

TESTIMONY OF

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COMMITTEE ON FINANCIAL SERVICES

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REGULATORY RESTRUCTURING AND REFORM OF
THE FINANCIAL SYSTEM

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ROOM 2128, RAYBURN OFFICE BUILDING

Chairman Frank, Ranking Member Bachus and members of the Committee, thank you for inviting me to testify today. My name is Joel Seligman. For the past 31 years I have been a professor whose research has addressed securities markets and financial regulation. I am here to offer my personal views. I am also the President of the University of Rochester and a member of the Board of Governors of FINRA. I am not speaking today on behalf of either of these organizations.

We have reached a moment of discontinuity in our federal and state system of financial regulation that will require a comprehensive reorganization. Not since the 1929-1933 period has there been a period of such crisis and such felt need for a fundamentally new approach to financial regulation.

The need for a fundamental restructuring of finance is based only in part on the current crisis in our housing and credit markets, the concomitant collapse of several leading investment and commercial banks and insurance companies and dramatic deterioration of our stock market indices. Quite aside from the current emergency, finance has fundamentally changed in recent decades while financial regulation has moved far more slowly:

- In the New Deal period, most finance was atomized into separate investment banking, commercial banking or insurance firms. Today finance is dominated by financial holding companies which operate in each of these and cognate areas such as commodities.
- In the New Deal period, the challenge of regulating finance was domestic. Now, when our credit markets are increasingly reliant on trades originating from abroad; our major financial institutions trade simultaneously throughout the world; and information technology has made international money transfers virtually instantaneous, the fundamental challenge is increasingly international.
- In 1930, approximately 1.5 percent of the American public directly owned stock on the New York Stock Exchange. Today a substantial majority of Americans own stock directly or indirectly through pension plans or mutual funds. A dramatic deterioration in stock prices affects the retirement plans and sometimes the livelihood of millions of Americans.
- In the New Deal period, the choice of financial investments was largely limited to stocks, debt and bank accounts. Today we live in an age of complex derivative instruments, some of which recent experience has painfully shown are not well understood by investors and on some occasions by issuers or counterparties.
- Most significantly, we have learned that our system of finance is more fragile than we earlier had believed. The web of interdependency that is the hallmark of sophisticated trading today means when a major firm such as Lehman Brothers is bankrupt, cascading impacts can have powerful effects on an entire economy.

Against this backdrop, what lessons does history suggest for this Committee to consider as it begins to address the potential restructuring of our system of financial regulation?

First, make a fundamental distinction between emergency rescue legislation which must be adopted under intense time pressure and the restructuring of our financial regulatory order which will be best done after systematic hearings and will operate best when far more evidence is available. The creation of the Securities and Exchange Commission and the adoption of six federal securities laws between 1933 and 1940, for example, were preceded by the Stock Exchange Practices hearings of the Senate Banking Committee held between 1932 and 1934. The longevity of the financial regulatory system that Congress adopted in the New Deal period was the consequence of the thoughtfulness of the hearings and legislative reports that preceded legislation.

Second, I would strongly urge each house of Congress to create a Select Committee similar to that employed after September 11th to provide a focused and less contentious review of what should be done. The most difficult issues in discussing appropriate reform of our regulatory system become far more difficult when multiple Congressional committees with conflicting jurisdictions address overlapping issues. This

is a time when it is important that all appropriate alternatives be considered, including consolidating regulatory agencies, creating new regulatory agencies and transferring jurisdiction. This type of review is far more likely to succeed before a single Select Committee, presumably including the chairs or appropriate representatives from the existing oversight committees.

Third, the scope of any systematic review of financial regulation should be comprehensive. This not only means that obvious areas of omission today such as credit default swaps and hedge funds need to be part of the analysis, but it also means, for example, our historic system of state insurance regulation should be reexamined. In a world in which financial holding companies can move resources internally with breathtaking speed, a partial system of federal oversight runs an unacceptable risk of failure.

Fourth, a particularly difficult issue to address will be the appropriate balance between the need for a single agency to address systemic risk and the advantages of expert specialized agencies. There is today an obvious and cogent case for the Federal Reserve System or the Department of Treasury to serve as a crisis manager to address issues of systemic risk including those related to firm capital and liquidity. But to move too rapidly to transform either agency into the sole or dominant federal financial regulator comes with enormous risks.

There are powerful advantages to the expertise a focused agency such as the Securities and Exchange Commission (SEC) historically has brought to financial regulation.

