

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

**PART I: DOCUMENT OVERVIEW AND FULL WRITTEN  
SUMMARIES OF SELECTED REPORTS AND COMMENTARIES**

**January 28, 2009**

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

## **PART I: DOCUMENT OVERVIEW AND FULL WRITTEN SUMMARIES OF SELECTED REPORTS AND COMMENTARIES**

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## **DOCUMENT OVERVIEW**

As part of the Emergency Economic Stabilization Act, Congress instructed the Congressional Oversight Panel to “submit a special report on regulatory reform... analyzing the current state of the regulatory system and its effectiveness in overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendation, and whether there are any gaps in existing consumer protections”<sup>1</sup>

Numerous reports and commentaries have analyzed industry best practices, risk management, and regulatory reform. Many responded to the current financial crisis, recommending ways to enhance regulatory effectiveness and strengthen risk management in order to avoid crises in the future. Other reports reflect concerns about the increasingly global nature of the financial markets and the competitive position of domestic financial markets, and raise questions regarding different regulatory and oversight structures. Several of these reports were completed or initiated prior to the current market crisis.

This two-part document, with Parts I and II included separately on the website of the Congressional Oversight Panel, summarizes a selection of these reports and commentaries. Part I presents the full summaries with citations and Part II presents them in abbreviated template form. Both Parts are organized in alphabetical order by issuing organization or author. It is important to note that this document is a summary. We have in many cases quoted or abstracted directly from the reports and commentaries. All credit for the reports and commentaries belongs to their original authors, and we direct readers to their full text for further reference.

Questions regarding these summaries may be directed to Christine Sgarlata Chung at Albany Law School (518-445-3249, [cchung@albanylaw.edu](mailto:cchung@albanylaw.edu)) or David P. McCaffrey at the University at Albany-SUNY (518-442-5282, [d.mccaffrey@albany.edu](mailto:d.mccaffrey@albany.edu)), the co-directors of the Center for Financial Market Regulation of the University at Albany and Albany Law School.

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<sup>1</sup> Emergency Economic Stabilization Act of 2008, 12 U.S.C. §5233 (b)(2)(2008).

## **SUMMARY OF REPORTS**

### **A. BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES OF SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION (SEPTEMBER 2008)<sup>2</sup>**

In September 2008, the Basel Committee on Banking Supervision released its Report on Principles of Sound Liquidity Risk Management and Supervision. Citing its review of banks' responses 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.<sup>3</sup> The Committee also found that many banks had not factored the possibility of market-wide strain into stress tests, nor had they fully considered the amount of liquidity necessary to satisfy contingent obligations.<sup>4</sup> 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.<sup>5</sup>

#### **Management And Supervision Of Liquidity Risk**

As its first and fundamental principle, the Basel Report affirms banks' fundamental obligation soundly to manage 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. As part of such a framework, the Report recommends that banks 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."<sup>6</sup> The Report also directs banks to make "conservative assumptions about the marketability of assets and its access to funding . . . during periods of stress."<sup>7</sup>

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<sup>2</sup> BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION (Sept. 2008), <http://www.bis.org/publ/bcbs144.pdf> .

<sup>3</sup> *Id.* at 1-2.

<sup>4</sup> *Id.*

<sup>5</sup> See Press Release, BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION (June 17, 2008), <http://www.bis.org/pres/p080617.htm>.

<sup>6</sup> Basel Report at 3-6.

<sup>7</sup> *Id.* at 6.

## **Governance Of Liquidity Risk Management**

### **Articulate Risk Management Strategy**

The Report advises banks to articulate a liquidity risk tolerance that is appropriate given the bank's strategy and its role in the financial system so that all levels of management can understand the bank's risk tolerance, including all tradeoffs between risk and profit.<sup>8</sup> The Report calls upon senior management to develop strategy, policies and practices to manage risk in accordance with risk tolerance, and recommends that the board of directors review and approve the strategy and critical policies and procedures at least annually. The Report also recommends that boards ensure that senior management "translates" the strategy into clear guidance and operating standards.<sup>9</sup>

### **Incorporate Liquidity Costs, Benefits and Risks Into Pricing**

To ensure that risk tolerance and business activities are aligned, the Report recommends that banks incorporate liquidity costs, benefits and risks in internal pricing, performance measurement, as well as in the new product approval process for all significant business activities. The Report emphasizes that this should occur whether business activities are off- or on-balance sheet.<sup>10</sup>

## **Measurement and Management of Liquidity Risk**

### **Define and Identify Risk Across All Legal Entities**

The Report makes it clear that banks should have a sound process for identifying, measuring, monitoring and controlling liquidity risk, including risks relating to (i) future cash flows of assets and liabilities (including derivatives); (ii) sources of contingent liquidity demand and related triggers associated with off-balance sheet positions; (iii) currencies in which the bank is active, and (iv) correspondent, custody and settlement activities.<sup>11</sup> In this regard, the Reports recommends that banks 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 (e.g., special purpose vehicles), considering both normal and market stress scenarios.<sup>12</sup>

### **Use a Variety of Measurement Tools**

With respect to risk measurement, the Report emphasizes that no single tool or metric can comprehensively quantify liquidity risk. With that in mind, the Report recommends that banks 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

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<sup>8</sup> Id. at 4.

<sup>9</sup> Id.

<sup>10</sup> Id. at 9.

<sup>11</sup> Id. at 10.

<sup>12</sup> Id. at 10-14.

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.<sup>13</sup>

### **Use Limits To Control Risk**

The Report recommends that banks use limits to control liquidity risk exposure and vulnerabilities. These limits should be relevant to the bank's business activities, and should be subject to regular review and defined escalation procedures. The limit framework should consider both normal and stressed operating conditions.<sup>14</sup>

### **Early Warning Indicators**

While emphasizing the importance of using good judgment to identify and manage risk, the Report also recommends that banks 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, and could include the following listed in (and quoted from) the Report:

- rapid asset growth, especially when funded with potentially volatile liabilities
- growing concentrations in assets or liabilities
- increases in currency mismatches
- a decrease of weighted average maturity of liabilities
- repeated incidents of positions approaching or breaching internal or regulatory limits
- negative trends or heightened risk associated with a particular product line, such as rising delinquencies
- significant deterioration in the bank's earnings, asset quality, and overall financial condition
- negative publicity
- a credit rating downgrade
- stock price declines or rising debt costs
- widening debt or credit-default-swap spreads

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<sup>13</sup> Id. at 15.

<sup>14</sup> Id. at 15-16.



- rising wholesale or retail funding costs
- counterparties that begin requesting or request additional collateral for credit exposures or that resist entering into new transactions
- correspondent banks that eliminate or decrease their credit lines
- increasing retail deposit outflows
- increasing redemptions of CDs before maturity
- difficulty accessing longer-term funding
- difficulty placing short-term liabilities (e.g. commercial paper).<sup>15</sup>

### **Monitoring System**

The Report recommends that banks develop reliable information management systems able to provide timely and forward-looking information on the liquidity position of the bank. The system should capture all sources of liquidity risk, including contingent risks, and should have the ability to generate more detailed and timely information during times of stress.<sup>16</sup>

### **Comprehensive Liquidity Risk Management**

The Report emphasizes that 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 to the transferability of liquidity.”<sup>17</sup> The Report argues that, “[r]egardless of its organisational structure and degree of centralised or decentralised liquidity risk management, a bank should actively monitor and control liquidity risks at the level of individual legal entities, and foreign branches and subsidiaries, and the group as a whole, incorporating processes that aggregate data across multiple systems in order to develop a group-wide view of liquidity risk exposures and identify constraints on the transfer of liquidity within the group.”<sup>18</sup> To reduce the possibility of reputational contagion, the Report argues that banks must communicate effectively with counterparties, credit rating agencies and other stakeholders when liquidity problems arise. The Report also suggests that “group-wide contingency funding plans, liquidity cushions and multiple sources of funding” also may mitigate reputational contagion.<sup>19</sup>

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<sup>15</sup> Id. at 16.

<sup>16</sup> Id. at 17.

<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> Id. at 18.

## **Diversified Funding Strategies**

The Report recommends that banks 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. The Report argues that this strategy should include limits by counterparty, secured versus unsecured market funding, instrument type, securitization vehicle, currency and geographic market.<sup>20</sup> In broad terms, the Report reminds banks to limit concentration in any one particular funding source or tenor, including the wholesale (versus retail) funding market.

The Report notes that maintaining market access is a critical component of ensuring funding diversity. In this regard, the Report urges banks to take a "prudent view of how . . . relationships [with funds providers] will be strained in times of stress."<sup>21</sup> The Report notes that asset securitization raises particular liquidity considerations. While recognizing that growth in variable secondary markets has broadened banks' opportunities to securitize more assets with greater speed, the Report observes that 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" during times of bank-specific or market-wide stress.<sup>22</sup>

## **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 particularly during times of market stress, counterparties may view the failure to settle when expected as a sign of weakness, causing additional liquidity pressure. The Report recommends a number of operational strategies designed to achieve intraday liquidity management objectives.<sup>23</sup>

## **Collateral Positions**

The Report recommends that banks actively manage collateral positions, distinguishing between encumbered and unencumbered assets. The Report recommends that banks diversify sources of collateral, "taking into consideration 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.<sup>24</sup> The Report notes that banks using collateral should take into account the potential for 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.

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<sup>20</sup> Id.

<sup>21</sup> Id. at 19.

<sup>22</sup> Id. at 20.

<sup>23</sup> Id. at 20-23.

<sup>24</sup> Id. at 23.

## **Effective Stress Tests**

The Report reminds banks to conduct 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.<sup>25</sup> Stress scenarios should consider short- and longer-term disruptions as well as institution-specific and market-wide stresses. Likewise, banks should consider the impact of stress scenarios on both individual entities and business lines and group-wide. The Report emphasizes that regardless of organization structure, banks should understand where liquidity risks may arise. The Report also recommends that banks use stress test outcomes to adjust liquidity risk management strategies, policies and positions and to develop contingency plans.<sup>26</sup>

In designing stress tests, banks should consider the full range of possible risks arising from the bank's activities, including risks associated with complex financial instruments and off-balance sheet items. The Report reminds banks that while historical experience may serve as a guide when designing stress tests, past events may or may not be a good predictor of future stresses or outcomes. The Report also urges banks to consider the link between reductions in market liquidity and constraints on funding capacity, recognizing that stress events may give rise to time-critical needs for liquidity in multiple currencies and multiple payment and settlement systems. The Report also suggests that banks should take a conservative approach when setting stress testing assumptions. In this regard, the Report identifies a number of assumptions (quoted here from the text of the Report) that might be relevant when designing stress testing scenarios:

- asset market illiquidity and the erosion in the value of liquid assets
- the run-off of retail funding
- the (un)availability of secured and unsecured wholesale funding sources
- the correlation between funding markets or the effectiveness of diversification across sources of funding
- additional margin calls and collateral requirements
- funding tenors
- contingent claims and more specifically, potential draws on committed lines extended to third parties or the bank's subsidiaries, branches or head office

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<sup>25</sup> Id. at 24-25.

<sup>26</sup> Id.

- the liquidity absorbed by off-balance sheet vehicles and activities (including conduit financing)
- the availability of contingent lines extended to the bank
- liquidity drains associated with complex products/transactions
- the impact of credit rating triggers
- FX convertibility and access to foreign exchange markets
- the ability to transfer liquidity across entities, sectors and borders taking into account legal, regulatory, operational and time zone restrictions and constraints
- the access to central bank facilities
- the operational ability of the bank to monetise assets
- the bank's remedial actions and the availability of the necessary documentation and operational expertise and experience to execute them, taking into account the potential reputational impact when executing these actions
- estimates of future balance sheet growth.<sup>27</sup>

Finally, in addition to recommending that banks consider how the behavior of counterparties (or their correspondents or custodians) might affect the timing of cash flows, the Report also urges banks to review stress scenarios regularly to ensure that the nature and severity of the scenarios tested remain appropriate given the bank's business activities.<sup>28</sup>

### **Contingency Funding Plan**

The Report recommends that banks 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.”<sup>29</sup> The Report notes that contingency funding plans should be commensurate with a bank's complexity, risk profile, scope of operations and role in the financial system.<sup>30</sup> The Report suggests that when designing contingency funding plans, banks should account for a range of factors and considerations including (i) the impact of market stress on the bank's ability to sell or securitize assets, (ii) the

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<sup>27</sup> Id. at 26.

<sup>28</sup> Id. at 26-27.

<sup>29</sup> Id. at 27.

<sup>30</sup> Id.

potential loss of typically available market funding options, (iii) the reputational impact of resorting to contingency funding measures, and (iv) the impact of transferring liquidity across entities, borders and lines of business.<sup>31</sup> The Report also advises banks to test contingency funding plans regularly to ensure that they are and remain effective and operationally feasible.<sup>32</sup>

### **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. The size of the liquidity cushion should be aligned with banks' liquidity needs during times of stress.<sup>33</sup>

### **Public Disclosure**

The Report states that 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.<sup>34</sup> In addition to improving transparency, the Report notes that disclosure "facilitates valuation, reduces uncertainty in the markets and strengthens market discipline."<sup>35</sup> The Report recommends that as part of its periodic financial reporting, banks provide both quantitative and qualitative information about liquidity position. In this regard, the Report lists a variety of potential qualitative disclosures, which are quoted here and described in the Report as illustrative rather than exhaustive:

- The liquidity risk tolerance articulated by the board of directors
- The aspects of liquidity risk to which the bank is exposed and that it monitors
- The concepts utilised in measuring its liquidity position and liquidity risk
- The assumptions used in its metrics
- The timeframe associated with the metrics
- An explanation of how stress testing is used
- A description of the stress testing scenarios modelled
- A description of its framework for developing contingency funding plans

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<sup>31</sup> Id. at 28.

<sup>32</sup> Id. at 29.

<sup>33</sup> Id. at 29-30.

<sup>34</sup> Id. at 31.

<sup>35</sup> Id.

- The limits imposed on its liquidity position and risks
- The frequency and type of internal liquidity reporting, including processes for additional reporting in times of market stress.<sup>36</sup>

### **The Role of Supervisors**

The Report makes it clear that supervisors should perform a regular and comprehensive assessment of 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.”<sup>37</sup> The Report suggests that 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.<sup>38</sup>

The Report makes it clear that if supervisors identify deficiencies in liquidity risk management, they should intervene to require effective and timely remedial action. The Report also suggests that supervisors should communicate with other relevant supervisors and public authorities (such as central banks) both within and across national borders to facilitate effective cooperation regarding supervision and oversight of liquidity risk management, particularly during times of stress.<sup>39</sup>

### **B. 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)**<sup>40</sup>

In their January 2007 report, New York City Mayor Michael Bloomberg and United States Senator Charles Schumer (New York) considered whether New York and the United States were at risk of ceding leadership in the financial services industry to international competitors.<sup>41</sup> To obtain a “comprehensive perspective” on the

<sup>36</sup> Id.

