SUMMARIES OF SELECTED REPORTS AND COMMENTARIES ON REGULATORY REFORM AND FINANCIAL INSTITUTIONS

PART II: SUMMARIES IN TEMPLATE FORM OF SELECTED REPORTS AND COMMENTARIES

January 28, 2009

LIST OF SUMMARIZED REPORTS AND COMMENTARIES IN TEMPLATE FORM

The list below of reports and commentaries and the templates are ordered alphabetically by sponsor or author. The table following the list identifies those with substantial attention to particular topics.

Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision*, September, 2008, http://www.bis.org/publ/bcbs144.htm. **[Basel Liquidity Risk Management September 2008]**

Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation, Sustaining New York's and the US' Global Financial Services Leadership, January, 2007, http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf. **[Bloomberg/Schumer January 2007]**

Committee on Capital Markets Regulation (CCMR), Interim Report of the Committee on Capital Markets Regulation, November, 2006, http://www.capmktsreg.org/. **[CCMR November 2006]**

Committee on Capital Markets Regulation, Recommendations for Reorganizing the U.S. Financial Regulatory Structure, January 14, 2009, http://www.capmktsreg.org/. (CCMR January 2009) **[CCMR January 2009]**

Consumer Federation of America (CFA), Comments on the Treasury Department's Review of the Regulatory Structure Associated with Financial Institutions, November 21, 2007 (http://www.consumerfed.org/pdfs/Financial_Services_Regulation_Treasury_Comments_11-07.pdf) **[Consumer Federation November 2007]**

The Counterparty Risk Management Policy Group (CRMPG) III, Containing Systemic Risk: The Road to Reform, August 6, 2008, http://www.crmpolicygroup.org/docs/CRMPG-III.pdf. **[CRMPG III August 2008]**

Professor Lawrence A. Cunningham for Council of Institutional Investors, Some Investor Perspectives on Financial Regulation Proposals, September, 2008, http://www.cii.org/UserFiles/file/Sept2008MarketRegulation.pdf. **[Cunningham/CII September 2008]**

Financial Services Roundtable (FSR), The Blueprint for U.S. Financial Competitiveness, November, 2007, http://www.fsround.org/cec/blueprint.htm. **[Financial Services Roundtable November 2007]**

Financial Stability Forum (FSF), Report of The Financial Stability Forum on Enhancing Market And Institutional Resilience and The Follow-Up On Implementation, April 7, 2008 and October 10, 2008, http://www.fsforum.org/publications/r_0804.pdf and http://www.fsforum.org/press/pr_081009f.pdf. **[Financial Stability Forum April 2007 and October 2008]**

Group of 30 (G-30), The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace, October, 2008, http://www.group30.org/pubs/pub_1428.htm. **[G-30 October 2008]**

Group of 30 (G-30), Financial Reform: A Framework for Financial Stability, January 15, 2009, http://www.group30.org/pubs/pub_1460.htm. **[G-30 January 2009]**

Institute of International Finance (IIF), Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007– 2008, July, 2008, http://www.ieco.clarin.com/2008/07/17/iff.pdf. **[Institute of International Finance July 2008]**

International Organization of Securities Commissions Technical Committee (IOSCO), Report on the Subprime Crisis, May, 2008, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf. **[IOSCO Subprime Crisis May 2008]**

International Organization of Securities Commissions Technical Committee (IOSCO), The Role of Credit Rating Agencies in Structured Finance Markets, May, 2008, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf **[IOSCO CRA May 2008]**

Robert Kuttner, Prepared for Dēmos, *Financial Regulation After the Fall*, January, 2009 (http://www.demos.org/pubs/reg_fall_1_8_09%20(2).pdf). **[Kuttner/Dēmos January 2009]**

North American Securities Administrators Association, Proceedings of the NASAA Financial Services Regulatory Reform Roundtable, December 11, 2008, http://www.nasaa.org/content/Files/Proceedings_NASAA_Regulatory_Reform_Roundtable.pdf. **[NASAA December 2008]**

President's Working Group on Financial Markets (PWG), Policy Statement on Financial Market Developments, March, 2008, http://www.ustreas.gov/press/releases/hp871.htm. **[PWG March 2008]**

President's Working Group on Financial Markets (PWG), Progress Update on March Policy Statement on Financial Market Developments, October, 2008, http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf **[PWG October 2008]**

Securities Industry and Financial Markets Association (SIFMA), Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force, July 2008, http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf. **[SIFMA July 2008]**

Professor Joel Seligman, Testimony for a Hearing of the House Committee on Financial Services on the Future of Financial Services Regulation, Oct. 21, 2008, http://www.house.gov/apps/list/hearing/financialsvcs_dem/seligman102108.pdf. **[Seligman October 2008]**

Senior Supervisors Group (SSG), Observations on Risk Management Practices in the Recent Market Turbulence, March 6, 2008, http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf. **[SSG March 2008]**

Professor Joseph E. Stiglitz, Testimony for a Hearing of The House Committee on Financial Services on The Future of Financial Services Regulation, October 21, 2008 (http://www.house.gov/apps/list/hearing/financialsvcs_dem/stiglitz102108.pdf) **[Stiglitz October 2008]**

United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century, March 2007, http://www.uschamber.com/publications/reports/0703capmarketscomm.htm. **[U.S. Chamber of Commerce 2007]**

United States Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure, March, 2008, http://www.treas.gov/press/releases/reports/Blueprint.pdf. **[Treasury March 2008]**

United States Government Accountability Office (GAO), Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (GAO-09-216), January, 2009, http://www.gao.gov/new.items/d09216.pdf. **[GAO January 2009]**

United States Securities and Exchange Commission Staff, Summary Report of Issues Identified in The Commission Staff's Examination of Select Credit Rating Agencies, July, 2008, http://www.sec.gov/news/studies/2008/craexamination070808.pdf. **[SEC Staff July 2008]**

DOCUMENT OR COMMENTARY DISCUSSES TOPIC AREA TO A SUBSTANTIAL EXTENT							
	Regulatory Structure	**Risk Management**	**Consumer and Investor Protection**	**Credit Ratings Agencies**	**Accounting and Valuation**	**Derivatives Markets**	**U.S Financial Market Competitiveness**
Basel Liquidity Risk Management September 2008		X			X	X	
Bloomberg/Schumer January 2007	X		X			X	X
CCMR November 2006	X		X		X	X	X
CCMR January 2009	X		X				X
Consumer Federation November 2007	X		X	X			X
CRMPG III August 2008	X	X	X		X	X	
Cunningham/CII September 2008	X		X			X	X
Financial Services Roundtable November 2007		X	X	X	X	X	X

	Regulatory Structure	Risk Management	Consumer and Investor Protection	Credit Ratings Agencies	Accounting and Valuation	Derivatives Markets	U.S Financial Market Competitiveness
Financial Stability Forum April 2007 and October 2008		X	X	X	X	X	
G-30 October 2008	X	X	X		X	X	
G-30 January 2009	X	X	X	X	X	X	
Institute of International Finance July 2008	X	X	X	X	X	X	X
IOSCO Subprime Crisis May 2008		X	X	X	X	X	
IOSCO CRA May 2008		X	X	X	X	X	
Kuttner/Dēmos January 2009	X	X	X	X	X	X	X
NASAA December 2008	X		X				

	Regulatory Structure	Risk Management	Consumer and Investor Protection	Credit Ratings Agencies	Accounting and Valuation	Derivatives Markets	U.S Financial Market Competitiveness
PWG March 2008	X	X	X	X	X	X	
PWG October 2008	X	X	X	X	X	X	
SIFMA July 2008			X	X	X		
Seligman October 2008	X		X		X		
SSG March 2008		X	X	X	X	X	
Stiglitz October 2008	X	X	X	X	X	X	X
U.S. Chamber of Commerce 2007	X		X		X		X
Treasury March 2008	X		X		X	X	X
GAO January 2009	X	X	X	X	X	X	X
SEC Staff July 2008		X	X	X	X	X	

Name of Issuer	**Basel Committee on Banking Supervision**
Name of Report	Principles of Sound Liquidity Risk Management and Supervision
Date of Report	September 2008
Background of Issuer	The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable (http://www.bis.org/bcbs/).

Objectives of the Report
Citing its review of banks' response to recent market turmoil, the Committee faulted banks for failing to pay attention to basic principles of liquidity risk management. The Committee found that many banks did not have an adequate framework in place to account for liquidity risks posed by products and business lines, causing incentives to be "misaligned" with overall risk tolerance. In an attempt to "underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process," the Report contains principles and related best practices recommendations designed to increase banks' resilience to liquidity stress.

Principal Findings of the Report
• **Management And Supervision of Liquidity Risk.** According to the Report, banks must establish a "robust" liquidity risk management framework capable of withstanding a range of stress events, whether bank-specific or market-wide. Banks should hold a cushion of "unencumbered high quality liquid assets" "commensurate with the complexity of . . . [the bank's] on- and off-balance sheet activities, the liquidity of its assets and liabilities, the extent of its funding mismatches and the diversity of its business mix and funding strategies." The

Report also directs banks to make "conservative assumptions about the marketability of its assets and access to funding during times of market stress."

- **<u>Governance Of Liquidity Risk Management.</u>** Governance principles include:
  - Articulate Risk Management Strategy: Banks should articulate a liquidity risk tolerance that is appropriate in light of the bank's strategy and role in the financial system so that all levels of management, and the board, understand the bank's risk tolerance, including all tradeoffs between risk and profit that arise from the bank's risk tolerance. Senior management must implement risk management strategy throughout the firm's operations.
  - Incorporate Liquidity Costs, Benefits and Risks into Pricing: Banks should incorporate liquidity costs, benefits and risks in internal pricing, performance measurement and new product approval for all significant business activities, whether off- or on-balance sheet.
- **<u>Measurement and Management of Liquidity Risk.</u>** Measurement and management principles include:
  - Define and Identify Risk Across All Legal Entities: Banks should have a sound process for identifying, measuring, monitoring and controlling liquidity risk, including risks relating to future cash flows of assets and liabilities (including derivatives); sources of contingent liquidity demand and related triggers associated with off-balance sheet positions; currencies in which the bank is active, and correspondent, custody and settlement activities. Banks should define and identify liquidity risks for all legal entities, branches and subsidiaries in the jurisdictions in which a bank is active, including those arising from both on- and off-balance sheet activities, considering both normal and market stress scenarios.
  - Use a Variety of Measurement Tools: The Report emphasizes that no single tool or metric can comprehensively quantify liquidity risk. Banks should use metrics that assess the structure of the balance sheet, cash flow and future liquidity projections, taking into account on- and off-balance sheet activities and both normal and stressed operating conditions. Given the role that assumptions play in cash flow projections, the Report urges banks to ensure that their assumptions are reasonable and appropriate, documented and periodically reviewed and approved.
  - Use Limits To Control Risk: Banks should use limits to control liquidity risk exposure and vulnerabilities in both normal and stressed markets, reviewing the limits regularly.
  - Early Warning Indicators: Banks should use a set of indicators to help identify emerging and/or increased risk. Such early warning indicators can be qualitative and/or quantitative in nature.
- **<u>Comprehensive Liquidity Risk Management.</u>** "Banks should actively monitor and control liquidity risk exposures and funding needs within and across legal

entities, business lines and currencies, taking into account any limitations on the transferability of liquidity." A bank should actively monitor and control liquidity risks at the level of individual legal entities, foreign branches and subsidiaries, and the group as a whole. Banks must communicate effectively with counterparties, credit rating agencies and other stakeholders when liquidity problems arise.

- **Diversified Funding Strategies**. Banks should diversify funding sources, and regularly monitor and gauge capacity to raise funds quickly from these various sources, as part of the bank's overall funding strategy. This strategy should include limits by counterparty, secured versus unsecured market funding, instrument type, securitization vehicle, currency and geographic market. Banks should limit concentration in any one particular funding source or tenor, including the wholesale funding market. Maintaining market access, including during times of stress, is a critical component of ensuring funding diversity. Over-reliance on the securitization of assets as a source of liquidity "raises concerns about a bank's ability to match cash flows received with funding needs in times" during times of bank-specific or market-wide stress.

- **Payment and Settlement Obligations.** The Report found that banks actively should manage intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Report notes that counterparties may view the failure to settle when expected as a sign of weakness, particularly during market stress, causing additional liquidity pressure, and recommends a number of related operational strategies to manage intraday liquidity.

- **Collateral Positions.** Banks should actively manage collateral positions, distinguishing between encumbered and unencumbered assets and diversifying sources of collateral, "taking into account capacity constraints, name-specific concentrations, the sensitivity of prices, haircuts and collateral requirements under conditions of name-specific and market-wide stress, and the availability of funds from private sector counterparties" in various stress scenarios. Banks using collateral should consider potential contractually specified collateral requirements as a result of trigger events, which could include changes in market positions, the bank's credit rating, or financial position.

- **Effective Stress Tests.** The Report reminds banks to conduct and review stress tests on a regular basis, considering a range of stresses alone and in combination, to identify sources of potential liquidity strain and to ensure that exposures remain in line with the bank's liquidity risk tolerance. Stress scenarios should consider short- and longer-term disruptions as well as at different institutional and market levels.

- **Contingency Funding Plan.** Banks should have a formal contingency funding plan that clearly sets out the strategies for addressing liquidity shortfalls and emergency situations. Such a plan should include policies for managing various stress environments, establish lines of responsibility, include escalation procedures, and be regularly tested and updated to ensure that it is "operationally

robust." These plans should be commensurate with a bank's complexity, risk profile, scope of operations, and role in the financial system.

- **Importance of Unencumbered Assets.** The Report recommends that banks maintain a cushion of high quality, unencumbered liquid assets to hold as collateral against a range of liquidity stress scenarios. This size of the liquidity cushion should be aligned with liquidity needs during times of stress.

- **Public Disclosure.** Banks should disclose information necessary for market participants to make informed judgments about the soundness of the bank's liquidity risk management framework and its liquidity position. In addition to improving transparency, the Report notes that disclosure "facilitates valuation, reduces uncertainty in the markets and strengthens market discipline."

- **The Role of Supervisors.** Supervisors should regularly and comprehensively assess a bank's liquidity risk management framework and liquidity position "to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system." Supervisors should consider the characteristics and risks of banks in their jurisdiction as well as legal framework and market structure. The Report instructs supervisors to pay particular attention to liquidity stress testing and contingency planning, and urges supervisors to evaluate whether and how senior management and the board use the results of stress testing to mitigate vulnerabilities exposed by stress tests. If supervisors identify deficiencies in liquidity risk management, they should intervene to require effective and timely remedial action.   They should communicate with other relevant supervisors and authorities within and across national borders to facilitate effective cooperation regarding supervision and oversight of liquidity risk management, particularly during times of stress.

Name of Issuer	**Mayor Michael Bloomberg and Senator Charles Schumer, with McKinsey & Company and New York City Economic Development Corporation**
Name of Report	Sustaining New York's and the US' Global Financial Services Leadership
Date of Report	January 2007
Background of Issuer	Mayor Michael Bloomberg and Senator Charles Schumer commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal and accounting professions, and investor, labor and consumer groups.

Objectives of the Report
In their January 2007 report, New York City Mayor Michael Bloomberg and Senator Charles Schumer considered whether New York and the United States were at risk of ceding leadership in the financial services industry to international competitors. To obtain a "comprehensive perspective" on the competitiveness of the U.S. financial services sector, with a particular focus on New York's contribution, Senator Schumer and Mayor Bloomberg commissioned McKinsey & Company and the New York City Economic Development Corporation (NYCEDC) to interview business leaders, subject matter experts in regulatory, legal and accounting professions, and investor, labor and consumer groups.

Principal Findings of the Report

- **The Report Identified a Number of "Domestic Drivers" as Potentially Shifting Business Away From New York.** These factors included:
  - Concern that the legal environment in the United States is less fair and predictable than that in the United Kingdom, particularly with regard to securities class action lawsuits and extraterritorial application of US law.
  - Concern that the U.S. legal system, "with its public and private enforcement mechanisms involving federal, state and private litigants,"

was "having a potentially negative impact on competitiveness."

  - Concern that while a strong regulatory system was perceived as "vital in giving market participants confidence," the U.K.'s single, principles-based financial sector regulator (the FSA) was "superior to what they [survey participants] see as a less responsive, complex US system of multiple holding company and industry segment regulators at the federal and state levels." Survey participants also commented that the U.K.'s "measured approach to enforcement" was seen as "more results-oriented and effective than a US approach sometimes described as punitive and overly public."

- **The Report Outlined Three Sets Of Recommendations.** Recommendations focused on legal and regulatory priorities, "leveling the competitive playing field" between the U.S. and international markets, and sustaining U.S. leadership in international financial markets. Among other recommendations, the Bloomberg/ Schumer Report suggested the following:
  - Shared Vision for Reform: Regulators should work together to "develop, agree on and pursue a shared vision for the importance and strategic direction of the financial sector…to meet customer needs, the management of systemic risks, the ethical conduct of business, the financing of a growing economy and the creation of new jobs."
  - Common Set of Principles: This shared vision should be supported by a "common set of principles for the regulation and supervision of financial institutions" which could include, by way of example, cost/benefit analysis, materiality tests, collaborative rulemaking and enforcement, and an escalation process for enforcement matters.
  - National Commission on Competitiveness: A national commission on financial market competitiveness should be formed "to assess long-term, structural issues that affect the health, competitiveness, and leadership of US financial markets and their contribution to the national economy." The Commission should consider regulatory integration and the possibility of a single regulator for firms operating within the United States.
  - The Report also suggests that, "with due deference to the separation of powers between executive and judicial enforcement agencies, as well as between state and federal officials, the Commission should also consider reforms that would improve the consistency and predictability of enforcement efforts nationwide."
  - Charter Modernization: "Regulators and Congress should assess and, where appropriate, modernize US financial services charters, holding company models, and operating structures (such as international banking facilities under Regulation K of the Federal Reserve) to ensure that they are competitive by international standards." The Report identified "an optional federal charter for insurance" as one potential area of reform.

