Reinvestment Act.[213] However, as the consumer base of some credit unions expands pursuant to the multiple-common bonds and the range of services provided to consumers grows, application of a principles-based approach to regulation of such credit unions may merit consideration.

Bank and thrift holding company regulation

Companies that own banks or savings associations are regulated and supervised by an "umbrella" regulator. If the holding company includes a national or state-chartered commercial bank, then the company is classified as a "bank" holding company and is regulated by the Federal Reserve Board. If the holding company controls a savings association (and not a bank), then the company is classified as a "thrift" holding company and is regulated by the Office of Thrift Supervision. This regulatory structure means that banking organizations are subject to regulation and supervision by two or more banking agencies, their chartering authority (either the OCC or a state) and the Federal Reserve Board. In addition, state nonmember banks are also subject to regulations and supervision by the Federal Deposit Insurance Corporation. In contrast, thrift holding companies that include a savings association are subject to supervision and regulation by a single agency, the OTS.

In many respects, the regulation of thrift holding companies is a starting model for the universal financial services charter, which we discuss further below. Thrift holding companies may engage in any type of financial activity through a subsidiary, and, as noted, the entire organization is subject to regulation by a single national regulator. Lehman Brothers, Merrill Lynch, Morgan Stanley, GE Capital, AIG, Allstate, State Farm, and Nationwide are examples of modern thrift holding companies.

Bank holding companies also may engage in a full range of financial activities if they file a declaration with the Federal Reserve Board that is not disapproved within 31 days. Financial holding companies were authorized by Congress in the Gramm-Leach-Bliley Act, which was passed in 1999.[214] At that time, it was widely anticipated that GLBA would result in widespread affiliations between banks, securities and insurance firms. Indeed, Congress sought to ensure that the financial holding company structure would be a viable option for all segments of the financial services industry.[215] Contrary to such expectations, few securities firms and insurance firms have opted for financial holding company status. Instead, most securities, and insurance firms that have affiliated with depository institutions have done so with thrifts or nonbank banks,[216] which are subject to supervision and regulation by the OTS or FDIC, respectively, and not the Federal Reserve Board. This lack of marketplace reaction to financial holding company status suggests that the financial holding company structure could be enhanced.

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[213] The NCUA is a voting member of the FFIEC and was a member of the Depository Institutions Deregulation Committee (DIDC) in the early 1980s, although credit unions were not subject to DIDC regulations.

[214] Thrifts had the authority to affiliate with financial firms prior to the passage of GLBA. In fact, until the passage of GLBA, thrifts could affiliate with any firm, financial or nonfinancial. New affiliations between thrifts and non-financial firms were barred by GLBA, but preexisting affiliations were grandfathered.

[215] The Committee believes that allowing broader affiliations within the bank holding company should place no segment of the financial services industry at a disadvantage. Banks, insurance companies, and securities firms should have equal opportunities to affiliate with one another." Report of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, to accompany S.900, the Financial Services Modernization Act of 1999, Report 106-44 (April 28, 1999), p. 6.

[216] For example, Utah Industrial Banks, which are FDIC-insured banks are not members of the Federal Reserve and are not subject to regulation under the Bank Holding Company Act.

Bank regulatory structure and missions

The regulation of commercial banks and savings associations is divided among four federal banking agencies and 50 state departments. The Comptroller of the Currency charters and regulates national banks. The Office of Thrift Supervision charters federal savings associations and is the federal supervisor for all savings associations. The states charter banks and savings associations, and supervise these institutions along with the federal regulators, either the Federal Reserve (for state-chartered banks that voluntarily join the Federal Reserve System) or the Federal Deposit Insurance Company (for state-chartered banks that are not members of the Federal Reserve System).

Each of the federal banking agencies has a "mission" statement, which guides the actions of the agency. While similar, these mission statements are not identical and may, at times, conflict. For example, only two agencies, the OCC and OTS, identify competitiveness as part of their mission. As chartering agencies, OCC and OTS are interested in ensuring that national banks and federal thrifts remain viable chartering options for banking institutions to serve their consumers. Moreover, other mission functions can impact the perspective of agencies on regulation. For example, the FDIC's responsibility as an insurer of deposits influences that agency's views on banking regulation. Similarly, the Federal Reserve Board's responsibility for monetary policy can affect its view of banking regulation.

The Commission's proposed Guiding Principles are designed to give federal and state banking and thrift regulatory agencies a unified, overarching set of principles while preserving their existing specific missions.[217]

Regulation of securities firms

Prior to the Great Depression, the regulation of securities dealers and underwriters was left largely to the states.[218] State laws enacted for the purpose of regulating securities dealers and underwriters became known as "Blue Sky" laws. These laws generally require a license to sell or deal in securities, registration of securities offered to the public, disclosure of material information, and the prohibition of fraud and similar practices. Many states have adopted the 1956 Uniform Securities Act, but often with individual modifications or omissions.[219]

The impetus for federal securities legislation came from the stock market crash of 1929 and the Congressional investigations of the securities industry that followed. The state-by-state approach for the regulation of a national securities market was shown to be inadequate, and Congress responded by passing a number of securities measures commencing with the Securities Act of 1933 (33 Act) and the Securities Exchange Act of 1934 (34 Act).

The 33 Act created the Securities and Exchange Commission to regulate securities markets. The 34 Act provided for the registration of brokers and dealers, and subjects them to SEC supervision, including minimum capital requirements, prohibitions against manipulative or deceptive practices, and the filing of required records and reports. These laws also authorized the formation of self-regulatory organizations to carry out the policies of the Act under the oversight of the SEC.[220]

Investment companies became subject to registration, disclosure and regulation with the passage of the

[217] Hurley-Beccia.

[218] The first significant securities regulatory provision was adopted by Kansas in 1911.

[219] New York's Martin Act authorizes the Attorney General to investigate suspected fraudulent activity, and California has unique statutes relating to fraud and manipulation.

[220] The National Association of Securities Dealers (NASD), the Municipal Securities Rulemaking Board (MSRB), and the New York Stock Exchange (NYSE) all performed self-regulatory functions under this authority. In an effort to relieve duplicative regulation, the NASD and NYSE regulatory operations were merged to form the Financial Industry Regulatory Authority (FINRA) in 2007. FINRA oversees nearly 5,100 brokerage firms, about 173,000 branch offices and more than 665,000 registered securities representatives. FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services.

Investment Company Act of 1940. Investment advisors are subject to registration and regulation under the Investment Advisors Act, with examination and enforcement duties split between the states and the SEC, depending on the size of the assets under management.

Both the 33 Act and the 34 Act preserved state authority to regulate securities activities within their borders, so long as the state requirements do not conflict with the federal provisions.[221] The scope of this authority has subsequently been narrowed, particularly through the National Securities Markets Improvement Act of 1996 (NSMIA), which responded to the states' failure to uniformly regulate national securities offerings.[222]

NSMIA created a class of securities, "covered securities," whose offer and sale through licensed broker-dealers are not subject to state securities law registration. The covered securities include securities listed (or approved for listing) on the NYSE, Amex, and Nasdaq National Market, and securities of the same issuer that are equal in rank or senior to such listed securities; mutual fund shares; certain securities exempt under Section 3(a) of the 33 Act; and securities exempt from registration under Rule 506 of Regulation D of the 33 Act.

Nonetheless, broker-dealers remain subject to state requirements along with federal requirements. Brokerage firms and stockbrokers face licensing requirements by FINRA and each state in which they operate.[223] They are also subject to inspection or examination by the state where they operate, the SEC, and the relevant SRO.