<sup>37</sup> Id. at 32.

<sup>38</sup> Id. at 32-34.

<sup>39</sup> Id. at 34-36.

<sup>40</sup> 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%20FINAL.pdf](http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20FINAL.pdf)

<sup>41</sup> See, e.g., Bloomberg/Schumer Report at p. i (“But to maintain our success over the long run, we must address a real and growing concern: in today’s ultra-competitive global marketplace, more and more nations are challenging our position as the world’s financial capital. Traditionally, London was our chief competitor in the financial services industry. But as

competitiveness of the U.S. financial services sector, with a particular focus on New York, 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.<sup>42</sup> Based on its review of the data, the Report identified a number of “domestic drivers” as having the potential to shift business away from New York:

- Concerns that the legal environment in the United States is less fair and predictable than the environment in the United Kingdom, particularly with regard to securities class action lawsuits and the extraterritorial application of US law.<sup>43</sup>
- Concerns that “the multi-tiered and highly complex nature of the US legal system,” with its public and private enforcement mechanisms involving federal, state and private litigants, was having a potentially negative impact on competitiveness.<sup>44</sup> While noting that “[t]he efforts of this diverse set of actors have served American companies, investors and consumers well in the past,” the Report comments that a “lack of coordination and clarity on the ways and means of enforcement have led to a perception – voiced by participants in the surveys and interviews conducted for this report – that the US system is neither fair nor predictable.”<sup>45</sup>
- Concerns that while a strong regulatory system was perceived as “vital in giving all 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.”<sup>46</sup> 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.”

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technology has virtually eliminated barriers to the flow of capital, it now freely flows to the most efficient markets, in all corners of the globe. Today, in addition to London, we’re increasingly competing with cities like Dubai, Hong Kong, and Tokyo.”)

<sup>42</sup> Id. at p. 8 (“[A] McKinsey team personally interviewed more than 50 financial services industry CEOs and business leaders. The team also captured the views of more than 30 other leading financial services CEOs through a survey and those of more than 275 additional global financial services senior executives through a separate on-line survey. To balance this business perspective with that of other constituencies, the team interviewed numerous representatives of leading investor, labor, and consumer groups. McKinsey also interviewed and, in some cases, worked with leaders and other subject matter experts in the regulatory, legal, and accounting professions. McKinsey complemented this primary research with its own financial services industry knowledge base, as well as secondary research into topics including investment banking, employment, immigration, litigation and regulation.”)

<sup>43</sup> Id. at p. 16.

<sup>44</sup> Id. at p. 16 – 17.

<sup>45</sup> Id. at p. 17.

<sup>46</sup> Id.

In response to these concerns, the Report outlines three sets of recommendations focused on (i) legal and regulatory priorities; (ii) “leveling the competitive playing field” between the U.S. and international markets; and (iii) sustaining the United States’ leadership in international financial markets over the longer term.<sup>47</sup> Among other recommendations, the Bloomberg/ Schumer Report makes the following suggestions for regulatory reform:

- **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.”<sup>48</sup>
- **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.<sup>49</sup> The Report opined that “[r]egardless of the details of the principles themselves, a common approach emphasizing collaboration and the open sharing of information between regulators and regulated entities would deliver more balanced, consistent and predictable outcomes for financial institutions, consumers, investors and other market participants.”<sup>50</sup>
- **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.”<sup>51</sup> The Report suggests that this 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.”<sup>52</sup>
- **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

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<sup>47</sup> Id. 18.

<sup>48</sup> Id. at 22.

<sup>49</sup> Id.

<sup>50</sup> Id.

<sup>51</sup> Id. at 24.

<sup>52</sup> Id. at 25.



standards.”<sup>53</sup> In this regard, the Report identified “an optional federal charter for insurance” as one potential area of reform.<sup>54</sup>

**C. COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (NOVEMBER 2006)**<sup>55</sup>

The Committee on Capital Markets Regulation (“CCMR”) describes itself as “an independent, bipartisan committee composed of 22 corporate and financial leaders from the investor community, business, finance, law, accounting, and academia.”<sup>56</sup>

Announced on September 12, 2006, the Committee’s purpose “is to explore a range of issues related to maintaining and improving the competitiveness of the U.S. capital markets. Our objective is to recommend policy changes that should be made, or areas of research that should be pursued, to preserve and enhance the balance between efficient and competitive capital markets and shareholder protection.”<sup>57</sup>

In its Interim Report on Capital Markets Regulation, the CCMR suggested that although the United States capital markets are critical to the nation’s economy and especially to regions with large clusters of related employment, they are becoming less competitive globally. The CCMR observed that the U.S. share of global equity markets trading value has fluctuated over time but remained relatively high, citing the figures 41, 54, and 43 percent in 1987, 1997 and 2007, respectively.<sup>58</sup> The CCMR added, however, that a “better measure of competitiveness is where new equity capital is being raised,” and pointed out that the United States’ share of global initial public offerings (IPOs) declined from 48 percent in 1990 to an estimated 8 percent in 2006.<sup>59</sup> More recent data reported on its website indicate that this trend has continued.<sup>60</sup>

The CCMR found that foreign companies are turning more frequently to the private rather than public markets in the United States for raising capital, but noted that supporting data must be used cautiously. The Committee highlighted the growth of the private equity market in general, suggesting that private markets were gaining a competitive advantage over more regulated public markets.<sup>61</sup> The CCMR also suggested that the premium that foreign companies pay for listing in the United States has declined, indicating a loss of competitiveness.<sup>62</sup>

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<sup>53</sup> Id.

<sup>54</sup> Id.

<sup>55</sup> See Committee on Capital Markets Regulation, Interim Report of the Committee on Capital Markets Regulation, November 2006, <http://www.capmksreg.org/>

<sup>56</sup> Id. at vii.

<sup>57</sup> Id.

<sup>58</sup> See SIFMA Fact Book 2008 at p. 98.

<sup>59</sup> See CCMR at pp. 2 and 29-34.

<sup>60</sup> See <http://www.capmksreg.org/competitiveness/measure-II.html>.

<sup>61</sup> See CCMR at pp. 34-38.

<sup>62</sup> See id. at 38-39, 47-48.

The Committee identified “four factors [that it believes] are responsible for loss of U.S. competitiveness to foreign and private markets: (i) an increase in the integrity of and trust in major foreign public markets resulting from more transparency and better disclosure; (ii) 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; (iii) improvements in technology that make it easier for U.S. investors to invest in foreign markets; and (iv) differences in regulation between the U.S. public markets and the foreign and private alternatives. 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.”<sup>63</sup> Thus, the CCMR opines that “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.”<sup>64</sup> The Committee recommended changes in five areas, including registration requirements governing foreign companies (“capital controls”), the regulatory process, the private and public enforcement system, shareholder rights, and implementation of Sarbanes-Oxley:

- **Easing of De-Registering Requirements for Foreign Companies [“Loosen Capital Controls.”]:** The Report noted that “[i]f foreign companies know they can leave U.S. markets, they will be more willing to come in the first place.”<sup>65</sup> The CCMR thus recommended that the SEC 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. It also argued that institutional investors should be excluded from calculations when determining the U.S. shareholder base, since institutional investors do not need the level of regulatory protection required by retail investors.<sup>66</sup>
- **The Regulatory Process Should Be Modified:** The Committee recommended that (i) the SEC and self-regulatory organizations should rely more thoroughly on cost-benefit analysis in managing regulatory risks; (ii) regulators should rely on principles-based rules and guidance rather than prescriptive rules to the extent possible, citing the Financial Services Authority in the United Kingdom, SRO formulation of a rule dealing with business entertainment expenses, and CFTC regulation generally as good examples of principles-based regulation; (iii) regulators, and especially the SEC, should avoid policy making through enforcement actions; and (iv) that national, federal, and state regulators should coordinate their actions more effectively. The Committee suggested that the 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.<sup>67</sup>

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<sup>63</sup> See CCMR at p. 39.

<sup>64</sup> *Id.* at xii.

<sup>65</sup> *Id.* at 50.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 59 – 70.

- The Private and Public Enforcement System for Financial Markets Should be Modified:** While noting that a “vigorous enforcement system makes financial markets safer and more competitively attractive,” the Committee emphasized that “the private litigation system needs modification in some dimensions and that the criminal enforcement system needs better balance.”<sup>68</sup> It recommended clarification of issues in private litigation under Rule 10b-5; that criminal enforcement should be a last-resort response used only for systematically corrupt companies; and that 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.<sup>69</sup>
- Shareholder Rights Should Be Strengthened:** The CCMR recommended improving shareholders’ abilities to oversee corporations. It suggested, among other steps, allowing shareholders to modify voting requirements and procedures for corporate takeovers, strengthening shareholders’ ability to nominate and vote for directors, and affording shareholders the right to choose alternatives to traditional litigation, such as arbitration or judge-conducted trials, as corporate control mechanisms.<sup>70</sup>
- 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 to reduce the expense of implementing Section 404 of the Act. The Committee recommended changing the definition of “materiality”; and “chang[ing] 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.”<sup>71</sup> The CCMR suggested that these changes would allow more discretion in professional judgment in auditing and reviews, and permit differential regulatory treatment of small firms and foreign firms tailored to their economic and regulatory circumstances.<sup>72</sup> The SEC’s guidance regarding Section 404 in June of 2007, after the CCMR November 2006 Report, also responded to the concerns that had been raised about implementation of Section 404.<sup>73</sup>

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<sup>68</sup> *Id.* at xii.

<sup>69</sup> *Id.* at 71 – 92.

<sup>70</sup> *Id.* at 93 – 114.

<sup>71</sup> *Id.* at 131.

<sup>72</sup> *Id.* at 115 – 135.

<sup>73</sup> United States Securities and Exchange Commission. 2007. Release Nos. 33-8810; 34-55929; FR-77; File No. S7-24-06: Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934. *Federal Register*, 72(123): 35324-25343.

**D. COMMITTEE ON CAPITAL MARKETS REGULATION,  
RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL  
REGULATORY STRUCTURE (JANUARY 14, 2009)**<sup>74</sup>

In its 2009 Report, the CCMR criticizes the cost of and quality of supervision afforded by the United States' existing regulatory regime:

The U.S. employs more financial regulators and expends a higher percentage of its gross domestic product on financial oversight than any other major country. There are approximately 38,700 financial regulatory staff in the U.S., versus some 3,100 in the United Kingdom. Meanwhile, financial regulatory costs in the U.S. total \$497,984 per billion dollars of GDP, versus \$276,655 in the United Kingdom. Yet recent events suggest that the far larger staffs and greater funding in the U.S. have not resulted in a correspondingly higher quality of supervision. The U.S. Treasury recognizes this, and issued its own bold recommendations, 'Blueprint for a Modernized Financial Regulatory Structure,' in March 2008.<sup>75</sup>

The Report observes that any financial regulatory structure should perform four functions effectively: (i) providing a lender of last resort; (ii) overseeing financial institutions' safety and soundness; (iii) regulating market structure and conduct; and (iv) protecting consumers and investors.<sup>76</sup> The CCMR believes that the functions must be coordinated by the President through the Secretary of the Treasury.<sup>77</sup> The Report focuses on the federal regulatory structure, not discussing—but potentially commenting in a subsequent report—on the role of states or self-regulatory organizations, internal agency organization, and global coordination.

**The CCMR Reached Consensus on Aspects of Regulatory Structure**<sup>78</sup>

**Two or Three Regulatory Bodies**

The CCMR says that the U.S. should have "only two or, at most, three independent federal regulatory bodies overseeing the U.S. financial system."<sup>79</sup> These would be the Federal Reserve Bank, a new independent United States Financial Services Authority (USFSA), and possibly an independent investor/consumer protection agency.<sup>80</sup> 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

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<sup>74</sup> Committee on Capital Markets Regulation, RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE, January 14, 2009, <http://www.capmksreg.org/> (last visited Jan. 21, 2009) [CCMR January 2009]

<sup>75</sup> Id. at 2.

<sup>76</sup> Id. at 1.

<sup>77</sup> Id.

<sup>78</sup> Id. at 5 – 7.

<sup>79</sup> Id. at 5.

<sup>80</sup> Id.

Exchange Commission and the Commodity Futures Trading Commission would be merged and consolidated into these two or three bodies.<sup>81</sup> While acknowledging that the U.S. system must recognize its distinctive traits, the Report says that other leading financial centers have moved toward consolidated regulatory oversight, with a “rapidly dwindling share of the world’s financial markets [] supervised under the fragmented, sectoral model still employed by the United States.”<sup>82</sup> The Report then outlines the responsibilities of the proposed new regulatory organizations:

### **Responsibilities of the Federal Reserve**

The Federal Reserve would retain control of monetary policy, perform a lender-of-last-resort function, and set capital requirements for all financial institutions.<sup>83</sup> Federal 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.<sup>84</sup>

### **Responsibilities of the USFSA**

The proposed United States Financial Services Authority (“USFSA”) “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).”<sup>85</sup> 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.<sup>86</sup> The USFSA must be independent, like the Fed, with its regulations subject only to judicial, but not executive, review.<sup>87</sup> Its governing body and membership, like the Fed, should be appointed and insulated from the electoral cycle.<sup>88</sup>

### **Responsibilities of an Independent Investor/Consumer Protection Agency or Division of the USFSA**

The CCMR could not reach consensus on whether investor/consumer protection should be in a separate agency or a division within the USFSA.<sup>89</sup> The Committee suggested, however, that the relevant prudential supervisor should comment on the safety and soundness impact of this agency’s regulatory actions,<sup>90</sup> with the Treasury empowered to

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<sup>81</sup> Id.

<sup>82</sup> Id.

<sup>83</sup> Id.

<sup>84</sup> Id. at 5 – 6.

<sup>85</sup> Id. at 6.

<sup>86</sup> Id.

<sup>87</sup> Id.

<sup>88</sup> Id.

<sup>89</sup> Id.