Name of Issuer	**Committee on Capital Markets Regulation (CCMR)**
Name of Report	Interim Report of the Committee on Capital Markets Regulation
Date of Report	November 2006
Background of Issuer	The Committee on Capital Markets Regulation is a non-profit research organization addressing issues in United States capital markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

Objectives of the Report
The Interim Report articulated concerns regarding the impact of regulatory policy and private litigation on United States capital markets.

Principal Findings of the Report

- **CCMR Stated that United States Capital Markets Are Becoming Less Competitive Globally.** It maintained that data support the following conclusions.
  - While the U.S. share of global equity markets trading value has remained relatively high, a "better measure of competitiveness is where new equity capital is being raised," and the United States' share of global initial public offerings (IPOs) has declined in recent years.
  - Foreign companies are turning more frequently to the private rather than public markets in the United States for raising capital.
  - The growth of the private equity market suggests that private markets are gaining competitive advantages over more regulated public markets.
  - The premium that foreign companies pay for listing in the United States has diminished, indicating a loss of competitiveness.
- **The CCMR Maintained That Four Factors Contribute to a Loss of Competitiveness.** These factors include:
  - More transparency and better disclosure in foreign markets, increasing their attractiveness to investors and issuers.

- A relative increase in the liquidity of foreign and private markets, thus making it less necessary to go to the U.S. public equity capital markets for funding.
- Improvements in technology that make it easier for U.S. investors to invest in foreign markets.
- Differences in regulation between the U.S. public markets and the foreign and private alternatives.

- **The CCMR Maintained That Public Policy Should Focus on Adjusting Systems for Litigation, Regulation, and Corporate Governance.** "There is little public policy can do to reverse the impact of the first three factors, but the United States could try to adjust its litigation and regulatory system so that we can continue to protect investors, but at a lower cost." Thus, "the solution to the competitive problem of U.S. capital markets lies, on the one hand, in reducing the burden of litigation and regulation and, on the other hand, in increasing shareholder rights." The CCMR recommended changes in five areas listed below.
- **Easing of De-Registration Requirements for Foreign Companies ("Loosen Capital Controls").** "If foreign companies know they can leave U.S. markets, they will be more willing to come in the first place." The SEC should permit foreign companies to specify in their offering documents that they have the right to deregister with adequate notice to U.S. investors and a reasonable transition period. Institutional investors should be excluded from the calculation when determining the U.S. shareholder base, since institutional investors do not need the level of regulatory protection required by retail investors.
- **The Regulatory Process Should Be Modified.** The Committee recommended:
    - The SEC and self-regulatory organizations should rely more thoroughly on cost-benefit analysis in managing regulatory risks.
    - Regulators should rely on principles-based rules and guidance rather than prescriptive rules to the extent possible.
    - Regulators, and especially the SEC, should avoid policy making through enforcement actions.
    - National, federal, and state regulators should coordinate their actions more effectively. National regulatory structure should be reorganized to align more closely with current financial market structure, but until such a change was made, better communication and coordination among regulators should be a priority.
- **The Private and Public Enforcement System for Financial Markets Should be Modified.** The CCMR argued that while a "vigorous enforcement system makes financial markets safer and more competitively attractive," "the private litigation system needs modification in some dimensions and…the criminal enforcement system needs better balance." It recommended:
    - Issues in private litigation under Rule 10b-5 should be clarified.

- Criminal enforcement should be a last-resort response used only for systematically corrupt companies.
- Policies regarding auditor and directory liability should be modified in light of the potentially severe economic consequences of the currently prevailing levels of private litigation and regulatory enforcement.

- **Shareholder Rights Should Be Strengthened.** The CCMR recommended improving shareholders' abilities to oversee corporations. It suggested, among other steps:
  - Shareholders should be allowed to modify voting requirements and procedures for corporate takeovers.
  - Shareholders should be able to nominate and vote for directors more easily.
  - Shareholders should be able to choose alternatives to traditional litigation, such as arbitration or judge-conducted trials, as corporate control mechanisms.
- **Sarbanes-Oxley Should Be Implemented in a More Risk-Based Way.** While recommending no statutory changes in the Sarbanes-Oxley Act, the Committee recommended changes in the implementation of 404 of the Act.
  - The CCMR recommended change in the definition of "materiality"; it "would change the probability threshold for the detection of control weaknesses from [Auditing Standard No. 2's] existing 'more than remote likelihood' standard to 'reasonably possible' that a material misstatement could occur."
  - Changes should allow more discretion in professional judgment in auditing and reviews.
  - Changes should permit differential regulatory treatment of small firms and foreign firms tailored to their economic and regulatory circumstances.

Name of Issuer	**Committee on Capital Markets Regulation**
Name of Report	Recommendations for Reorganizing the U.S. Financial Regulatory Structure
Date of Report	January 14, 2009
Background of Issuer	The Committee on Capital Markets Regulation is a non-profit research organization addressing issues in United States capital markets. Its membership, focus, and activities are described at http://www.capmktsreg.org/index.html.

Objectives of the Report
Its 2009 report recommends "sweeping" changes in regulatory organization. The report focuses on the federal regulatory structure, not discussing—but potentially commenting in a subsequent report—on the role or states or self-regulatory organizations, internal agency organization, and global coordination.

Principal Findings of the Report

- **The CCMR Reached Consensus on Aspects of Regulatory Structure**. The CCMR discussed consensus recommendations on certain organizational issues listed below.
- **Two or Three Regulatory Bodies.** The U.S. should have "only two or, at most, three independent federal regulatory bodies overseeing the U.S. financial system." These would be the Federal Reserve Bank, a new independent United States Financial Services Authority (USFSA), and possibly an independent investor/consumer protection agency. Existing regulatory agencies, such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission would be merged and consolidated into these two or three bodies. It outlined the responsibilities of these new organizations.
    - Responsibilities of the Federal Reserve: The Federal Reserve would retain control of monetary policy and lender-of-last-resort function, and set capital requirements for all financial institutions. Fed control of capital requirements would ensure consistency across financial institutions,

enable rapid reform, and avoid the adverse consequences of different agencies setting different capital standards for essentially similar activities in financial institutions.

- Responsibilities of the USFSA: The United States Financial Services Authority "would regulate all aspects of the financial system, including market structure and activities and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged with the USFSA)." The CCMR argues that only by lodging regulation in one agency can the U.S. assure consistency, rapid reform, and avoid problems from inconsistent financial regulation. The USFSA must be independent, like the Fed, with its regulations subject only to judicial, but not executive, review; its governing body and membership, also like the Fed, should be appointed and insulated from the electoral cycle.
- Responsibilities of an Independent Investor/Consumer Protection Agency or Division of the USFSA: The CCMR could not reach consensus on whether this activity should be a separate agency or a division within the USFSA. The relevant prudential supervisor, however, should comment on the safety and soundness impact of this agency's regulatory actions; the Treasury should resolve any conflict between the supervisory and investor/consumer protection body. The head of the agency should be Senate-confirmed to ensure strong congressional oversight and rigorous enforcement by the division if investor/consumer protection is undertaken in a division of the USFSA.
- Role of the Treasury: The Treasury would coordinate the work of the regulatory bodies, ensuring that written procedures, perhaps in memoranda of understanding, specify the responsibilities of the regulatory bodies. The Treasury also should oversee the expenditure of public funds used to provide support to the financial sector, as in the Troubled Asset Relief Program. Any existing Fed loans to the private sector which are uncollateralized or insufficiently collateralized should be transferred in an orderly fashion to the balance sheet of the federal government through asset purchases by the Treasury from the Fed.
- Phased Transition over Time: The regulatory consolidation should proceed in steps. These would include: (1) immediate enhancement of the President's Working Group on Financial Markets to play a coordinating role within the present federal regulatory structure; (2) legislation creating an independent USFSA and possibly an independent consumer/investor protection agency; and (3) subsequent legislation authorizing the merger of all other federal supervisory agencies, and possibly the investor/consumer agency, into the USFSA.

- **Aspects of Regulatory Structure on Which the Committee Did Not Reach Consensus.** The Committee listed arguments for and against certain options for financial supervision and the location of a consumer/investor protection agency.

- **Supervision of Financial Institutions.** CCMR said that consolidated prudential supervision offers significant advantages over what it calls the current model of overlapping or fragmented supervision. Consolidated prudential supervision can (1) ensure the implementation of consistent regulatory requirements across different sectors, drawing from best practices and past experiences in all sectors; (2) enhance the capacity to attract and retain high quality staff and to reassign those staff promptly as needed across different sectors of the industry; (3) diminish the risk of regulatory capture; and (4) enhance accountability. The CCMR presented three options for consolidated supervision.
    - Option 1: Federal Reserve Supervision of Financial Institutions Determined to be "Systemically Important" and USFSA Supervision of All Other Institutions: This option has potential advantages and liabilities.
        - Advantages: The Fed understands the range of issues confronting financial institutions; its quality of examinations arguably is higher than at other agencies; it needs the detailed knowledge of financial institution operations that comes from a unified structure; it needs corrective action powers to control the risks to financial institutions and ultimately to itself; and it would focus on only those institutions determined to be "systemically important," arguably optimizing its institutional competence to oversee institutions to which it may have to lend.
        - Disadvantages: It would be difficult to determine in advance and over time which institutions are systemically important; designating some institutions as "systemically important" and not others may create capital market distortions; and Fed supervisory jurisdiction over systemically important institutions risks could distract it from its core mission of conducting monetary policy and expose it to political pressures.
    - Option 2: Fed Supervision of All Financial Institutions: The CCMR reviewed advantages and disadvantages of Federal Reserve supervision of all financial institutions.
        - Advantages: The Fed's unique "institutional competence" gives this option many of the same benefits of Fed supervision of systemically important institutions.
        - Disadvantages: Expanding its supervisory jurisdiction, particularly over relatively small institutions, risks distracting the Federal Reserve from its core mission of conducting monetary policy and dealing with systemic risk and could concentrate too much power in one agency; a new USFSA could have the same quality of examination as is provided by the Fed today for most institutions; and the Fed could face high levels of political pressures were it to supervise all financial institutions.

- Option 3: USFSA Supervision of All Financial Institutions:
    - Advantages: The Fed would be free to focus on its core mission of monetary policy while the USFSA could focus on supervisory economies of scale and consistency of supervision; the USFSA could vary its examinations consistent with the financial institution's level of risk and the nature of the activities; the Fed could rely on this new agency if it supervised financial institutions at the same level of quality as the Fed; and putting rule-making and supervision in one agency takes advantage of their complementary nature.
    - Disadvantages: The USFSA might not give the "systemically important" institutions the same attention the Fed would, and the arrangement would not give the Fed the same real-time information necessary to make lender-of-last- resort decisions since it would need to rely on the USFSA.

- **Location of Consumer/Investor Protection.** The CCMR discussed locating its proposed consumer/investor protection body either as a division within the USFSA or as a separate agency. "If part of the USFSA, Senate confirmation of the division/agency head would help ensure strong Congressional oversight and rigorous enforcement." The Committee was unable to reach consensus on which of these two alternatives would be preferable.
    - Locating the Consumer/Investor Protection Division within the USFSA: The USFSA could consider and balance competing investor/consumer protection, safety/soundness, and market structure/conduct issues if it contained the consumer/investor protection agency. The division could benefit from the institutional expertise of the broader agency. In practice, a separate agency might not be inclined to make intelligent tradeoffs among the broader range of competing issues. The arguable disadvantages are the other side of this point; a broader agency looking to make tradeoffs may not pursue consumer/investor protection relentlessly.
    - Creating a Separate Consumer/Investor Protection Agency: A separate agency would have a single mission and commitment. However, it might not effectively balance competing considerations, and it would be difficult to coordinate conflicts between prudential regulation and consumer/investor protection.

Name of Issuer	**Consumer Federation of America (CFA)**
Name of Report	Comments on the Treasury Department's Review of the Regulatory Structure Associated with Financial Institutions
Date of Report	November 21, 2007
Background of Issuer	CFA is an advocacy, research, education, and service organization addressing issues on behalf of consumers. Its membership consists of about 300 nonprofit organizations throughout the United States with a combined membership exceeding 50 million people.

Objectives of the Report
In this document, the Consumer Federation of America (CFA) comments on the Department of the Treasury's Blueprint for a Modernized Financial Regulatory Structure. The CFA does not express a position on question of regulatory structure, but focuses on the quality of the standards and the effectiveness of enforcement of those standards. It notes, "we are concerned less with regulatory form than with regulatory effectiveness. As a result, our comments address the urgent need for regulatory reform that is focused on strengthening consumer and investor protections, the key underlying causes of ineffective financial regulation that must be addressed if financial regulation is to be improved, and the principles that should guide any such pro-consumer/pro-investor regulatory reform."

Principal Findings of the Report

- **<u>The CFA Questions the Treasury's Emphasis on Competitiveness.</u>** The CFA maintains that the concerns about the impact of financial market regulation on U.S. competitiveness have been "grossly exaggerated," and the market crisis—which appeared after the "competitiveness" reports were published or undertaken—indicates the costs of not having regulatory systems effectively protecting investors and consumers. It identified "regulatory failures" and policy concerns, including:
  - Failure to prevent predatory mortgage lending.
  - Failure to anticipate or deal with the widespread deteriorating practices in securitization.

- The loss of credibility of the credit rating process given its conflicts of interest and unreliable ratings, the deficient due diligence by investment banks and others involved in securitization, and the SEC's failure to hold organizations accountable for this conduct.
- Failure of FASB or IASB to develop standards applying appropriately to structured investment vehicles, and of auditors to prevent financial firms from inappropriately removing SIV risks from their financial statements.
- State insurance regulators, for the most part, do not protect consumers from unreasonable rate hikes or from abusive claims payment practices.
- The series of scandals in the securities industry since the beginning of this decade, with widespread abuses uncovered in areas as diverse as mutual fund trading practices, backdating of stock options, and IPO allocation practices, in addition to highly publicized accounting and analyst scandals.
- Failure of Federal banking regulators "to act against a number of predatory credit practices, in some cases because of a lack of authority but in others because of an apparent lack of will."
- The primary concern of any regulatory reform should be how regulatory changes strengthen consumer and investor protection; concerns over regulatory overlap or increasing regulatory efficiency ought to be secondary.

- **"Principles-Based" Regulation is Not a Solution.** The CFA stresses that the uncritical endorsement of principles-based regulation papers over fundamental problems. The CFA maintained:
  - The approach overstates the ease with which regulators can apply vague principles, meaning that disagreements will wind up in informal negotiations with the firm or in court. Most often, disagreements will be resolved in closed negotiations between the regulator and the firm, which could disadvantage consumers and investors and undermine the credibility of the regulatory process.
  - Even those calling for "principles-based regulation" do so inconsistently, advocating broad rules when it suits them but then calling for "bright line tests" when they want clarity, as the Chamber of Commerce and Committee on Capital Markets Regulation do when they call for bright-line rules to define scienter and materiality in litigation. By way of other example, the White House, insurance industry, and mortgage industry all have recently criticized "subjective" regulations, when "flexibility" is supposedly the advantage of principles-based regulation.
  - Clearer statements and greater uniformity of principles underlying regulations across financial services will only benefit consumers and investors if such efforts supplement our rules-based system, not replace it. "Replacing our current system with a more principles-based approach would diminish transparency and clarity, would rob the public of an

important opportunity to participate in the regulatory process, and would in all likelihood lead to weaker enforcement."

- **<u>Underlying Causes of Regulatory Failures Must Be Addressed.</u>** Ultimately, regulatory reorganization will not improve performance unless fundamental problems are addressed. These problems include:
    - Regulators are too close to the industries they regulate. "At all of the financial services regulators, a 'revolving door' exists between the regulator and the regulated industry," infusing the regulatory agency with the attitudes and biases of the industry.
    - Regulatory balkanization leads to downward pressure on consumer protections or slows cooperative action to raise standards on industry. The CFA identified both liabilities and benefits of having multiple regulatory agencies in an area.
        - Industries try to choose the weakest regulator to the extent they can: "Insurers have a long history of seeking regulation at the level they perceive will be weakest… Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC [National Association of Insurance Commissioners] and the states into gutting consumer protections over the last seven years."
        - Multiple regulators also can increase regulation's strength: In the securities industry, "the existence of multiple regulators has sometime led to more rigorous regulation," and "state preemption has made it more difficult for state officials to protect their citizens from abusive practices…it is in the interest of consumers to restore state authority to enforce consumer protection laws against national banks, not preempt that authority with regard to securities firms. If state preemption were rolled back, consumers might benefit from competition among regulators that drives regulatory quality up, not down."
        - Laborious negotiations among multiple regulatory agencies slow adoption of improvements, but consolidating regulation may not accelerate improvements. Complex negotiations have slowed consumer reforms, such as those in credit card lending practices. However, while "regulatory consolidation offers the possibility of a more timely response to emerging problems...Such delays could be even more common at a bulky consolidated financial services regulator with jurisdiction over a vast array of issues, particularly as it seeks to balance the sometimes competing interests of different industry players."
    - An excessive focus on "prudential" regulation and ensuring institutional safety and soundness undermines consumer protections. Focusing more on safety and soundness than on consumer protection, and more on inspection than enforcement, "has been a notable failure in protecting

consumers from abusive credit practices, including those that have led to the recent mortgage foreclosure crisis." Furthermore, this supervisory process occurs away from the public's view. "At best, these factors combine to create a culture of coziness with regulated institutions at many of the agencies. At worst…they appear to have led to regulatory capture."