The investment advisors also remain subject to a bifurcated system of licensing and regulation. Pursuant to NSMIA, investment advisers managing less than $25 million in assets must register with the state in which their place of business is domiciled and in any state where more than five clients reside. Investment advisers managing $25 million or more in assets, or advising a registered investment company must register with the SEC and are subject to examination or inspection through the SEC. However, SEC-registered investment advisers still must submit anything filed with the SEC with all states where they maintain more than five clients. Furthermore, while most state securities laws follow the Uniform Securities Act of 1956, they vary widely. As a result, a broker-dealer that provides a range of securities products, as well as investment advice, to consumers in multiple states faces a combination of national and state licensing and examination requirements.

The Commission's proposed optional national securities charter is intended to give securities firms and brokers the option of a single national system of regulation and supervision. This would promote uniformity for efficient competition consistent with the mandate of NSMIA, which requires the SEC to promote efficiency, competition, and capital formation. Additionally, this national licensing would complement the evolution of a seamless "national market system" mandated by Congress.[224]

Regulation of commodities futures

In 1921, Congress instituted federal regulation of the commodities market for agricultural products with the passage of the Futures Trading Act. The Act required commodity futures trading to be conducted on a federally-licensed exchange, rather than through unregulated markets that were open to manipulation

[221] J. Barth, G. Caprio, R. Levin, Rethinking Bank Regulation: Till Angles Govern (2006).

[222] P.L. 104-290 (1996). Among other things, the law preempted state laws that differ or go beyond federal requirements for registered broker-dealers with regard to capital, custody, financial responsibility, recordkeeping, and reporting. This law also preempted state registration and reporting requirements for securities listed on the Exchanges or NASDAQ market, securities issued by a registered investment company, and securities sold to "qualified" purchasers.

[223] There are a few exceptions to state registration, which vary from state to state.

[224] A U.S. national market system was mandated by the Securities Act Amendments of 1975. At the heart of the national market is the ITS (intermarket trading system), which began operation in 1978. Markets are linked electronically by ITS computers. This allows traders at any exchange to seek the best available price on all other exchanges on which a particular security is eligible to trade. The national market system also includes a consolidated electronic tape, which combines last-sale prices from all markets into a single stream of information.

and fraud. However, the following year, the Supreme Court declared the law unconstitutional.[225] It was reenacted in a different form in 1923 as the Grain Futures Act, and this time survived a constitutional challenge.[226] In 1933 and 1935, large price collapses in the wheat, corn, and cotton markets led Congress to conclude that additional legislation was needed, and in 1936 Congress passed the Commodity Exchange Act.

The Commodity Exchange Act established the Commodities Exchange Commission. Futures commission merchants were required to register, and certain practices were prohibited, such as options trading on regulated commodities. However, trading on unregulated commodities was not covered. The collapse of firms trading in unregulated commodities led to the establishment of the Commodity Futures Trading Commission (CFTC) in 1974. The CFTC was given enhanced power to regulate the commodities markets, and registration requirements were expanded to include commodity trading advisers and commodity pool operators.

Following the enactment of the Commodity Futures Modernization Act of 2000 (CFMA), the CFTC adopted a more principles-based approach to regulation.[227] The CFMA was passed, in part, to address increasing competition from foreign markets.[228] At the time, it was concluded that those markets had a distinct advantage over U.S. markets because they followed less prescriptive regulatory regimes. The Senate report states that the CFMA codifies regulatory reform to ensure the competitiveness of the futures exchanges.[229] It also cites the growth of EUREX and that the U.S. regulatory regime at the time was inhibiting the development of markets.[230] The CFTC also recognized that a principles-based regime in conjunction with its foreign exchange recognition process would give it greater flexibility in responding to the rapid pace of innovation and global growth.

As part of the transition to a more principles-based approach to regulation, the CFTC embarked on a detailed review of its rulebook and eliminated rules that were deemed to be unnecessary or redundant. The agency also maintained rules deemed to be consistent with the guiding principles. Regulated entities have been given the ability to develop tailored practices as an alternative means to compliance. A key part of this process is an ongoing dialogue between regulatory entities and CFTC staff.

One example of the flexibility provided under the CFTC's principles-based approach is the participation of ICE Futures (ICE) in U.S. markets. ICE is headquartered in London. Prior to the CFMA, ICE participation with U.S. markets would have required registration with the CFTC and adherence to all of the requirements attached to that registration. Following the enactment of the CFMA, the CFTC was able to assess whether regulation in ICE's home country would achieve the same objectives as the CFTC core principles. Having found that regulation to be consistent with the objectives of its core principles and after ICE submitted to certain U.S. surveillance requirements, ICE was granted

[225] Hill v. Wallace, 259 U.S. 44 (1922).
[226] Chicago Board of Trade v. Olsen 262 U.S. 1 (1923).
[227] P.L. 106-554.
[228] Reauthorization of the Commodities Futures Trading Commission: Hearing before the Senate Committee on Agriculture, Nutrition and Forestry, 109th Congress, 1st Session, March 8, 2005 (Statement of Dr. James Newsome, President of New York Mercantile Exchange).
[229] Senate Report 106-390.
[230] Ibid.

a recognition letter, allowing U.S. customers to participate with ICE.[231]

Since enactment of the CFMA, U.S. futures volume has increased by 240 percent. The Chicago Mercantile Exchange's market capitalization is approximately $20 billion while the New York Stock Exchange is $15.5 billion. Moreover, U.S. market share in the global futures industry has grown from 34 percent in 2000 to 43 percent in 2006.[232]

Historically, there has been little overlap between the SEC and the CFTC.[233] However, as markets integrate and globalize, and new innovative products with mixed features cross regulatory boundaries, the lines between what these agencies regulate and supervise are increasingly blurred, just as they increasingly regulate the same institutions at the national level.

Regulation of insurance firms

Like banking and securities regulation, the regulation of the insurance industry began at the state level. Unlike those industries, however, the regulation of the business of insurance has remained with the states with limited specific exceptions. In fact, in 1869 the Supreme Court ruled (Paul v. Virginia) that insurance was not part of interstate commerce, and thus not an appropriate subject for federal regulation.[234]

In 1944 the Supreme Court overturned the Paul case and held that insurance was part of interstate commerce.[235] In response, Congress enacted the McCarran-Ferguson Act [236] the following year preserving the traditional role of the states as the sole regulatory authority over the insurance industry, with exceptions for such matters as anti-trust, fraud, and discrimination. Each state thus has its own licensing and examination requirements, solvency and investment policy rules, premium approval requirements, authorized contract terms, consumer disclosure requirements, and similar mandates.

The primary purpose of state regulation is to protect policyholders against the insolvency of an insurance company that may occur many years after the premiums have been paid.[237] Capital adequacy, investment policies, asset-liability matching, accounting, reserves, reinsurance requirements, financial reporting requirements, and examinations are some of the key tools used by the states to protect the long-term solvency of insurance firms.[238] Beginning in the 1990s, under the leadership of the NAIC, the states significantly tightened these standards and enhanced licensing stringency. [239]

State insurance authorities also view consumer protection as a "paramount" objective of state insurance supervision.[240] Every state has adopted detailed market conduct rules that address advertising, sales activities, policy administration and claims. Furthermore, most states continue to regulate rates to protect consumers from excessive charges. Rate regulation also is intended to prevent companies from reducing rates below prudent levels in order to

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231 Walter Lukken, Commissioner of CFTC, remarks to Federation of European Securities Commissions, July 26, 2007.

232 Ibid.

233 These two agencies do share jurisdiction over securities futures, which include single securities and securities indices.

234 Paul v. Virginia, 75 U.S. 168 (1869).

235 United States v. South Eastern Underwriters Assn., 322 U.S. 533 (1944).

236 15 U.S.C. § 1011 et seq.

237 R. Klein, "Insurance Regulation in Transition," 62 J. of Risk and Insurance, pp. 363, 365-66 (1995).

238 The NAIC maintains an Insurance Regulatory Information System (IRIS) to monitor insurers' financial reports to identify those companies requiring further regulatory attention. Insurance company data is also subject to a financial analysis and surveillance-tracking (FAST) program that assigns different points to various financial ratios and an overall score for the company.