<sup>90</sup> Id.

resolve any conflict between the supervisory and investor/consumer protection body.<sup>91</sup> “[T]he 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.<sup>92</sup>

### **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.<sup>93</sup> “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 (“TARP”).”<sup>94</sup> The Report notes that

[A]ny 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). Any losses of the Fed are ultimately losses for U.S. taxpayers and should be directly and transparently accounted for as part of the federal budget. . . . the Fed’s assumption of credit risk by lending against insufficient collateral may compromise its independence by: (1) making the Fed more dependent on the Treasury for support in carrying out its core functions, including the conduct of monetary policy (see the supplemental finance facility under which the Treasury supplied additional Treasury bills to the Fed); (2) jeopardizing the ability of the Fed to finance its own operations and thus the need to look for budgetary support from the government; (3) tarnishing its image and financial credibility in the event that the Fed ends up with minimal or negative capital; and (4) making it more subject to political pressures. Shifting risk to the Treasury from the Fed has already begun with the Treasury’s use of the TARP to both purchase \$40 billion in preferred AIG shares (allowing the Fed to reduce its line of credit to AIG) and absorb the first \$20 billion in losses associated with the Fed’s new Term Asset-Backed Securities Loan Facility (“TALF”) created to purchase newly issued asset-backed paper.<sup>95</sup>

### **Phased Transition over Time**

The regulatory consolidation should proceed in steps.<sup>96</sup> 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

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<sup>91</sup> Id.

<sup>92</sup> Id.

<sup>93</sup> Id.

<sup>94</sup> Id.

<sup>95</sup> Id. at 6-7.

<sup>96</sup> Id. at 7.

agency); and (3) . . . [subsequent] legislation authorizing the merger . . . of all other federal supervisory agencies, [and possibly the investor/consumer agency, into the USFSA].<sup>97</sup> “The merger of the SEC and CFTC discussed in the Treasury’s Blueprint should not be an end in itself; full consolidation into the USFSA or the independent consumer/investor protection enforcement agency should be the ultimate outcome.”<sup>98</sup> A plan to shift risky assets from the Fed to the Treasury should immediately be put in place.<sup>99</sup> “The completion of the entire process could take several years.”<sup>100</sup>

## **Aspects of Regulatory Structure on Which The Committee Did Not Reach Consensus**

### **Supervision of Financial Institutions**<sup>101</sup>

The CCMR says that consolidated prudential supervision, as implemented in major jurisdictions around the world, offers significant advantages over what it calls the current model of overlapping or fragmented supervision.<sup>102</sup>

While regulatory failures of the past decade can be traced to many causes, the fragmented U.S. system of prudential supervision narrowed the field of vision of every regulatory body and dissipated supervisory resources through contests over jurisdictional boundaries. Such a system also impairs our ability to coordinate supervision internationally . . . . We believe supervision should be undertaken by agencies with sufficient resources and expertise, *i.e.*, either the newly created USFSA or the Fed. 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.<sup>103</sup>

The CCMR presented three options for consolidated supervision.<sup>104</sup>

### **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. With respect to advantages, the Fed understands the range of issues confronting financial institutions because of its

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<sup>97</sup> Id.

<sup>98</sup> Id.

<sup>99</sup> Id.

<sup>100</sup> Id.

<sup>101</sup> Id. at 7-9.

<sup>102</sup> Id. at 7.

<sup>103</sup> Id. at 7 - 8.

<sup>104</sup> Id. at 8.

supervision of bank holding companies and state-chartered banks that are members of the Federal Reserve, its open market operations, lender-of-last-resort function, and oversight and operation of payments and settlement systems.<sup>105</sup> Its quality of examinations arguably is higher than at other agencies “due to culture and salary levels” and might remain higher than in a new USFSA.<sup>106</sup> The Fed needs detailed knowledge of financial institutions’ operations and risks since it may have to lend to financial institutions, either as a matter of course through the discount window, or in a crisis; it needs corrective action powers to control the risks to financial institutions and ultimately to itself.<sup>107</sup> It would focus on only those institutions determined to be “systemically important,” arguably optimizing its institutional competence.<sup>108</sup> “At the same time, the USFSA would supervise those institutions determined not to be ‘systemically important,’ . . . [and] the Treasury alone, the Fed alone, or the Fed and Treasury jointly could determine which institutions are ‘systemically important.’”<sup>109</sup>

With respect to disadvantages, it could be difficult to determine in advance and over time which institutions are “systemically important.”<sup>110</sup> “[D]esignating any institution as ‘systemically important’ may create a moral hazard because the market will see such institutions as ‘too big too fail,’” giving them competitive advantages distorting the cost of capital in financial markets.<sup>111</sup> “Conversely, being regarded as non-systemically important might . . . [relegate] an institution to second class status.”<sup>112</sup> The market already sees some institutions as systemically significant or not, but this approach could codify the distinction and its distorting effects. Finally, 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, though it may already face such pressures with respect to its current supervision of state member banks and bank holding companies.<sup>113</sup>

## **Option 2: Fed Supervision of All Financial Institutions**

With respect to advantages, the Fed’s unique “institutional competence” gives this option many of the same benefits of Fed supervision of systemically important institutions.<sup>114</sup> On the other hand, expanding its supervisory jurisdiction, “particularly over relatively small institutions, . . . risks distracting . . . [it] from its core mission of conducting monetary policy and dealing with systemic risk” and could concentrate too much power in one agency.<sup>115</sup> Only “systemically important” institutions will pose risk to the Fed’s

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<sup>105</sup> Id.

<sup>106</sup> Id.

<sup>107</sup> Id.

<sup>108</sup> Id.

<sup>109</sup> Id.

<sup>110</sup> Id.

<sup>111</sup> Id.

<sup>112</sup> Id. at 8 -9.

<sup>113</sup> Id. at 9.

<sup>114</sup> Id.

<sup>115</sup> Id.



lending operations, and so one can question the need for broader jurisdiction.<sup>116</sup> Also, “a new USFSA could . . . [have] the same quality of examination as is provided by the Fed today for most institutions.”<sup>117</sup> Finally, the Fed could face high levels of political pressures were it to supervise all financial institutions, as discussed above.<sup>118</sup>

### **Option 3: USFSA Supervision of All Financial Institutions**

The advantages of this approach are that 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.<sup>119</sup> While maintaining consistent standards, the USFSA could vary its examinations in accord with the financial institution’s level of risk and the nature of the activities, as the U.K.’s FSA does.<sup>120</sup> The Fed could rely on the supervision and get needed information from this new agency if it supervised financial institutions at the same level of quality as the Fed.<sup>121</sup> Also, rule-making and supervision complement each other and so putting both in one agency makes sense.<sup>122</sup>

The disadvantages are that 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.<sup>123</sup>

### **Location of Consumer/Investor Protection**<sup>124</sup>

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.”<sup>125</sup> “The Committee was unable to reach consensus on which of these two alternatives it preferred.”<sup>126</sup>

### **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.<sup>127</sup> The division could benefit from the institutional

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<sup>116</sup> Id.

<sup>117</sup> Id.

<sup>118</sup> Id.

<sup>119</sup> Id.

<sup>120</sup> Id.

<sup>121</sup> Id.

<sup>122</sup> Id.

<sup>123</sup> Id.

<sup>124</sup> Id. at 10.

<sup>125</sup> Id.

<sup>126</sup> Id.

<sup>127</sup> Id.

expertise of the broader agency.<sup>128</sup> In practice, a separate agency might not be inclined to make intelligent tradeoffs among the broader range of competing issues.<sup>129</sup> On the other hand, one could argue that a broader agency looking to make tradeoffs may not pursue consumer/investor protection as a dominant purpose.<sup>130</sup>

### **Creating a Separate Consumer/Investor Protection Agency**

A separate agency would have a single mission and commitment.<sup>131</sup> However, it might not effectively balance competing considerations, and it would be difficult to coordinate conflicts between prudential regulation and consumer/investor protection.<sup>132</sup>

#### **E. CONSUMER FEDERATION OF AMERICA, COMMENTS ON THE TREASURY DEPARTMENT'S REVIEW OF THE REGULATORY STRUCTURE ASSOCIATED WITH FINANCIAL INSTITUTIONS (NOVEMBER 21, 2007)**<sup>133</sup>

In its comments on the Treasury Department's Blueprint for a Modernized Financial Regulatory Structure, the Consumer Federation of America ("CFA") emphasized that it is much less concerned with how regulation is organized than it is with how effectively regulation protects consumers and investors. It questions the Treasury's emphasis on competitiveness, saying that the concerns about the impact of financial market regulation on U.S. competitiveness have been "grossly exaggerated," and argues that the market crisis—which appeared after the "competitiveness" reports were published or undertaken—indicates the costs of not having regulatory systems that protect investors and consumers. "Regulatory failures" identified by the CFA include (i) the failure to prevent predatory mortgage lending; (ii) the failure to anticipate or deal with the deteriorating practices across the board in securitization; (iii) the loss of credibility of the credit rating process given its conflicts of interest and unreliable ratings, as well as the deficient due diligence by investment banks and others involved in securitization; (iv) failure of FASB or IASB to develop standards applying appropriately to structured investment vehicles; and (v) failures of auditors to prevent financial firms from inappropriately removing SIV risks from their financial statements.

With regard to state-level regulation, the CFA argued that "state insurance regulators have, for the most part, shown themselves unable or unwilling to protect consumers from unreasonable rate hikes or from abusive claims payment practices. Decades of bid rigging and kickbacks in the insurance industry went unchecked until uncovered by an

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<sup>128</sup> Id.

<sup>129</sup> Id.

<sup>130</sup> Id.

<sup>131</sup> Id.

<sup>132</sup> Id.

<sup>133</sup> Consumer Federation of America, COMMENTS ON THE TREASURY DEPARTMENT'S REVIEW OF THE REGULATORY STRUCTURE ASSOCIATED WITH FINANCIAL INSTITUTIONS 1 (2007), [http://www.consumerfed.org/pdfs/Financial\\_Services\\_Regulation\\_Treasury\\_Comments\\_11-07.pdf](http://www.consumerfed.org/pdfs/Financial_Services_Regulation_Treasury_Comments_11-07.pdf).

investigation of the New York Attorney General. In the 1990s, insurance regulators failed to uncover evidence that some of the nation's largest life insurers engaged in market conduct abuses related to disappearing premiums and other anti-consumer sales practices. The securities industry has also reeled from scandal to scandal 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 the highly publicized accounting and analyst scandals. Finally, federal banking regulators have failed 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.”<sup>134</sup>

The CFA further argued that regulatory reform proposals should be judged primarily by how they “would have prevented these and other regulatory failures.”<sup>135</sup> Concerns like regulatory overlap or increasing regulatory efficiency ought to be secondary concerns; the primary concern should be how any regulatory changes strengthen consumer and investor protection.

The sections below summarize the conclusions at the front of the comments. The balance of the document contains supplementary material on specific issues, including a detailed treatment of issues regarding insurance.

### **“Principles-Based” Regulation Is Not a Solution**

The CFA stresses that principles-based regulation is not a solution to these problems, arguing that the uncritical endorsement of principles-based regulation papers over fundamental problems. The CFA suggests that the principles-based approach to regulation 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, they will be resolved in closed-door negotiations between the regulator and the firm, which could disadvantage consumers and investors and undermine the credibility of the regulatory process.

The CFA also suggested that 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 examples, the CFA cites calls by the Chamber of Commerce and Committee on Capital Markets Regulation for bright-line rules to define scienter and materiality. The CFA also notes that the White House, insurance industry, and mortgage industry all recently have criticized “subjective” regulations, when “flexibility” is supposedly the advantage of principles-based regulation. “In short, even those who typically advocate a principles-based approach to regulation object to its lack of clarity and certainty when they see it in practice... In short, the case can be made for providing a clearer statement of the many principles that under-gird our regulations, and for seeking to promote greater uniformity of principles across the various financial services industries. However, this will only benefit consumers and investors if it is provided as a supplement to add clarity and consistency to our rules-based system, not as

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<sup>134</sup> *Id.* at 2.

<sup>135</sup> *Id.* at 2 – 3.

a replacement, or even a partial replacement, for that system. 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.”<sup>136</sup>

### **Underlying Causes of Regulatory Failures Must Be Addressed**

The CFA takes no position on the value of a consolidated regulator, recognizing that the approach has potential benefits and potential liabilities. A consolidated regulator that applied principles such as fairness and transparency across the variety of financial products would benefit consumers, and consumers might find it easier to navigate an integrated, well-functioning organization. On the other hand, a consolidated regulator might find itself dealing with complex and conflicting roles better divided among multiple organizations, and “regulatory competition” often has benefitted consumers and investors “when one or more regulators ‘got out ahead of the crowd,’”<sup>137</sup> inducing others to act as well. “Furthermore, the likelihood that a consolidated regulator would act to strengthen consumer and investor protections is called into question by the fact that this proposal is being put forward as a way to streamline regulation and promote competitiveness, not improve regulatory effectiveness. In fact, one could argue that a consolidated regulator that does not have to take into consideration the views of other regulatory agencies could be more subject to regulatory capture.”<sup>138</sup> Ultimately, regulatory reorganization will not improve performance unless fundamental problems are addressed. These problems include:

#### **Regulators Who Are Too Close to the Industries They Regulate**<sup>139</sup>

“At all of the financial services regulators, a ‘revolving door’ exists between the regulator and the regulated industry,”<sup>140</sup> infusing the regulatory agency with the attitudes and biases of the industry. This is particularly the case with respect to the insurance industry, but is found in other areas of financial services as well. The fact that banking agencies receive significant funding from industry sources intensifies this problem in banking regulation.

#### **Regulatory Balkanization That Leads to Downward Pressure on Consumer Protections or Results In Cooperative Action To Raise Standards That Is Extremely Slow**<sup>141</sup>

This is the “dark” potential of having multiple regulatory agencies; to the extent to they can do so, industries try to choose the weakest regulator.

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<sup>136</sup> Id. at 4 – 5.

<sup>137</sup> Id. at 5.

<sup>138</sup> Id. at 5 – 6.

<sup>139</sup> Id. at 6-7.

<sup>140</sup> Id. at 6.

<sup>141</sup> Id. at 7-10.

The same force is at work behind some members of the insurance industry's support for an optional federal charter. Insurers have a long history of seeking regulation at the level they perceive will be weakest. It is not surprising that, today, the industry would again seek a federal role at a time they perceive little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will. Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years. Unfortunately for consumers, the strategy has already paid off. Believing that reducing state consumer protections is the way to "save" state regulation, by placating insurance companies and encouraging them to stay in the fold, the NAIC has moved suddenly in the last few years to cut consumer protections adopted over a period of decades.<sup>142</sup>

The CFA then immediately added, however, that "we have seen a contrary example of the securities industry, where the existence of multiple regulators has sometime led to more rigorous regulation,"<sup>143</sup> and where "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. Even among federal banking regulators, consumers have occasionally benefited from divided regulatory authority, when one agency was quicker to acknowledge the existence of a problem and helped convince others of the need to act."<sup>144</sup>

The presence of multiple regulatory agencies and thus laborious negotiations may slow the adoption of 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, that is far from guaranteed."<sup>145</sup> Citing actions at the SEC, the CFA suggested that "[s]uch 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."<sup>146</sup>

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<sup>142</sup> Id. at 7 – 8.