- **Pro-Consumer Principles Should Guide Regulatory Reform.** The CFA maintained that pro-consumer, pro-investor principles must be a foundation of regulatory reform efforts. Current regulatory operations and proposals for reform frequently clash with these principles, and "We therefore…urge all financial services regulators to adopt the principles below."
    - Regulators should be independent of the industries they regulate.
    - "Regulators should be required to regularly assess the effectiveness of their consumer and investor protections and suggest improvements," just as they must assess regulatory burdens on industries. "The agencies should be required to consult consumer representatives, state regulators, and Attorneys General as part of this review."
    - Financial products and services should be designed to benefit consumers. "One of the most meaningful reforms financial services regulators could adopt would be to hold the institutions they regulate accountable for providing products and services that are designed to benefit consumers and investors. Consistent with that principle, they should apply a suitability obligation to all sales of financial services and products. Advisory services should be subject to a fiduciary duty."
    - Consumers should have access to timely and meaningful information about the costs, terms, risks, and benefits of the financial products and services marketed to them. Disclosures need to be more clear and timely, and, to the extent possible, permit comparison among similar products even when the products are offered by different financial institutions or regulated by different agencies.
    - All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency, transparency, and convenience. They should be protected from technological changes that threaten their privacy and information security. Regulators should hold financial institutions accountable for strong privacy and security protections; consumers should control whether their personal information is shared with affiliates or third parties.
    - Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices, or other violations. Consumers should be able to take complaints to court, access fair and efficient arbitration, and be backed by strong regulatory enforcement.

Name of Issuer	**The Counterparty Risk Management Policy Group (CRMPG) III**
Name of Report	Containing Systemic Risk: The Road To Reform
Date of Report	August 6, 2008
Background of Issuer	The Counterparty Risk Management Policy Group III is a group of senior officials and staff from a number of major financial institutions. This is the third report prepared by the CRMPG focusing on improving risk management and financial infrastructure, with the earlier reports issued in 1999 and 2005.

Objectives of the Report
The CRMPG sets out a series of private initiatives intended to complement official oversight to help contain systemic risk. These include reconsideration of accounting standards for consolidation under U.S. GAAP of entities currently off-balance sheet coming on-balance sheet; measurement and management of high-risk financial instruments; improvements in risk monitoring and management; and measures to strengthen the resiliency of financial markets generally and the credit markets in particular, with a special emphasis on OTC derivatives and credit default swaps. The report also highlights important emerging issues.

Principal Findings of the Report
• **Five Precepts on Which Management and Supervision of Large Integrated Financial Intermediaries Must Rest.** These precepts include the basics of corporate governance, of risk monitoring, of estimating risk appetite, of focusing on contagion, and of enhanced oversight. • **Precept I: The Basics of Corporate Governance.** “From time to time, all large integrated financial intermediaries must examine their framework of corporate governance in order to ensure that it is fostering the incentives that will properly balance commercial success and disciplined behavior over the cycle while ensuring the true decision-making independence of key control personnel from business unit personnel.”

- **Precept II: The Basics of Risk Monitoring**. "All large integrated financial intermediaries must have, or be developing, the capacity (1) to monitor risk concentrations to asset classes as well as estimated exposures, both gross and net, to all institutional counterparties in a matter of hours and (2) to provide effective and coherent reports to senior management regarding such exposures to high-risk counterparties."
- **Precept III: The Basics of Estimating Risk Appetite**. "All large integrated financial intermediaries must periodically conduct comprehensive exercises aimed at estimating risk appetite. The results of such exercises should be shared with the highest level of management, the board of directors and the institution's primary supervisor."
- **Precept IV: Focusing on Contagion**. "All large integrated financial intermediaries must engage in a periodic process of systemic 'brainstorming' aimed at identifying potential contagion 'hot spots' and analyzing how such 'hot spots' might play out in the future."
- **Precept V: Enhanced Oversight**. "Highest-level officials from primary supervisory bodies should meet at least annually with the boards of directors of large integrated financial intermediaries. The purpose of the meeting would be for the supervisory authorities to share with the board of directors and the highest levels of management their views of the condition of the institution with emphasis on high-level commentary bearing on the underlying stability of the institution and its capacity to absorb periods of adversity."
- **Recommendation I: Standards for Accounting Consolidation.** The report recommended a global consolidation framework for accounting "that is based on control and the ability to benefit from that control." The new consolidation framework should require reassessment each period and reflect a "holistic and principles-based approach to disclosure of off-balance sheet activities similar to that found in international standards."
- **Recommendation II: Improvements in Markets for High-Risk Complex Instruments.** Market participants should elevate the sophistication of eligible market participants, enhance disclosure, strengthen ongoing relationships between parties to transactions, and ensure satisfactory diligence standards for issuers and placement agents.
    - CRPMG III "strongly recommends that high-risk complex financial instruments should be sold only to sophisticated investors." All participants in transactions should be able to understand and manage the transactions in light of their goals.
    - While recognizing necessary variability in appropriate documentation for transactions, the report suggested, "as a matter of industry best practice," core content for documentation and disclosure.
    - Participants in complex transactions should communicate with each other in appropriately timely, active, and complete ways.

- Underwriters and placement agents should have clear procedures to continuously evaluate the performance and reputation of issuers and the quality of assets.

- **Recommendation III: Improvements in Risk Monitoring and Risk Management.**
    - Risk management and control functions should be reasonably independent of income-producing units, staffed appropriately, and equipped with requisite technology.
    - The highest levels of management should approve the risk tolerance of the firm, and share their decisions with the board of directors.
    - Units involved in managing risk should work closely with each other on the task, communicating fully as required. Upper management should frequently participate in meetings of risk management-related committees.
    - The firm should be able to compile detailed, accurate, daily information on exposures across the firm, including the capability of generating such information on shorter notice if required by special circumstances. The firm should run periodic exercises testing these capabilities.
    - While quantitative measures of risk are critical tools, the firm should not depend on these measures in mechanical ways, but should supplement them with active consideration of possible, unexpected threats, and continually refine stress tests.
    - Firms should attend carefully to particularly large exposures to specific counterparties, positions, or less liquid instruments, adjusting margin and capital requirements as necessary.
    - Firms should employ robust, consistent valuation procedures, and firms and industry groups should consider developing standardized methods of dispute resolution as well as the need for high levels of cooperation among firms in managing collective risk.
    - Firms should consider using, "wherever possible, transparent and liquid instruments rather than bespoke products," and should consider imposing higher internal charges or restrictions for hard to value or illiquid transactions.
    - The firm should price the same types of transactions consistently across the firm.
    - Firms should conduct regular, comprehensive stress tests and maintain sufficient liquidity reserves based on those tests.

- **Recommendation IV: Enhanced Credit Market Resiliency.** The current settlement, legal, and operational infrastructure of the OTC credit markets should be improved. The CRPMG III identified "six interrelated areas of weakness in need of immediate improvement and enhancement":

- Timeliness and integrity of transaction details.
- Daily reconciliation of collateral valuations.
- Reaching an operationally manageable number and gross notional value of outstanding trades in the market.
- Credit event settlements, including greater efficiency and certainty of the process.
- Close-outs of defaulting counterparties.
- Central clearing mechanisms.

- **Emerging Critical Issues in the Regulatory and Supervisory Process.**
  - Valuation and price verification: "Individual financial institutions must ensure that wholly adequate resources, insulated by failsafe independent decision-making authority, are at the center of the valuation and price verification process."
  - There are emerging public policy issues over whether or not, and how, to intervene in asset price bubbles, the oversight of "near banks" and "private pools of capital," and redesign of regulatory structure.
  - "The case for devoting greater resources to the supervisory effort is clear and compelling. The case for greater resources starts with attracting and retaining more, and more highly skilled, personnel and compensating such personnel in ways that will not fully match private sector practices, but will at least narrow the so-called 'public service discount' in compensation."
  - "Recent experience reminds us that the fiscal costs of enhancements to the resources applied to the supervisory process must be evaluated relative to the costs of failing to move in that direction."

Name of Issuer	**Professor Lawrence A. Cunningham for Council of Institutional Investors**
Name of Report	Some Investor Perspectives On Financial Regulation Proposals
Date of Report	September, 2008
Background of Issuer	The Council of Institutional Investors (CII) is a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners. Professor Lawrence A. Cunningham, author of the paper, is Henry St. George Tucker III Research Professor of Law at George Washington University Law School.

Objectives of the Report
Professor Lawrence A. Cunningham of George Washington University Law School, wrote this paper for the Council of Institutional Investors (CII). It assesses, "from an investor's perspective," mutual recognition in securities regulation, integration of securities and futures regulation, and a model of financial regulation relying on a single agency to oversee all financial markets. The analysis examines the U.S. Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure*.

Principal Findings of the Report
• **The Treasury Blueprint Does Not Address Topics that Are Important to Investors and Consumers.** The Blueprint equates "investor protection" with "consumer protection" when investors are best thought of as suppliers of capital and consumers are buyers of services. It discusses securities markets in operational and administrative terms but not substantive terms. It examines stock exchanges and securities clearing agencies extensively, but pays little attention to issuers of securities, investment advisors, accountants, lawyers, credit rating agencies and underwriters affecting investor and consumer protection. It combines very different activities into "financial services." • **Investor Protection Does not Motivate the Blueprint.** The paper says that "Investor protection is no part of the blueprint's motivation'; the "stated motivation is to bolster the competitiveness of the U.S. financial system in the face of competitive pressure from non-U.S. financial markets, some of which

have different—and, Treasury believes—better regulatory structures."

- **<u>Investor Concerns Regarding Mutual Recognition in Financial Services.</u>** "Mutual recognition" means agreements in which a domestic regulator, like the SEC, and similar regulators in other nations reciprocally cede supervision of non-domestic organizations operating within a nation to their foreign counterparts. Foreign firms thus can operate in other nations without the large costs of local registration in that nation as long as they are regulated under a comparable foreign system. Regulators thus aid global capital flows while preserving regulatory protections. Such systems have several challenges.
    - Specifying what "sufficiently comparable" protections actually means; U.S. investor protections will be weakened if firms operating in the U.S. are governed by foreign regulators with weaker standards.
    - The qualities of other regulatory and legal institutions in a nation have to be factored in when determining whether protections are sufficiently comparable.
    - One must question if the SEC can be confident that foreign regulators are enforcing their rules on firms operating in the United States when the SEC itself cannot examine the process. Arguably, firms operating in the United States should be required to register with the SEC and be inspected by it.
- **<u>Investor Concerns Regarding Integration of Securities and Futures Regulation.</u>** The Blueprint proposes merging the Securities and Exchange Commission and Commodities Futures Trading Commission, with the merged agency relying on the CFTC's "principles based" regulatory approach. But this does not consider the reasons for different SEC and CFTC approaches; applying CFTC-type "principles based" regulation to securities markets, particularly in which retail investors are much more active, would harm investor protections. Investor organizations and other should scrutinize such a merger carefully.
- **<u>Investor Concerns Regarding The Treasury's Optimal Regulatory Structure.</u>** So many variations exist among financial institutions, participants, and services or products "that it becomes difficult to accept the blueprint's opinion that there is a single financial market suitable for singular regulatory oversight." In banking, for example, this would require "rolling up all existing state and federal law into this single regulator." Generally, "having undertaken the process of merging the CFTC and SEC, increasing use of vague principles over detailed rules, and expanding delegation from federal agencies to self-regulatory organizations, the content of these investor protection laws are likely to differ radically from present law or laws that emerge in the usual manner."

Name of Issuer	**Financial Services Roundtable (FSR)**
Name of Report	The Blueprint for U.S. Financial Competitiveness
Date of Report	November, 2007
Background of Issuer	The Financial Services Roundtable is an organization of banking, securities, insurance, and investment organizations.

Objectives of the Report
The FSR Blue Ribbon Commission on Enhancing Competitiveness developed a set of Guiding Principles for what it called a more balanced, consistent, and predictable legal and financial regulatory system; articulated a financial services reform agenda based upon the application of the Guiding Principles to important legal and regulatory issues; and proposed changes in systems of chartering for existing financial services institutions. The Blueprint for U.S. Financial Competitiveness proposed ten policy reforms.

Principal Findings of the Report

- **The United States Should 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." National and state financial regulators and firms would be expected to abide by these principles:
  - **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.
  - **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.
  - **Proportionate, risk-based regulation**. Costs and burdens of financial regulation, 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 consumers.

- **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.
- **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.
- **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. Its systems for complying with regulations should have adequate financial resources, skilled personnel, ethical conduct, effective risk management, and adequate infrastructure. The firm should adhere to basic tenets of safety, soundness, financial stability, and appropriate conflict of interest management.
- Congress should establish under law the President's Working Group on Financial Markets (PWG) as overseer of financial regulatory agencies. 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." It would oversee the implementation of the Guiding Principles specified above through oversight of Regulatory Action Plans prepared by national and state financial regulators.

- **<u>All Financial Services Regulators, Including Self-Regulatory Organizations, Should Adopt and Rely on Principles-Based Regulation.</u>** This "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." The FSR cited federal banking regulation, the CFTC (especially since 2000), and the SEC's Consolidated Supervised Entity program as examples of prudential supervision. [The SEC terminated the CSE program in September 2008 [http://www.sec.gov/news/press/2008/2008-231.htm].
- **<u>Securities and Other Class-Action Litigation Should Be Reformed.</u>** The FSR emphasized what it considered damaging effects of private litigation on financial services firms and recommended 19 specific litigation reforms.
- **<u>Consumers' Access to Credit and Opportunities for Long-term Financial Security Should Be Improved.</u>** The FSR defined its improvements to "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."

- **Anti-money Laundering Supervision Should Be Made More Effective.** "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." The FSR cited the U.K. Financial Services Authority's anti-money laundering rules as exemplary.
- **Regulators Should Expand the Risk-based Focus of Capital Regulation.** Regulators should build upon the Basel II accord to develop a risk-based focus to capital regulation for all financial services firms, particularly given international competitiveness of financial markets. The report cited the state-regulated insurance industry as an example of misaligned capital rules, recommending creation of an optional national insurance charter.
- **Government Should Ensure the Effective Implementation of Sarbanes-Oxley Act (Section 404) Regulatory Reforms.** The report noted the concerns with Section 404 of the Sarbanes-Oxley act, acknowledged the SEC's and PCAOB's "recent administrative reforms…which we applaud," and offered "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."
- **U.S. Accounting Standards Modernization Should Be Accelerated.** The FSR endorsed the full use of International Financial Reporting Standards without a required reconciliation to GAAP as soon as possible, and rapid convergence of global accounting standards.
- **Existing Financial Institution Charters Should Be Modernized.** Statutory and administrative changes should give national and state banks, federal and state savings associations, and financial holding companies a choice of "the most modern, competitive, and productive charters and legal structures possible." Diverse charters and regulatory organizations can produce difficult complexities, but such variety also produces competitive benefits.
- **New National Charters Should Be Enacted.** A national insurance charter, a federal securities authority, and possibly a national universal financial services charter should be established.

Name of Issuer	**Financial Stability Forum (FSF)**
Name of Report	Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience and The Follow-Up On Implementation
Date of Report	April 7, 2008 and October 10, 2008
Background of Issuer	The Financial Stability Forum (FSF), first convened in 1999, consists of senior representatives of national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. The FSF is serviced by a secretariat housed at the Bank for International Settlements. The FSF assesses vulnerabilities in the international financial system, identifies and oversees appropriate responses, and improves co-ordination and information exchange among the various authorities responsible for financial stability. It seeks to strengthen financial systems and the stability of international financial markets, and any recommended changes are enacted by the relevant national and international financial authorities. http://www.fsforum.org/about/overview.htm

Objectives of the Report
In October 2007, the G7 Ministers and Central Bank Governors asked the Financial Stability Forum to analyze the causes and weaknesses producing the financial crisis and make recommendations by April 2008 to increase the resilience of markets and institutions. Collaborating in the work were the Basel Committee on Banking Supervision (BCSB), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centers. The FSF also drew on private sector participants. The follow-up report in October reviewed the implementation of the recommendations made in the April report.

Principal Findings of the Report

- **Strengthened Prudential Oversight of Capital, Liquidity, and Risk Management.** The Basel II capital framework needs timely implementation, ongoing evaluation, and strengthening in light of the market crisis. Supervisors should examine closely weaknesses in risk management systems, including how compensation systems produce incentive structures excessively increasing risk.
- **Settlement and Clearing for OTC Derivatives**. Market participants should put in place systems ensuring that settlement, legal, and operational infrastructure underlying OTC derivatives market are sound.
- **Enhanced Transparency and Valuation.** Weaknesses in disclosure contributed substantially to the market crisis. Financial institutions should improve their disclosures of risk. Supervisors should strengthen requirements for accounting, disclosure, and audits, including improvements in processes for valuations of financial positions and accounting for off-balance sheet vehicles. Firms, industry and accounting organizations, and regulators took a number of positive steps in 2008 but further improvement is needed.
- **Changes in the Role and Uses of Credit Ratings.** Poor credit assessments, particularly of complex structured subprime debt, contributed greatly to the financial crisis. Conflicts of interest in the credit rating process and uncritical reliance on historical data and credit ratings by financial intermediaries and investors contributed to these failures. These conflicts of interest must be addressed, and regulators and supervisors should review the extent to which their rules induced investors to rely excessively on ratings. Steps to address these concerns were taken in 2008 but more action is needed.
- **Strengthening the Authorities' Responsiveness to Risks.** More effective regulatory supervision could have prevented some of the problems over the past two years. International processes for agreements to strengthen supervision operate more slowly than financial innovation. Supervisors often failed to verify that firms actually were complying with supervisory guidance they had accepted, and firms often have not improved even when urged to do so by supervisors. Supervisors must have the resources, expertise, and performance required to oversee financial innovation and to verify that firms understand and are managing risks effectively.
- **Improvements in International Regulatory Cooperation**. Supervisory bodies should cooperate amongst themselves more effectively by establishing an international college of supervisors for each of the largest global financial institutions. International supervisors demonstrated during the crisis that they could share information about globally active firms and markets risks in mutually beneficial ways; it was important to sustain such active cooperation during "normal" periods.