In 1934, there was a strong preference of those who sought the most effective federal securities regulation that the Federal Trade Commission, which initially enforced the Securities Act of 1933, remain the federal securities regulator.¹ The FTC in 1934 was very sympathetic to far-reaching securities regulation and included among its members James Landis who championed continuing the FTC as the federal securities regulator. Only later would Landis revise his view and come to believe that an agency like the SEC with a narrow jurisdiction had advantages in providing administrative expertise that an agency with a broad jurisdiction, like the FTC, did not.²

More recent experience amplifies this point. The broader an agency's jurisdiction the more likely it is to not have the resources or capability to address all appropriate priorities. A significant illustration of this involved the SEC during the late 1990s. Given an inadequate budget, Commission ongoing review of periodic disclosure documents such as Form 10-K badly deteriorated. In October 2002, a staff report of the Senate Governmental Affairs Committee, for example, found that in FY 2001 the SEC's Division of Corporate Finance was able to complete a full review of only 2280 of 14,600

¹ Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 100 (Aspen 3d ed. 2003).

² *Id.* at 97.

Form 10-K annual reports, roughly 16 percent, far short of the Division's stated goal to review every company's annual report at least once every three years. "Of more than 17,300 public companies, approximately 9200 or 53%, have not had their Form 10-Ks reviewed in the past three years." Enron, then the most notorious example of staff neglect, had last received a partial review of its Form 10-K annual report in 1997 and had been last subject to a full review in 1991.³ The argument can be made that had the SEC had the resources to have run the Division of Corporate Finance at more appropriate levels, the Public Company Accounting Oversight Board might not have been needed.

The creation of the PCAOB, however, ensured that there would be one federal agency solely responsible for audit quality. The Board, unlike the SEC of 1990s, had a narrow agenda and did not have to balance using resources for audit review with a broad array of other potential priorities such as market regulation, broker-dealer and investment adviser regulation, new securities offerings, municipal and governmental securities dealers, and enforcement. While the first SEC Chair, Joseph Kennedy, memorably observed in 1935 that "I'd hate to go out of here thinking that I had just made some changes in accounting practices,"⁴ it is reasonable to assume that no one at the PCAOB has ever derogated improving audit quality.

This point should not be overstated. The narrower an agency's agenda, the less likely it will be to galvanize White House or Congressional support for its budget and administrative priorities. An expert specialized agency runs the risk of being lost in the alphabet of federal agencies, subject, like the SEC too often has been, to a boom and bust cycle of budgetary and legislative support with effective support most likely only in times of crisis.⁵

The challenge is to find the right balance between expertise, which is a byproduct of a well run regulatory agency, and effectiveness, which often can be better achieved by reducing the number of responsible agencies and increasing resources for each. There is no algebraic formula to achieve this balance. Too little weight, in my view, was accorded to agency expertise in the Treasury Department's recent Blueprint for a Modernized Financial Regulatory Structure and there is a need for detailed hearings in the near term future not only to examine what went wrong but also to examine what existing financial regulatory agencies do well and what the costs of restructuring might be.

³ II Staff Report to Senate Comm. on Gov't Affairs, Financial Oversight of Enron: The SEC and Private Sector Watchdogs 13, 31-32 (Oct. 8, 2002).

⁴ Seligman, *supra* n.1, at 116-117.

⁵ Cf. William Cary, *Politics and Regulatory Agencies* (1967), including the observation that "government regulatory agencies are stepchildren whose custody is contested by both Congress and the Executive, but without much affection from either one... Without the cooperation of both Congress and the Executive, little constructive can be achieved. To reemphasize the point, an agency is literally helpless if either branch is uninterested or unwilling to lend support."

Let me highlight why these types of hearings are best done by Select Committees. The politics of Congress and the agencies themselves tend to fortify inertia. In the wake of the October 19, 1987 stock market crash, for example, the Report of the Presidential Task Force on Market Mechanisms argued that “the markets for stocks, stock index futures and stock options – are in fact one market” and accordingly “one agency must have the authority to coordinate a few but critical intermarket regulatory issues, monitor intermarket activities and mediate intermarket concerns.”⁶ The Report concluded that the Federal Reserve Board “is well qualified to fill the role of intermarket agency.”⁷

Within one month, this proposal was effectively dead. Federal Reserve Board Chair Alan Greenspan testified that he “seriously [questioned] this recommendation”:

To be effective, an oversight authority must have considerable expertise in the market subject to regulation, something that the CFTC and SEC have developed over time. Moreover, were the Federal Reserve to be given a dominant role in securities market regulation there would be a presumption by many that the federal safety net applicable to depository institutions was being extended to these markets and the Federal Reserve stood ready to jump in whenever a securities firm or clearing corporation was in difficulty.⁸

Beyond the Federal Reserve Board’s lack of enthusiasm, there were other fundamental reasons for then rejecting the single regulatory proposal as initially formulated. The intermarket coordinator could be criticized for being overgeneral. In effect, the coordinator would be expected to address three quite distinct tasks: (1) The liquidity of the banking system in making available credit to stock brokers, futures, commodities merchants and clearing agencies; (2) stock market-stock options-stock index futures coordination issues including circuit breaker mechanisms, information systems, market surveillance, and enforcement as well as planning for market emergencies; and (3) harmonizing margin requirements across markets.