<sup>143</sup> Id. at 8.

<sup>144</sup> Id.

<sup>145</sup> Id. at 9.

<sup>146</sup> Id.

## **An Excessive Focus on “Prudential” Regulation and the Regulatory Conflict Between Ensuring Institutional Safety and Soundness and Protecting Consumers**<sup>147</sup>

The CFA also argued that advocates of a “more prudential” approach to regulation “typically refer to a regulatory style that both focuses more on safety and soundness than on consumer protection and that relies more on inspection than enforcement. But this ‘prudential’ regulation has been a notable failure in protecting consumers from abusive credit practices, including those that have led to the recent mortgage foreclosure crisis.”<sup>148</sup> The CFA maintained that federal banking regulators accent safety and soundness at the expense of consumer protection considerations in their oversight and enforcement priorities. Emphasizing the value of supervision through the inspection process, the regulators allegedly minimize reliance on the enforcement process and thus bank practices harming consumers persist. 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, as in the case of the OCC, they appear to have led to regulatory capture. If combined with a more principles-based approach to regulation, there is a very real threat that any meaningful opportunity for the public and for consumer and investor advocates to participate in the process would be eliminated.”<sup>149</sup>

## **Pro-Consumer Principles Should Guide Regulatory Reform**<sup>150</sup>

The CFA maintained that pro-consumer, pro-investor principles must be a foundation of regulatory reform efforts. The Report suggests, sometimes explicitly and sometimes implicitly, that current regulatory operations and proposals for reform frequently clash with these principles, and “therefore...urg[ed] all financial services regulators to adopt the principles below.”<sup>151</sup>

- **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,**<sup>152</sup> just as they are required to assess regulatory burdens and “paperwork” on industries. “The agencies should be required to consult consumer representatives, state regulators, and Attorneys General as part of this review.”<sup>153</sup>
- **The financial products and services offered to consumers should be designed to benefit those consumers,** rather than primarily benefiting the financial

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<sup>147</sup> Id. at 9-12.

<sup>148</sup> Id.

<sup>149</sup> Id. at 11.

<sup>150</sup> Id. at 11-13.

<sup>151</sup> Id.

<sup>152</sup> Id.

<sup>153</sup> Id.

institutions marketing them. “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.”<sup>154</sup>

- **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, and 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.

The CFA concluded by noting that “[f]inancial services regulation is badly in need of reform, but the primary focus of that reform should be to strengthen the protections provided to consumers and investors, not reduce its burdens on industry.”<sup>155</sup>

**F. THE COUNTERPARTY RISK MANAGEMENT POLICY GROUP (CRMPG) III, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM (AUGUST 6, 2008)**<sup>156</sup>

**Analysis Of Causes**

In its report on containing systemic risk, the Counterparty Risk Management Policy Group III (CRMPG III) suggested that the market crisis stemmed from five factors.<sup>157</sup>

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<sup>154</sup> Id. at 12.

<sup>155</sup> Id. at 13.

<sup>156</sup> COUNTERPARTY RISK MANAGEMENT POLICY GROUP, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM (2008) (CRMPG III August 2008), <http://www.crmpolicygroup.org/>.

<sup>157</sup> Id. at 3-6.

- First, due to economic conditions developing over more than a decade, “global financial markets had been awash in liquidity.”<sup>158</sup> Liquidity and low interest rates pushed a “reach for yield,” triggering demand for highly complex structured products.<sup>159</sup>
- Second, “credit risk had been mispriced for some time,” as evidenced by the flourishing of the subprime mortgage market, the leveraged finance sector, and “the willingness of market participants to acquire highly leveraged structured credit products whose attractiveness relied on a continuation of benign credit conditions for an extended period of time.”<sup>160</sup>
- Third, for structural, technological, and behavioral reasons, contemporary finance has become incredibly complex:

We see this in the speed and complexity of capital flows, we see it in the complexity of many classes of financial instruments (some of which contain significant embedded leverage), and we see it in the extraordinary complexity faced by individual financial institutions in their day-to-day risk management activities and in their policies and practices related to valuation and price verification for some classes of financial instruments. Needless to say, the complexity factor is an issue as it pertains to the capacity of the international community of supervisors and regulators to discharge their responsibilities.

The key issue here is not complexity *per se* but rather the extent to which complexity feeds on itself thereby helping to create or magnify contagion risk “hot spots” that may have systematic implications. Thus, we are faced with the pressing need to find better ways to manage and mitigate the risk associated with complexity, a subject that will continue to challenge the best and the brightest among us.<sup>161</sup>

- Fourth, the speed and reach of contagion were “different in degree, if not kind” from earlier periods of financial instability. The crisis spread across diverse instruments and institutions. Those most heavily affected share three common characteristics: contraction in liquidity due to extreme uncertainty and thus risk aversion, high leverage accelerating losses, and deficient risk management.
- Fifth, “it is likely that flaws in the design and workings of the systems of incentives within the financial sector have inadvertently produced patterns of

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<sup>158</sup> Id. at 3.

<sup>159</sup> Id.

<sup>160</sup> Id.

<sup>161</sup> Id. at 4.



behavior and allocations of resources that are not always consistent with the basic goal of financial stability.” Compensation systems and other types of rewards promoted heavy discounting of possible future problems and inhibited effective risk management and internal control systems.<sup>162</sup>

Remarking on the prevalence of financial crises since the 1980s, the CRMPG III said that while each crisis had unique triggers and dynamics, “there is evidence of certain common denominators across all the post-1980 financial crises . . . . (1) credit concentrations, (2) broad-based maturity mismatches, (3) excessive leverage, and (4) the illusion of market liquidity—or the belief that such liquidity will always be present so that the individual instruments or classes of instruments can be bought or sold in an environment of narrow bid-ask spreads. The wild card is periodic macroeconomic imbalances, including such forces as inflation, recession, budget deficits, and large external imbalances . . . . At the end of the day, however, the root cause of financial market excesses on both the upside and the downside of the cycle is collective human behavior: unbridled optimism on the upside and fear on the downside, all in a setting in which it is literally impossible to anticipate when optimism gives rise to fear or fear gives rise to optimism.”<sup>163</sup>

In addition to pointing out commonalities across crises, the CRMPG III also emphasized the importance of core precepts:

The CRMPG III is strongly of the view that the focus on the complexity of the subject matter tends to blur the fact that in this world of financial complexity there are certain relatively simple, readily understandable, and forward-looking core precepts upon which the management and supervision of large integrated financial intermediaries must rest. These precepts are relatively easy to communicate to employees, to boards of directors, to investors and to supervisors. Moreover, they lend themselves to relatively straightforward evaluation exercises on the part of boards of directors and supervisory bodies. These precepts are in no way a substitute for the front-line “blocking and tackling” imperatives that are at the center of all control and risk management systems. If anything, they provide the intellectual and policy framework which helps to ensure that the working level, control-related policies and procedures are both robust and flexible over business and credit cycles.<sup>164</sup>

These precepts include the basics of *corporate governance*, of *risk monitoring*, of *estimating risk appetite*, of *focusing on contagion*, and of *enhanced oversight*.

## **Precepts**

- **Precept I: The Basics of Corporate Governance.**

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<sup>162</sup> *Id.* at 5.

<sup>163</sup> *Id.* at 6-7.

<sup>164</sup> *Id.* at 8.

Effective corporate governance breaks down the “silo mentality” that leads some units to pursue goals relentlessly at the expense of the firm as a whole, and ensures that critical considerations and information get the attention of units throughout the firm. It ensures, through reporting systems, rewards, and other mechanisms, that firms do not subordinate risk management and control systems to short-term transactions. Thus, “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 [emphasis here and below in original].”<sup>165</sup>

- **Precept II: The Basics of Risk Monitoring.**

Sophisticated risk management systems work only if individuals and institutions implement them effectively. Thus, “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.”<sup>166</sup>

- **Precept III: The Basics of Estimating Risk Appetite.**

Firms should use qualitative as well as quantitative methods to balance risks and rewards. Quantitative methods of risk management are essential, but unreflective reliance on them, without careful qualitative analysis, produces misleading results: “[a]t best, ...the quantitative inputs can provide insights into a range of potential loss estimates that help to guide judgments about risk appetite. The more difficult task for senior management, boards of directors and prudential supervisors is how to build into the risk appetite exercise the necessary judgments as to factors such as incentives, the quality of the control environment, the point in the business cycle and other qualitative inputs that should temper the quantitative factors either to a higher or lower appetite for risk. Accordingly, the Policy Group recommends that 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.”<sup>167</sup>

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<sup>165</sup> Id. at 9-10.

<sup>166</sup> Id. at 10.

<sup>167</sup> Id. at 11-12.

- **Precept IV: Focusing on Contagion.**

Contagion refers to “the channels and linkages through which local financial disturbances can take on systemic characteristics.”<sup>168</sup> The CRMPG III noted that contagion usually involve credit concentrations, broad-based maturity mismatches, excessive leverage either on balance sheets or embedded within financial instruments, and the illusion of market liquidity. The Report maintained that institutions needed to anticipate contagion more effectively, and so the Report recommended that “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.” The point of the exercise, of course, is that even if the ‘hot spots’ do not materialize or even if unanticipated ‘hot spots’ do materialize, the insights gained in the brainstorming exercise will be of considerable value in managing future sources of contagion risk.”<sup>169</sup>

- **Precept V: Enhanced Oversight.**

Boards of directors and supervisory bodies are responsible for overseeing complex financial firms. Boards are responsible for senior management personnel decisions and compensation, including how compensation structure affects incentives. Independent directors on boards can grasp the working details of risk exposures only to a limited extent. “What they can do, and what management can help them do, is to ask the right questions and insist that they have the information—properly presented—that allows them to exercise their oversight responsibilities.”<sup>170</sup>

Prudential supervisors, in turn, have broad authority to prescribe standards of behavior and, in extreme conditions, require the firm to undertake specific personnel and operational decisions to assure their viability. Boards of directors and supervisors accordingly can complement each other in their oversight responsibilities.

That being said, the Policy Group believes that there is a relatively simple way to reinforce the effectiveness of these oversight responsibilities. Specifically, the Policy Group recommends arrangements whereby the 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

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<sup>168</sup> Id. at 12.

<sup>169</sup> Id. at 12.

<sup>170</sup> Id. at 13.

institution and its capacity to absorb periods of adversity. The details of examination and inspection reports should not be discussed except to the extent that such reports relate in a material way to underlying stability issues. Obviously, this format would help to stimulate an exchange of views between the supervisors and the boards, which in turn should help each to better discharge their respective oversight duties. If these arrangements—which already exist in some jurisdictions—are to achieve their objective, it is essential that the spokesperson from the supervisory body be a true policy level executive or, preferably, a principal of the supervisory body. Finally, these high level exchanges of views should minimize the use of quantitative metrics and maximize the use of discussion and informed judgment.<sup>171</sup>

The CRMPG III described the core precepts and the ensuing recommendations as a “package deal:”

That is, success in achieving any one of the core precepts and recommendations is dependent on achieving success in the others. Moreover, partly because of competitive realities and partly because of practical realities, no one institution can, by itself, accomplish all that needs to be done in restoring the credibility of the industry, much less provide some reasonable assurance that we can better limit or contain the damage associated with future financial shocks.

What is needed to achieve that result, therefore, are collective and concerted industry wide initiatives supported by progressive and enlightened prudential supervision conducted in the spirit of the March 6, 2008 Report of the Senior Supervisors Group. In the private sector, greater financial discipline at individual institutions must be reinforced by a renewed commitment to collective discipline in the spirit of “financial statesmanship” that recognizes that there are circumstances in which individual institutions must be prepared to put aside specific institutional interests in the name of the common good.<sup>172</sup>

Finally the CRMPG III urged financial institutions to learn from past mistakes:

[F]inancial institutions and their supervisors must avoid the mistakes that were made following the publication of CRMPG II almost three years ago to the day. In some areas, the follow-up and implementation of recommendations in CRMPG II were good. In other areas, the follow-up by individual firms and their supervisors

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<sup>171</sup> Id. at 13-14.

<sup>172</sup> Id. at 15.

was poor and certainly was not sustained. In some of the areas covered by this Report (notably the material in Section V on Enhanced Credit Market Resiliency), there is a built-in framework for follow-up in the form of ongoing coordination and cooperation between the dealer community, on the one hand, and the Federal Reserve Bank of New York and other official groups, on the other hand.”<sup>173</sup>

## **Recommendations**

### **Standards for Accounting Consolidation**

The CRMPG III endorsed, in principle, the direction of changes in U.S. GAAP provided that the changes are principles-based, convergent with International Financial Reporting Standards, and include sufficiently flexible disclosure and transition rules regarding regulatory capital. It recommended a global consolidation framework for accounting “that is based on control and the ability to benefit from that control.”<sup>174</sup> The new consolidation framework should require reassessment each period. Standard setters and industry participants should work together, expeditiously and globally, to develop this framework. They should consider a “holistic and principles-based approach to disclosure of off-balance sheet activities similar to that found in international standards.”<sup>175</sup> Detailed information that changes in response to new risks and uncertainties should supplement enterprise-wide disclosure. Firms should “provide tabular disclosures about the effects of restrictions on the use of consolidated assets, non-recourse liabilities, and minority interests.”<sup>176</sup>

### **High-Risk Complex Instruments**

Control problems emerge in high-risk complex instruments because they normally use relatively large amounts and varieties of leverage, they are prone to periods of reduced market liquidity, and their prices frequently are not transparent. The CRMPG III’s recommendations in this area focused on elevating the financial sophistication of eligible market participants, enhancing disclosure, strengthening ongoing relationships between parties to transactions, and insuring satisfactory diligence standards for issuers and placement agents.<sup>177</sup>

The Report “**strongly recommends** that high-risk complex financial instruments should be sold only to sophisticated investors.”<sup>178</sup> All participants in transactions should be able to understand and manage the transactions in light of their goals. This includes understanding the risk and return of the relevant instruments; the ability to run

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<sup>173</sup> Id. at 16.

<sup>174</sup> Id. at 18.

<sup>175</sup> Id. at 19.

<sup>176</sup> Id. See also id. at 18-19, 38-52.

<sup>177</sup> Id. at 53-57.