239 The National Association of Insurance Commissioners adopted a formal accreditation program in 1990 under which each state's insurance regulator must meet key standards in order to receive "accreditation," and states that fail to meet required standards receive guidance on necessary steps to improve. Ibid., pp. 364, 394.

240 Statement of Alessandro Iuppa, Maine Superintendent of Insurance and President of the National Association of Insurance Commissioners to the Senate Banking Committee, July 11, 2006.

gain market share.

Beginning in 1969 states started to establish "guaranty funds" to protect consumers from insurance company insolvencies. These guaranty funds are established as mutual organizations of which insurance companies must become members. Except in New York, funding is not required until after a loss occurs.

In recent years, some efforts have been made to reduce the burden of 50 different regulatory requirements and procedures. In 1999 the Gramm-Leach-Bliley Act adopted provisions to encourage the states to recognize licenses granted by other states through the development of uniform laws on licensing, and to permit the reciprocal recognition of insurance licenses granted by other states. As a result, most states have enacted laws recognizing the licensing decisions of other states.[241] In addition, 30 states have joined an interstate compact, The Interstate Insurance Product Regulation Commission, which develops uniform standards for life insurance annuities, disability protection, and long-term care, and established a central filing point for registering and reviewing these products.[242]

Despite efforts by the states to coordinate the regulation of insurance, the business of insurance has evolved significantly since the state-based system of insurance regulation was established more than a century ago. Today, the business of insurance, like all other financial services businesses, is a national business. Many large U.S. insurers also are active in markets around the world. Complying with varying state requirements, therefore, complicates the activities of insurers and producers that operate in multiple states and impedes their ability to meet the needs of consumers.

The Commission's endorsement of an optional national charter for insurers and producers is intended to address the limitations of the current state-based system of regulation. Research by the Perryman Group has found that the impact of this proposal on the economy would drive growth in GDP and retail sales as well as create jobs in virtually every economic sector. The benefits of the proposal include regulatory and administrative cost savings, reduced delays in product introduction, and lower prices and greater mobility for insurance products. The Perryman Group's analysis estimates the magnitude of these potential gains, under baseline conditions, would be $38.4 billion in annual gross domestic product and a permanent job creation total of 362,015 jobs.[243]

Efforts to coordinate regulatory policies

Given the multiplicity of financial regulators, policy makers have made some efforts to coordinate regulatory and supervisory policies. The best examples of this are the Federal Financial Institutions Examination Council and the President's Working Group on Financial Markets.

The FFIEC was established in 1979 to prescribe uniform reporting and examination standards for the four federal banking agencies and the National Credit Union Administration. Last year, the membership in the Council was expanded to include a representative state banking supervisor.[244] The FFIEC has contributed to the coordination of examination policies and procedures among the federal banking agencies. However, its focus is limited to banking supervision, and it lacks the authority to require individual agencies to adhere to specific policies and procedures.

The PWG was established by President Reagan in 1988, in response to the 1987 stock market crash.[245] It consists of the Secretary of the Treasury as chairman, the Chairman of the Federal Reserve Board, the Chairman of the SEC and the Chairman of the CFTC. The PWG has a broad mandate to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets and to maintain investor confidence in those markets. It

[241] The Insurance Journal, June 14, 2001.
[242] Interstate Insurance Product Regulation Commission, press release, June 25, 2007.
[243] "The Potential Impact of More Efficient Regulation of the Property/Casualty and Life Insurance Sectors on U.S. Business Activity," The Perryman Group (December 2006).
[244] The addition of a state banking supervisor was made by Section 714 of the Financial Services Regulatory Relief Act of 2006, P.L. 109-351
[245] Executive Order 12631.

has used that mandate to make recommendations on matters such as hedge funds, over-the-counter derivatives, and terrorism risk insurance. However, like the FFIEC, the PWG lacks the authority to fundamentally change the direction of financial regulation in the United States.

POLICY REFORM IX. MODERNIZE EXISTING CHARTERS.

As discussed above, existing banking and thrift charters are the product of policy determinations that span decades and are based upon market conditions that, in many cases, no longer exist. Therefore, to remain competitive in today's markets, banking and thrift charters should be modernized.

Support for modernization of charters can be found in a recent World Bank-sponsored study of banking regulation in more than 150 countries. That study found that the countries that impose fewer regulatory restrictions on banking activities enjoy better performance and a lower probability of a major banking crisis.[246] The study also found that market discipline, enhanced through the required disclosure of reliable, timely, and comprehensive financial information, rather than stringent regulation of products and services, is a much more effective supervisory model for serving consumers and promoting financial stability.

The Commission recognizes that the federal banking agencies have proposed various charter reforms over the years, particularly within the context of proposed "regulatory relief" bills. As a follow-up to Recommendation 9 below, the Financial Services Roundtable looks forward to working with the federal banking agencies and the Congress to pursue charter reforms that are consistent with the Commission's proposed Guiding Principles.

Recommendation 65. Existing Depository Institutions Charters. The financial regulators and Congress should modernize national and state banking and thrift charters by removing outdated or redundant requirements that inhibit the ability of firms to innovate and serve their consumers more effectively and efficiently in their local markets as well as the global financial marketplace. For example, Congress should eliminate outdated restrictions on the interstate and intrastate operations of banks and thrifts. Banks and thrifts should be able to use different organization forms as they evolve. Congress also should review and amend the Bank Holding Company Act and the International Banking Act to enhance the competitiveness of financial

[246] J. Barth, G. Caprio, R. Levin, Rethinking Bank Regulation: Till Angels Govern (2006). "Empowering direct official supervision of banks and strengthening capital standards does not boost bank development, improve bank efficiency, reduce corruption in lending, or lower banking system fragility. Indeed, the evidence suggests that fortifying official supervisory oversight and disciplinary powers actually impedes the efficient operation of banks, increases corruption in lending, and therefore hurts the effectiveness of capital allocation without any corresponding improvement in bank stability."

holding companies and internationally active financial services firms.

POLICY REFORM X. CREATE NEW OPTIONAL NATIONAL CHARTERS.

Principle 5 states that the providers of financial services should have a wide choice of charters and organizational options. The Commission's recommendations for three new optional national charters are designed to meet this principle.

The creation of three new optional national charters would not only enhance the competitiveness of financial services firms nationally and globally,[247] it would also result in the creation of more regulatory agencies. While our current system of multiple national and state regulators has its drawbacks (as we have noted extensively in this Blueprint), the existence of multi-agencies can create a healthy competitive tension that provides an important public benefit. Because no one agency has a monopoly position, each agency is consistently looking for ways to improve regulatory policies and procedures, streamline processing time, and enhance the effectiveness of their regulatory program and the competitiveness of the institutions they charter and supervise. Once an improvement is demonstrated, the other agencies will often take advantage of the development, or take the improvement one step further. For example, in the 1990s the OCC developed the concept of risk-based examinations that replaced across-the-board audits with a focus on the bank's own policies and procedures to control and detect risk, and examination attention to the most risky areas within a bank. This system of examination has since been emulated by other banking agencies.

Congress should authorize three new optional national charters that permit financial services firms to serve and protect consumers better both domestically and internationally, and which permits individual firms to be subject to regulation, supervision, and enforcement by a single national authority.

During the past 20 years, various proposals have been made to reform the existing regulatory system by merging regulatory bodies without consideration of the full impact on competition and meeting consumers' needs. None of those proposals has been successful. Accordingly, we have taken a different approach to regulatory reform, based heavily on enhancing competitiveness and better meeting consumer needs in the future.

