TESTIMONY OF JOEL SELIGMAN

CONGRESSIONAL OVERSIGHT PANEL

THE CURRENT STATE OF THE FINANCIAL REGULATORY SYSTEM AND FUTURE REGULATORY RESTRUCTURING

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ROOM 253, RUSSELL SENATE OFFICE BUILDING

Chairperson Warren, Congressman Hensarling, Senator Sununu, Mr. Neiman and Mr. Silvers, 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.

There is today an urgent need for a fundamental restructuring of federal financial regulation primarily based on three overlapping causes:

First, an ongoing economic emergency, initially rooted in our housing and credit markets, which has been succeeded by the collapse of several leading investment and commercial banks and insurance companies, dramatic deterioration of our stock market indices, and now a rapidly deepening recession.

Second, serious breakdowns in the enforcement and fraud deterrence missions of federal financial regulation, notably in recent months as illustrated by matters involving Bear Stearns and the other four then independent investment banks subject to the Securities and Exchange Commission's (SEC) former Consolidated Supervised Entities program,[1] the government

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[1] See, e.g., Testimony of SEC Chair Christopher Cox, Reform of the Financial Regulatory System, House Comm. on Financial Services, 110th Cong., 2d Sess. (July 24, 2008) (describing creation of Consolidated Supervised Entities program); SEC Off. of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program (Report No. 446-A Sept. 2008); SEC Chair Announces End of Consolidated Supervised Entities Program, SEC Press. Rel. 2008-230 (Sept. 26, 2008).

creation of conservatorships for Fannie Mae and Freddie Mac,[2] the Bernard Madoff case,[3] and more generally a significant decline in the number of prosecutions for securities fraud at least in 2008.[4]

Third, a misalignment between federal financial regulation and financial firms and intermediaries. The structure of financial regulation that was developed during the 1930s[5] has not kept pace with fundamental changes in finance:

- 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. A recent report estimates that in the first quarter of 2008 approximately 47 percent of U.S. households owned equities or bonds.[6] 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.[7]

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[2] Federal Gov't Seizes Control of Fannie, Freddie Mac; GSEs Put in Conservatorship, 40 Sec. Reg. & L. Rep. (BNA) 1410 (2008).

[3] SEC Statement Regarding Madoff Investigation (Press Rel. 2008-297 (Dec. 16, 2008).

[4] See, e.g., Eric Lichtblau, Wall St. Fraud Prosecutions Fall Sharply, N.Y. Times, Dec. 25, 2008 at A1 (133 securities fraud prosecutions in the first 11 months of 2008 compared to 513 cases in 2002).

[5] See generally Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance chs. 1-7 (Aspen 3d ed. 2003).

[6] Investment Co. Inst. & Securities Indus. & Fin. Mrkts. Ass'n, Equity and Bond Ownership in America (2008).

[7] In November 2008, the President's Working Group announced a new policy to create central counterparts for OTC derivatives by year end. The same day the SEC, CFTC, and Federal Reserve System issued an MOU to implement the central counterparty concept. PWG,

- 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.[8]

The size and scope of finance today is breathtaking. On September 1, 1929, the aggregate value of all securities listed on the New York Stock Exchange was approximately $90 billion.[9] At year end 2006, the total assets of the United States securities sector equaled $12.4 trillion, the banking sector had assets of $12.6 trillion, and the United States insurance industry held assets totaling $6 trillion.[10]

It is difficult to rationalize our current federal system of regulation that includes five separate federal depository institutions, specifically 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 banking regulation in each state. We are one of the few countries that separately regulate 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.

Against this backdrop, I would offer the following broad principles to guide consideration of a restructuring of federal 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 background reports. This Panel already has well illustrated the risks associated with the creation and implementation of the Troubled Asset Relief Program.[11] A case can be made that the sense of crisis that preceded the enactment of the Economic Emergency Stabilization Act of 2008[12] justified moving with alacrity. But a fundamental restructuring of financial regulation should occur at a far more measured pace. The

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Regulators Work to Encourage Launch of CDS Clearinghouse to End of December, 40 Sec. Reg. & L. Rep. (BNA) 1869 (2008).