<sup>178</sup> Id. at 57.

appropriate stress tests; the governance, technology, and internal controls necessary to trade or manage the instruments' risks; financial resources to withstand related losses; and legal authorization to enter the transactions. Financial intermediaries should develop procedures to determine when they would obtain written confirmation of these capabilities from counterparties.<sup>179</sup>

While recognizing variability in appropriate documentation for transactions, the Report suggested “as a matter of industry best practice” core content for documentation and disclosure.<sup>180</sup> The Report recommended “strengthening the relationship between intermediaries and counterparties in sales, marketing, and ongoing communications associated with high-risk complex financial instruments” in ways that go beyond the basic understandings regarding sophisticated and core disclosures recommended earlier.<sup>181</sup> This should involve appropriately timely, active, and complete communication between participants in complex transactions. Underwriters and placement agents “should have in place an ongoing framework for evaluating the performance and reputation of issuers as well as effective and clearly articulated procedures for evaluating the quality of assets. The Policy Group strongly urges that underwriters and placement agents redouble efforts to adhere fully to the letter and spirit of existing diligence standards, and seek opportunities to standardize and enhance such standards.”<sup>182</sup>

### **Risk Monitoring and Risk Management**

The CRMPG III noted, failures of risk monitoring and management loom large in any analysis of the current crisis:

As is now widely recognized, the events leading up to the credit market crisis and the crisis itself have demonstrated shortcomings in risk monitoring and risk management across many institutions and classes of institutions. . . . While these and other shortcomings in risk monitoring and risk management can, with the benefit of hindsight, be explained, there is a larger and more profound issue at work in this context. That is, despite all of the complexities of risk management, the essence of risk monitoring and risk management is quite straightforward. Specifically, risk monitoring and management reduces to the basics of getting the right information, at the right time, to the right people, such that those people can make the most informed judgments possible.

Looked at in that light, several things stand out. Risk management assumes that risk monitoring is effective and that critical information flowing into and out of risk monitoring processes can be distilled and compiled in a coherent and timely manner and made available, not only to the risk managers, but to key business leaders across the institution and to top management. Only when this logical sequence of conditions is present and is supported by a rigorous but flexible

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<sup>179</sup> Id. at 19-20, 57-59.

<sup>180</sup> Id. at 20-21, 59-62.

<sup>181</sup> Id. at 21.

<sup>182</sup> Id. at 21-22, 62-69.

framework of corporate governance will there be reasonable prospects that business judgments can better anticipate and respond to contagion and systemic events. This is the fundamental reason why the Policy Group has placed so much emphasis on the core precepts [of corporate governance] outlined in Section I.<sup>183</sup>

The Report recommends that firms make risk management and control functions reasonably independent of income-producing units, staff them appropriately, and equip them 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. All the units involved in managing risk should work closely with each other on the task, communicating fully as required. Upper management frequently should participate in meetings of risk management-related committees. The firm should be able to compile detailed, accurate information on exposures across the firm on a daily basis, including the capability of generating such information on shorter notice if required by special circumstances, and 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.<sup>184</sup>

Firms should attend carefully to particularly large exposures to specific counterparties, positions, or less liquid instruments, adjusting margin and capital requirements as necessary. They should employ robust, consistent valuation procedures, and firms, together with 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.<sup>185</sup> Firms 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. The CRMPG III emphasized the fundamental importance of the firms’ relevant units communicating with each other in risk management, and senior management being involved actively in it. Also, under Basel II, “the experience of the credit market crisis provides a sobering reminder to individual institutions, their senior management and their supervisors that future judgments about capital adequacy should be more sensitive to downside risks than perhaps has been the case in the past.”<sup>186</sup>

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<sup>183</sup> *Id.* at 70-71.

<sup>184</sup> *Id.* at 23-26, 70-86.

<sup>185</sup> *Id.* at 27.

<sup>186</sup> *Id.* at 26-31, 86-101.

## **Enhanced Credit Market Resiliency**<sup>187</sup>

The Report stressed the importance of improving the current settlement, legal, and operational infrastructure of the OTC credit markets. It identified “six interrelated areas of weakness in need of immediate improvement and enhancement:” (i) timeliness and integrity of transaction details; (ii) daily reconciliation of collateral valuations; (iii) reaching an operationally manageable number and gross notional value of outstanding trades in the market; (iv) credit event settlements, including greater efficiency and certainty of the process; (v) close-outs of defaulting counterparties; and (vi) central clearing mechanisms.<sup>188</sup>

The CRPMG III recommended improvements to the infrastructure for processing trade confirmation and reconciling transaction details, and suggested timelines for implementation. It recommended improvements in the daily valuation and collateral management process, and endorsed the efforts of the ISDA Portfolio Compression Working Group to effectively establish systems for offsetting trades. It also called for formal adoption of auction-based, net physical settlement procedures for credit events as part of standard ISDA documentation for transactions and other mechanisms to effectively close out trades in the event of defaults, and establishment of central clearing arrangements.<sup>189</sup>

## **Emerging Issues Highlights**

The CRMPG III Report concluded with a brief discussion of emerging issues. It discussed valuation and price verification, and noted the debates regarding related accounting issues, adding that, “regardless of what may emerge, the Policy Group is strongly of the view that under any and all standards of accounting and under any and all market conditions, 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. While the details of approaches and the family of techniques used for these purposes may—and will—differ from time to time and from institution to institution, these efforts should always pass the two common sense tests of (1) reasonableness and (2) consistency, both of which apply equally to positions

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<sup>187</sup> By late 2008 there had been a large amount of activity effecting these improvements in credit market operations. The President’s Working Group on Financial Markets announced on November 14 an initiative to strengthen OTC derivatives oversight and infrastructure, and, while industry and other participants recognized that stresses remained and the need for continuing improvements, there had been substantial progress on improving the market infrastructure as discussed in the CRMPG III Report. See U.S. DEP’T OF THE TREASURY, PWG ANNOUNCES INITIATIVES TO STRENGTHEN OTC DERIVATIVES OVERSIGHT AND INFRASTRUCTURE, NOV. 14, 2008, <http://www.ustreas.gov/press/releases/hp1272.htm>; <http://www.isda.org>; MOODY’S INVESTORS SERVICES, CREDIT DEFAULT SWAPS: MARKET, SYSTEMIC, AND INDIVIDUAL FIRM RISKS IN PRACTICE (New York: Moody’s Investors Service, October 2008); Hal Weitzman, *Citadel and CME win CDS clearing consent*, Financial Times, Dec. 24, 2008, <http://www.ft.com/cms/s/0/cd943d68-d15b-11dd-8cc3-000077b07658.html>.

<sup>188</sup> *Id.* at 103.

<sup>189</sup> *Id.* at 31-36, 102-131.



or instruments that have gains and positions or instruments that have losses.”<sup>190</sup> The CRMPG III also noted the public policy issues over whether or not, and how, to intervene in asset price bubbles, the emergence of “near banks” or “private pools of capital,” and regulatory structure.<sup>191</sup> The Report concluded with a final mention of Supervisory Policy and Practice:

As noted throughout CRMPG II and CRMPG III, supervisory practice and policy as applied to large integrated financial intermediaries constitute a sizeable challenge for the international community of prudential supervisors. On the whole, however, the supervisory process works reasonably well, especially as the emphasis of supervisory practices has shifted, in recent years, toward a principles-based approach... While acknowledging the gains that have been made in supervisory practice, the Policy Group believes that 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.

There are, obviously, direct and indirect fiscal costs associated with devoting more resources to the supervisory process that are quite real in the current setting of pressing fiscal problems in virtually all countries. However, in weighing and balancing fiscal priorities, 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.<sup>192</sup>

**G. LAWRENCE A. CUNNINGHAM, FOR COUNCIL OF INSTITUTIONAL INVESTORS, SOME INVESTOR PERSPECTIVES ON FINANCIAL REGULATION PROPOSALS (SEPTEMBER 2008)**<sup>193</sup>

This is a paper by Professor Lawrence A. Cunningham of George Washington University Law School (September, 2008), commissioned for the Council of Institutional Investors (CII). It is not a CII document, but an analysis by Professor Cunningham for its members. It assesses, “from an investor’s perspective: (i) mutual recognition in securities regulation, (ii) integrating securities and futures regulation and (iii) a model of financial regulation that relies on a single agency to oversee all financial markets. Much of the analysis focuses on proposals contained in the U.S. Treasury Department’s March 2008 Blueprint for a Modernized Financial Regulatory Structure.”<sup>194</sup>

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<sup>190</sup> Id. at 133.

<sup>191</sup> Id. at 133-137.

<sup>192</sup> Id. at 137.

<sup>193</sup> Lawrence A. Cunningham, SOME INVESTOR PERSPECTIVES ON FINANCIAL REGULATION PROPOSALS 5 (2008), <http://cii.org/UserFiles/file/Sept2008MarketRegulation.pdf> at 5.

<sup>194</sup> Id. at 5.

## **Introductory Comments**

“A principal investor concern with the [Treasury] blueprint is that it doesn’t distinguish investors in securities from other, diverse constituents in the financial markets.”<sup>195</sup> In particular, it often equates “investor protection” with “consumer protection” when investors are best thought of as suppliers of capital and consumers are buyers of services. “Another problem with the blueprint’s limitations from an investor’s perspective is that it addresses securities markets in operational and administrative terms but not substantive terms. While it considers stock exchanges and securities clearing agencies extensively, the blueprint pays scant attention to issuers of securities or their advisors and others who protect investors, such as accountants, lawyers, credit rating agencies and underwriters.”<sup>196</sup> It similarly does not distinguish among different types of financial markets and instruments in a sufficiently detailed way, lumping very different activities into “financial services,” and the paper reviews different types of financial instruments and structures.<sup>197</sup> It says that “[i]nvestor protection is no part of the blueprint’s motivation,” and comments that “[t]he 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.”<sup>198</sup>

## **The Issue of Mutual Recognition**

“Globalization of capital markets has led financial regulators worldwide to explore how to facilitate global capital flows while addressing national objectives. The term “mutual recognition” is often used to describe these efforts, although the term itself is abstract; the content of any mutual recognition program would require examination to determine its effects on investors. In general, the term refers to programs where a domestic regulator, such as the SEC, and its counterparts in other nations, reciprocally cede supervision of non-domestic organizations to their foreign counterparts. This enables foreigners to operate domestically without local registration so long as they are registered under a sufficiently comparable foreign system.”<sup>199</sup>

The paper reviews the “small steps” that have been taken in the mutual recognition area. Challenges in establishing a widely acceptable system of mutual recognition include:

- Specifying what “sufficiently comparable” protections actually means. U.S. investor protections will be weakened if firms operating the U.S. are governed by foreign regulators with weaker standards.

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<sup>195</sup> Id. at 7.

<sup>196</sup> Id.

<sup>197</sup> Id. at 9-12.

<sup>198</sup> Id.

<sup>199</sup> Id. at 12.

- The wider structure of the nation, including other regulatory and legal institutions, has to be factored in when determining whether protections are sufficiently comparable.”
- One must question if the SEC really can be confident that foreign regulators are enforcing their rules on firms operating in the United States when the agency cannot itself examine the process. Arguably, firms operating in the United States should be required to register with the SEC and be inspected by it.

### **Summary of Pros and Cons**

- **“Proponents of mutual recognition argue that it will advance the interests of investors worldwide by increasing access to investment opportunities without undermining traditional investor protection laws and policies.** Some believe that mutual recognition is important to promote U.S. capital market competitiveness. Others note that global trends drive mutual recognition among other nations, and they suggest that the SEC will enjoy a stronger leadership role if it actively pursues a program rather than adopting a wait-and-see posture.
- **Opponents of mutual recognition argue that mutual recognition risks diminishing traditional U.S. investor protection ideals and traditions.** Some believe that by necessity, mutual recognition involves a trade-off pitting investor protection against investor choice.”<sup>200</sup>

### **The Issue of Integrating Securities and Futures Regulation**<sup>201</sup>

“The blueprint says convergence between securities and futures environments makes separate regulatory regimes for these two areas ‘untenable, potentially harmful and inefficient.’ The blueprint’s solution is to merge the CFTC and SEC to oversee the futures and securities industries and meld their procedures and practices. A presidential task force explored this idea two decades ago without necessarily endorsing it. But, according to the blueprint, it is now vital to make the change.”<sup>202</sup>

The Treasury says that the SEC and CFTC have different regulatory philosophies, and the Blueprint clearly prefers the CFTC’s. But, Cunningham says, the Blueprint does not look closely enough at why the SEC and CFTC differences exist and whether applying CFTC-type “principles based” regulation to securities markets, particularly in which retail investors are much more active, would harm investor protections. Even leaving aside any evaluation of CFTC controls in futures markets, applying them to securities markets could undermine investor protections. Thus, the type of “merger” envisioned by the Treasury Blueprint should happen only after critical scrutiny by investor organizations and others.

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<sup>200</sup> Id. at 14-15

<sup>201</sup> Id. at 15-22.

<sup>202</sup> Id. at 15.

## Summary of Pros and Cons

- **“Proponents of integrating securities and futures regulation argue that, because financial products increasingly blur the lines between traditional securities and futures instruments, merging the SEC and the CFTC and melding their philosophies would result in more effective and efficient regulation.** Some believe moving the SEC to the CFTC’s ‘principles-based regulatory philosophy’ would modernize the SEC’s regulatory approach and facilitate a smoother merger of the two organizations. Those steps may enhance investor protection, market integrity, market and product innovation, industry competitiveness and international regulatory dialogue.
- **Opponents of integrating securities and futures regulation argue that such integration could weaken important investor protections by incorporating prevailing, weaker futures practices into securities practice.** Some believe philosophical and regulatory differences between the SEC and the CFTC and the reasons for the differences—including differences in margin accounts, customer funds, insider trading, suitability, insider trading and private litigation—warrant a continued distinction between the two entities. Similarly, regarding the rules vs. principles debate, some note that important differences between futures and securities markets justify different regulations. Ultimately, a SEC-CFTC merger, depending on its structure, could significantly and negatively impact investor rights and protections.”<sup>203</sup>

## The Issue of Optimal Regulatory Structure<sup>204</sup>

The paper reviews the “optimal regulatory structure” presented in the Treasury Blueprint (discussed below), focusing on the Conduct of Business Regulatory Agency (CBRA), as having “potentially great significance to investors.”<sup>205</sup> “Despite the blueprint’s basic conception of convergence across financial contexts and the senior regulator’s outlook, discussion ultimately recognizes important differences between kinds of institutions, participants and services or ‘products’ (including securities). For example, the blueprint notes that ‘the requirements for financial capacity and managerial expertise should vary by type of financial product being sold.’ So many variations appear that it becomes difficult to accept the blueprint’s opinion that there is a single financial market suitable for singular regulatory oversight.”<sup>206</sup> For banking this also would require “rolling up all existing state and federal law into this single regulator.”<sup>207</sup> The paper argues that “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

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<sup>203</sup> Id. at 22.

<sup>204</sup> Id. at 22-27.

<sup>205</sup> Id. at 25.

<sup>206</sup> Id. at 25 -26.