Rather than eliminate agencies, we recommend the creation of new charters to serve and protect consumers better in the future, and we further recommend that each type of charter be regulated by only a single supervisory agency. These recommendations result in new national regulators for national insurance companies, a federal securities authority, and possibly a national universal financial services charter. These new national charter options would put U.S. financial services firms on a more equal competitive footing with their international competitors that often operate with a single license supervised by a single prudential regulator.

It is envisioned that the national regulator for these new optional national charters would have enforcement powers patterned after those given that Congress has given to the Office of the Comptroller of the Currency in the National Bank Act. In other words, the regulator would have exclusive authority to enforce compliance with these new laws. Like national banks, however, that authority would reserve to individual consumers and the states an ability to

[247] See Gregory P. Wilson, The Importance of Financial Market Regulation for the Competitiveness of the U.S. Economy, testimony to the National Commission on the Regulation of Capital Markets in the 21st Century, U.S. Chamber of Commerce, October 20, 2006, and Gregory P. Wilson, "A New U.S. Regulatory Strategy to Enhance Financial Competitiveness," American Enterprise Institute, January 24, 2007 on the AEI Web site at www.aei.org/docLIB/20070124_WilsonPaper.pdf.

pursue compliance with certain categories of laws such as state contract and criminal laws.

Recommendation 66. Optional national insurance charter. Congress should provide for the optional chartering, regulation, supervision and enforcement of national insurers, agencies, and individual insurance producers by a bureau of the Treasury Department. Nationally-chartered insurance firms, agencies and producers would be permitted to operate in any state with full competitive pricing, subject to one license and one set of prudential and market conduct rules.

This optional charter would result in significant cost savings and speed the development of new products to the market for consumers. It also would give the United States a single, accountable voice in international negotiations on insurance. Further, the fact that insurance providers would have a federal option would provide a significant incentive for state regulators to accelerate the reduction of unnecessary regulatory burdens and to develop new and innovative regulatory policies and procedures. As a result, regulatory overhead would decrease, cost savings would occur for the entire industry and all consumers, and new products would be brought to the market on a faster basis.[248]

Recommendation 67. Optional national securities charter. Congress should provide for the optional chartering, regulation, supervision and enforcement of national securities firms and individual brokers by a single national authority, such as the SEC, FINRA, or some new agency. Nationally-chartered securities firms and brokers should be permitted to operate in any state, subject to one license and one set of prudential and market conduct rules.

An optional national securities charter would permit a firm or individual to engage in securities sales activities in any state under the exclusive regulation, supervision, and enforcement of a single national regulatory authority. In other words, with this single license, a firm or individual would be subject only to examination and enforcement by the national regulatory authority, not any individual state authorities.

Like the current NASD licensing series, a national license could be limited (e.g., bonds only) or comprehensive (e.g., all securities). Additionally, a national license could permit advisory activities and annuity sales. Thus, under a single national license, a firm or individual could provide a full range of investment products and services.

Recommendation 68. Optional universal financial services charter. Congress should create a new, optional universal financial services charter that would permit a financial services firm to engage in financial activities under the regulation, supervision, and enforcement

[248] "The Potential Impact of More Efficient Regulation of the Property/Casualty and Life Insurance Sectors on U.S. Business Activity," The Perryman Group (December 2006).

by a single national authority, which could be the Office of the Comptroller of the Currency, the Federal Reserve Board, or some new agency. For purposes of this charter, "financial activities" are activities that are financial in nature, incidental or complementary thereto, but are not commercial activities.

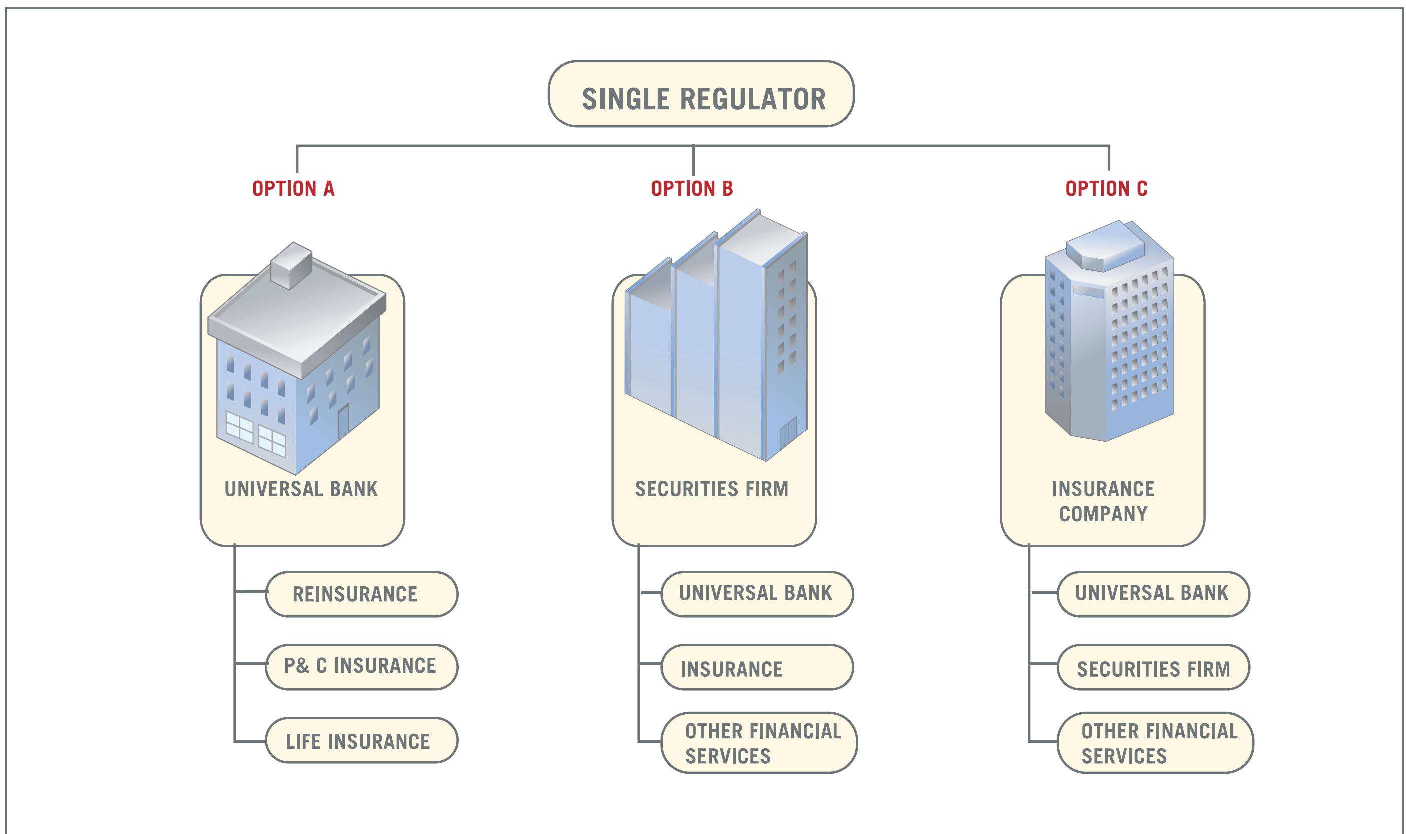
This universal model is an efficient organizational form that is recognized in the United Kingdom, many European countries, and, increasingly, in other parts of the world. It facilitates broader risk diversification and management than is possible in a more limited charter. With such a charter, a financial services firm would be permitted to engage in any financial activity, including banking, securities, and insurance activities.

The "universal bank" within this model would be able to engage in both commercial banking and investment banking activities, subject to appropriate firewalls. Insurance underwriting would be placed in legal entities because of the longer-term nature of insurance liabilities.

A universal financial services charter would be a substitute for any existing banking charter, securities, or insurance license. In other words, a financial services firm that selects this option would not need any other charter, since this option would permit the firm to engage in all forms of financial activities. Exhibit 4-2 illustrates some of the structural options available to firms that select a universal financial services charter under a single regulator.