- **Robust Arrangements for Dealing with Stress in the Financial System.** Central banks should be able to intervene to deal with extraordinary situations and make efforts to reduce the stigma among banks of receiving central bank assistance even in times of stress. Central banks also should be able to coordinate among themselves, including arrangements for establishment of standing swap lines with other banks, possible use of collateral across borders and currencies, and joint arrangements for dealing with weak banks. They should strengthen deposit insurance arrangements and, in general, strengthen international cooperation in crisis management. Events in 2008 and policy initiatives under way furthered these objectives.

Name of Issuer	**Group of 30 (G-30)**
Name of Report	The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace
Date of Report	October 2008
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." (http://www.group30.org/)

Objectives of the Report
In July 2007, the Group of 30 (G-30) commenced a 17-jurisdiction review of financial regulatory approaches. The G-30 Report outlines four approaches to financial supervision in use in jurisdictions around the world and assesses the strengths and weaknesses of each approach. Work on the October 2008 Report began before the current crisis, and thus it does not assess how different regulatory regimes performed in response to the crisis.

Principal Findings of the Report

- **Four Approaches to Financial Supervision.** The G-30 identified and assessed four approaches to financial supervision in use around the world.
    - The Institutional Approach: Under the institutional approach to financial supervision, a firm's legal status determines which regulator is tasked with overseeing its activity from both a safety and soundness and a business conduct perspective. The report describes this model as suboptimal given the evolution of markets and financial institutions.
    - The Functional Approach: The functional approach is one in which supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of

business may have its own functional regulator. The functional approach to regulation works well so long as coordination amount agencies is achieved and maintained, but this form of regulation may be suboptimal, and noted that a number of jurisdictions are moving away from the model.

- The Integrated Approach: Under the integrated approach, a single, universal regulator conducts both safety and soundness and conduct-of-business regulation for all sectors of the financial services business. This model can be effective and efficient in smaller markets where one regulator can oversee the broad spectrum of financial services successfully, but this model may create the risk of a single point of regulatory failure.
- The Twin Peaks Approach. The Twin Peaks approach is a form of regulation by objective in which there is a separation of regulatory functions between two regulators, with one performing safety and soundness and the other focused on conduct-of-business regulation. The Report notes growing interest in the Twin Peaks model.

- **The Current System in the United States and Requisites of an Effective System.** The current system of regulation in the United States, with its origins in historical experiences and federalism, does not fall neatly under any of these categories. Whatever the approach to financial supervision, certain characteristics are important to any system of financial regulation:
  - Coordination among Agencies: Any system of regulation should strive effectively to coordinate among supervisory agencies, central banks and financial ministries at both operational and principal levels.
  - Importance of the Central Bank: Communication, information-sharing, and decision-making linkages between a central bank and large, systemically important financial institutions are critical during times of both normal operation and crisis.
  - Deposit Protection Schemes: Effective, transparent and efficient deposit protection schemes are essential components of a financial system.
  - International Communication: International communication is important, as in the case of supervisory colleges for systematically important global financial institutions in which regulatory agencies build linkages during times of normal operations as well as crisis.

Name of Issuer	**Group of 30 (G-30)**
Name of Report	Financial Reform: A Framework for Financial Stability
Date of Report	January 15, 2009
Background of Issuer	"The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers." (http://www.group30.org/)

Objectives of the Report
The report considers how the financial system should be organized after the present crisis. It seeks a consensus on future arrangements that will be useful both in the long term and in restoring confidence in the present. The report examines the policy issues related to redefining the scope and boundaries of prudential regulation; the structure of prudential regulation, including the role of central banks, the implications for the workings of "lender-of-last-resort" facilities and other elements of the official "safety net," and the need for greater international coordination; improvements in governance, risk management, regulatory policies, and accounting practices and standards; and improvements in transparency and financial infrastructure arrangements.

Principal Findings of the Report
• **Part 1: An Overview of a Program for Reform.** Large, complex banking organizations generating the major share of credit extension and financial infrastructure must be held to a higher level of prudential regulation and supervision, with tighter restrictions on their activities. On the other hand, restrictions should not be so severe that they impede productive financial intermediation. Balancing these two considerations thoughtfully requires: ○ Clearer boundaries between institutions and activities subject to higher levels of formal regulation, because of their impacts on financial stability,

and other institutions.

  - Holding systemically significant institutions to the highest standards of governance and risk management through stronger regulatory incentives.
  - Using regulation to mitigate inherent tendencies toward excessive risk-taking or risk aversion.
  - Establishing a more robust failure resolution regime, permitting orderly closings of large financial institutions, and administering safety net resources in ways reinforcing discipline on managers, shareholders, and sophisticated creditors.
  - Ensuring that those responsible for prudential regulation and supervision have a high degree of political and market independence, and the resources required to supervise giant institutions and keep abreast of market innovations.
  - Ensuring that central banks responsible for promoting financial stability have adequate authority and capacity.
  - Strengthening incentives for higher levels of risk transparency in financial products, markets, and institutions.
  - Achieving better international consistency and coordination in regulatory, supervisory, and accounting policies and crisis resolution practices.

- **Guiding Principles for Financial Reform.** Reform of the financial system must enable "diverse, competitive, predominantly privately owned and managed institutions and markets" to efficiently and flexibly meet the needs of global, national, and local businesses, governments, and individuals. It should put in place arrangements so that financial market instability does not again undermine national or international economies. Certain principles guide the report's recommendations, outlined below.
- **The Public Sector Role in Safeguarding Financial Stability.** Regulatory policy should recognize how the inherent volatility of free and open financial markets may occasionally threaten economic stability. Prudential regulation should contain this tendency by:
  - Regulating and supervising the most systemically important, complex banking organizations at the highest level of international standards.
  - Assuring, through prudential regulation and supervision, appropriate standards for capital, liquidity, and risk management in systemically important non-bank financial institutions.
  - Assuring that the infrastructure supporting the financial system, including clearing and settlement systems and related legal frameworks, can permit the orderly closing of large, complex financial institutions.
  - Avoiding accounting, regulatory, or other practices that inadvertently reinforce excessive exuberance or risk aversion.

- **Fair and Effective Competition.** Regulatory policies and approaches should, insofar as feasible, enhance fair and effective competition by treating financial services common to different institutions uniformly. They should:
    - Recognize the benefits of open and free competition, but also address the potential for unfair competition arising from explicit and implicit government protection, excessive concentration of financial resources, or extensive conflicts of interest.
    - Restrict risk-prone activities or unmanageable conflicts of interest while protecting systemically important institutions through access to liquidity support by central banks.
- **Official Oversight and Crisis Response**. Effective public agencies that are substantially insulated from political or private interests should oversee the financial system. This requires that:
    - Central banks play key roles in financial market oversight because of their responsibilities for financial stability and for being "lenders-of-last-resort," their financial resources, and their typically professional management and independence within governments.
    - Appropriate governmental authorities should authorize the expenditures and affirm and support central bank decisions when budgetary resources are required or governmental funds are placed at risk to deal with crises.
    - Official agencies should have in place the procedures and resources required to resolve crises that potentially impair financial systems.
- **International Consistency and Coordination**. Nations should implement these principles in consistent, coordinated ways. They should:
    - Work to achieve common capital, accounting, and reporting standards.
    - Respond to failures or near failures of internationally active and systemically important financial institutions jointly, when required, and consistently.
- **Governance and Risk Management**. High standards of institutional governance and risk management are necessary. These standards require:
    - Engaged and knowledgeable independent boards of directors focused on long-run performance.
    - Corporate governance that demands well-balanced compensation systems and disciplined, strong, and independent risk management.
    - Regulatory and supervisory policies that reinforce such corporate governance.
- **A Consistent Theme in These Principles is the Importance of Containing Systemic Risk and Maintaining Close Oversight of "Systemically Important" Financial Institutions.** Financial regulation and supervision should primarily focus on maintaining the health of the financial system and containing systemic

risk, not preventing all failures even among the largest players. It succeeds to the extent that it limits seriously disruptive institutional failures, manages failures in ways disciplining senior management and shareholders, and contains market fallout from such failures.

  - "Potentially systemically significant" financial institutions are—in some combination—large, use relatively high amounts of leverage, connect tightly with many other institutions, and provide critical infrastructure services for the markets. Prudent regulators can define these criteria in general terms, but should not define them precisely or inflexibly.
  - A country's prudential regulator, in cooperation with its central bank in those countries where these roles are separate, should have sufficient authority to set and modify criteria used to make these determinations. Central bankers should be able to identify firms that require more oversight and potential regulatory intervention to manage any failures.

- **Four Core Recommendations.** Four core recommendations organize the report's specific proposals.
  - Prudential supervision must oversee, to an appropriate degree, all systemically significant financial institutions, regardless of type (Recommendations 1 through 5.)
  - Prudential regulation and supervision must operate more effectively. This will require more resources for prudential regulators and higher levels of national and international policy coordination (Recommendations 6 through 8.)
  - Institutional policies and standards—and especially standards for governance, risk management, capital, and liquidity—must be strengthened. Regulatory policies and accounting standards must guard against pro-cyclical effects and maintain prudent business practices (Recommendations 9 through 12.)
  - Financial markets and products must be made more transparent, and market incentives should not systematically produce crises. Failures of even large financial institutions must not damage market infrastructure (Recommendations 13 through 18.)

Core Recommendation 1: Gaps and Weaknesses in the Coverage of Prudential Regulation and Supervision Must Be Eliminated. Prudential supervision must oversee, to an appropriate degree, all systemically significant financial institutions, regardless of type. We must redefine the boundaries of the official "safety net" and of prudential regulation, strengthen the effectiveness of and streamline financial regulation, and reassess the role of central banks and the tools available to them.

- **Recommendation 1: Prudential Regulation and Supervision of Banking Organizations.**
  - In all countries, a single regulator should oversee government-insured, deposit-taking institutions (consolidated supervision). Regulators should

supervise the largest and most complex banking organizations particularly closely, assuring that they meet prudent, consistent international standards.

  - Regulators should restrict activities of systemically important banking institutions presenting particularly serious risks and conflicts of interest. Ordinarily such institutions should not sponsor and manage commingled private pools of capital (that is, hedge and private equity funds in which the banking institution's own capital is commingled with client funds), and strict capital and liquidity requirements should limit their proprietary trading. They should retain a meaningful part of the credit risk when they package and sell collective debt instruments.
  - In general, unregulated non-financial organizations should not own or control government-insured deposit-taking institutions, and regulators should limit dealings among such banking institutions and partial non-bank owners.
  - Nations should consider limiting deposit concentration in national banking given concentration's effects on official oversight, management control, and competition.

- **Recommendation 2: Consolidated Supervision of Non-Bank Financial Institutions.** Recent experience demonstrates the need for consolidated regulation and supervision of systemically significant non-bank financial institutions.
  - Nations should establish a framework for consolidated regulation and supervision of internationally active insurance companies if they do not already have such arrangements.
  - An appropriate prudential regulator should oversee large investment banks and broker-dealers that are not organized as bank holding companies.
- **Recommendation 3: Money Market Mutual Funds and Supervision.** Mutual funds often operate as "large pools of maturity transformation and liquidity risk," yet capital rules, supervision, and safety provisions covering banks do not apply to them. Regulators should distinguish services that are most appropriately housed in regulated and supervised banks, "particularly the right to withdraw funds on demand at par," and those that mutual funds, focused on short-term fixed-rate credit instruments, can reasonably provide.
  - Money market mutual funds that offer bank-like services, "such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par," should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
  - Remaining money market mutual funds should offer only conservative investment options that are clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds. They

should offer no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. "Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US$1.00 per share."

- **Recommendation 4: Oversight of Private Pools of Capital.** Limited and flexible official regulation should apply to private pools of capital, especially hedge funds. This would provide official supervisors with information required to track funds and monitor systemic risk, and encourage continuous improvement in market and counterparty discipline.
    - Managers of private pools of capital that employ substantial borrowed funds should register with an appropriate national prudential regulator. Minimum size and venture capital exemptions from the registration requirement should be available.
    - Such regulators should have authority to require periodic reports and public disclosures regarding the size, investment style, borrowing, and performance of the funds, and to establish appropriate standards for capital, liquidity, and risk management for funds above a size judged to be potentially systemically significant. "Disclosure and suitability standards will have to be reevaluated" since registration and regulation can create a false impression of lower investment risk.
    - The primary business location of the manager of such funds, not the legal domicile of the funds themselves, should determine the appropriate regulator. Regulation should operate on an internationally consistent basis because the managers and funds operate globally.
- **Recommendation 5: Government-Sponsored Enterprises.** The hybrid business model of Government-Sponsored Enterprises (GSEs), which are both profit-seeking private companies and agents of government policy, is unworkable, particularly during crises.
    - Private sector mortgage finance risk intermediation should be clearly separated from government sector guarantees or United States insurance of mortgage credit risk.
    - Explicit statutory backing and financial support should apply to any governmental entities supporting the mortgage market through purchases. Hybrids of private ownership with government sponsorship should be avoided. Existing GSE mortgage purchasing and portfolio activities eventually should be spun off to private sector entities, with the government, if it desires, maintaining a capacity to intervene in the market through a wholly owned public institution.

Core Recommendation II: The Quality and Effectiveness of Prudential Regulation and Supervision Must Be Improved. This will require better-resourced prudential regulators and central banks operating within structures that afford much higher levels of

national and international policy coordination. (Recommendations 6 through 8.)

- **Recommendation 6: Regulatory Structure.** Stronger prudential supervision requires complex judgments about the stability of large banking organizations. The public sector needs to attract, develop, and retain individuals fully capable of engaging senior private sector counterparts in meeting these challenges.
    - Countries should seek to remove unnecessary overlaps, gaps, and complexity in regulatory coverage, thereby reducing regulatory arbitrage and improving regulatory coordination.
    - Countries should explicitly insulate national regulatory authorities from political and market pressures and evaluate authorities' needs for resources to fulfill their responsibilities.
- **Recommendation 7: The Role of the Central Bank.** Central banks should have an explicit role in assuring financial stability. That requires adequate authority and tools.
    - Central banks should accept a role in promoting and maintaining financial stability if they have not already done so. This responsibility applies during rapid credit expansion and increased use of leverage that could lead to crises as well as during crises themselves.
    - When the central bank is not the prudential regulator, the central bank should have a strong role on its governing body, should formally review proposed changes in key prudential policies, especially capital and liquidity policies and margin arrangements, and should help supervise systemically significant firms and critical payment and clearing systems.
    - Public policy should sharply distinguish regulated banking organizations with normal access to central bank liquidity facilities from other types of financial institutions whose access, if any, should be limited to extreme emergency situations of critical systemic importance.
    - Central banks should have emergency lending authority for highly unusual and exigent circumstances, but appropriate political authorities should support any extensions of credit to non-bank institutions.
    - Central bank liquidity support operations should not entail lending against or the outright purchase of high-risk assets, or other forms of long-term direct or indirect capital support. "In principle, those forms of support are more appropriately provided by directly accountable government entities. In practice, to the extent the central bank is the only entity with the resources and authority to act quickly to provide this form of systemic support, there should be subsequent approval of an appropriate governmental entity with the consequent risk transfer to that entity."
- **Recommendation 8: International Coordination**. International regulatory and supervisory coordination can be improved, both under existing and enhanced arrangements for cooperation. International policy forums should seek these

improvements expeditiously and at high levels.

  - "National regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination." They should:
    - Coordinate oversight of the largest international banking organizations, share relevant information, and clarify home and host responsibilities both during normal times and crises more effectively.
    - Move beyond coordinated rule making and standard setting to identifying and modifying material national differences in how such standards are applied and enforced.
    - Close regulatory gaps and raise standards, where needed, with respect to offshore banking centers.
    - Jointly consider systemic risk concerns and the cyclicality implications of regulatory and supervisory policies.
  - Agencies should strengthen their actions in member countries to promote implementation and enforcement of international standards.
  - Excessive leverage contributes to financial disruptions, and it is employed in increasingly complex ways on and off balance sheets. Prudential regulators, central bank, and international agencies should collaboratively define leverage and then collect and report data on the degree of leverage and maturity and liquidity mismatches in various national systems and markets.
  - The initial focus of any new international regulatory organizations should be on developing more formal regional mechanisms, such as in the European Union, but attend continuously to the global dimension of financial markets.

Core Recommendation III: Institutional Policies and Standards—And Especially Standards for Governance, Risk Management, Capital, and Liquidity—Must Be Strengthened. Regulatory policies and accounting standards must also guard against pro-cyclical effects and be consistent with maintaining prudent business practices (Recommendations 9 through 12).

- **Recommendation 9: Regulatory Standards for Governance and Risk Management.** Standards of governance and risk management should be raised. These improvements should include:
  - Strengthening boards of directors, with greater engagement of independent members having financial industry and risk management expertise.
  - Effective board oversight of compensation systems to balance risk taking with prudence and the long-run interests of and returns to shareholders.
  - Ensuring systematic board-level reviews and exercises to establish the most important parameters of the firm's risk tolerance and risk profile

relative to those parameters.

- Ensuring the risk management and auditing functions are fully independent and adequately resourced. The risk management function should report directly to the chief executive officer rather than through the head of another functional area.
- Reviewing periodically a firm's potential vulnerability to risk arising from credit concentrations, excessive maturity mismatches, excessive leverage, or undue reliance on asset market liquidity.
- Ensuring that all large firms can continuously monitor, within a matter of hours, their largest counterparty credit exposures on an enterprise-wide basis and make that information available, as appropriate, to its senior management, its board, and its prudential regulator and central bank.
- Ensuring industry-wide adoption of risk management practice improvements recommended in the reports of the Counterparty Risk Management Policy Group and the Institute of International Finance.