The first task was already addressed by the Federal Reserve Board; the second and third might most easily have been addressed by consolidating in the SEC all financial futures then overseen by the CFTC that were part of what correctly had been labeled “one market.” Indeed the SEC-CFTC relationship required a considerable degree of duplication of effort when the SEC reviewed petitions for approval before the CFTC and had led to protracted litigation to determine which agency had jurisdiction over various hybrid financial instruments. But this type of argument, though advanced by SEC Chair

⁶ Report of the Presidential Task Force on Market Mechanisms 55, 59 (1988).

⁷ Id. at 69.

⁸ Black Monday, The Stock Market Crash of October 19, 1987, Hearings before Senate Comm. on Banking, Hous. & Urban Affairs, 100th Cong., 2d Sess. 98-99 (1988).

David Ruder in 1988⁹ among many others before and after,¹⁰ did not receive serious Congressional consideration for the simple reason that the SEC and the CFTC were subject to separate Congressional oversight committees. The most likely way in which there can be a mature consideration of the wisdom of consolidation of the SEC and CFTC would be to vest in a single committee in each house of Congress oversight responsibility for all stocks, stock options, and financial futures (or all futures). Similarly, the most likely way there could be mature consideration of broader types of financial regulatory consolidation today would involve vesting in a single committee in each house of Congress oversight responsibility over all relevant financial agencies.

Let us suppose that questions of agency expertise could be effectively addressed through some form of agency consolidation and that Congressional oversight issues could be resolved. There would then remain the most significant consideration that will confront Congress when it seeks to restructure regulation. How should a new regulatory order be designed? No one seeks more regulation for the sake of regulation. The real challenge is how to design the wisest system of regulation.

Until quite recently, it was assumed that proposals to consolidate regulatory agencies would be accompanied by calls for broader exemptions for smaller firms, as was proposed by a 2006 SEC Advisory Committee¹¹ or proposals to restrict private litigation as were made by several recent proponents.¹² A frequently expressed theme involves replacing detailed financial regulation with more principles-based regulation.¹³

Indeed a leitmotiv of the Treasury Department Blueprint was its strong preference for “core principles” rather than detailed legal standards. Core principles are an inspiring aspiration. All of us would like to make regulation simpler and more efficient. There is no more serious question that in some instances regulatory rules are historical artifacts or have grown longer and more expensive in terms of compliance costs than is wise. But that said, core principles are only part of what a mature regulatory system requires. For example, the Treasury Department repeatedly praised the Commodity Future Modernization Act Core Principles. These include:

- 3) Contracts not readily subject to manipulation – The board of trade shall list on the contract market only contracts that not readily subject to manipulation.

⁹ Ruder, October Recollections: The Future of the U.S. Securities Markets, a paper delivered before the Economics Club of Chicago (Oct 20, 1988).

¹⁰ Recently, see Casey Hails Congress’ Consideration of Possible SEC-CFTC Combination, 39 Sec. Reg. & L. Rep. 1657 (2007); SIFMA Advocates SEC-CFTC Merger under Treasury’s Reg Reform Initiative, 39 id. 1840.

¹¹ SEC Advisory Committee on Smaller Public Companies, 87 SEC Dock. 1138 (2006)

¹² See, e.g., Interim Report of the Comm. on Capital Market Regulation (Nov. 30, 2006).

¹³ See, e.g., Financial Services Roundtable, Blueprint for U.S. Financial Competitiveness (2007).

17) Recordkeeping – The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.¹⁴

While these core principles may be helpful, they cannot stand alone without an enabling statute, often detailed regulation, case law, and agency interpretative guidance. What, for example, is manipulation? It is not a self-defining term. What records must be retained? What form and manner will be acceptable to the Commission?