<sup>207</sup> Id. at 26.

organizations, the content of these investor protection laws are likely to differ radically from present law or laws that emerge in the usual manner.”<sup>208</sup>

### **Summary of Pros and Cons**

- **“Proponents of a model of financial regulation featuring a single agency overseeing all financial markets argue that such a structure creates an efficient model that ensures that a single responsible regulator has all the information and flexibility necessary to address future financial crises promptly and effectively.”**
- **“Opponents of a model of financial regulation featuring a single agency overseeing all financial markets observe that such a structure could, absent vigilant and successful investor engagement, substantially diminish investor protections.”<sup>209</sup>**

### **H. THE FINANCIAL SERVICES ROUNDTABLE, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS (NOVEMBER 2007)**<sup>210</sup>

The Blueprint for U.S. Financial Competitiveness, by the Financial Services Roundtable (“FSR”), proposed ten policy reforms.

- **Policy Reform I: The United States Should Enact Principles-based Regulation:** The FSR recommended that “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.”<sup>211</sup> National and state financial regulators and firms would be expected to abide by these principles, quoted below from pp. 13-14 of the Report:
  - ***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.

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<sup>208</sup> Id. at 26 -27.

<sup>209</sup> Id. at 27.

<sup>210</sup> See Financial Services Roundtable, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS, November 2007, <http://www.fsround.org/cec/blueprint.htm>

<sup>211</sup> Financial Services Roundtable November 2007 at 11.

- ***Proportionate, risk-based regulation.*** The costs and burdens of financial regulation, which ultimately are borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and consumers.
- ***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. These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety, soundness, and financial stability, and appropriate conflict of interest management.

Congress should formally establish the President’s Working Group on Financial Markets through law to oversee the range of financial market regulatory agencies, with the Secretary of the Treasury continuing to chair the PWG.<sup>212</sup> The PWG would oversee the implementation of the Guiding Principles specified above through oversight of Regulatory Action Plans. The FSR recommended that 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.”<sup>213</sup>

“Each financial regulator”—national and state—“would be required to develop its own Regulatory Action Plan to implement the Guiding Principles,” with these being “multi-year plan[s] to conduct a comprehensive and balanced review of all regulations that affect the ability of financial services firms to compete and serve consumers’ financial needs.”<sup>214</sup> The PWG would report annually to the President and Congress on the implementation of the Principles through the Regulatory Action Plans.

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<sup>212</sup> *Id.* at 11.

<sup>213</sup> *Id.* at 53.

<sup>214</sup> *Id.* at 12 – 13.

- Policy Reform II: Apply Prudential Supervision to All Financial Services Firms:** All financial services regulators, including self-regulatory organizations, should adopt and rely on prudential supervision. 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.”<sup>215</sup> It cites federal banking regulation, the CFTC (especially since 2000), and the SEC’s Consolidated Supervised Entity program as examples of prudential supervision.<sup>216</sup>
- Policy Reform III: Reform Securities and Other Class-Action Litigation:** The Financial Services Roundtable Commission emphasized what it considered a draining, damaging effect of private litigation on financial services firms, articulating points similar to those in the Committee on Capital Markets, Bloomberg/Schumer, and Chamber of Commerce Reports, and recommended 19 specific litigation reforms.<sup>217</sup>
- Policy Reform IV: Improve Consumers’ Access to Credit and Opportunities for Long-term Financial Security:** This reform would “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.”<sup>218</sup>
- Policy Reform V: Make Anti-money Laundering Supervision More Effective:** While emphasizing the importance of effective anti-money laundering rules, the Report notes that “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.” Here again, the Report cites the U.K.’s Financial Services Authority regarding its “new risk-based approach to anti-money laundering. The FSA eliminated its detailed money-laundering rules and replaced them with a set of high-level rules” that “simply require a firm to establish systems and controls to identify, assess, monitor, and manage money-laundering risk, and to ensure that such systems and controls are ‘comprehensive and proportionate to the nature, scale, and complexity of its activities.’”<sup>219</sup>
- Policy Reform VI: Expand the Risk-based Focus of Capital Regulation.** The Report recommends that regulators build upon the Basel II accord to develop a risk-based focus to capital regulation for all financial services firms.<sup>220</sup> In particular, it focuses on the international implications of choices of capital rules,

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<sup>215</sup> Id. at 14.

<sup>216</sup> Id. at 57.

<sup>217</sup> Id. at 63 – 72.

<sup>218</sup> Id. at 14, 73 – 80.

<sup>219</sup> Id. at 83.

<sup>220</sup> Id. at 14.

accenting the importance of international competitiveness. It cites the state-regulated insurance industry as an example of the impact of misaligned capital rules, and recommends creation of an optional national insurance charter, consistent with the Guiding Principles specified in the report.<sup>221</sup>

- **Policy Reform VII: Ensure the Effective Implementation of Sarbanes-Oxley Act (Section 404) Regulatory Reforms:** Similar to the reports discussed above, the Report noted the concerns with Section 404 of the Sarbanes-Oxley act, acknowledged the SEC and PCAOB “recent administrative reforms...which we applaud,” and offers “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.”<sup>222</sup>
- **Policy Reform VIII: Accelerate U.S. Accounting Standards Modernization.** The Financial Services Roundtable 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.<sup>223</sup>
- **Policy Reform IX: Modernize Existing Charters:** The Report recommended statutory and administrative changes to enhance the ability of national and state banks, federal and state savings associations, and financial holding companies to operate more effectively. It recommended allowing them a choice of “the most modern, competitive, and productive charters and legal structures possible.” This Report allowed for the continued operation of diverse state and federal charters for financial institutions, and in this sense departed somewhat from the emphasis on federal preemption found in some other analyses over the past two years. In general, the Report recognized how diverse charters and regulatory organizations can produce difficult complexities, but also indicated the competitive benefits that can stem from such variety. Thus, the Financial Services Roundtable emphasized improvements in existing charters and permitting choices among a variety of options.<sup>224</sup>
- **Policy Reform X: Enact New National Charters.** Consistent with Policy Reform IX, the Report recommended creation of a national insurance charter, a federal securities authority, and possibly a national universal financial services charter. It noted that these “new national charter options would put U.S. financial services firms on a more equal competitive footing with their international competitors that operate globally with a single license supervised by a single prudential regulator.”<sup>225</sup>

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<sup>221</sup> Id. at 94 – 102.

<sup>222</sup> Id. at 15,102 – 107.

<sup>223</sup> Id. at 15, 107 – 112.

<sup>224</sup> Id. at 15, 113 – 125.

<sup>225</sup> Id. at 15, 125 – 128.



**I. FINANCIAL STABILITY FORUM (FSF), REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE (APRIL 7, 2008)<sup>226</sup> AND THE FOLLOW-UP ON IMPLEMENTATION (OCTOBER 10, 2008)<sup>227</sup>**

The Financial Stability Forum identified as “underlying weaknesses” in the financial system the “poor underwriting standards” that developed during favorable economic conditions, shortcomings in firms’ risk management, poor investor due diligence, poor performance by credit rating agencies, several incentive distortions contributing to these conditions, weaknesses in disclosure, feedback effects between valuation and risk taking that relentlessly reduced asset prices, and weaknesses in regulatory frameworks and policies.<sup>228</sup> In both its original Report in April and the “Follow-up” in October, the FSF recommended five areas for improvements, noting in its October Report that progress that had taken place in 2008: (i) strengthening prudential oversight of capital, liquidity, and risk management; (ii) enhancing transparency and valuation; (iii) implementing changes in the role and uses of credit ratings; (iv) strengthening the authorities’ responsiveness to risks; and (v) developing robust arrangements for dealing with stress in the financial system.

**Recommended Improvements**

**Strengthen Prudential Oversight of Capital, Liquidity, and Risk Management**

The FSF wrote that “[t]he Basel II capital framework needs timely implementation” and that “[s]upervisors will assess the impact of the implementation.”<sup>229</sup> Basel II provides incentives for better risk management practices, and supervisors are monitoring its effects on capital levels. The BCBS and IOSCO in July proposed additional capital requirements for credit exposures in banks’ and securities firms’ trading books and the BCBS “will issue later this year proposals to raise capital requirements for complex structured credit products and strengthen the capital treatment of liquidity facilities extended to off-balance sheet vehicles.”<sup>230</sup>

Given the problems experienced in 2008, “[a]uthorities should ensure that the capital buffers for monoline insurers and financial guarantors are commensurate with their role

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<sup>226</sup> Financial Stability Forum, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE (2008) (“FSF APRIL”), [http://www.fsforum.org/publications /r\\_0804.pdf](http://www.fsforum.org/publications /r_0804.pdf)

<sup>227</sup> Financial Stability Forum, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE, FOLLOW-UP ON IMPLEMENTATION (2008) (“FSF OCTOBER”),

[http://www.fsforum.org/press/pr\\_081009f.pdf](http://www.fsforum.org/press/pr_081009f.pdf)

<sup>228</sup> FSF APRIL at 5 – 11.

<sup>229</sup> *Id.* at 12, 53.

<sup>230</sup> FSF OCTOBER at 10 – 11.

in the financial system.”<sup>231</sup> The International Association of Insurance Supervisors had surveyed supervisors regarding current rules and planned changes, finding that “a strengthening of the regulatory framework for these institutions, including capital requirements, is being considered in key countries,” including the United States.<sup>232</sup>

The October Report noted that the BCBS had released in September Principles for Sound Liquidity Risk Management and Supervision (discussed separately below). Commenting on these and related developments, the FSF opined that supervisors “have committed considerable resources to strengthen risk monitoring and management practices at firms where weaknesses have come to light.”<sup>233</sup> IOSCO and BCBS were jointly to study the internal control systems of financial firms in different jurisdictions, focusing on risk management of structured products, with a target date of 2009. Two industry groups—the Institute of International Finance and the Counterparty Risk Management Policy Group III—had addressed how compensation systems had produced “inappropriate incentive structures,” recommending changes (we discuss both reports separately below).<sup>234</sup> The FSF said that “market participants should act promptly to ensure that the settlement, legal, and operational infrastructure underlying OTC derivatives markets is sound,”<sup>235</sup> noting that the Federal Reserve Bank of New York had convened major market participants and their supervisors in June 2008 to address financial infrastructure, and industry and supervisors had taken several related actions, including establishment of central clearing for OTC credit markets late in the year.<sup>236</sup>

### **Enhance Transparency and Valuation**

The April and October FSF Reports both state that financial institutions “should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.”<sup>237</sup> The April Report remarked that “[d]uring the early stages of the market turmoil, public disclosures by financial institutions did not always make clear the risks associated with their on- and off-balance sheet exposures. The information disclosed about risk exposures was not sufficiently timely and useful to many investors and other market participants. A number of financial institutions and auditors worked together to improve risk disclosures for structured products and other exposures, for example in financial accounts and other disclosures for the second half and for year-end 2007. However, a lack of adequate and consistent disclosure of risk exposures and valuations continues to have a corrosive effect on confidence.”<sup>238</sup>

The April and October Reports also emphasized the importance of improvements in accounting and disclosure standards, saying “[t]he IASB should improve the accounting

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<sup>231</sup> FSF OCTOBER at 12, 28.

<sup>232</sup> Id. at 12.

<sup>233</sup> Id. at 13.

<sup>234</sup> Id. at 14, 30.

<sup>235</sup> Id. at 15, 30.

<sup>236</sup> Id.

<sup>237</sup> FSF APRIL at 22, 56; FSF OCTOBER at 16, 30.

<sup>238</sup> FSF APRIL at 22.

and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence.”<sup>239</sup> International standard setters [also] “should enhance accounting, disclosure, and audit guidance for valuations. Firms’ valuation processes and related supervisory guidance should be enhanced.”<sup>240</sup> Echoing the Senior Supervisors’ “Observations On Risk Management Practices In The Recent Market Turbulence” (discussed below), the April Report noted that firms performing relatively well in late 2007 had established “rigorous internal processes requiring critical judgment and discipline in the valuation of holdings of complex or potentially illiquid securities.”<sup>241</sup> In contrast, other firms “generally had not established or made rigorous use of internal processes to challenge valuations.”<sup>242</sup> Both Reports examined moves by firms, industry and accounting organizations, and regulators to increase transparency and disclosure in securitized products and underlying assets.<sup>243</sup>

### **Changes in the Role and Uses of Credit Ratings**

The FSF wrote in its April Report:

CRAs play an important role in evaluating and disseminating information on structured credit products, and many investors have relied heavily on their ratings opinions. Poor credit assessments by CRAs contributed both to the build up to and the unfolding of recent events. In particular, CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models. As investors realised this, they lost confidence in ratings of securitised products more generally.

CRAs have since undertaken, individually and collectively, a series of actions to draw lessons for their internal governance and operational practices to strengthen ratings quality, enhance the rating process, manage conflicts of interest and enhance the information they provide on rating methodologies and the meaning and limitations of ratings. The steps are welcome but more is needed.<sup>244</sup>

The FSF discussed how close communication between the CRA and the issuer, particularly in structured products in an issuer-pays model, creates potential conflicts of interest, even more so when the CRA does other business with the issuer.<sup>245</sup> It also cited CRAs’ uncritical reliance on historical data in dealing with the subprime market and failure to provide adequate resources to handle their increasing volume of work without reducing ratings quality.<sup>246</sup>

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<sup>239</sup> FSF APRIL at 25, 56; FSF OCTOBER at 16, 30.

<sup>240</sup> FSF APRIL at 26, 56; FSF OCTOBER at 17, 31.

<sup>241</sup> FSF APRIL at 28.

<sup>242</sup> FSF April at 25 – 26, 28.

<sup>243</sup> FSF April at 26 – 31; FSF October at 16 – 20.

<sup>244</sup> FSF April at 32.

<sup>245</sup> Id.