- **Recommendation 10: Regulatory Capital Standards.** Regulatory policies should try to moderate the effects of business cycles by influencing economic activity, and avoid intensifying cycles when doing so is harmful.
    - International regulatory capital standards should address tendencies toward pro-cyclicality. Benchmarks for being well-capitalized should be raised, given the limitations of even the most advanced tools for estimating firm-wide risk.
    - These benchmarks should be expressed as a broad range within which capital ratios should be managed. Supervisors should guide firms to operate in the upper end of such a range when markets are exuberant and tendencies for underestimating and under-pricing risk are great.
    - Existing international definitions of capital should be more closely aligned with national definitions of capital.
    - Capital and risk disclosure standards should make more transparent a firm's risk appetite, estimated needs for and allocation of capital, and valuation practices.
- **Recommendation 11: Standards for Liquidity Risk Management.** Standards governing liquidity risk, in addition to enhanced risk-based capital standards, are required to ensure financial stability.
    - "Base-level liquidity standards should incorporate norms for maintaining a sizable diversified mix of long-term funding and an available cushion of highly liquid unencumbered assets. Once such standards are developed, consideration should be given to what is the preferred mix of senior and subordinated debt in bank capital structures."
    - Supervisory guidance for liquidity standards should analyze in a more refined way a firm's capacity to maintain ample liquidity under stress

conditions, including evaluation of its liquidity management policies and contingency funding plan.

  - Liquidity disclosure standards, building on the practices recommended by the Basel Committee, should complement improved disclosure practices for capital and risk profile information.

- **Recommendation 12: Fair Value Accounting.** Accounting principles should seek a better principles-based balance between the legitimate needs of investors for useful current financial information and the business model of the regulated financial institutions.

  - Fair value accounting principles and standards should seek to develop more realistic guidelines for dealing with less-liquid instruments and distressed markets.

  - Principles-based standards that better reflect the business model of regulated financial institutions that intermediate credit and liquidity risk, apply appropriate rigor to valuation and evaluation of intent, and require improved disclosure and transparency should be developed. This should be done to resolve the tension between the business purpose served by these institutions and the interests of investors and creditors. Prudential regulators should review these standards to ensure application in a fashion consistent with safe and sound operation of such institutions.

  - "Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit-loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios. There should be full transparency of the manner in which reserves are determined and allocated."

  - As emphasized in the third report of the CRMPG, individual financial institutions must ensure that wholly adequate resources and fail-safe independent decision-making authority are central to the valuation and price verification process.

Core Recommendation IV: Financial Markets and Products Must Be Made More Transparent, With Better-Aligned Risk and Prudential Incentives. Failures of even large financial institutions must not undermine the infrastructure supporting such markets (Recommendations 13 through 18.)

- **Recommendation 13: Restoring Confidence in Securitized Credit Markets.** The excessive complexity and lack of transparency of certain financial instruments contributed to the current loss of confidence. Solutions will require strengthened regulatory capital and liquidity standards and broader efforts to reduce risk and restore investor confidence in these markets.

  - Market Supervision: Securitized and other structured product and derivatives markets must be held to regulatory, disclosure, and transparency standards at least comparable to those historically applied to the public securities markets. This may require broader market

monitoring, adequate transparency regarding transaction volumes and holdings across all products, and thorough understanding of both credit and leverage elements of each product.

    - Credit Underwriting Standards: Market confidence in the adequacy and sustainability of underwriting standards for securitized credit markets must be restored. Regulators should require regulated financial institutions to retain a meaningful portion of the credit risk they are packaging into securitized and other structured credit products.
    - Off-Balance-Sheet Vehicles: Pending accounting rule changes for consolidating many types of off-balance-sheet vehicles are positive and needed improvements. "It is important, before they are fully implemented, that careful consideration be given to how these rules are likely to impact efforts to restore the viability of securitized credit markets."

- **Recommendation 14: Rating Agency Reforms.** The incentives of the issuer, the investor, and the rating service provider must be aligned more effectively. Regulatory policies should be revised, preferably on an internationally coordinated basis, to achieve the following:
    - Users of risk ratings, and especially regulated users, should strengthen or acquire a capacity for independently evaluating the risk of credit products in which they are investing.
    - NRSRO risk ratings should be made more robust, to reflect the risk of losses not just from default probabilities and loss in the event of default, but also from the full range of potential risk factors, including liquidity and price volatility.
    - Regulators should encourage payment models that align more effectively the incentives among the providers of risk ratings and their clients and users, and permit evaluation of NRSROs' work products.

- **Final Areas of Recommendation: Infrastructure Developments.** Three final recommendations of the G-30 focus on market infrastructure improvements.

- **Recommendation 15: Oversight of Credit Default Swaps (CDS) and Over-the-Counter (OTC) Markets.** The infrastructure in support of the OTC derivatives markets must be strengthened.
    - Legislation to establish a formal system of regulation and oversight of OTC derivatives markets should support planned improvements to OTC market infrastructure.
    - Given the global nature of these markets, regulatory frameworks should be consistent, and national regulators should cooperate with authorities of other countries responsible for overseeing market activities.

- **Recommendation 16: A Resolution Mechanism for Financial Institutions.** Mechanisms to resolve failures while avoiding major disruptions and contagion must be strengthened. These mechanisms must "permit timely but not forced

actions on the part of creditors and other counterparties to protect their interest."

- Legal regimes should provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions. In the United States, legislation should establish a process for resolving the failures of non-depository financial institutions, including non-bank affiliates within a bank holding company structure, comparable to the process for depository institutions.
- The regime for non-depository financial institutions should apply only to those few organizations whose failure might pose a threat to the financial system.
- A regulatory body, with powers comparable to those available for the resolution of banking institutions, "should be empowered to act as a receiver or conservator of a failed non-depository organization and to place the organization in liquidation or take action to restore it to a sound and solvent condition."
- "The special treatment accorded to various forms of financial contracts under current U.S. law should be examined in light of recent experience, with a view toward resolving claims under these contracts in a manner least disruptive to the financial system."

- **Recommendation 17: Improving Transparency of Structured Product Markets.** Appropriate new disclosure standards for asset-backed and other structured fixed-income markets should be developed. Such information should be comparable and facilitate analysis over time and across transactions.
    - "The disclosure and dissemination regime for asset-backed and other structured fixed income financial products (including securities and other financial products) in the public and private markets should be enhanced."
    - The appropriate national regulator should, in conjunction with investors, consider enhancing existing rules or adopting new rules ensuring disclosure of material information for asset-backed and synthetic structured products.
    - "The appropriate national regulator should condition transactions in the private and wholesale markets on satisfaction of appropriate information disclosure standards."
- **Recommendation 18: Sharing Market Activity and Valuation Information.** "Efforts to restore investor confidence in the workings of the OTC market suggest a need to revisit evaluations of the costs and benefits of infrastructure investments that would facilitate a much higher level of transparency around activity levels, traded prices, and related valuations. Part of the costs of such changes is the impact on firm-specific concerns regarding the private nature of their market activity. These concerns, and direct investment costs, need to be weighed against the potential benefits of higher levels of market transparency."

Name of Issuer	**Institute of International Finance (IIF)**
Name of Report	Final Report of The IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations—Financial Services Industry Response to the Market Turmoil of 2007– 2008
Date of Report	July 2008
Background of Issuer	The Institute of International Finance, established in 1983 in response to the international debt crisis, is a global association of financial institutions. Its members include most of the world's largest commercial and investment banks and a growing number of insurance companies and investment management firms (http://www.iif.com/)

Objectives of the Report
The IIF Committee on Market Best Practices set out principles of conduct, best practice recommendations, and considerations for officials. The report examined risk management; compensation policies; liquidity risk; structured vehicles such as conduits and securitization; valuation; credit underwriting, ratings, and investor due diligence in securitization markets; and transparency and disclosure. The Committee suggested that rigorous self-assessment and monitoring are necessary to improve conduct in each of these areas. However, higher industry standards can only work within an effective and efficient regulatory framework.

Principal Findings of the Report
• **The Need to Establish a Risk Culture Throughout the Firm.** A fundamental cause of the crisis was that firms, to varying degrees, failed to identify and manage key risks. Firms thus should embed effective risk management practices thoroughly in business operations while maintaining the independence of those directly responsible for specific risk management tasks. Senior managers and the CEO in particular are responsible for the performance of risk management,

subject to oversight by the board of directors.

- **Compensation Policies Must Not Encourage Excessive Levels of Risk.** The growth of structured products and the "originate-to-distribute" business model created incentives harming underwriting practices and risk management. For example, bonus payouts often were tied to current production, without sufficient regard for risk. Compensation should be designed to avoid the destructive incentives evident over the past two years.

- **Firms Must Manage More Effectively Liquidity Risks Arising from Conduit and Securitization.** Failures to monitor, evaluate, and anticipate liquidity risks on an ongoing basis contributed to the current crisis. Firms must have an agreed-upon and well-communicated strategy for day-to-day liquidity risk management, and establish robust methodologies to monitor and manage funding strategies, including by currency, maturity, and jurisdiction, among other categorizations. Central banks and supervisors play critical roles in overseeing these practices and intervening as appropriate.

- **Firms Must Produce and Provide More Stable and Better-Understood Valuations.** Many instruments became hard to value due to illiquidity in the market crisis, producing questionable valuations and loss of confidence in markets. Firms must maintain robust, independent, and critical valuation processes in accordance with accounting and regulatory guidance, and incorporating critical expert judgment and discipline. They should engage auditors, rating agencies, investors, analysts, accounting standard setters, and supervisors in a comprehensive technical dialogue in these activities.

- **Credit Underwriting, Ratings, and Investor Due Diligence In Securitization Markets Must Be Improved.** Erosion of underwriting standards and due diligence contributed heavily to the market crisis. Credit rating agencies did not effectively convey the risks of structured products, nor provide sufficient information on assumptions used to assess risks. The Committee proposed a number of recommendations to improve the credit rating process and due diligence; these recommendations applied to the underwriting and due diligence chain of originators, sponsors, underwriters, distributors, rating agencies and investors.

- **Transparency and Disclosure Issues.** Firms must improve disclosure documents and processes for shareholders, counterparties, and regulators, particularly for structured products. Officials must develop clear and consistent accounting and financial reporting standards.

- **Systemic Risks and the Creation Of A Market Monitoring Group.** The IIF will create a Market Monitoring Group (MMG) to monitor global financial markets for early signs of vulnerabilities having systemic implications, to examine financial market dynamics potentially straining markets, and to develop appropriate responses.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	Report On The Subprime Crisis
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and an effective surveillance of international securities transactions; and provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses (http://www.iosco.org/about/).

Objectives of the Report
IOSCO's May *Report on the Subprime Crisis* identified causes of the market crisis and made recommendations to mitigate the current crisis and prevent such breakdowns in the future.

Principal Findings of the Report
• **Issuer Transparency and Investor Due Diligence.** Failures in disclosure by issuers, combined with investor failures to perform due diligence on transactions, contributed to the crisis. The report outlined information that investors should request about complex transactions and that firms should provide as a matter of course. It particularly focused on disclosures regarding complex structured transactions, and how a secondary market reporting system for structured transactions might operate. • **Firm Risk Management and Prudential Supervision.** Failures in firms' risk management included inadequate risk modeling and internal controls, over-reliance on credit ratings, inadequate balance-sheet liquidity, and off-balance sheet entities with liquidity puts. Standing committees of IOSCO would examine

and consider recommendations in each of these areas.

- **Valuation.** Firms with effective systems of risk management addressed valuation and accounting issues more effectively than other firms; thus, supervisors should focus on encouraging maintenance of such effective internal systems. Regulators also need to engage related questions over accounting.
- **Credit Rating Agencies.** This section of the report summarized IOSCO's *The Role of Credit Rating Agencies in the Structured Finance Markets* (May, 2008), discussed separately below.

Name of Issuer	**International Organization of Securities Commissions Technical Committee (IOSCO)**
Name of Report	The Role of Credit Rating Agencies in Structured Finance Markets
Date of Report	May, 2008
Background of Issuer	The member agencies of the International Organization of Securities Commissions cooperate to develop and maintain high standards of regulation; exchange information on their respective experiences in order to promote the development of domestic markets; seek to establish standards and effective surveillance of international securities transactions; and provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses (http://www.iosco.org/about/).

Objectives of the Report
Because of apparent failures in the credit rating process, the IOSCO Technical Committee asked its Credit Rating Agency Task Force to analyze the role CRAs play in structured finance markets and to recommend changes to the IOSCO CRA Code of Conduct as necessary. The May 2008 Report and related revisions to the IOSCO Code of Conduct for CRAs are the outgrowth of this effort.

Principal Findings of the Report
• **Deficiencies in the Credit Rating Process Contributed to the Financial Crisis.** CRAs had a major effect on the crisis because investors and market participants tended to "outsource" valuation and risk analysis to them at the expense of their own due diligence. CRAs did not discourage this trend given their growth and profitability. Faulty models, assumptions, and analysis produced flawed ratings. • **Deficient Transparency and Comparability of Ratings Performance Data.** Many CRAs do not publish verifiable and easily comparable historical rating performance data. The CRAs should make ratings performance data transparent and comparable.

- **Limitations on Ratings Methodologies.** IOSCO reports that some have accused CRAs of being too slow to modify methodologies and assumptions despite rapid market changes, and of not adequately disclosing assumptions used when rating structured finance products.
- **System of Symbols For Traditional vs. Structured Products.** Given the differences in the amount of historical data available for debt instruments such as corporate and municipal bonds as compared to structured finance products, IOSCO reports that some market observers have suggested that CRAs should use a different set of symbols when issuing opinions on the default risk and loss characteristics of structured products. The CRA Task Force recommended study of this approach.
- **Ratings Downgrades.** CRAs have been criticized for being slow to review and, if necessary, downgrade credit ratings on structured products. The Report recommends that CRAs take steps to ensure the objectivity of ratings review, including potentially separating the initial rating function from the monitoring function.
- **Independence and Avoidance of Conflicts of Interest.** IOSCO reports that many market observers have expressed concerns about conflicts of interest in the credit rating agencies because they receive a substantial portion of their revenue from the issuers that they rate, raising concerns that a CRA may have an incentive to downplay credit risk in order to obtain or retain issuer business. Related, the CRAs are not simply rating structured finance securities, but also advising issuers on how to design the securities trust structure. The Report questions whether CRAs have sufficient controls in place to minimize such conflicts.
- **Competition.** IOSCO notes that there are concerns that lack of competition in the credit rating industry may have hindered the development of new CRA methodologies, led to increased prices by dominant established CRAs, and inhibited rating innovation and quality.
- **Recommended Improvements in the Quality and Integrity of the Rating Process.** The report recommended a number of improvements.
  - Conduct the ratings downgrade process in an objective manner.
  - Establish a rigorous and formal review process for methodologies and models. Where possible, this process should be independent of business lines responsible for ratings.
  - Assure that information used to generate a rating is of sufficient quality to support a credible rating, and that employees on rating committees have sufficient expertise.
  - Establish a new products review function made up of one or more appropriately experienced senior managers to review feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates.
  - Assess whether existing methodologies and models for determining credit

ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially.

  - Prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.
  - Ensure that adequate resources are allocated to monitoring and updating its ratings.

- **<u>CRA Independence and Avoidance of Conflicts of Interest.</u>** Procedures to mitigate conflicts of interest should be in place.
  - CRAs should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer that the analyst has rated, or a financial firm with which an analyst has had significant dealings as an employee of the CRA.
  - CRAs should conduct formal and periodic reviews of remuneration policies and practices for CRA analysts to ensure that these policies and practices do not compromise the objectivity of the CRA's rating process.
  - Disclose whether any one issuer, originator, arranger, subscriber or other client and its affiliates make up more than 10 percent of the CRA's annual revenue.
  - To discourage "ratings shopping," CRAs should encourage structured finance issuers and originators of structured finance products to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct their own independent analyses of structured finance products. CRAs should disclose in their rating announcements whether the issuer has publicly disclosing all relevant information or if the information remains non-public.
  - CRAs should define what is considered to be (and not to be) an ancillary business and why.
- **<u>CRA Responsibilities to the Investing Public and Issuers</u>**
  - CRAs should assist investors in developing a greater understanding of what a credit rating is, and the limits on its quality and predictive value.
  - CRAs should publish verifiable, quantifiable historical information about the performance of rating opinions. This information should be organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.
  - Where a CRA rates a structured finance product, it should provide investors and/or subscribers with sufficient information so that an investor can understand the basis for the CRA's rating. A CRA should disclose the degree to which it analyzes how sensitive a rating of a structured financial product is to changes in the CRA's underlying rating assumptions.
  - CRAs should differentiate ratings of structured finance products from other ratings, preferably through a different rating symbology. A CRA

should clearly define a given rating symbol and apply it in the same manner for all types of products to which that symbol is assigned.

- CRAs should disclose the principal methodology or methodology version used in determining a rating.

Name of Issuer	**Robert Kuttner, prepared for Dēmos**
Name of Report	Financial Regulation After the Fall
Date of Report	January 9, 2009
Background of Issuer	Robert Kuttner, founder and co-editor of the American Prospect, prepared this paper for Dēmos. Dēmos is a non-partisan public policy research and advocacy organization headquartered in New York City (http://www.demos.org/).

Objectives of the Report
Kuttner writes that "This paper is an effort to catalogue abuses and suggest ways to think about regulatory remedies. Because of the continuing undertow of the market-fundamentalist ideology and the continuing political power of the very people and institutions that brought us this catastrophe, some of the most robust remedies will seem at the margins of mainstream debate. But, in order to move them to center stage where they can gain a proper hearing, it is necessary to at least inject these ideas into discussion."