Exhibit 4-2

MULTIPLE UNIVERSAL FINANCIAL SERVICES OPTIONS ARE POSSIBLE*



*Could be structured with a parent holding company above the lead entity with a single regulator.

Firms holding this charter would be subject to regulation, supervision and enforcement by a single national authority. This authority could be an existing regulator, such as the Federal Reserve Board or the Office of the Comptroller of the Currency, or a newly created agency that could be established de novo or built from existing units of various regulatory agencies. The expertise required to staff this new regulator can either come from the existing agencies or from the private sector. Additionally, the enhanced PWG will need to help coordinate the supervisory policies of the chartering authority with existing functional regulators to ensure that firms engaged in the same activities are subject to similar supervision.

As former FDIC Chairman Donna Tanoue testified to the House Financial Services Committee, this structure can provide "superior" protection to the FDIC if the lead institution is a bank or thrift:

> *The properly insulated operating subsidiary structure and the holding company structure can provide similar safety and soundness protection when the bank is sound and the affiliate/subsidiary is financially troubled. However, when it is the bank that is financially troubled and the affiliate/subsidiary is sound, the value of the subsidiary serves to directly reduce the exposure of the FDIC. If the firm is a nonbank subsidiary of the parent holding company, none of these values is available to insured bank subsidiaries, or to the FDIC if the bank should fail. Thus, the subsidiary structure can provide superior safety and soundness protection.*[249]

A universal financial services charter should accommodate market and technological developments by authorizing activities that are "incidental to" or "complementary to" financial activities. This charter also should be an option for any U.S. firm that controls an FDIC-insured depository institution or foreign bank that is subject to consolidated comprehensive supervision as of the date of enactment of the law that creates the charter. In other words, the universal financial services charter would be an option for firms that engage in non-financial activities as long as they have a banking operation before this charter is created. Such "grandfathering" is not only equitable, but consistent with many previous national laws, including the Gramm-Leach-Bliley Act, which grandfathered pre-existing affiliations between commercial firms and savings associations. Any further modifications to the separation between banking and commerce should be the subject of a broader public policy debate.

Given increasing international competition, there is a growing need for a single, market-oriented financial services license that encompasses the broad spectrum of financial intermediaries – commercial banks, investment banks, insurance companies, and other financial services firms. The Bloomberg-Schumer report advocated a similar approach,[250] although it stopped short of supporting a single, optional financial services or universal charter.

Moving to a single financial services charter would help to reduce the complexity and costs for financial services firms that hold multiple charters today and must interact with multiple regulators here and, increasingly, overseas. Moreover, it would help consumers by allowing them to do business with a single legal entity and avoid the complexity and costs of thinking they are doing business with a single, seamless firm, only to find out that they are simultaneously dealing with multiple legal entities that have different legal requirements for everything from transaction processing, to record keeping, to disclosures.

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[249] Testimony of Donna Tanoue, Chairman, FDIC, before the Committee on Banking and Financial Services, U.S. House of Representatives, February 12, 1999.
[250] Bloomberg-Schumer Report, pp. 116-118.

Chapter 5: An Action Plan for Serving and Protecting Consumers Better in the Future

The major regulatory and competitive issues facing financial services firms doing business in the United States stem primarily from the current rules-based approach to regulation and the structure of the U.S. legal and regulatory system. As discussed in this Blueprint and other preceding studies, factors such as the complexity of the regulatory environment, potential litigation exposure, delays in gaining approval for innovative consumer products and services, and rising legal and regulatory costs collectively are having a direct and unfavorable impact on the ability of U.S.-based firms to compete and serve and protect consumers domestically and globally. We have the ability to correct these short comings, but that will require concerted effort.

The Blueprint for U.S. Financial Competitiveness is intended by the Financial Services Roundtable as a collective call for better, more effective regulation based upon Guiding Principles and greater prudential supervision across the entire financial services industry. Our proposed Guiding Principles would not replace rules, but they would provide regulatory agencies and firms with a common framework to guide regulations, policies and practices. Similarly, our call for greater prudential supervision is not a call for de-regulation; it is a call for a more constructive engagement between regulators and firms that allows issues to be addressed in a timely and effective manner before they become serious problems. Prudential supervision also does not necessarily imply less regulation, but it should foster greater and more timely responsiveness to changing market conditions that affect consumers and financial services firms alike. Based on this Blueprint, we are convinced that our recommended approach to needed legal and regulatory changes will benefit and protect consumers individually and collectively.

The Commission recognizes that a key issue for policymakers and regulators is how to structure a regulatory system that balances achieving important societal objectives with maintaining competitive markets and firms. That is why we believe the Guiding Principles should support three fundamental national policy objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation.

Achievement of these goals requires that our financial system remain competitive so that it can continue to meet the needs of all consumers of financial services and achieve our national economic policy objectives. Our Blueprint and its 10 policy reforms and over 60 specific recommendations are intended to provide a roadmap for accomplishing that outcome. Accordingly, we offer them as a starting point for discussions by national and state legislators and regulators, consumers and financial services firms.

By recommending that our proposed Guiding Principles be enacted into law, it is the Commission's intent to encourage a broad national debate on the importance of enhancing the competitiveness of U.S. financial firms and markets in an increasingly dynamic global marketplace and how a principles-based approach to financial regulation is vital to assuring that competitiveness. This needed public debate should involve the Congress, the Administration, financial regulators, industry participants, and consumers.

We believe it is essential to enact the Guiding Principles into law. We recognize that our recommendations are ambitious, but we believe they are necessary to assure that the U.S. financial system remains vibrant, healthy, stable, and competitive.

We also recommend that the Congress codify and expand the current President's Working Group on Financial Markets to oversee implementation of the Guiding Principles and to ensure greater accountability and transparency across financial market regulatory agencies. In addition, the recent financial market crisis has demonstrated shortcomings of our financial regulatory system, notwithstanding the efforts of individual regulatory agencies to address immediate problems in the segments of the financial system for which they are responsible. Therefore, the second part of the PWG's mission would be to serve as a forum for more effective regulatory communication, collaboration and coordination.

Implementation of needed reforms to financial regulation will be challenging and will require a concerted effort by everyone. From this perspective, it is crucial that the Financial Services Roundtable and all other interested parties combine efforts to ensure that better regulation and enhanced competitiveness are top priorities on the U.S. national policy agenda. Successful achievement of this agenda will ensure that all consumers are well served by a vibrant and robust financial services industry that is governed by guiding principles, better regulatory oversight and coordination, and more prudential supervision.

Appendix A – Detailed Recommendations

This appendix lists the 10 policy reforms and 68 recommendations contained in The Blueprint for U.S. Financial Competitiveness.

POLICY REFORMS AND RECOMMENDATIONS

POLICY REFORM I. PRINCIPLES-BASED REGULATION
Recommendations 1 – 3

POLICY REFORM II. PRUDENTIAL SUPERVISION
Recommendations 4 – 9

POLICY REFORM III. LITIGATION REFORM
Recommendations 10 - 29

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Recommendations 30 - 34

POLICY REFORM V. ANTI-MONEY LAUNDERING
Recommendations 35 – 51

POLICY REFORM VI. RISK-BASED CAPITAL REGULATION
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POLICY REFORM VIII. MODERN ACCOUNTING STANDARDS
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POLICY REFORM IX. MODERNIZE EXISTING CHARTERS
Recommendation 65

POLICY REFORM X. NEW NATIONAL CHARTER OPTIONS
Recommendations 66 - 68

POLICY REFORM I. PRINCIPLES-BASED REGULATION.

Congress and the Administration should enact principles-based financial regulation. Specifically:

Recommendation 1. Principles. Congress and the Administration, with input from the private sector, should enact the following Guiding Principles into law by 2008.