[8] Lehman Brothers Holdings Files Ch. 11 Petition after Gov't Denies Funding, 40 Sec. Reg. & L. Rep. (BNA) 1476 (2008). The next day, the Department of Treasury decided to orchestrate an $85 billion bailout for insurance giant, AIG, see ibid, and subsequently sought the $700 billion Economic Emergency Stabilization Act of 2008, ___Stat.___, 110th Cong., 2d Sess. (2008).

[9] SELIGMAN, supra n.5, at 1.

[10] Department of Treasury, Blueprint for a Modernized Regulatory Structure 165 (2008).

[11] See, e.g., Accountability for the Troubled Asset Relief Program: The Second Report of the Congressional Oversight Panel (Jan. 9, 2009).

[12] ___ Stat. ___, 110th Cong., 2d Sess. (2008)

creation of the Securities and Exchange Commission (SEC) and the adoption of the six federal securities laws between 1933 and 1940, for example, was preceded by the Stock Exchange Practices hearings of the Senate Banking Committee held between 1932 and 1934. The longevity of the federal regulatory system that Congress adopted in the New Deal period was a consequence of the thoughtfulness of these hearings and legislative and regulatory commission reports that preceded legislation. In the post-World War II period, after the late 1950s when the SEC was subject to harsh criticism for under-enforcement of the securities laws, the key to its subsequent successful revival was a combination of new leadership, a significant increase in its enforcement budget, and the 1961-1963 Special Study of the Securities Markets which framed the evolution of securities regulation for much of the next 20 years.[13]

Second, 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[14] 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 as well as current securities law exemptions for areas including municipal securities[15]. A reexamination also is urgently needed of the adequacy of the current regulation of credit rating agencies[16] and the scope of investment adviser exemptions. 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. The fact that the federal government provided over $100 billion to insurance giant AIG alone suggests that insurance regulation is no longer purely a state matter.[17]

Third, Congress especially should focus on the structure of financial regulation, rather than addressing specific standards at too great a level of granularity. Historically Congress has had considerable success establishing regulatory agencies that address specific challenges subject to ongoing Congressional oversight. The creation of the Federal Reserve System and the SEC are two illustrations of this point. In contrast, it is often difficult given the crowded agenda of Congress to address specific problems with the detail and attention they deserve.

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[13] See, e.g., SELIGMAN, supra n.5, chs. 9-10.

[14] SEC Chair Christopher Cox has proposed regulating the $58 trillion market for credit default swaps to address a "regulatory hole … "completely lacking in transparency" that "is ripe for fraud and manipulation." SEC Chairman Urges Lawmakers to Confer Authority to Regulate Credit Default Swaps, 40 Sec. Reg. & L. Rep. (BNA) 1531 (2008).

[15] Pay-to-play practices have continued. See, e.g., Sisung Sec. Corp., Sec. Ex. Act Rel. 56,741, 91 SEC Dock. 2531 (2007).

[16] See, e.g, SEC Staff Examination of Select Credit Agencies, 2008 Fed. Sec. L. Rep. (CCH) 88,244 (2008) (criticizing credit agency examinations of residential mortgage-backed securities and collateralized debt obligations).

[17] Fed Again Invokes Emergency Powers with $37.8 Billion in New Loans to AIG, 40 Sec. Reg. & L. Rep. (BNA) 1643 (2008) (in addition to the provision of an earlier $85 billion).

Fourth, let me today address structure. I would propose consideration of a revitalized approach to federal financial regulation that:

(1) Designates the Federal Reserve System as the apex or supervisory agency for all financial regulation with an express mission to address and minimize systematic risk.

(2) Consolidates industry specific regulatory agencies in the areas of banking and thrifts, securities, and commodities to preserve expert examination, inspection, and enforcement roles. Particular attention here should be devoted to revitalizing enforcement including the effective use of private rights of action and self-regulatory organizations to complement the role of the federal regulatory agencies.