Principal Findings of the Report

- **Financial De-Regulation Produced The Current Financial Crisis.** Financial markets historically have demonstrated "lack of transparency, insider conflicts of interest, and dangerously high levels of leverage—all of which were given a free pass by regulators then and now. Investment banking firms and other credit intermediaries systematically understated risks, and regulators failed to provide necessary checks and balances."
- **The Crash of an Ideology.** Kuttner argues that the current financial crisis contradicts certain ideas behind deregulation. These ideas include:
  - Innovations in financial markets that attract buyers and investors are almost always beneficial. Financial innovations almost always enhance economy efficiency and hence economic growth.
  - Financial markets can police themselves, and government intervention undermines beneficial financial innovation. Financial innovators can

circumvent regulation by shifting to unregulated activities and organizational in the United and/or shifting business operations overseas. Thus, regulation is wasteful because it slows innovation and stimulates costly but successful efforts to avoid it.

  - Deregulatory initiatives based on the ideas listed above failed their own tests of efficiency. Accounting frauds and opaque securitizations and other instruments diverted capital to inefficient uses at the tremendous costs to the economy we see now. Efficient regulation could have prevented these losses. Better financial markets will require more disclosure, but also will require more prohibitions.

- **Abuses and Remedies.** The paper advocates changes in the practices discussed below.
  - Credit Rating Agencies: Credit ratings agencies (CRAs) largely determine the cost of credit to borrowers and returns for investors and determine patterns of investment because of the signals they provide. Further, regulations frequently direct institutional investors to rely on credit rating agencies when designing portfolios by restricting investments to those with certain ratings.
    - Reports have demonstrated how conflicts of interest, assessment failures, and mismanagement undermined both initial ratings and revaluations in ratings for asset-backed securitizations and other valuations in recent years.
    - He argues that there "is a strong case that the credit rating agencies could be turned into public institutions or non-profits accountable directly to the SEC, on the premise that they carry out a public function that is too important to the economic efficiency of credit markets and too easily corrupted to be left in private hands."
  - Securitization of Credit: Securitization has become more complex, and regulators have not examined the process closely.
    - Kuttner says that his research demonstrates that securitization did not in fact increase the availability of credit to borrowers.
    - The government should restore underwriting standards and simplify the securitization process. Furthermore, there "is even a case for prohibiting" the use of complex tranching on the grounds that it generates large fees for financial intermediaries but no clear economic benefits.
  - Home Finance and Housing Policy: Kuttner maintains that a relatively simple system of housing finance from 1940 through the mid-1960s increased the home ownership rate from about 40% to about 64%, with rare defaults and few failures of participating financial institutions. Now, he argues, the system has become complicated and economically wasteful, serving mainly to generate fees for financial intermediaries.

- Derivatives and Shadow Banks: Much of the current activity in derivatives market consists of "bets on bets on bets" without constructive economic purpose, generating fees for financial intermediaries and producing excessive levels of leverage in the financial system—extremely "high levels of credit backed by no reserves" with no regulatory supervision.
    - Since the 1970s, regulatory standards governing credit extension weakened, producing a series of financial crises. Policy makers did not respond to the crises by putting in place the necessary long-term regulatory controls.
    - While regulating risks more effectively, we also should consider prohibiting some types of "exotic securities" directly or through mandatory reserve levels high enough to make them unprofitable. Action should be based on careful study of the economic benefits and costs of such transactions.
    - Improvements in regulation should include tighter examinations of asset portfolios and strategies of bank holding companies; requirements that liabilities of off-balance sheet entities posing risks to an institution be added to its balance sheet; more comprehensive reserve requirements for entities creating credit; and regulatory powers to restrict or prohibit "dangerous and deceptive behavior" and "inherently hazardous products…No significant financial transactions should escape regulatory scrutiny."
- Non-Exchange Traded Derivatives: Credit default swaps and other OTC derivatives, not subject to any meaningful public regulation, "created the serious problems of excessive speculation, dangerously high leverage, and eventual collapse."
    - Requiring that derivatives like credit default swaps be traded on exchanges, while desirable, might not mitigate their risks because they would be thinly traded and their prices would be unstable. If we do move them to exchanges, the CFTC, which likely would regulate them, must be strengthened.
    - In general, such derivatives should be registered as securities with all of the required disclosure, examination, and reserve requirements. The United States should consider prohibiting many such derivative transactions entirely because otherwise financial engineers continuously will develop ways to circumvent restrictive regulations, allowing the underlying problems to persist.
- Credit Default Swaps: Insuring bonds against default can facilitate socially valuable financing. However, credit default swaps facilitate speculation under the guise of insurance, as was the case at AIG. Regulating such transactions as insurance likely would expose large areas of the credit default swaps market as excessively risky.

- Hedge Funds and Private Equity: Hedge funds and private equity escape most regulation because, under the terms of the securities laws, they do not sell shares to the public. They pose systemic problems because they account for a large share of financial market activity, intensify market disruptions by acting in similar ways, and engage in "dubious, highly-leveraged, and lightly regulated" transactions.
- Short Selling: Kuttner maintains that short sellers facilitate risky, complex derivatives by acting as counterparties in such transactions, aggravate market volatility, and need to be examined critically.
- TARP, Yardstick Competition, and Public Ownership: The paper criticizes the Department of the Treasury's implementation of the TARP as involving enormous public expenditures with few meaningful concessions or restraints in exchange for the funding. He suggests that the TARP could provide a way for the government to establish even a limited number of banks to serve as exemplars of prudent lending and practice.

- **The Regulatory Architecture.** The paper refers to a "patchwork" nature of the United States regulatory system with its large number of federal and state regulators. "Few of these agencies distinguished themselves" in 2007-2008.
  - Securities Regulation and Self-Regulation: Kuttner maintains that the "pervasive ideology of deregulation has weakened a once strong SEC."
    - Regulations of executive compensation, proxy reform, rights of private action in litigation, mutual fund transparency and disclosure, enforcement of disclosure requirements governing publicly traded corporations, hedge fund regulation and registration, and stock options practices need more attention. He also argues for longer intervals between SEC service and relevant employment with regulated firms.
    - Discussing the possibility of SEC/CFTC merger or related organizational changes, he expresses concern over the CFTC record and opposes any weakening of the SEC.
    - "There is a good argument that the whole self-regulation model has failed, and that something as fundamental to the integrity of the nation's capital markets as the conduct of stock exchanges, broker-dealers, and investment bankers should revert to the SEC itself; or at the very least to an independent nonprofit responsible to the SEC rather than to the regulated industry."
- The Question of a Super-Regulator: The Department of the Treasury Blueprint in March 2008 proposed that the Federal Reserve be authorized explicitly to search for and respond to systemic financial risk.
    - Kuttner expresses concerns that the Fed is not a public agency, is not fully accountable, and that "in practice, the Federal Reserve has been a feeble regulator, especially when it comes to the non-

bank affiliates of bank holding companies, which have been the source of so many recent problems."

  - He argues that the "prudential regulation (and hence investor protection) of financial exchanges, broker-dealers, investment offerings, mutual funds, hedge funds, private equity, credit-rating agencies, accounting standards, and of corporate finance, is best entrusted to a much strengthened SEC. The Federal Reserve's supervisory capacity needs to be dramatically upgraded before it can be fully relied upon as a prudential regulator of universal banks and their holding company affiliates."

- Regulatory Havens and International Regulatory Harmonization: Differences in regulatory quality among jurisdictions allow regulated firms "to play off one regulator against another in search of the weakest jurisdiction (a practice known as regulatory arbitrage)." Effective regulation of complex firms thus requires international cooperation among regulators and some degree of appropriate standardization. Achieving this cooperation can be difficult.

- Historic Memory, Genies, and Bottles: The New Deal limited interest rates that banks could pay depositors. Government removed the interest rate restraint during the inflation of the 1970s so that banks could compete with less-regulated institutions for deposits, and then relaxed other rules, steadily increasing banks' latitude to expand their business models, leading them to take on more risk. He suggests that we should reassert regulation to return the financial system to core functions: "Indeed, it was a system of strict financial regulation that allowed the low interest rates of the 1940s, 1950s, and early 1960s to serve the real economy rather than be squandered in wasteful speculation."

- The Case for Drastic Simplification: "In the recent past, the burden of proof was on those who sought to constrain newly invented financial instruments. But now that all this innovation has produced the most serious crash since the Great Depression, it is time to shift that burden and make it acceptable to ask: *what do these innovative instruments and financial techniques really add to economic efficiency*? Do they add to the supply of credit and 'spread risk' in a wholesome and efficiency-enhancing way? Or are they primarily devices to generate fees for middlemen and pass risk along to someone else, adding nothing of value to the real economy, undermining rather than enhancing efficient pricing—and increasing systemic risk?"

Name of Issuer	**North American Securities Administrators Association**
Name of Report	Proceedings of the NASAA Financial Services Regulatory Reform Roundtable, December 11, 2008
Date of Report	December 11, 2008
Background of Issuer	Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association with a membership consisting of securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico (http://www.nasaa.org/home/index.cfm).

Objectives of the Report
This document summarizes presentations by state securities regulators in a discussion of regulatory reform designed to provide advice to the incoming administration of President Obama. It stems from its core principles for regulatory reform, found at found at http://www.nasaa.org/issues___answers/legislative_activity/9775.cfm,

Principal Findings of the Report

- **NASAA's Core Principles For Regulatory Reform**. NASAA's core principles for regulatory reform are set out as counsel to the incoming administration of President Obama. They are quoted below.
- **Introduction to NASAA's Core Principles.** Our system of financial services regulation must be improved to better protect our investors, our markets, and our economy as a whole. To serve all of these vital interests, Congress and the Administration, working together with federal regulators, state regulators, and self-regulatory organizations, should take steps to ensure that our new approach is ***strong***, ***comprehensive***, ***collaborative***, and ***efficient***. We can achieve these objectives by applying five core principles for regulatory reform.
- **Preserve Our System of State/Federal Collaboration While Streamlining Where Possible.** Regulating our financial markets is an enormous challenge, one that can only be met through the combined efforts of state and federal regulators,

working together to protect the integrity of the marketplace and to shield consumers from fraud and abuse. We must resist attempts to weaken this collaborative system. State securities regulators, for example, must not be preempted or marginalized as mere advisers to federal authorities. Particularly in the areas of enforcement, licensing, and compliance examinations, state regulators provide indispensable consumer protections. At the same time, we should look for opportunities within this collaborative framework to make regulation more streamlined and efficient.

- **Close Regulatory Gaps by Subjecting All Financial Products and Markets To Regulation.** An enormous amount of capital is traded through esoteric investment instruments on opaque financial markets that are essentially unregulated. Our system must be more comprehensive and transparent, so that all financial markets, instruments, and participants—from derivatives to hedge funds—are subject to effective regulation through licensing, oversight, and enforcement.
- **Strengthen Standards of Conduct, and Use "Principles" to Complement Rules, Not Replace Them.** We should strengthen the standards of conduct that apply in all financial sectors. In the area of securities regulation, for example, we should impose the fiduciary duty—in addition to existing standards—on all securities professionals who dispense investment advice, including broker-dealers. We should strengthen shareholder rights, and in every sector, we need to revisit our accounting standards and capital requirements to ensure transparency and solvency. We must also recognize that a "principles-based" approach to regulation is no substitute for a clear and strong system of prescriptive rules. Broadly framed standards of conduct can serve as helpful guides for industry as well as useful enforcement tools for regulators, but standing alone, they leave too much room for abuse.
- **Improve Oversight through Better Risk Assessment and Interagency Communication.** We should enhance our ability to manage risk in all financial markets. The keys to this reform are better detection, communication, and intervention. These improvements are best achieved not by creating a new federal regulator, but rather by improving the tools and methods that existing agencies have at their disposal for identifying and limiting risk. In addition, to facilitate communication and coordination, the President's Working Group on Financial Markets should be expanded to include representatives from the state agencies that regulate banking, insurance, and securities.
- **Toughen Enforcement and Shore Up Private Remedies.** Enforcement is one of the most effective tools for deterring lawless behavior in our markets, but for years, it has received far less support than it deserves. We should toughen punishments for those who violate the law and increase enforcement budgets for state and federal regulators, including the SEC. In addition, we must remember that the private rights and remedies of injured consumers are an essential complement to government enforcement efforts aimed at deterring fraud. The pendulum has swung too far in the direction of limiting private rights of action,

and now Congress should legislatively reverse some of the Supreme Court's most ill-conceived and anti-consumer decisions.

- **Themes in the Proceedings Regarding These Principles.** The Proceedings present the statements by state official supporting and expanding on these themes. Their comments make the following key points.
  - Having multiple regulators generates a variety of effective approaches and ideas regarding financial market regulation. Thus, preempting financial market regulation by states would damage the regulatory system's ability to adapt to the growing complexity of financial markets.
  - State securities regulators bring a unique local perspective to the regulatory process. They are likely to identify investor protection issues before federal regulators because they deal with such investors more directly.
  - State securities regulators have a history of bringing enforcement actions in many areas of securities violations in advance of federal agencies, likely reflecting their local knowledge and orientations. These examples include enforcement actions for investment banking conflicts of interest, mutual fund practices, auction rate securities, day trading, limited partnerships, and others. Reducing their ability to bring such cases would damage enforcement in financial markets.
  - State securities regulators are informed by knowledge of local conditions. Thus, for example, Texas is more sensitive to financial market violations in the oil and gas industries, while other states have comparable knowledge of their own major industries. Preempting state roles in financial market regulation would cause us to lose these valuable perspectives.
  - The presence of multiple regulators can induce regulatory competition and innovation.
  - There is a need for formalized sharing of information. Alabama State Securities Commission Director Joseph Borg commented, with respect to federal and state financial market regulation, that "We must replace the current ad hoc personality-dependent form of information sharing that goes on among the agencies, and establish and enforce minimum standards of information sharing at the appropriate agency level…To facilitate an increasing communication and cooperation, perhaps consideration should be given to the establishment of some type of council of experts to monitor financial activity in all sectors and recommend corrective action where necessary… Entities such as the President's Working Group on Financial Markets should be expanded to include representatives from state agencies that regulate banking, insurance, and securities. It's hardly possible to imagine policy-relevant financial information derived from a single source or a limited source in today's complex and interdependent economy."

- Strong enforcement programs are essential to effective financial market regulation, and states emphasize that they have frequently taken strong enforcement actions through both criminal and civil actions.
- Congress should seek to reinstate the ability of investors to sue for securities fraud, such as addressing investors' ability to file suits for the aiding and abetting of fraud. Congress also should consider precluding mandatory arbitration agreements.

Name of Issuer	President's Working Group On Financial Markets (PWG)
Name of Report	Policy Statement on Financial Market Developments and Progress Update on March Policy Statement on Financial Market Developments
Date of Report	March, 2008 and October, 2008
Background of Issuer	The President's Working Group on Financial Markets (PWG) consists of the Department of the Treasury, the Federal Reserve, Securities and Exchange Commission, and the Commodity Futures Trading Commission. The Treasury Secretary chairs the group. The PWG worked with the Office of the Comptroller of the Currency and Federal Reserve Bank of New York in preparing these reports.

Objectives of the Report
These policy statements offered recommendations to improve the future state of U.S. and global financial markets. The March statement addressed the causes of the market crisis and offered proposals to mitigate systemic risk, restore investor confidence, and facilitate stable economic growth. The October statement reviewed interim developments and provided a progress report on these initiatives.

Principal Findings of the Report
• **Reform Mortgage Origination Process**. States should implement nationwide licensing standards for mortgage professionals, federal and state regulators should strengthen oversight of mortgage origination, and the Federal Reserve should issue stronger consumer protection rules and mandate greater disclosures. The October update indicated that state regulators had a new mortgage licensing system. New federal legislation mandated licensing and registration by states and federal banking regulators of all loan originators taking residential loan applications and offering or negotiating residential mortgage loans. Federal and state authorities had, among other steps, issued new guidance on underwriting of subprime mortgages, strengthened examinations of those originating mortgages, and initiated numerous enforcement actions.

- **Improve Investors' Contribution to Market Discipline**. Investors and their asset managers should obtain better information about the risks of securitized credits on an ongoing basis, not rely solely on credit ratings, and obtain independent view of risks. The reports proposed improvements in disclosure and due diligence requirements and reviewed progress in 2008.
- **Reform Ratings Processes and Practices Regarding Structured Credit and Other Securitized Credit Products**. Credit rating agencies (CRAs) should improve disclosures and the integrity and transparency of their rating process. The October update reviewed new regulatory and industry initiatives regarding CRAs.
- **Strengthen Global Financial Institutions' Risk Management Practices**. Global financial institutions should remedy weaknesses in their risk management practices through both private sector and regulatory actions. Regulators should align capital requirements to encompass a wider range of risks and consider changes in regulations regarding disclosures, accounting standards, and OTC market infrastructure. The October updated reviewed actions in this area.
- **Improvements Have Been Made but More Are Needed**. The October PWG update emphasized that "Notwithstanding the substantial progress that has occurred in implementing its recommendations, the PWG believes that further progress is still warranted in each of the areas in which it made recommendations." Firms' conduct in actually implementing new "best practices" will substantially determine whether risk management, disclosure, and other operational areas will operate more effectively.

Name of Issuer	**Securities Industry and Financial Markets Association (SIFMA)**
Name of Report	Recommendations of The Securities Industry and Financial Markets Association Credit Rating Agency Task Force
Date of Report	July 2008
Background of Issuer	The Securities Industry and Financial Markets Association (SIFMA) is a principal trade association of the financial services industry. Its membership consists of securities firms, banks and asset managers. Its stated mission is to promote policies and practices to expand and improve financial markets, help to create new products and services and create efficiencies for member firms, and preserving and enhancing the public's trust and confidence in financial markets and the industry.

Objectives of the Report
The Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force (the Task Force) is a global task force formed to examine credit ratings and credit rating agencies (CRAs). It includes experts in structured finance, corporate bonds, municipal bonds, and risk and members from the US, Europe, and Asia. The President's Working Group on Financial Markets (PWG) designated the Task Force as the private-sector group to provide the PWG with industry recommendations on credit rating matters. The Task Force identified the credit-rating-related causal variables contributing to the current crisis, ranked, in order of importance designated by its members, 16 key issues and addressing those issues in its recommendations.