Proposed Guiding Principles for U.S. Financial Regulation

> ***Preamble.*** *These Guiding Principles are intended to ensure that the regulation of financial services and markets is more balanced, consistent, and predictable for consumers and firms, and therefore achieves three fundamental objectives: 1) enhancing the competitiveness of firms to serve and protect consumers better; 2) promoting financial market stability and security; and 3) supporting sustained U.S. economic growth and job creation. Consumers' needs include those of retail customers, small- and medium-sized businesses, larger national and international businesses, investors, issuers, governments, and others who rely upon financial services firms in the conduct of their business. These Guiding Principles should guide the supervisory and regulatory policies and practices of financial regulatory authorities as well as the policies and practices of financial services firms, and they should be enforced by the firm's primary regulator. They are not intended as a complete substitute for rules, but should guide both the development of new rules and the review of existing rules.*

1. **Fair treatment for consumers (customers, investors, and issuers).** Consumers should be treated fairly and, at a minimum, should have access to competitive pricing; fair, full, and easily understood disclosure of key terms and conditions; privacy; secure and efficient delivery of products and services; timely resolution of disputes; and appropriate guidance.

2. **Competitive and innovative financial markets.** Financial regulation should promote open, competitive, and innovative financial markets domestically and internationally. Financial regulation also must support the integrity, stability, and security of financial markets.

3. **Proportionate, risk-based regulation.** The costs and burdens of financial regulation, which ultimately are borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and their consumers.

4. **Prudential supervision and enforcement.** Prudential guidance, examination, supervision, and enforcement should be based upon a constructive and cooperative dialogue between regulators and the management of financial services firms that promotes the establishment of best practices that benefit all consumers.

5. **Options for serving consumers.** Providers of financial services should have a wide choice of charters and organizational options for serving consumers, including the option to select a single national charter and a single national regulator. Uniform national standards should apply to each charter.

6. **Management responsibilities.** Management should have policies and effective practices in place to enable a financial services firm to operate successfully and maintain the trust of consumers. These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety and soundness and financial stability, and appropriate conflict of interest management.

Recommendation 2. President's Working Group on Financial Markets. Congress should codify the President's Working Group on Financial Markets, under the Chairmanship of the Secretary of the Treasury, with the following three responsibilities: 1) oversee implementation of the Guiding Principles; 2) manage the oversight of the Regulatory Action Plans in Recommendation 1.C. for existing and new regulations; and 3) provide greater coordination on policy issues across financial markets, including collaboration during times of market volatility and financial crises. The President's Working Group should include regulatory representation across the financial services industry, including representatives of state financial regulatory agencies, as appropriate.

Recommendation 3. Regulatory Action Plans. The President's Working Group on Financial Markets, with input from the private sector, should oversee individual agencies Regulatory Action Plans to revise and align existing and proposed regulations are consistent with the Guiding Principles. The President's Working Group should report at least annually to Congress and the President on the progress consistent with its responsibilities.

POLICY REFORM II. PRUDENTIAL SUPERVISION.

Congress should enact laws to apply prudential supervision to all sectors of the financial services industry. Regulators and regulated entities should maintain a constructive engagement and open dialogue to ensure compliance with all applicable laws and rules. Prudential supervision should rely on regular communication between firms and regulators to discuss and address issues of mutual concern as soon as

possible. Prudential supervision also should encourage regulated entities to bring matters of concern promptly to the attention of regulators. Rather than respond to matters of concern with immediate enforcement actions, prudential supervision contemplates the regulator working with firms to correct practices, to address impacts of practices on consumers, and inform other firms of best practices developed from the process. Prudential supervision, however, should not be a means to avoid immediate enforcement in the case of serious abuse or fraud. Specifically:

Recommendation 4. Mitigating factors. Financial regulators should be required by federal law to consider mitigating factors when initiating enforcement decisions under a system of prudential supervision.

Recommendation 5. Continuum of prompt corrective actions. Congress should require financial regulators to pursue prompt corrective actions based upon a continuum of requirements, which begins with regulatory identification of an infraction and the opportunity for the institution to bring itself into compliance promptly through voluntary actions, and eventually graduates to public cease-and-desist orders and civil money penalties.

Recommendation 6. Field examiners. The SEC and state insurance regulators should train and utilize their field examination forces consistent with Principle 4 (Prudential supervision and enforcement).

Recommendation 7. SEC communication and coordination. Building on the progress the SEC has made on prudential supervision for the nation's largest securities firms, the SEC should establish better lines of communication and coordination between the Office of Compliance, Inspections and Examinations (OCIE), and its nonenforcement divisions. Moreover, OCIE should be subject to greater oversight by the Commissioners to ensure that its investigations are resolved in a timely fashion consistent with the principle of prudential supervision and with a better balance between its responsibilities, including its mandate on competitive markets and capital formation.

Recommendation 8. Attorney-client waivers. Congress should enact the Attorney-Client Privilege Protection Act to reverse government policies requiring companies to waive their attorney-client privilege to be deemed cooperative in a government investigation or prosecution. However, after enactment of this legislation and consistent with a system of prudential supervision, Congress should establish a limited waiver for attorney-client privilege and work product protections for materials provided by the

regulated firms to the SEC and insurance regulators.

Recommendation 9. Fair Notice. Before authorizing an enforcement action, financial regulators should be required to find that an institution had "fair notice" of the requirement upon which the action is based.

POLICY REFORM III. LITIGATION REFORM.

Recommendation 10. SEC shareholder review litigation process. Congress should establish a shareholder litigation review process under which shareholders present potential Section 10b-5 cases to the SEC prior to filing. Such cases would not be filed and would have no standing if the SEC determines to pursue an investigation and review of the matter.

Recommendation 11. Joint and several liability. Congress should limit joint and several liability in securities litigation cases to the most egregious cases.

Recommendation 12. Removal. Congress should expand the removal authority in the Class Action Fairness Act to facilitate the removal of cases from state to federal court when national matters are at issue.

Recommendation 13. Interlocutory appeals. Congress should amend the PSLRA to permit interlocutory appeals of dispositive motions (e.g., motions to dismiss and summary judgments).

Recommendation 14. Loss causation. Congress should amend the PSLRA to require that loss causation be pleaded with particularity.

Recommendation 15. Discovery stays. Congress should amend the PSLRA to eliminate gaps in discovery stay.

Recommendation 16. Pay-to-play. Congress should amend the PSLRA to eliminate "pay-to-play."

Recommendation 17. Aggregation. Congress should amend the PSLRA to bar aggregation of plaintiffs for purpose of determining the lead plaintiff.

Recommendation 18. Refunds. Congress should amend the PSLRA to require refunds of uncollected amounts of settlement funds, thus allowing each class member to take only his or her pro rata share of the settlement.

Recommendation 19. Coordination. Congress should amend the PSLRA to better coordinate SEC Fair Funds and litigation distributions.

Recommendation 20. Lead counsel. Congress should amend the PSLRA to authorize auctions for lead counsel.

Recommendation 21. Certifications. Congress should amend the PSLRA to require certifications by lead plaintiffs.

Recommendation 22. Arbitration. Congress should preserve the current securities industry arbitration system.

Recommendation 23. Appellate review. Congress should amend SLUSA to permit appellate review of remand orders.

Recommendation 24. Discovery stay. Congress should amend SLUSA to fix holes in discovery stay.

Recommendation 25. Spin-off cases. Congress should amend SLUSA to preclude "spin-off" cases by institutional investors (or require that they be stayed until the resolution of federal class-actions).

Recommendation 26. Interlocutory appeals. Congress should permit interlocutory appeals in all consumer class-action cases, consistent with the rationale set forth in Recommendation 13 above.