<sup>246</sup> The April Report notes that IOSCO and the SEC had pushed for governance changes: “IOSCO issued in May a revised *Code of Conduct Fundamentals for CRAs* that sets out

The FSF observed that many investors used the CRAs' ratings uncritically, although "structured finance ratings differ from traditional corporate debt ratings in that they are model-based and to a larger degree assumption-driven, result from an 'inverted' ratings process in which a structure is fitted to a desired rating, often rely on non-public information about the underlying assets, and have the potential for significantly higher ratings volatility in certain circumstances."<sup>247</sup> Thus, the FSF maintained that CRAs should differentiate structured finance ratings from those on bonds, and expand the information available on risk characteristics of structured products.<sup>248</sup> The CRAs also were told to improve their reviews of data quality.<sup>249</sup> The FSF also urged investors to not rely on ratings at the expense of their own due diligence, and suggested that regulators and supervisors should review the extent to which their rules induced investors to rely excessively on ratings.<sup>250</sup>

### **Strengthen the Authorities' Responsiveness To Risks**

The April Report argues that more effective regulatory supervision could have prevented some of the problems over the past two years. It noted that work under development might have mitigated the crisis, but points out that international processes for agreements operated more slowly than pace of financial innovation. Also, supervisors did not always follow up to verify that firms actually were complying with supervisory guidance they had accepted. The Report also found that "[w]here authorities have expressed concerns about risks to markets or to individual institutions, they have not always been successful in changing behaviour."<sup>251</sup> The FSF maintained that "[s]upervisors should see that they have the requisite resources and expertise to oversee the risks associated with financial innovation and to ensure that firms they supervise have the capacity to understand and manage the risks."<sup>252</sup> They have to maintain regular communication with firms, direct concerns to firms' boards and senior management early and explicitly, and verify that firms had responded to regulatory and supervisory directives.<sup>253</sup>

In addition, supervisory bodies should cooperate amongst themselves more effectively by establishing "an international college of the most relevant supervisors for each of the largest global financial institutions by end-2008. The purpose of the colleges would be to enhance cooperation on ongoing supervisory issues."<sup>254</sup> Similarly, supervisors could

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materially enhanced requirements for processes and procedures that should be in place to protect the quality and integrity of the rating process . . . IOSCO and its member authorities expect CRAs to give full effect to the revised Code of Conduct and to demonstrate to regulators and market participants how they adopt the Code in their own codes of conduct." FSF OCTOBER at 20.

<sup>247</sup> FSF APRIL at 34.

<sup>248</sup> FSF APRIL at 34 – 36; FSF OCTOBER at 21 – 22.

<sup>249</sup> FSF APRIL at 36 – 37; FSF OCTOBER at 22.

<sup>250</sup> FSF APRIL at 37 – 39; FSF OCTOBER at 22 – 23.

<sup>251</sup> *Id.* at 40.

<sup>252</sup> FSF APRIL at 40; FSF OCTOBER at 33.

<sup>253</sup> FSF APRIL at 40; FSF OCTOBER at 33 – 34.

<sup>254</sup> FSF APRIL at 42. See also FSF OCTOBER at 33.

collaborate on issues cutting across firms. The April Report cited the Senior Supervisors Group March “Observations On Risk Management Practices In The Recent Market Turbulence” as “an example of the way supervisors can flexibly organise themselves to address in a timely way issues having a common effect across a number of institutions and to draw common lessons.”<sup>255</sup> Also, 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.<sup>256</sup>

### **Robust Arrangements for Dealing With Stress In the Financial System**

The FSF discussed the ways in which central banks should be able to intervene to deal with extraordinary situations, particularly in cooperation with each other. Monetary policy should be able to inject reserves “without running the risk of driving overnight rates substantially below policy targets for significant periods of time.”<sup>257</sup> Being able to widen the range of acceptable collateral, maturities of transactions, and counterparties would enable banks to deal flexibly with the need for banks to support firms’ funding plans during crises; banks also need to reduce the stigma associated with receiving central bank assistance even in times of stress.<sup>258</sup> They should be able to coordinate among themselves, including establishment of standing swap lines with other banks, possible use of collateral across borders and currencies, and joint arrangements for dealing with weak banks.<sup>259</sup> They should strengthen deposit insurance arrangements and, in general, strengthen international cooperation in crisis management. The October Report noted several actions taken by banks in 2008 to deal with specific cases, and policy initiatives under way, furthering these objectives.<sup>260</sup>

### **J. GROUP OF 30 (G-30), THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (October 2008)**<sup>261</sup>

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

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<sup>255</sup> FSF APRIL at 42.

<sup>256</sup> FSF APRIL at 43; FSF OCTOBER at 23 – 24.

<sup>257</sup> FSF APRIL at 45, 61; FSF OCTOBER at 34.

<sup>258</sup> FSF APRIL at 45, 47; FSF OCTOBER at 61.

<sup>259</sup> Id.

<sup>260</sup> FSF April at 45 – 53; FSF October at 25 – 27.

<sup>261</sup> Group of 30 (G-30), THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE, October 2008, (“G-30 October 2008”), [http://www.group30.org/pubs/pub\\_1428.htm](http://www.group30.org/pubs/pub_1428.htm).

- The G-30 Report describes the **institutional approach** as one in which 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 G-30 Report describes the **functional approach** as one in which supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status, and notes that each type of business may have its own functional regulator. The G-30 found that the functional approach to regulation works well so long as coordination among agencies is achieved and maintained, but concluded that this form of regulation may be suboptimal, and noted that a number of jurisdictions are moving away from this model.
- The G-30 Report describes the **integrated approach** as one in which a single, universal regulator conducts both safety and soundness and conduct-of-business regulation for all sectors of the financial services business. The Report concludes that this model can be effective and efficient in smaller markets where oversight of the broad spectrum of financial services successfully can be coordinated and conducted by one regulator. The Report noted, however, that this model may create the risk of a single point of regulatory failure.
- The G-30 Report describes the **Twin Peaks approach** as 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 Report notes that 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. The Report also references the Treasury Blueprint as one attempt at proposing regulatory reform. Whatever the approach to financial supervision, the G-30 Report identifies a number of characteristics 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:** The Report discusses the importance of communication, information-sharing, and decision-making linkages between a central bank and large, systemically important financial institutions during times of both normal operation and crisis.
- **Deposit Protection Schemes:** The Report emphasizes the importance of effective, transparent and efficient deposit protection schemes.

- **International Communication:** International communication is also important, as in the case of supervisory colleges for systematically important global financial institutions in which regulatory agencies build linkages during times of both normal operations and crisis.

**K. GROUP OF 30 (G-30), FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY( JANUARY 15, 2009)**<sup>262</sup>

The G-30 January 2009 Report considers how the financial system should be organized after the present crisis. It seeks a consensus on identifying arrangements that will be useful both in the long term and in restoring confidence in the present. The Report examines:

- 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.
- Improvements in transparency and financial infrastructure arrangements.

**Introduction**

After reviewing the current crisis, the Report notes interacting conditions distinguishing it from earlier events:

Highly aggressive and unbalanced compensation practices have strongly encouraged risk taking over prudence. At the same time, highly engineered financial instruments, in their complexity, obscured the risk and uncertainties inherent in those instruments, giving rise to false confidence and heavy use of leverage to enhance profits, as asset prices rose. As those asset prices began declining, the risks became apparent, triggering sales of assets. A downward spiral of deleveraging has undermined the stability of even the largest financial institutions at the core of the system, contributing to an economic contraction of global proportions. Authorities in most countries have been stretched to and even

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<sup>262</sup> GROUP OF 30, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY, (2009) (“G-30 January 2009”), [http://www.group30.org/pubs/pub\\_1460.htm](http://www.group30.org/pubs/pub_1460.htm).

beyond the limits of their capacity to restore liquidity and contain the instability.<sup>263</sup>

### **Part 1: An Overview of a Program For Reform**

The Report says that 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.<sup>264</sup> On the other hand, it adds, 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

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<sup>263</sup> Id. at 13.

<sup>264</sup> Id. at 15-20.



the needs of global, national, and local businesses, governments, and individuals.<sup>265</sup> 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:

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<sup>265</sup> Id. at 17-20.

- 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 of effective regulation and supervision 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.

The Report maintains that “[t]he common expression ‘too big to fail’ is both misleading and too facile to reflect the reality of official support for ‘failing’ institutions.” Most typically, resolutions involve equity holders losing practically all of their investments, depositors and often other unsophisticated creditors are protected, and the institution loses its identity by liquidation, merger, or effective public ownership. In some recent instances, all types of creditors receive some protection and stockholders also retained some equity interest with a hope of recovery, thus more accurately fitting the description of ‘too big to fail.’”<sup>266</sup>

#### **Four Core Recommendations**

The Report's specific proposals are organized around four core recommendations:<sup>267</sup>

- 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.)

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<sup>266</sup> *Id.* at 20.

<sup>267</sup> *Id.* at 21.

## **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.<sup>268</sup>

### **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.<sup>269</sup>

- Regulators should restrict activities of systemically important banking institutions that present 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.<sup>270</sup>

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<sup>268</sup> Id. at 24-32.

<sup>269</sup> Id. at 27-28.

<sup>270</sup> Id. at 29.

- 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:<sup>271</sup>

- 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.<sup>272</sup> 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.

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<sup>271</sup> Id. at 29.

<sup>272</sup> Id. at 30-31.

- 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 also 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.<sup>273</sup>

- 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**

Improvement of prudential regulation and supervision 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).<sup>274</sup>

### **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

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<sup>273</sup> *Id.* at 31.

<sup>274</sup> *Id.* at 34-38.

fully capable of engaging senior private sector counterparts in meeting these challenges:<sup>275</sup>

- 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 tool:<sup>276</sup>

- 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."

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<sup>275</sup> Id. at 34-35.

<sup>276</sup> Id. at 35-37.

## **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, and “[n]ational regulatory authorities and finance ministers are strongly encouraged to adapt and enhance existing mechanisms for international regulatory and supervisory coordination.”<sup>277</sup> 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 cyclical 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 with continued attentiveness 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).<sup>278</sup>

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<sup>277</sup> *Id.* at 37-38.

<sup>278</sup> *Id.* at 40-46.



### **Recommendation 9: Regulatory Standards for Governance and Risk Management**

Standards of governance and risk management should be raised.<sup>279</sup> 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 establishing 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:<sup>280</sup>

- International regulatory capital standards should address tendencies toward procyclicality. Benchmarks for being well-capitalized should be raised, given the limitations of even the most advanced tools for estimating firm-wide risk.

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<sup>279</sup> Id. at 40-42.

<sup>280</sup> Id. at 42-43.

- 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.<sup>281</sup>

- “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.<sup>282</sup>

- 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

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<sup>281</sup> Id. at 43-44.

<sup>282</sup> Id. at 44-46.

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 CRMPG III, 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.)<sup>283</sup>

#### **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:<sup>284</sup>

- **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.

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<sup>283</sup> *Id.* at 48-56.

<sup>284</sup> *Id.* at 48-49.

- **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.<sup>285</sup> 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 product.

#### **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:<sup>286</sup>

- 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.<sup>287</sup> These mechanisms must “permit timely but not forced actions on the part of creditors and other counterparties to protect their interest”:

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<sup>285</sup> Id. at 50-51.

<sup>286</sup> Id. at 52-53.

<sup>287</sup> Id. at 53-55.

- 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 asset-backed and other structured fixed-income markets should be developed.<sup>288</sup> 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**

The Report notes the tradeoffs between the public benefits of transparency and firms’ legitimate concerns about the private respects nature of their market activity.<sup>289</sup> It

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<sup>288</sup> Id. at 55-56.

suggests that “[e]fforts 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.”

**L. 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)**<sup>290</sup>

In July 2008, the Committee on Market Best Practices of the Institute of International Finance (IIF) issued a report setting out principles of conduct, best practice recommendations, and considerations for officials in the areas of risk management; compensation policies; liquidity risk, conduit, and securitization; valuation; credit underwriting, ratings, investor due diligence in securitization markets; and transparency and disclosure. In issuing its Report, the Committee suggested that rigorous self-assessment and IIF monitoring, coupled with “recent painful experience and the market discipline by counterparties and investors” would “reinforce the drive toward consistently higher standards of conduct.”<sup>291</sup> That said, the Committee also said that it did not view industry standards as an attempt at self-regulation, nor did it view standards as a substitute for supervisory oversight of regulated financial institutions. Rather, it suggested that standards must “work in the context of an effective and efficient regulatory framework, adjusted as deemed necessary by the official sector, to rebuild market confidence.”<sup>292</sup>

**Risk Management**

**Establish a Risk Culture Throughout the Firm**

In evaluating the market crisis, the Committee found that certain firms failed to develop a comprehensive approach to risk management, causing them to fail to identify and/or manage key risks. As its first Principle of Conduct, the Committee concluded that for firms to manage risks more effectively, they must cultivate a “robust and pervasive risk culture throughout the firm . . . This risk culture should be embedded in the way the firm operates and cover all areas and activities, with particular care not to limit risk

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<sup>289</sup> *Id.* at 56.

<sup>290</sup> Institute of International Finance, 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 (2008), <http://www.iif.com/regulatory/>.

<sup>291</sup> *Id.* at 24.

<sup>292</sup> *Id.* at 8.

management to specific business areas or to restrict its mandate only to internal control.”<sup>293</sup>

### **Role of Board and Senior Management**

As part of this principle, the Committee affirmed that senior management and the CEO in particular must be responsible for risk management.<sup>294</sup> Among other best practices, the Committee made the following recommendations to implement this principle:

- Adopt clear policies that define risk management as the responsibility of senior management, and the CEO in particular, subject to oversight by the board of directors.<sup>295</sup>
- Make risk management a priority for the whole firm, and ensure that it is not focused only on a particular business or made a purely quantitative oversight process or an audit/ control function.
- Ensure that risk management is a key responsibility of the entire business line management team, not just of those that invest the capital of the firm on a proprietary basis.
- Ensure that all employees have a clear understanding of their responsibilities with regard to risk management and hold them accountable for their performance.
- “Implement controls to ensure that the governance structure that has been adopted is actually implemented in managing day-to-day business.”<sup>296</sup>
- Make control and “audit functions independent of organizations whose activities they review.”<sup>297</sup>
- Ensure that “finance and treasury functions operate in a coordinated and cohesive manner with the risk management function.”
  - Ensure that capital levels are adequately aligned to the risk of the firm.
  - “Ensure that risk considerations are taken into account during the planning process.”<sup>298</sup>
  - “Monitor the funding of the balance sheet together with the contingent liquidity commitments of the firm.”<sup>299</sup>

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<sup>293</sup> Id. at 31.

<sup>294</sup> Id. at 32.

<sup>295</sup> Id. at 32.

<sup>296</sup> Id. at 34.

<sup>297</sup> Id.

<sup>298</sup> Id.

- Cooperate in the profit-and-loss evaluation of risk models.<sup>300</sup>

### **Assess and Monitor Organizational Risk Appetite**

In addition to affirming the role of senior management, the Committee also found that firms must articulate their appetite for risk, and ensure that this tolerance for risk is adopted and applied throughout the firm. Among other best practices in this area, the Committee recommended the following steps:

- “Set basic goals for risk appetite and strategy and monitor how performance against such strategy evolves over time.”<sup>301</sup>
- “Consider all types of risk when defining risk appetite, including risks arising from the firm’s relationship to off-balance-sheet vehicles.”<sup>302</sup>
- Consider risk from both a quantitative and qualitative perspective, including by providing clearly defined quantitative elements to the board and senior management.
- Use risk appetite to establish risk limits which cascade down throughout the organization, including to business lines, division, regions and trading desks.
- Connect risk appetite to the firm’s overall business strategy, including assessment of business opportunities.
- “Involve the risk management function from the beginning of the business planning process to test how growth or revenue targets fit with the firm’s risk appetite and to assess potential downsides.”<sup>303</sup>

### **Role of The Chief Risk Officer**

The Committee found that one of the “clear lessons” from the current market turmoil is that risk management organizational structures need to be strengthened.<sup>304</sup> The Committee recommended the following best practices with respect to chief risk officers and the risk management function in general:

- “Assign responsibility for risk management to an officer at a senior level, in most cases a Chief Risk Officer (CRO) who should have sufficient seniority, voice, and

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<sup>299</sup> Id. at 34.