Principal Findings of the Report
• **Enhanced Disclosure of CRA Rating Methodologies.** The information on ratings methodologies published by CRAs was insufficient for investors to understand CRA rating methodology for structured securities, so investors could not independently, effectively monitor the ratings' quality. CRAs should disclose more fully the structures, assumptions, sensitivities, and other key aspects of the models. • **Enhanced Disclosure of Due Diligence Information.** CRAs did not independently review or perform due diligence to confirm the accuracy of data

provided to them regarding the assets underlying structured securities, relying on publicly available information or other parties, including issuers. The CRAs should disclose the extent to which they rely on other parties for information and its verification in the ratings process. The "CRA is the party best suited to disclose the due diligence and examination information that the CRA used in issuing its rating."

- **Disclosure of CRA Surveillance Procedures.** More timely and diligent surveillance of rated securities would reduce delays between deteriorating asset performance and ratings downgrades and uncertainty regarding downgrades. CRAs should disclose the nature and extent of their surveillance to be performed after initial ratings are issued; the task force identified specific elements that should be disclosed.
- **Disclosure of Comparable CRA Performance.** Market participants cannot easily compare the performance of different CRAs because CRAs have not routinely published easily verifiable and comparable historical performance data regarding their ratings. The CRAs should publish verifiable, quantifiable historical information about their ratings in formats that help investors compare CRA performance.
- **Differentiation between Core and Consulting Services.** SIFMA reported that some market participants believe that the degree and nature of interaction between CRAs and issuers during the ratings process results in conflicts of interest biasing ratings in favor of issuers. The CRAs have committed to not provide consulting or advisory services to issuers that they rate, but the task force recommended that CRAs clearly define "core" rating services they will perform in interaction with issuers and distinguish them from "consulting or advisory" services they will not perform. The task force identified a list of what should be permissible core services.
- **Creation of Global Credit Ratings Advisory Board and Convergent Regulatory Framework.** The task force recommended creation of a global, independent industry credit ratings advisory board under the auspices of SIFMA. Governmental and regulatory bodies should develop a more fully harmonized and convergent global regulatory framework for the credit rating process.
- **Disclosure of CRA Fees.** SIFMA reported that some market participants believe that the issuer-pays model of CRA compensation creates conflicts of interest, particularly in the structured finance that is the source of an increasing amount of CRAs' revenues. The concern is that CRAs may inflate ratings to ensure continued client relationships. CRAs should be required to submit disclosures regarding their fee structures to applicable regulators for review. CRAs and issuers of structured securities should agree that rating fees associated with surveillance will be paid directly from the related transaction structures on a periodic basis.
- **Consistent Ratings and Ratings Modifiers.** The recent pace and extent of ratings downgrades, and inconsistency between ratings migration with respect to

structured products and other asset classes such as corporate bonds, has reduced market confidence in the rating of structured products, particularly for RMBS and certain CDOs. CRAs should review ratings processes for structured products to ensure that the performances of ratings are line with other asset classes. The task force also supported the CRAs' efforts to enhance disclosure relating to volatility, but questioned the value of distinguishing through formal codes the ratings of structured products from those of traditional asset classes such as corporate bonds.

- **Independent Risk Analysis By Investors.** Investors rely on credit agency ratings to the detriment of their own valuations, risk analyses and continuing review of structured products. CRA ratings thus disproportionately affect the valuation and liquidity of structured products, and RMNS and CDOs in particular. To combat this trend, the report urges investors to conduct their own independent risk analysis, aided by the enhanced disclosure recommended in the SIFMA CRA Report.
- **Disclosure by Issuers and Underwriters.** All market participants, including issuers and underwriters, should examine measures they can take to improve the ratings system. Issuers and underwriters should consider giving greater disclosure to investors, including disclosure of specific types of information designated in the SIFMA CRA Report.

Name of Issuer	**Professor Joel Seligman**
Name of Report	Testimony for a Hearing of the House Committee on Financial Services on the Future of Financial Services Regulation, Oct. 21, 2008.
Date of Report	October 21, 2008
Background of Issuer	Professor Joel Seligman is President of the University of Rochester. He is one of the leading scholars of securities laws in the United States. He also has served as reporter for the National Conference of Commissioners on Uniform State Laws, Revision of Uniform Securities Act (1998–2002); as chair of the Securities and Exchange Commission Advisory Committee on Market Information (2000–01); and as a member of the American Institute of Certified Public Accountants Professional Ethics Executive Committee. He was a member of the board of the National Association of Securities Dealers (2004-07) and is currently a member of the board of the Financial Industry Regulatory Authority (http://www.rochester.edu/president/bio.html)

Objectives of the Report
Given major changes in financial markets in recent decades, Professor Seligman asks "what lessons does history suggest for this Committee to consider as it begins to address the potential restructuring of our system of financial regulation?"

Principal Findings of the Report

- **The Need to Distinguish Time Pressures for Short Term Remedies and Long Term Restructuring.** Seligman writes that Congress should distinguish between emergency rescue legislation which must be done quickly, and restructuring of financial regulation, which should be done only after careful review of the financial markets and regulatory options. This analysis can be done expeditiously, but it must not be rushed to the point that its quality suffers. The system of securities regulation has operated as successfully as it has for decades because of the extensive hearings, studies, and thought supporting the design of the laws in the 1930s.
- **Congress Should Convene a Select Committee To Review What Must Be Done.** Congress should create a Select Committee similar to that used after

September 11 to review what must 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."

- **The Review Should Be Comprehensive.** The review should be comprehensive, spanning visible topics such as credit default swaps and hedge funds but also less contentious issues such as state insurance regulation. In this case, "a partial system of federal oversight runs an unacceptable risk of failure."
- **Congress Must Examine Carefully the Tradeoffs Between Having a Single Agency Addressing Systemic Risk And Having Several Expert Specialized Agencies.** Seligman notes that, while a good case can be made for having the Federal Reserve or Treasury as a central crisis manager, to make either the Federal Reserve or Treasury dominant federal financial regulators would be risky.
- **The Tradeoffs of Narrow and Broad Regulatory Jurisdiction.** A focused agency with a high level of expertise in a particular area, such as the Securities and Exchange Commission, provides important benefits. Seligman also recognized the risks of a narrow jurisdiction, including a lack of White House or Congressional support for its work. 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."
- **The Place of Principles-Based Regulation and Overall Regulatory Strategy.** With respect to the issue of principles-based regulation, Seligman notes the practical difficulties of implementing principles without often detailed rules.
- **The Need to Consider Thoughtfully the Details of Reorganization.** While it makes sense to explicitly identify a crisis manager, Seligman questions the benefits of consolidating routine regulation in an agency with vast jurisdiction because of significant differences in regulatory problems. He writes, "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 management powers with the roles of those specialized financial regulatory agencies that continue to exist," given that federal financial regulatory agencies often have quite different purposes, scopes, and political structures.

Name of Issuer	**Senior Supervisors Group (SSG)**
Name of Report	Observations on Risk Management Practices in the Recent Market Turbulence
Date of Report	March 6, 2008
Background of Issuer	The Senior Supervisors Group is composed of seven international supervisory agencies, including the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the U.K. Financial Services Authority, and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve.

Objectives of the Report
In 2007 the Financial Stability Forum, which promotes international financial stability through information exchange and regulatory cooperation, initiated a study of risk management practices by firms preceding and during the financial crisis. The Senior Supervisors Group (SSG) surveyed 11 global banking organizations and securities firms in 2007 regarding their oversight and risk management, meeting with select firms' senior management in November 2007 and industry representatives in February 2008. Based principally on a survey and access to information on the firms' operations, it identified risk management practices differentiating firms' performance in weathering the crisis. Firms varied in how effectively their senior management team, business line risk owners, and control functions worked together to manage risks.

Principal Findings of the Report
• **Managing Risk.** Firms varied in how effectively their senior management team, business line risk owners, and control functions worked together to manage risks. • **Rating Agencies.** Firms that performed better were skeptical of rating agencies' assessments of complex securities and so developed effective internal systems for valuing securities. In contrast, firms that had more problems did not have internal

systems to challenge valuations and relied relatively passively on external ratings.

- **Monitoring.** Firms that performed better monitored actively how decisions by individual business units would affect the firm's consolidated balance sheet, liquidity, and capital positions; other firms failed to do so.
- **Information Systems.** Firms that performed better had information systems that used multiple tools and assumptions to estimate risks across business unit lines and the entire firm, using both quantitative and qualitative analysis. Other firms relied more uncritically on simple measures of risk or credit ratings.
- **Management Oversight.** Senior management varied substantially in how personally, actively, and effectively they pushed the entire organization to manage risk.

Name of Issuer	**Professor Joseph E. Stiglitz**
Name of Report	Testimony for a Hearing of The House Committee on Financial Services on The Future of Financial Services Regulation
Date of Report	October 21, 2008
Background of Issuer	Professor Joseph Stiglitz is University Professor at Columbia University. In 2001, he was awarded the Nobel Prize in economics for his analyses of markets with asymmetric information. He was a member of the Council of Economic Advisers from 1993-95, during the Clinton administration, and served as CEA chairman from 1995-97. He then became Chief Economist and Senior Vice-President of the World Bank from 1997-2000. In 2008, he was appointed by French President Nicolas Sarkozy to chair a Commission on the Measurement of Economic Performance and Economic Progress (http://www2.gsb.columbia.edu/faculty/jstiglitz/bio.cfm)

Objectives of the Report
The testimony suggests, for the House Committee on Financial Services, a series of principles, objectives, and instruments of a 21st century regulatory structure.

Principal Findings of the Report
• **General Background for Financial Regulation Reform.** Professor Stiglitz maintains that reform of financial regulation must begin with a broader reform of corporate governance, including reform of distorted incentive structures producing short-term focus and excessive risk taking. Accounting systems that allow and encourage such activity need to be changed. The recession will deepen without more direct governmental assistance to homeowners. • **Reasons For Market Failures.** Distorted incentives in financial markets have produced short-sighted, risky behavior jeopardizing the economy. Accounting rules, complex securitizations, and derivatives increased profits, concealed risks,

and deceived investors, consumers, and others.

- **Regulations for The Twenty-First Century.** The regulatory system must distinguish types of institutions and manage information asymmetry.
    - The regulatory system must distinguish between financial activities that, if disrupted, would undermine the economy, and those primarily assisting the very wealthy. Core financial activities must be heavily regulated given their collective impact. "There needs to be a strong ring-fencing of these core financial institutions—they cannot lend money to or purchase products from less highly regulated parts of our financial system, unless such products have been individually approved by a Financial Products Safety Commission."
    - An effective regulatory system should manage as effectively as possible inherent information asymmetries between the regulated and the regulator. As firms and individuals try, often successfully, to circumvent regulations, regulations must adjust constantly to changes in the environment and attempts to evade rules.
- **Key Elements of a Regulatory Structure.** Professor Stiglitz identifies essential functions of the financial regulatory structure.
    - Providing Transparency and Disclosure: Financial markets must be based on transparency and disclosure, but complex derivatives and similar financial products are opaque. Derivatives and similar products therefore should "neither be purchased nor produced by highly regulated financial entities, unless they have been approved for specific uses by a financial products safety commission…and unless their use conforms to the guidelines established by the FPSC."
    - Regulators should encourage wider use of standardized products increasing the transparency of the economy. There will be loss of some ability to custom-tailor structured products for purchasers, but, Stiglitz maintains, the benefits in improved transparency and stability of the system will exceed the costs.
    - The financial services industry frequently has resisted efforts to increase transparency in financial markets because it restricts marketing and subjects firms to greater scrutiny from investors, regulators, and others. Stiglitz maintains that we must reject these objections.
    - "Realizing that there is no perfect information system," we may need combined approaches to financial information. "But at the very least, we should not abandon mark-to-market accounting…Part of improving transparency is to restrict—eliminate—off balance sheet transactions. There also needs to be clear disclosure of conflicts of interest, and if possible, they should be restricted."
    - Compensation systems should change. Executives should not be compensated in stock options. Incentive pay should be awarded over

longer periods. Compensation based on short-term performance should include provisions in which the pay could be pulled back in the event of unexpected losses induced by poor performance. Compensation should be related to performance on both organizational and individual levels.

  - Other incentives should be regulated. Those participating in mortgage securitizations or other financial products should bear some consequences for failures; mortgage originators should retain at least a 20% equity share. Public policy should remove or reduce conflicts of interest in rating agencies, and a government rating agency could be established. Public policy should seek out and eliminate or reduce conflicts of interest throughout the financial sector.
  - Exploitive practices should be curbed. Regulations and enforcement should target exploitive practices such as pay-day loans, predatory lending, rent-a-furniture, and similar tactics. A usury law, also applying to credit cards, should limit the effective rate of interest paid by borrowers.
  - Risky practices should be curbed. Regulations and enforcement should target risky practices that also often are exploitive, such as loans beyond people's ability to pay, mortgages where payments can vary substantially in ways imposing unexpected hardships on homeowners, and various arrangements with large transaction costs.
  - Excessive expansion of lending should be restricted. Stiglitz maintains that restricting the speed with which banks could have expanded their portfolio of loans or other assets—excessive expansion leading them to reduce loan standards—could have prevented the crisis. Other options to restrict excessive expansion of lending include increased capital requirements, increased provisioning requirements, or increased deposit insurance.
  - Restricting derivatives would curb risky practices. When standardized, such products can help risk management, but banks and other core financial institutions were speculating in many of these transactions.
  - Excessive Leverage Should Be Restricted. Commercial banks and other "core" financial institutions must have adequate capital to guard against excessive risks. Regulators must design and enforce capital rules carefully.
  - Regulators must be aware of how leverage, pricing, and ratings of rating agencies will vary with economic conditions. They can design countercyclical capital adequacy and provisioning requirements, adjust limits on loan-to-value ratios, or issue rules to adjust values of collateral depending on cyclical price variations. Banks should be required to make compulsory provisions for bond defaults, and put up provisions/reserves when loans are disbursed rather than when repayments are expected.

- **Establishing Better Regulatory Institutions.** Professor Stiglitz suggests that we should strive for relatively simple regulatory institutions that avoid regulatory capture in its different forms.

- “Relatively simple regulatory systems may be easier to implement and more robust. There needs to be sensitivity to the risk of regulatory capture. It may also be optimal to have duplicative regulatory systems: the costs of a mistake overwhelm the extra costs of regulation. And one must guard against regulatory competition—allowing a choice of regulators, which can lead to a race to the bottom.”
- “Regulatory capture” can be a matter of regulators accepting the perspectives of industry.
- The testimony also maintains that much industry influence comes from political action such as campaign contributions and other inducements. Thus, “deeper political reforms, including campaign finance reform, are an essential part of any successful regulatory reform.”
- Activities will flow to unregulated parts of the financial system if regulation is not comprehensive. Policy makers need to be aware of key parts of the system escaping regulation. There should be a financial markets stability commission overseeing the entire financial system.
- The paper maintains that individuals embedded within the financial markets will not examine systemic risks in a critical way. Thus, those who will lose from failed regulation, such as retirees, homeowners, ordinary workers, and small businesses, should have a voice in regulation. While they may not have the knowledge or resources to participate directly in regulatory politics, Stiglitz writes, “Fortunately, there are very competent experts who are committed to representing those interests.”
- A new Financial Products Safety Commission (FPSC) should evaluate the merit and pricing of new financial products. The Commission “would assess the risk of particular products and determine their suitability for particular users.”

- **The Need for a Broad Approach To Financial Market Regulation.** Improvements in financial markets will require more than attention to specific regulations and regulatory structures. Tax and legal structures, including those affecting corporate governance, anti-trust, and bankruptcy, must be modified and/or enforced effectively to remedy the problems surfacing in the credit crisis.
- **Need for Global Regulatory Cooperation.** Crises may originate and extend throughout the world. Global regulators must establish new cooperative agreements. He argues that the U.S. should not wait for such an agreement before it establishes regulatory improvements within the United States.
- **The Recommended Changes Will Aid Financial Innovation.** By “restricting the scope for the kinds of ‘innovations’ that have contributed not to economic growth but to economic instability—the liar loans, the financial alchemy that purported to be able to convert F rated sub-prime mortgages into products safe enough to be held by commercial banks or pension funds—hopefully this creative energy will be diverted to more constructive uses.”

Name of Issuer	**United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century (the Commission)**
Name of Report	Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century
Date of Report	March 2007
Background of Issuer	The Chamber of Commerce indicates that it is "the world's largest business federation, representing 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations….As the voice of business, the Chamber's core purpose is to fight for free enterprise before Congress, the White House, regulatory agencies, the courts, the court of public opinion, and governments around the world" (http://www.uschamber.com/about/default.htm).

Objectives of the Report
The Commission stated that it "believes that with quick and decisive adjustments in the U.S. legal and regulatory framework, U.S. government regulators and market participants will be better positioned to ensure that U.S. investor and business interests are best served in the global marketplace. To better protect investors and promote capital formation, the Commission is setting forth a series of recommendations that would significantly improve the U.S. position in the global markets. These recommendations can be implemented quickly and without overly burdensome costs."

Principal Findings of the Report

- **The Coordination of U.S. Financial Services Regulatory Policy Should Be Improved.** The President should enhance the role of the President's Working Group on Financial Markets (PWG) to increase coordination among the nation's financial services regulators. The PWG should develop:
    - A unified, coherent vision for the financial sector and a more efficient and unified regulatory structure.

- A comprehensive strategy for the sector and its regulation.
- A set of shared values to support the vision and drive the strategy.
- More effective mechanisms and policies regarding the U.S.'s interaction with foreign markets and regulators.
- More effective definitions of the relationship between federal and state jurisdictions in different aspects of the U.S. capital markets.
- A blueprint for a modern U.S. financial services regulatory regime that will ensure that our markets remain competitive and globally attractive.