Recommendation 27. Settlement. The Advisory Committee on Civil Rules of the Federal Judicial Conference should endorse the appointment of special masters or interim class counsels to facilitate early settlements in consumer class-action cases.

Recommendation 28. Shared costs. Congress should amend the Federal Rules of Civil Procedure to require that costs of discovery be shared by the parties.

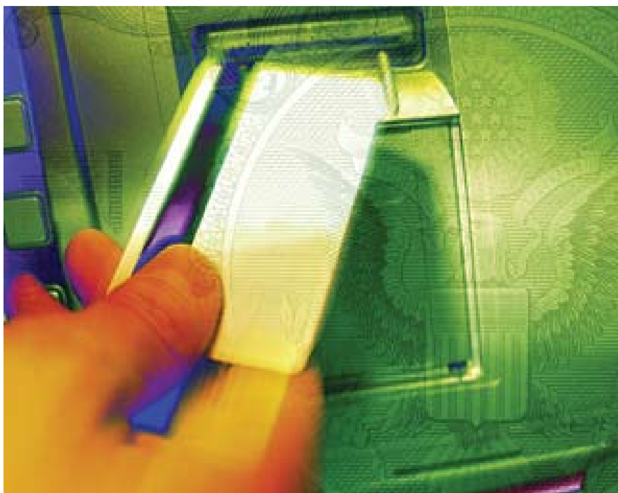
Recommendation 29. Deference to regulatory determinations. Congress should require trial judges in class-actions case to give appropriate deference to regulatory determinations.

POLICY REFORM IV. CONSUMER CREDIT AND FINANCIAL SECURITY.

Financial services opportunities for all consumers should be enhanced through a combination of policy, regulatory, and industry initiatives. Specifically:

Recommendation 30. National financial literacy plan. National and state educational authorities, working in conjunction with financial regulators and the financial services industry, should develop a national financial literacy program that includes the incorporation of financial literacy training in school

curricula. Such a program should address not only the use of credit, but also long-term retirement savings and financial security.



Recommendation 31. Alternative dispute resolution mechanism. Congress, with input from the financial services industry and its consumers, should create alterative dispute resolution mechanisms for consumer disputes.

Recommendation 32. Model disclosure forms. Congress should authorize the federal financial regulators to develop simplified model disclosure forms for consumer lending and other financial activities based upon extensive consumer testing and interaction with the financial services industry, and shield firms from class-action lawsuits when they follow the forms in good faith. To be most effective, disclosures should be provided at the beginning of a transaction, not the end. Moreover, Congress also should resist mandating specific disclosure terms, type, size, or other details in favor of a more general principles-based approach to consumer disclosure.

Recommendation 33. Uniform application. Congress should ensure that national consumer protection laws are applied uniformly throughout the United States.

Recommendation 34. Consumer compliant portal. Federal and state financial regulators should establish a uniform consumer complaint form and single point of contact for consumer complaints related to financial products and services.

POLICY REFORM V. ANTI-MONEY LAUNDERING.

Policymakers and regulators should make anti-money laundering supervision more proportionate, risk-based, and prudential.

Recommendation 35. New guidelines for examinations. The Director of FinCEN and the heads of financial regulatory agencies should adopt a revised approach to examinations – throughout all levels of their agencies – that is based upon the following factors:

- Consistency – The agencies should continue to strive toward consistency in examination approaches and interpretation of anti-money laundering laws and regulations

- Context – Examination findings should be placed in the context of an institution's overall

risk-based program and profile

- Collaboration – Examiners and management should share information to find more effective ways to detect significant risks

- Coordination – Examinations should be coordinated among regulators to eliminate supervisory or regulatory duplication.

Recommendation 36. Information sharing. Regulators and law enforcement agencies should enhance confidential information sharing between governmental authorities and financial institutions to prevent money-laundering.

Recommendation 37. Security clearance. Regulators and law enforcement agencies should provide appropriate security clearances to select financial institution personnel, beginning with money center banks.

Recommendation 38. Selective information sharing. Regulators and law enforcement agencies should promote more selective information and targeted sharing based on financial and other intelligence.

Recommendation 39. Greater use of Section 314(a) process. Regulators and law enforcement agencies should reduce the burden of conducting unfocused information searches for most financial institutions by making greater use of the Section 314(a) process.

Recommendation 40. Regular meetings. Regulators and law enforcement agencies should organize periodic meetings between industry and regional SAR review teams in local US attorneys' offices to discuss trends, and patterns of activities, and share examples of effective SAR filings.

Recommendation 41. Customer due diligence. The current guidance and direction by regulatory authorities for financial institutions to collect and document "usual and expected" activity should be reviewed to determine if it should be subject to public comment.

Recommendation 42. Training of examiners. Treasury and the financial regulators should develop a training program designed to give both compliance staff and examiners a better understanding of the operations and business of financial institutions.

Recommendation 43. CTR filings. Regulators should reform the CTR filing process to reduce the compliance burden associated with this filing requirement, while preserving the goals of anti-money laundering enforcement. Specifically:

Recommendation 44. SAR filings. Regulators should substitute SAR filings for the CTR report and Form 8300 (cash equivalent reports) on multiple transactions under $10,000.

Recommendation 45. GAO study. Regulators and the GAO should meet with representatives of the financial services industry prior to the release of the GAO's report on CTRs to discuss the GAO's pending recommendations.

Recommendation 46. Title 31 enforcement. To encourage the use of CTR exemptions, the Title 31 enforcement doctrine for CTR exemption violations should be evaluated by law enforcement agencies and financial regulators.

Recommendation 47. Guidance. Law enforcement agencies and regulators should provide guidance to the industry on stored value cards and domestic political persons.

Recommendation 48. Outcomes-based SARs. FinCEN, in conjunction with feedback from the industry, should develop outcomes-based SARs.

Recommendation 49. Affiliates SAR sharing. Regulators should allow the sharing of SARs with affiliates.

Recommendation 50. Standardized training. Regulators should develop a standardized training program for agents and brokers. Insurance companies should be given a safe harbor for compliance when they use agents or brokers who have successfully passed such a training program.

Recommendation 51. International compliance guidance. U.S. regulators should provide financial services firms with guidance on compliance with privacy and anti-money laundering requirements imposed by other countries that conflict with U.S. requirements.

POLICY REFORM VI. RISK-BASED CAPITAL REGULATION.

The U.S. and international financial regulators should build upon the approach taken in the Basel II Capital Accord and apply a consistent risk-based focus to capital regulation for all financial services firms. More specifically:

Recommendation 52. Competitiveness. As U.S. financial regulators implement the new Basel II Capital Accord, they should adhere to Principle 2 (open and competitive markets), to ensure that the Accord does not place either smaller U.S. banks at a competitive disadvantage to larger banks or larger U.S. banks at a competitive disadvantage to their foreign competitors. To meet this objective, regulators should implement the

international standardized approach as an option for non mandatory banks.

Recommendation 53. Capital components. U.S. financial regulators should review all components of capital, with the active participation of the financial services industry, to make sure they are fully aligned internationally. The regulators should report their findings publicly.

Recommendation 54. Leverage ratio. The U.S. financial regulators should undertake a review of the continued role of the leverage ratio within the Basel II framework in the context of international competitiveness. The regulators should report their findings publicly.

Recommendation 55. Comparable capital rules. The U.S. and international financial regulators should harmonize capital requirements across industry lines. Moreover, the Secretary of the Treasury, in the absence of a national insurance regulator, should begin a dialogue with U.S. insurers and the NAIC on the Solvency II process to ensure that the requirements for U.S. and E.U. firms are comparable.

POLICY REFORM VII. SOX 404 IMPLEMENTATION.