There are sometimes quite negative consequences of an overemphasis on core principles. To the extent that this may result in ambiguity in legal requirements, core principles may inspire greater litigation. The history of the SEC in areas such as the net capital rule suggests that without detail and customizing by type of transaction a principle or rule itself can be undermined by unexpected SRO or industry initiatives as was done in the late 1960s during the so-called back office crisis.¹⁵

To be sure, it is almost inconceivable that if Congress were writing on a clean slate that Congress would create our current system of financial regulation. This system involves five separate federal institutions that address depository institutions, including the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration, as well as state regulation of banking in each state. We are one of the few countries in the world that separately regulates securities and commodities. Securities regulation, like banking, occurs both at the national and state level. Insurance regulation, in contrast, occurs solely at the state level.

The Federal Reserve Bank often has stepped up and played a lead role in crisis management. This occurred after the October 1987 Stock Market Crash and in several other subsequent events such as the 1990s Asia, Russian and Long Term Capital crises. But the Fed's role, as with the role of the Department of Treasury before the adoption of the Emergency Economic Stabilization Act of 2008, has been improvised and ad hoc.

To formalize one agency as unequivocally in charge during times of crisis seems wise. It has become all the more appropriate as financial firms increasingly are no longer just involved in securities or insurance or commodities or banking but can be involved in combinations that involve some or all of those product lines.

But to create a single clear crisis manager only begins analysis of what an appropriate structure for federal financial regulation should be. Subsequently there would need to be considerable thought given as to how best to harmonize these new risk

¹⁴ Department of Treasury, Blueprint for a Modernized Financial Regulatory Structure 215-218 (Mar. 2008).

¹⁵ Seligman, *supra* n.1, at 457-458 (describing different approaches to net capital at the New York Stock Exchange and the SEC and how then NYSE Rule 325 permitted withdrawal of capital during a shorter period of time than SEC Rule 15c3-1).

management powers with the roles of those specialized financial regulatory agencies that continue to exist.

Existing federal financial regulatory agencies often have quite different purposes and scopes. Bank regulation, for example, has long been based on safety and solvency priorities; securities regulation largely focuses on investor protection. The scope of banking regulation addresses, among many other topics, consumer protection. Securities laws address full disclosure, accounting standards, audit quality, broker-dealer and investment adviser regulation, regulation of stock exchanges and fraud enforcement, among many other topics. Insurance and commodities regulation have similar distinctive purposes and scope.

These differences in purpose and scope, in turn, are often based on the quite different pattern of investors (retail versus institutional, for example), different degree of internationalization, and different risk of intermediation in specific financial industries.

The political structure of our existing agencies also is strikingly different. The Department of Treasury is part of the Executive Branch. The Federal Reserve System and Securities Exchange Commission, in contrast, are meant to be independent regulatory agencies. Independence, however, as a practical reality, is quite different at the Federal Reserve System, which is self-funding, than at the SEC and most independent federal regulatory agencies, whose budgets are presented as part of the administration's budgets. In creating the SEC and most independent regulatory agencies, Congress did stress the need to depoliticize leadership by requiring that "[n]o more than three of such commissioners shall be members of the same political party..."

Consolidation of existing agencies wisely should be considered. But the case for consolidation is weakened if the Federal Reserve or Department of Treasury is unequivocally given the role of crisis manager.

Each proposed consolidation should be analyzed on its individual merits. It is likely that some of the proposed mergers will prove wiser than others.

Underlying any potential financial regulatory consolidation are pivotal policy questions such as:

What should be the fundamental purpose of new legislation? Should Congress seek a system that effectively addresses systemic risk, safety and solvency of intermediaries, investor or consumer protection or other overarching objectives? If there are multiple objectives, as is likely, how should they be harmonized?

How should Congress address such topics as coordination of inspection, examination, conduct or trading rules, enforcement or private rights of action? Should one approach be used in all financial industries or should the different underlying context of different industries justify different rules?

Should new financial regulators be part of the Executive Branch or be independent regulatory agencies? If they are independent regulatory agencies, should they follow the self-funding model of the Federal Reserve System or rely on annual budget review as we now do at the SEC and independent regulatory agencies generally?

Should the emphasis in a new financial regulatory order be on command and control to best avoid economic emergency or on depoliticization to ensure that all relevant views are considered by financial regulators before decisions are made?

How do we analyze the potentialities of new regulatory norms in an increasingly global economy?

What role should self-regulatory organizations such as FINRA play in a new system of financial regulation?

These and similar pivotal questions should inform the most consequential debate over financial regulation that we have experienced since the New Deal period. The answers are neither simple nor obvious, but one conclusion is inevitable: How well we develop the structure of financial regulation will help determine this nation's financial stability for decades to come.