- **The SEC Should Improve Its Rulemaking Processes.** The SEC should review any new significant policies through the rule-making procedure set forth in the Administrative Procedure Act. In addition to using its Office of Economic Analysis and the Chief Economist to evaluate potential rule-making, the SEC should consider independently reviewing the economic impact of new major regulations one to two years after enactment to assess their operations or any necessary changes.
- **The SEC Should Rely on Prudential Supervision.** The SEC should adopt a prudential approach to supervision akin to that used by the U.K.'s Financial Services Authority and U.S. federal banking regulators. Such an approach would include:
  - An open flow of information between the regulator and its regulated institutions to enable the regulator to become aware of important trends and developments, emerging risks and industry best practices.
  - Full access by examiners to institutions coupled with an examination privilege.
  - Expert, practical examiners capable of sharing insights and information about industry best practices.
  - Lead examiners in residence at large, complex institutions.
  - No automatic enforcement referrals.
  - A focus on safety and soundness.
  - Industry self-regulation should be enhanced through the establishment of a federal "self-evaluation" privilege for SEC-regulated institutions and their independent audit firms.
- **Reorganization of the Structure of the SEC.** New divisions at the SEC should oversee regulation of market professionals, market structure, and regulation of securities products. Congress should consider transferring regulatory authority over the creation of trading of futures on securities from the CFTC to the SEC.
- **Creation of a Federal Insurance Charter.** Congress should enact legislation to establish an optional federal insurance charter.

Name of Issuer	**United States Department of the Treasury**
Name of Report	Blueprint for a Modernized Financial Regulatory Structure
Date of Report	March, 2008
Background of Issuer	The Department of the Treasury plays a central role in U.S. financial regulatory policy. For example, the Secretary of the Treasury chairs the President's Working Group on Financial Markets (PWG), currently consisting of the Treasury, Federal Reserve, Securities and Exchange Commission, and Commodity Futures Trading Commission.

Objectives of the Report
The Department of the Treasury's *Blueprint for a Modernized Financial Regulatory Structure* calls for reorganization of the financial regulatory system. The work on the report began before the market downturn, so the *Blueprint* does not focus on many of the specific problems surfaced by the financial crisis, nor limits itself to proposing "emergency relief" for current economic ills. Rather, the *Blueprint* focuses on what it describes as regulatory gaps, redundancies and inefficiencies in the U.S. regulatory system and proposes broad reforms to the domestic regulatory regime.

Principal Findings of the Report

- **The U.S. Financial Regulatory System Does Not Align With Current Market Conditions.** With its combination of different federal and state regulators, no single regulator "has all of the information and authority necessary to monitor systemic risk." The system faces "the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected. The inability of any regulator to take coordinated action throughout the financial system makes it more difficult to address problems related to financial market stability." The *Blueprint* recommends actions in the short and intermediate terms, and, as long-term goal, an ideal regulatory structure.
- **The *Blueprint*'s Short Term Recommendations Focus on Improving Regulatory Coordination and Oversight in Response to the Credit Crisis.** Short-term recommendations include:
    - The Federal Government Should Strengthen the PWG: An Executive

Order should strengthen the PWG as an ongoing coordination and communication mechanism for the financial sector more broadly, and direct it to reach beyond financial markets. Its membership should be expanded to include the heads of the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The Executive Order also should specify that the PWG has the authority to consult in its deliberations with other domestic and international organizations affecting the financial sector.

  - Create a Mortgage Origination Commission: The Federal government should create a Mortgage Origination Commission (MOC) to evaluate, rate, and report on states' systems for licensing and regulating participants in the mortgage origination process. Legislation should establish, or permit the MOC to establish through rules, uniform minimum licensing qualification standards for state mortgage market participation systems. [Note: Subsequently, Title V, Sections 1501-1517 of H.R. 3221, the Housing and Economic Recovery Act of 2008 (the "Secure and Fair Enforcement [S.A.F.E.] Mortgage Licensing Act), addressed this issue to a significant degree.]
  - Federal Reserve's Role in Providing Liquidity: The Federal Reserve's authority and actions in providing liquidity to financial markets should be structured carefully and made transparent, and the possibility of extending its assistance to non-depository institutions should be considered. [Note: Events following March 2008 extended the federal government's role in this area.]

- **<u>The Treasury's Intermediate Term Recommendations Focus on Reducing Regulatory Duplication and Modernizing the Regulatory Structure in Banking, Insurance, Securities, and Futures.</u>** These intermediate term recommendations included the following:
  - National Bank Charter: The federal thrift charter should be eliminated over two years and transitioned into a national bank charter, with a concurrent merger of the Office of Thrift Supervision into the Office of the Comptroller of the Currency.
  - Reconfigure Role of the Federal Reserve and FDIC: A study, with subsequent action, should recommend a reconfiguring of the roles of the Federal Reserve and the Federal Deposit Insurance Corporation in their regulation of state-chartered banks with a federal guarantee.
  - Federal Charter for Payment and Settlement Systems: Congress should create a federal charter, overseen by the Federal Reserve, for systematically important payment and settlement systems.
  - Principles-Based Expedited Regulatory Process: The SEC should adopt a more principles-based, expedited regulatory process for overseeing exchanges, clearing agencies, and self-regulatory organizations, and it should exempt under the Investment Company Act certain products

actively trading in the United States or overseas.

- Regulatory Changes for Investment Companies and Investment Advisors: The Congress should expand the Investment Company Act to permit a new "global" investment company. The regulations governing the relationships between retail customers and their broker-dealers or investment advisors should be harmonized, and a new self-regulatory organization overseeing investment advisors should be established.
- Merger of the CFTC and SEC: The CFTC and the SEC should merge, with the combined organization adhering to the CFTC's principles-based regulatory approach.
- Federal Insurance Regulatory Structure and Charter: Congress should establish a federal insurance regulatory structure and an optional federal insurance charter, creating a dual-regulatory system such as the one operating in banking regulation. An Office of National Insurance within the Department of the Treasury should oversee the federal regulatory structure. As an intermediate step, Congress should establish a Federal Office of Insurance Oversight within Treasury to oversee national and international dimensions of regulatory issues related to insurance.

- **The *Blueprint* Articulates For "Long-Term Consideration" What It Described as an Optimal Objectives-Based Regulatory Structure.** This structure would include the following:
  - Market Stability Regulator: A market stability regulator should oversee financial market stability as it affects the economy.
  - Prudential Financial Regulatory Agency: A Prudential Financial Regulatory Agency (PFRA) should oversee problems of market discipline caused by government guarantees.
  - Conduct of Business Regulatory Agency: A Conduct of Business Regulatory Agency (CBRA) should oversee consumer protection and related business practices in financial markets.
  - Federal Insurance Guarantee Corporation: A Federal Insurance Guarantee Corporation (FIGC) should administer the deposit insurance program now overseen by the Federal Deposition Insurance Corporation and, if one is created, a Federal Insurance Guarantee Fund (FIGF). The Federal Insurance Guarantee Corporation would not possess any direct regulatory authority.
  - Corporate Finance Regulator: A Corporate Finance Regulator should oversee corporate activities in public securities markets, encompassing the SEC's current responsibilities over corporate disclosures, corporate governance, accounting oversight, and similar issues. The Conduct of Business Regulatory Agency would assume the SEC's current business conduct and enforcement activities bearing on financial institutions.

Name of Issuer	**United States Government Accountability Office (GAO)**
Name of Report	Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (GAO-09-216)
Date of Report	January, 2009
Background of Issuer	The United States Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. Its work is done at the request of congressional committees or subcommittees or is mandated by public laws or committee reports, and the GAO also undertakes research under the authority of the Comptroller General (http://www.gao.gov/about/index.html).

Objectives of the Report
The Government Accountability Office report describes the origins of the current financial regulatory system, market developments and changes shaping the regulatory systems, and suggests issues to be addressed in designing and evaluating proposals for change. It describes structural gaps and stresses in the system rather than evaluates agencies' implementations of regulatory programs.

Principal Findings of the Report

- **Financial Regulation Has Sought To Achieve Four Goals.** The report summarizes the goals of financial market regulation.
  - Ensure adequate consumer protections. Regulators try to prevent fraudulent or unsuitable sales of financial products, ensure consumers and investors have information required to make the best decisions, and oversee financial firms' business conduct and sales practices to prevent harms to consumers and investors.
  - Ensure the integrity and fairness of markets. Regulators try to prevent fraud, manipulation, information asymmetries, and other potential market failures.
  - Monitor the safety and soundness of institutions. Regulators try to prevent

excessive risks by institutions that damage the economy.

  - o Act to ensure the stability of the overall financial system. Regulators try to assure the financial system's stability by intervening in various ways, including providing emergency funding to financial institutions.

- **The Report Reviews The Development of the Financial Regulatory System.** The U.S. system of financial regulation developed over 150 years.
  - o As a result, the regulatory system is complex, fragmented, and not aligned well with current market conditions.
  - o The report examines specific changes in financial markets that have posed serious challenges for financial market regulation.

- **Emergence of Large, Complex, Globally Active Interconnected Financial Conglomerates.** Large financial conglomerates increase the range of consumer options for investing and retirement, provide one-stop shopping options, and facilitate consumer awareness of diverse products. However, they also generate risks that regulators have had difficulty managing in the current structure.
  - o Regulators often do not have sufficient authority or regulatory tools to oversee the activities and related risks in diversified financial institutions.
  - o Large diversified financial firms make identifying, managing, and mitigating systemic crises more difficult. With regulators tasked to focus on specific areas, no agency has the authority or information to oversee comprehensively these diversified firms and the financial system.

- **Less-Regulated Entities Have Come to Play Increasingly Critical Roles in the Financial System.** Many organizations have organized themselves in ways bypassing regulatory laws. These less-regulated organizations and activities contributed substantially to the current financial market crisis.
  - o Less-regulated entities carry out an increasingly important share of financial market activities. The GAO points out that these entities can provide useful products, but an important part of the financial system escapes the regulation seen as necessary for banks, broker-dealers, and insurance firms with similar functions.
  - o Oversight of less-regulated entities has improved recently, but regulators remain concerned with the risks they pose to the financial system.

- **Overreliance on Credit Ratings of Mortgage-Backed Products Contributed to the Recent Turmoil in Financial Markets.** Credit rating agencies (CRAs) play a critical role in financial markets but have not been overseen closely by regulators until recently, and serious problems exist in credit rating processes.
  - o Until recently—and to a large extent still—CRAs were not explicitly required to enable investors to understand the bases of ratings, or to evaluate the quality of ratings over time as a guide to future performance.
  - o Issuers of securities generally pay credit rating agencies for ratings, and

rating agencies have engaged issuers in transactions largely outside the ratings process, creating conflicts of interest that can bias ratings.

  - Investors rely on credit ratings to evaluate bonds and other securities, and local, federal, and international laws specify that banks, pension funds, and certain other institutional investors must use credit ratings as benchmarks for permissible investments. This came at the expense of investors' own due diligence in assessing the quality of investments.
  - In 2008 regulators have put in place new controls on CRAs, including new final rules by the SEC in December, with additional proposals outstanding, to enhance ratings transparency and reduce conflicts of interest.

- **Financial Institutions' Use of Off-Balance Sheet Entities Led to Ineffective Risk Disclosure and Exacerbated Recent Market Instability.** The GAO notes that these off-balance sheet entities were vulnerable to market disruptions. Current accounting and disclosure standards "had not required banks to extensively disclose their holdings in off-balance sheet entities and allowed for very low capital requirements."
- **New and Complex Products Pose Challenges to Financial Stability and Investor and Consumer Understanding of Risks.** The GAO notes the benefits of new, complex products, including enhanced credit market liquidity and better techniques for hedging. However, their growth and complexity pose serious disclosure and risk management issues.
  - Complexity of some products has made it difficult for institutions and their regulators to manage associated risks. For example, although "CDOs have existed since the 1980s, recent changes in the underlying asset mix of these products led to increased risk that was poorly understood by the financial institutions involved in these investments."
  - The SEC, CFTC, or other U.S. regulators do not regulate OTC derivatives in ways comparable to other economically comparable financial products.
  - Organizations have taken steps to improve clearance and settlement systems, but many of the improvements are not yet operational.
  - Investors and consumers have had difficulty understanding complex financial products because they failed to seek out necessary information, were misled by sales practices, or disclosures were too complicated.
  - Regulators have not responded to these problems sufficiently quickly, partly because the disclosures involve the multiple regulators' jurisdictions, slowing collective work.
  - Assessing and managing risks of complex financial products requires effective accounting and financial reporting requirements, but designing major changes in accounting rules is especially difficult when dealing with the types of complex financial technology involved in the market crisis.

- **Regulators Have Had to Coordinate Their Efforts Internationally.** The GAO examined efforts at international financial regulatory coordination.
  - Standard setters and regulators face new challenges in dealing with global convergence of accounting and auditing standards.
  - The fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators, such as in negotiations on Basel II and certain insurance matters.
  - On the other hand, the GAO noted that "regulatory officials told us that the final outcome of the Basel II negotiations was better than it would have been with a single U.S. representative because of the agencies' varying perspectives and expertise."
- **A Framework for Crafting and Assessing Alternatives for Reforming the U.S. Financial Regulatory System.** The GAO suggests that organizations designing and evaluating proposals for regulatory reform consider nine characteristics of an effective regulatory system. These characteristics are quoted from the report below:
  - Clearly Defined Regulatory Goals: A regulatory system should have goals that are clearly articulated and relevant, so that regulators can effectively conduct activities to implement their missions.
  - Appropriately Comprehensive: A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. Activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.
  - System-wide Focus: A regulatory system should include a mechanism for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.
  - Flexible and Adaptable: A regulatory system should be adaptable and forward-looking such that regulators can readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.
  - Efficient and Effective: A regulatory system should provide efficient oversight of financial services by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.
  - Consistent Consumer and Investor Protection: A regulatory system should include consumer and investor protection as part of the regulatory mission to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards, and suitability

requirements.

- Regulators Provided with Independence, Prominence, Authority, and Accountability: A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals.
- Consistent Financial Oversight: A regulatory system should ensure that similar institutions, products, risks, and services are subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.
- Minimal Taxpayer Exposure: A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

Name of Issuer	**United States Securities and Exchange Commission Staff**
Name of Report	Summary Report of Issues Identified in The Commission Staff's Examination of Select Credit Rating Agencies
Date of Report	July 2008
Background of Issuer	The United States Securities and Exchange Commission exercises regulatory jurisdiction over the credit rating process.

Objectives of the Report
In August 2007, the Staff of the Securities and Exchange Commission conducted examinations of three leading credit rating agencies (CRAs) to review their role in market turmoil. The Staff focused on the rating agencies' activities with respect to subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) linked to RMBSs. In July 2008, the staff issued its summary report on issued identified by those examinations.

Principal Findings of the Report
• **Increases in Volume and Complexity of RMBS and CDO Deals Strained CRAs' Performance.** From 2002 through 2006, the volume and complexity of RMBS and CDO deals rated by the CRAs, and the associated revenues to CRAs, substantially increased. Two of the three rating agencies examined struggled to adapt to the increase in the volume and complexity of the deals. Each examined CRA should assess on a periodic basis whether it has sufficient staff and resources to manage its volume of business and meet its obligations under Section 15E of the Securities Exchange Act of 1934 and rules applicable to NRSROs. • **Aspects of the Ratings Process Were Not Disclosed.** CRAs did not fully disclose significant aspects of the ratings process and the methodologies used to rate RMBS and CDOs. They used unpublished rating criteria and made "out of model" adjustments without documenting the rationale for the adjustment. Each NRSRO should review its current disclosures relating to processes and methodologies for rating RMBS and CDOs to determine whether it is fully disclosing its ratings methodologies. They also should review policies concerning the timing of disclosures of significant changes to process and/or methodologies.

- **Information Provided To Rating Agencies Was Not Verified.** No regulation requires rating agencies to verify the information contained in RMBS loan portfolios presented for rating, to insist that issuers perform due diligence, or to obtain reports concerning the issuer's level of due diligence. Rating agencies publicly disclosed that they did not engage in due diligence or otherwise seek to verify the accuracy or quality of the loan data in the RMBS pools that they rated. That said, all of the examined firms informed the Staff that they had implemented, or planned to implement, measures designed to improve the integrity and accuracy of the loan data received on underlying RMBS pools.

- **Inadequate Documentation of Policies and Procedures for Rating RMBS and CDOs.** None of the examined firms had specific written procedures for rating RMBS and CDOs or to identify and address modeling errors. The Staff recommended that each firm determine whether it is fully documenting its policies and procedures for credit ratings of RMBS and CDOs as required by Exchange Act Rule 17g-2.

- **Monitoring/ Surveillance Was Not Timely.** A lack of resources may have reduced the timeliness of surveillance and monitoring efforts. The Staff recommended that each firm determine whether its resources devoted to monitoring and surveillance are adequate, and adopt comprehensive written surveillance procedures and maintain surveillance records.

- **Conflicts of Interest Policies Not Consistently Implemented.** Examined CRAs did not take sufficient steps to prevent considerations of market share and other business interests from influencing ratings or ratings criteria. Each firm should review its practices, policies and procedures for managing and mitigating conflicts of interest from the "issuer pays" model and consider implementing steps preventing market share considerations or other business interests from influencing ratings or ratings criteria.

- **Analyst Compensation.** While each of the rating agencies prohibited contact between persons with significant business or any economic ties to a rated entity from participating in the ratings process for the issuer, and monitored and restricted individual trading activity, the agencies varied in how rigorously they monitored or enforced these policies and prohibitions. Each CRA should review its policies and procedures to ensure compliance with regulatory requirements.

- **Internal Audit.** The Staff found that one firm's internal audit program related to RMBS and CDO groups appeared to inadequately assess compliance with internal control procedures. The Staff recommended that two of the examined firms conduct a review to determine whether internal audit functions, particularly in the RMBS and CDO ratings areas, are adequate.