(3) Effectively allocates unregulated areas so that we eliminate today's regulatory holes.

Let me address each of these points in turn.

(1) The Federal Reserve Bank in recent years frequently has played a lead role in crisis management. This occurred after the October 1987 Stock Market Crash, the 1990s Asia, Russian and Long Term Capital crises, as well as the Stock Market Crash of 2008. The Fed's role, as with the role of the Department of Treasury, before the adoption of the Emergency Economic Stabilization Act of 2008, was typically ad hoc.

There is today a cogent case for the Federal Reserve System to serve as a crisis manager to address issues of systemic risk including those related to firm capital and liquidity. This 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.[18]

But to transform the Federal Reserve Bank or, for that matter, the Department of Treasury, into the sole federal financial regulator, in my view, would be highly unwise.

The Federal Reserve System and the Department of Treasury do not focus on enforcement or fraud deterrence. The Fed and the Department of Treasury have multiple purposes, but a priority for each has been the safety and solvency of financial intermediaries, most notably commercial banks. As many have recognized,[19] there are "inherent conflicts that may arise from time to time between the objectives of safety and soundness and consume

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[18] A caution here is appropriate. In response to the financial emergency we may see some dissolution of universal banks. See, e.g., David enrich, Citigroup Takes First Step toward Breakup, Wall St. J., Jan. 10-11, 2009, at A1.

[19] See, e.g., Group of Thirty, The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace (2008).

protection and transparency."[20] More specialized agencies such as the SEC, in contrast, have made fraud deterrence and the full disclosure system priorities with a particular mission of investor protection. While the SEC's recent performance today justifiably is subject to serious question, it should not be forgotten, that for much of its 75 year history, the Commission has been a leading independent regulatory agency because of its success in providing investors with confidence in its mandatory disclosure system. At its best, the Commission is the "cop on Wall Street." Even during a period when its performance has been quite question-begging, the SEC in Fiscal Year 2008, helped generate over $50 billion in settlements for injured investors and brought more than 670 cases that year, including 50 cases involving subprime lending.[21] More recently its work as the "investor's advocate" has been reflected in several significant settlements involving auction rate securities, including a very recent $30 billion settlement with Citigroup and UBS.[22]

It is improbable that a single super-federal financial regulator, regardless of its purposes, could systematically provide the same quality of enforcement and expertise than a structure that had a crisis manager at the apex of a structure and that also included specialized federal regulatory agencies such as the SEC and some of the depository institution regulatory agencies.

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 itself 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 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.[23] 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

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[20] Id. at 10.

[21] SEC, 2008 Performance and Accountability Report at 2-3.

[22] See, e.g, Citigroup, UBS Agree to Pay Record $30 Billion in ARS Settlement, 40 Sec. Reg. & L. Rep. (BNA) 2049 (2008).

[23] 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).

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,"[24] it is reasonable to assume that no one at the PCAOB has ever derogated improving audit quality.

There are pivotal advantages to having expert, well focused agencies. In emergency circumstances such as those of last July or September, the SEC was able to invoke its powers under Section 12(k)(2) of the Securities Exchange Act to adopt orders that addressed naked short sales very rapidly with considerable precision in designing the rule give the agency's understanding of the securities markets.[25]

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 Blueprint for a Modernized Financial Regulatory Structure[26] 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 will be.

(2) A pivotal criterion to addressing the right balance in designing a regulatory system is one that reduces as much as is feasible regulatory arbitrage. Whatever the historical reasons for the existence of a separate SEC and Commodities Futures Trading Commission (CFTC), the costs of having a system where in borderline cases those subject to regulation may choose their regulator is difficult to justify.[27] In too many instances such as those involving OTC derivatives, ambiguity with respect to responsibility has led to a system that too often has ignored or under-regulated pivotal aspects of our economy. Similarly, a disadvantage of a federal financial regulatory system with five depository institution regulatory agencies as well as the opportunity for banks or thrifts to solely choose state regulation undermines the ability to create and enforcement appropriate standards.