Policymakers, regulators, and the financial services industry should monitor the implementation of recent regulatory initiatives to enhance the implementation of Sarbanes-Oxley Section 404 and, based on the results of this monitoring, take appropriate actions as necessary. Specifically:

Recommendation 56. Methodology. Both the regulatory agencies and the industry should establish a methodology for monitoring and measuring the impact of recent initiatives to enhance the implementation of Sarbanes-Oxley Section 404. Specifically, they should jointly establish benchmark levels for the time and cost involved in Section 404 compliance, (e.g., the number and type of process and entity-level controls examined, and the number of deficiencies identified). Public companies, the regulatory agencies, and the accounting industry should compare the actual implementation burden with the benchmarks and if the benchmarks are exceeded, further study and modification should be undertaken.

Recommendation 57. SEC supervision of the PCAOB. The SEC should take a more active supervisory role with the PCAOB to ensure the PCAOB takes a more balanced role in executing its responsibilities and in the furtherance of the SEC's mandate for competitiveness, efficiency, and capital formation.

Recommendation 58. Roundtable survey. The Financial Services Roundtable should take a leading role in monitoring the implementation of the new SEC and PCAOB Section 404 guidance.

Recommendation 59. PCAOB industry participation. The PCAOB should be expanded to include a representative of the public reporting companies.

Recommendation 60. Periodic public reporting. The PCAOB should be required to make both annual and quarterly public reports. These reports should include information on the Board's proposed regulatory agenda, the status of the implementation of PCAOB policies, the existence of identified problem areas and explanation of the cause of these problems, and a summary of significant comments raised to the PCAOB by the public, public reporting companies, or the accounting industry.

POLICY REFORM VIII. MODERN ACCOUNTING STANDARDS.

Accelerate needed reforms in U.S. accounting and reporting standards to improve comparability and efficiency of financial reporting across global markets. Policymakers, regulators, and public companies including financial services firms should continue to advocate improving U.S. accounting standards. Specifically:

Recommendation 61. Current initiatives. Policymakers, regulators, and public companies including financial services firms should support current policy efforts by the Treasury Department, the SEC, FASB and the IASB to improve financial reporting and accounting.

Recommendation 62. IFRS. Policymakers and regulators should permit the full use of IFRS now without reconciliation to GAAP. Both the Roundtable and individual member companies should participate in the current public comment period and any future considerations.

Recommendation 63. Convergence. Policymakers and regulators, with support

from public companies including financial services firms, should accelerate the convergence of IFRS and U.S. GAAP.

Recommendation 64. Transition. Policymakers and the regulators should allow an appropriate transition period to educate issuers, investors, accountants, and others on IFRS.

POLICY REFORM IX. MODERNIZE EXISTING CHARTERS.

Recommendation 65. Existing Depository Institution Charters. The financial regulators and Congress should modernize national and state banking and thrift charters by removing outdated or redundant requirements that inhibit the ability of firms to innovate and serve their consumers more effectively and efficiently in their local markets as well as the global financial marketplace. For example, Congress should eliminate outdated restrictions on the interstate and intrastate operations of banks and thrifts. Banks and thrifts should be able to use different organization forms as they evolve. Congress also should review and amend the Bank Holding Company Act and the International Banking Act to enhance the competitiveness of financial holding companies and internationally active financial services firms.

POLICY REFORM X. NEW NATIONAL CHARTER OPTIONS.

Congress should authorize three new optional national charters that permit financial services firms to serve and protect consumers better both domestically and internationally, and which permits individual firms to be subject to regulation, supervision, and enforcement by a single national authority.

Recommendation 66. Optional national insurance charter. Congress should provide for the optional chartering, regulation, supervision and enforcement of national insurers, agencies, and individual insurance producers by a bureau of the Treasury Department. Nationally-chartered insurance firms, agencies and producers would be permitted to operate in any state with full competitive pricing, subject to one license and one set of prudential and market conduct rules.

Recommendation 67. Optional national securities charter. Congress should provide for the optional chartering, regulation, supervision and enforcement of national securities firms and individual brokers by a single national authority, such as the SEC, FINRA, or some new agency. Nationally-chartered securities firms and brokers should be permitted to operate in any state, subject to one license and one set of prudential and market conduct rules.

Recommendation 68. Optional universal financial services charter. Congress should create a new, optional universal financial services charter that would permit a financial services firm to engage in financial activities under the regulation, supervision, and enforcement by a single national authority, which could be the Office of the Comptroller of the Currency, the Federal Reserve Board, or some new agency. For purposes of this charter, "financial activities" are activities that are financial in nature, incidental or complementary thereto, but are not commercial activities.

Appendix B – Abbreviations

Abbreviation	Name
ABCP	Asset-backed commercial paper
ACLI	American Council of Life Insurers
AML	Anti-money laundering
ARM	Adjustable rate mortgage
BHCA	Bank Holding Company Act
BIS	Bank for International Settlements
BSA	Bank Secrecy Act
CCS	Comprehensive consolidated supervision (E.U.)
CFR	Code of Federal Register
CFTC	Commodity Futures Trading Commission
COSO	Committee of Sponsoring Organizations (Treadway Committee)
CRA	Community Reinvestment Act
CSE	Consolidated supervised entity (SEC)
CTR	Currency transaction report
DIDC	Depository Institutions Deregulation Committee
DPG	Derivatives Policy Group (SEC)
E.U.	European Union
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FFIEC	Federal Financial Institutions Examination Council
FinCEN	Financial Crimes Network
FINRA	Financial Institutions Regulatory Authority
FMOB	Financial Markets Oversight Board
FRB	Federal Reserve Board
FSA	Financial Services Authority (United Kingdom)
FSLIC	Federal Savings and Loan Insurance Corporation
FSMA	Financial Services and Markets Act (United Kingdom)
FTC	Federal Trade Commission
GAAP	Generally accepted accounting principles
GAO	General Accounting Office
GDP	Gross domestic product
GLBA	Gramm-Leach-Bliley Act
HOPEA	Home Owners Equity Protection Act
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board (United Kingdom)

IFRS	International Financial Reporting Standards
IPO	Initial public offering
LSE	London Stock Exchange
MSRB	Municipal Securities Rulemaking Board
NAIC	National Association of Insurance Commissioners
NASD	National Association of Securities Dealers
NCUA	National Credit Union Administration
NFA	National Futures Association
NOW	Negotiable order of withdrawal
NPR	Notice of proposed rulemaking
NSMIA	National Securities Markets Improvement Act
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OCIE	Office of Compliance, Inspections, and Examinations (SEC)
OFAC	Office of Foreign Asset Control (U.S. Treasury Department)
OFC	Optional federal insurance charter
OFII	Organization for International Investment
OTC	Over-the-counter (derivatives)
OTS	Office of Thrift Supervision
PCAOB	Public Company Accounting Oversight Board
PEP	Politically exposed person
PSLRA	Public Securities Litigation Reform Act
PWG	President's Working Group on Financial Markets
QIS	Quantitative impact studies (Basel II)
QTL	Qualified thrift lender
RCSA	Risk control self assessments (Basel II)
RESPA	Real Estate Settlement Procedures Act
SAIF	Savings Association Insurance Fund
SAR	Suspicious activity report
SEC	Securities and Exchange Commission
SIFMA	Securities Industry and Financial Markets Association
SIPC	Securities Industry Protection Corporation
SLUSA	Securities Litigation Uniform Standards Act
SOX	Sarbanes-Oxley Act
SRO	Self-regulatory organization
TRIA	Terrorist Risk Insurance Act

Appendix C – Commission Members

Mr. James Dimon, Co-Chairman
Chairman and Chief Executive Officer
JP Morgan Chase & Co.

Mr. Richard M. Kovacevich, Co-Chairman
Chairman
Wells Fargo & Company

Ms. Ellen Alemany
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Mr. Robert Wolf
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Americas
UBS

Notes

1001 Pennsylvania Ave., NW, Suite 500 South
Telephone: 202.289.4322 | Fax: 202.628.2507
Website: www.fsround.org