The design of an appropriate regulatory structure should take into account several fundamental questions which also will include identification of the purposes or objectives of each agency, their jurisdiction or scope, their political structure, enforcement and other powers,

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[24] Seligman, supra n.5, at 116-117.

[25] See, e.g,. Sec. Ex. Act Rel. 58,572, ___ SEC Dock. ___ (2008),

[26] DEPARTMENT OF TREASURY, supra n.10.

[27] Cf. Testimony of Joel Seligman, House Comm. on Fin. Serv., Regulatory Restructuring and Reform of the Financial System (Oct. 21, 2008) (addressing political challenges of consolidating the SEC and CFTC). Among others, the Department of Treasury has supported this consolidation. DEPARTMENT OF TREASURY, supra n.10, at 11-13, 106-126.

and coordination with international regulatory norms. Each of these topics deserves thoughtful consideration.

Until quite recently, for example, 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 Committee[28] or proposals to restrict private litigation as were made by several recent proponents.[29] A frequently expressed theme involves replacing detailed financial regulation with more principles-based regulation.[30]

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.
>
> 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.[31]

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

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

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

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

31 DEPARTMENT OF TREASURY, supra n.10, at 215-218.

by unexpected SRO or industry initiatives as was done in the late 1960s during the so-called back office crisis.[32]

I would urge a separate significant caution with respect to ongoing initiatives to substitute international standards in areas such as accounting for existing United States standards.[33] As Financial Accounting Standards Board Chair Bob Herz has aptly stated: "We have the best reporting system, but the rest of the world will not accept it."[34] We also have the largest proportion of individual investors. Internationalization of accounting standards, if done unwisely, potentially could significantly weaken our system of investor protection.

To make this point in other terms, creation of a single crisis manager at the apex of our financial regulators 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 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

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[32] Seligman, supra n.5, 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).
[33] The Securities and Exchange Commission has proposed a roadmap for potential use of financial statements prepared in accordance with international financial reporting standards by United States issuers. See Sec. Act. Rel. 8982, ___ SEC Dock. ___ (2008); see also Sec. Act Rel. 8831, ___ SEC Dock. ____ (2008) (related concept release). This initiative has drawn strong criticism. See, e.g., Remarks of PCAOB Board Member Charles Niemeir, 2008 Sarbanes-Oxley, SEC and PCAOB Conference, N.Y. State Soc'y of CPAs, N.Y. City (Sept. 10, 2008)
[34] Herz quoted in NIEMEIR, supra n.33.

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…"

With respect to the SEC, as in the past, there is today a particular need for a combination of new leadership, a budget better aligned with its mission and legislation that specifically addresses regulatory gaps that are no longer acceptable. President-elect Obama has wisely selected a talented and experienced new Chair in Mary Schapiro and emphasized his personal interest in prioritizing the restructuring of financial regulation. These are critical initial steps. Over time, the Commission, working with Congress, will want to address a number of specific topics such as better harmonizing broker-dealer and investment adviser regulation and reviewing its ethics rules to obviate the appearance or reality that service at the Commission involves a revolving door with industry.

(3) I have urged that any new system of federal financial regulation should be comprehensive. A final caution is in order. The fragility we have seen in global financial markets in recent months inevitably will reduce for a time willingness to rely solely on self-interest or the markets to provide optimal behavior. As SEC Chair Christopher Cox memorably wrote when the Commission disbanded the Consolidated Supervisory Entities program that previously had regulated the five largest independent investment banks, "voluntary regulation does not work."[35] The challenge in a new order will be to avoid the tendency to over-regulate. Independent regulatory agencies such as the SEC often have shown talent in customizing Congressional enactments, often adopted in times of crisis, to achieve the best balance between investors and industry. That talent too is urgently needed today.

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[35] SEC Press-Rel. 2008-230 (Sept. 26, 2008).