<sup>300</sup> Id. at 34.

<sup>301</sup> Id. at 9.

<sup>302</sup> Id.

<sup>303</sup> Id. at 35, 117.

<sup>304</sup> Id. at 9.



independence from line business management to have a meaningful impact on decisions.”<sup>305</sup>

- “Consider having the CRO report directly to the CEO and assign the CRO a seat on the management committee.”<sup>306</sup>
- Ensure that the CRO has the ability to influence key decision makers in the firm, with the mandate to:
  - Oversee the risk management organization.
  - “Ascertain that the firm’s risk level is consistent with its risk appetite, providing a thoughtful, integrated view of the overall risks the firm faces.”
  - Identify “developing risks, concentrations, and other situations that need to be examined via stress testing and other techniques.”<sup>307</sup>
  - “Oversee internal risk-rating systems, segmentation systems and models to ensure that they are adequately controlled and validated.”<sup>308</sup>
- Ensure that CRO and risk management function play a key role in analyzing, developing and introducing new products.
  - “New products with risk exposure, including those for which the bank accepts contingent liquidity or credit exposure, should be explicitly approved by the risk organization.”<sup>309</sup>

### **Risk Models and Integration of Risk Management Areas**

The Committee recognized that in the current market environment, risk management tools that were thought to be robust can nevertheless fail or prove inadequate. Among other recommendations, the Committee proposed the following conduct principles and best practices with respect to risk management tools and strategies:

- Adopt a comprehensive, firm-wide approach to risk management ensuring that risks can be identified and managed across business lines and portfolios.
  - Firms should use the approved risk parameters and regulatory requirements to assess risks, and should not rely solely upon external ratings of transactions.

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<sup>305</sup> Id.

<sup>306</sup> Id. at 36, 117.

<sup>307</sup> Id. at 10.

<sup>308</sup> Id. at 37, 118.

<sup>309</sup> Id. at 37.

- Adopt policies and procedures to identify and manage risk concentration, ensuring that risk management frameworks do not rely on a single risk methodology.
  - “Metrics should be calibrated closely to risk-appetite horizons.”<sup>310</sup>
  - “Take into account the technical limitations of risk metrics, models, and techniques (such as Value at Risk, or ‘VaR’).”<sup>311</sup>
- “Eschew the ‘silo’ approach toward risk management and take a comprehensive approach to risk, integrating strands such as credit, market, operational, liquidity, and reputational risk.”<sup>312</sup>
- “Ensure that the appropriate governance structure that has been adopted is actually implemented in managing day-to-day business.”<sup>313</sup>

### **Securitization and Complex Structured Products**

The Committee noted that a number of firms have experienced losses from securitized exposures far beyond amounts predicted by internal risk calculations and models. The Committee found that these losses have reinforced the perception that existing models and methodologies need to be refined to capture “fat-tail” risks.<sup>314</sup> In this regard, the Report recommends a number of best practices:

- Use an “integrated approach to risk management when dealing with complex structured products,”<sup>315</sup> and recognize “interdependencies along the product chain, including those aspects in which the firm is not directly involved.”<sup>316</sup>
- “Ensure that risk models ‘look through’ the direct risk and capture the market sensitivities of underlying exposures (e.g., mortgages).”<sup>317</sup>
- Ensure that “both the risk management and finance functions clearly understand the sources and risk/reward implication of P&L effects.”<sup>318</sup>
- Consider performance under stress, including both firm-specific and market stress, and new product approvals should include the conditions under which

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<sup>310</sup> Id. at 40, 119.

<sup>311</sup> Id. at 10.

<sup>312</sup> Id. at 10.

<sup>313</sup> Id. at 10.

<sup>314</sup> Id. at 43.

<sup>315</sup> Id. at 10.

<sup>316</sup> Id. at 42, 120.

<sup>317</sup> Id. at 10, 42 – 43, 120.

<sup>318</sup> Id. at 42, 120.

authorization is granted, including limits, performance requirements and assumptions that must remain valid.<sup>319</sup>

- For the public sector, “review the Basel II framework for securitizations.”<sup>320</sup>

### **Stress Testing**

The Committee also recognized that the market crisis exposed weaknesses in many firms’ stress testing methodologies. The Committee found that stress testing was not consistently applied, too rigidly defined, or inadequately developed. The Committee issued the following principles and recommendations (among others) to begin to address these issues:

- “Make stress testing part of management culture, so that its results have a meaningful impact on management decisions.”<sup>321</sup>
- Apply stress testing methodologies consistently and comprehensively across the firm, and use stress testing to complement and address the limitations of other risk management tools.<sup>322</sup>
- Include challenging scenarios in stress testing, and do not consistently underestimate the likelihood of severe events. Stress testing also should take into account the risk of model error and, in general, uncertainties associated with models, valuations and concentration risks.<sup>323</sup>
- “Ensure that methodologies identify and take into account firm-wide risk concentrations [whether on or off-balance sheet, contractual or non-contractual, contingent or non-contingent, including underwriting and pipeline risks], and integrate these methodologies into the overall risk management infrastructure.”<sup>324</sup>
- “Ensure that stress testing includes pipeline and warehousing risks (e.g., with respect to securitizations and leveraged loans) where the firm accumulates positions for subsequent distribution, incorporating events that might delay or prevent such distribution.”<sup>325</sup>
- “Take account of the effect of stresses on exposures to leveraged counterparties—including potential cross-correlation of the creditworthiness of such counterparties with the risk of the assets being hedged.”<sup>326</sup>

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<sup>319</sup> Id. at 43, 120 – 121.

<sup>320</sup> Id. at 42 – 45.

<sup>321</sup> Id. at 45, 121.

<sup>322</sup> Id. at 45.

<sup>323</sup> Id.

<sup>324</sup> Id. at 10.

<sup>325</sup> Id.

<sup>326</sup> Id.

- Take an analytical and exploratory approach to stress testing. Its results should be taken into account in decision making, but such output should be used with an appropriate degree of judgment and not made automatic.<sup>327</sup>

### **Compensation Policies**

The Committee found that the “growth of structured products and the originate-to-distribute business model have created incentives for firms and [in some cases] individual employees that conflicted with sound underwriting practices, realization of risk management goals, or the long-term interests of firms and shareholders.”<sup>328</sup> As an example of this problem, the Committee found that “in some cases, bonus payouts [were] tied to current production, without sufficient regard for [risk].”<sup>329</sup> To begin to address these concerns, the Committee issued a number of principles of conduct relating to compensation (among others):

- Base compensation incentives on performance and align them with shareholder interests, and long-term, firm-wide profitability, taking into account overall risks and the cost of capital.
- “Ensure that compensation incentives do not induce risk-taking in excess of the firm’s risk appetite.”<sup>330</sup>
- Ensure that payout of compensation incentives are based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time-horizon of the profit.<sup>331</sup>
- Ensure that incentive compensation reflects the firm’s overall results and risk management goals.
- Take into account realized performance for shareholders over time in determining severance pay.<sup>332</sup>
- Make the approach, principles, and objectives of each firm’s compensation policies transparent to stakeholders.<sup>333</sup>

The Committee provided a number of examples which it might develop into best practices over time, including the following compensation techniques:<sup>334</sup>

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<sup>327</sup> Id. at 10 – 11.

<sup>328</sup> Id. at 49.

<sup>329</sup> Id.

<sup>330</sup> Id. at 11.

<sup>331</sup> Id. at 49, 124.

<sup>332</sup> Id. at 124.

<sup>333</sup> Id. at 11, 49.

- Structure a significant portion of incentive pay in the form of deferred or equity-related components.
- Use risk-adjusted compensation metrics, including adjustment for the cost of capital.
- Distinguish an employee’s “alpha” value added to profits from advantages provided by the firm (e.g., a low cost of funding).
- Link a more material portion of pay packages to the risk time horizon.
- Review policies and performance periodically to maintain alignment of compensation policies with the firm’s risk appetite.
- Ensure effective management oversight to guard against manipulation and arbitrage of the compensation metrics chosen.
- Make incentives for risk-takers as comparable as possible across firms’ business groups.

## **Liquidity Risk, Conduit, and Securitization Issues**

### **General Principles**

With respect to liquidity risk and related issues arising out of the use of securitization and conduits, the Committee confirmed recommendations from the IFF’s March 2007 Report entitled *Principles of Liquidity Risk Management*. That Report said that firms should take a number of steps to reduce risk:

- “Have an agreed-upon and well-communicated strategy for day-to-day liquidity risk management, approved by the board of directors, and executed by an effective management structure.”<sup>335</sup>
- “Establish robust methodologies to monitor and manage funding strategies, [including] by currency, maturity, and jurisdiction, among other categorizations.”<sup>336</sup>

In addition to these recommendations, the Committee noted that because the use of (and risks posed by) conduits and securitization vary from firm to firm, “[t]here are no simple

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<sup>334</sup> The selected examples are taken directly from page 11 of the Executive Summary of the Report.

<sup>335</sup> Id. at 11.

<sup>336</sup> Id.

metrics or ex-ante quantitative measures that can provide adequate liquidity safeguards or adequate disclosure for internal or regulatory requirements. Instead, liquidity risk management practices should be tailored to each firm’s business model and the extent to which it participates in liquidity-dependent securitized markets.”<sup>337</sup> Among other recommendations, the Committee suggested that firms should diversify asset portfolios held for liquidity purposes and maintain a comprehensive, group-wide view of liquidity requirements.<sup>338</sup>

### **Transfer Pricing Mechanisms**

The Committee also suggested that firms improve internal transfer pricing mechanisms to ensure that business lines remain cognizant of liquidity risks generated by their operations:

- Firms should use prudent internal transfer pricing policies to reflect implied or incurred actual or potential costs related to liquidity demands from both on-and off-balance sheet businesses. Transfer pricing should take into account the liquidity of the underlying asset, the structure of underlying liabilities and risk exposures.<sup>339</sup>

### **Liquidity and Stress Testing**

The Committee also argued that firms should take the following steps to emphasize the importance of stress testing in liquidity risk management:

- Tailor funding liquidity risk management practices to business models in light of recent experience.
  - Ensure access to diverse sources of funding.
  - “Ensure that stress testing includes contingent liquidity exposures.”<sup>340</sup>
- “Examine through stress testing and analysis the conditions under which their balance sheets might expand during times of stress, and consider contingency plans.”<sup>341</sup>

### **Market Liquidity**

The Committee noted that during the recent crisis, problems often arose when markets failed and/or became illiquid. Accordingly, the Committee found that “firms that rely on market funding—in particular secured funding, including from securitization of assets or

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<sup>337</sup> Id. at 11 – 12.

<sup>338</sup> Id. at 12.

<sup>339</sup> Id. at 132, 141.

<sup>340</sup> Id. at 12.

<sup>341</sup> Id. at 11, 56, 126.

use of conduits—need to evaluate asset liquidity and potential reputation risks under stressed market conditions.”<sup>342</sup> The Committee advised such firms to “conduct rigorous contingency planning for market-risk developments, working with the official sector to the extent practicable.”<sup>343</sup>

### **Role of Central Banks And Supervisors**

The Committee found that central banks’ measures in response to the current crisis have been “essential in meeting liquidity challenges.”<sup>344</sup> Going forward, the Committee made a number of additional suggestions for action:

- Make recently developed instruments (such as term auction, securities lending, and swap facilities) part of central banks’ toolkits and harmonize them across national systems. More generally, work towards greater cooperation and harmonization across systems, considering structural or legislative changes that may be necessary.
- Consider expanding and harmonizing the eligibility of central bank collateral.
- Harmonize the availability of central bank currency swaps.
- “Consider providing greater clarity of their roles with respect to market-related liquidity needs”<sup>345</sup> for both firm-specific and market-related crises.
- “Participate in firms’ contingency planning, including periodic testing of central bank facilities.”<sup>346</sup>

### **Structured Finance Vehicles**

The Committee made a number of recommendations designed to capture and take into consideration risks related to the use structured finance and other off-balance sheet vehicles, including conduits:

- Capture “exposure to structured finance vehicles such as conduits . . . in liquidity planning, disclosure, and management.”<sup>347</sup>
- Consider contingent obligations to off-balance-sheet vehicles and the impact of having to support such vehicles when considering and responding to potential risks.

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<sup>342</sup> Id. at 12. See also id. at 57 – 58.

<sup>343</sup> Id. at 12, 58, 126.

<sup>344</sup> Id. at 58.

<sup>345</sup> Id. at 12.

<sup>346</sup> Id. at 61, 127.

<sup>347</sup> Id. at 12.

- “Assess all material potential exposures to securitization products and formal commitments to off-balance-sheet vehicles, including exposures to guarantors of transactions (such as monoline insurers)”<sup>348</sup> when designing and implementing risk management and governance procedures.
- Perform a “periodic look-through analysis of securitized assets [to] provid[e] early-warning signals of deterioration in underlying assets or other emerging securitization risks.”<sup>349</sup>

## **Valuation Issues**

With respect to valuations, the Committee affirmed that “fair-value accounting is an essential element of global capital markets, fostering transparency, discipline, and accountability.”<sup>350</sup> The Committee also found, however, that during the recent market crisis, many instruments became hard to value due to illiquidity. The Committee noted that during the run up to the crisis, as assets became less liquid and thus harder to value, certain market participants used indirect or model-based valuation methods. The Committee issued a number of recommendations to help firms provide more stable and better-understood valuations, including those reproduced from the Executive Summary here:<sup>351</sup>

- Maintain robust valuation processes in accordance with applicable accounting and regulatory guidance, incorporating critical expert judgment and discipline.
- Have an appropriate governance framework for valuations, including relevant functions such as risk management, finance, and accounting policy.
- Have an internal governance structure that ensures independence of control and validation of valuations, while providing for regular involvement of the CRO and CFO.
- Ensure that all relevant parties apply judgment in valuation, and not rely solely on mechanical processes.
- Ensure consistent application of independent and rigorous valuation practices, making use of all available modeling techniques and conducting regular review of independent price-verification procedures and sources.<sup>352</sup>

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<sup>348</sup> Id. at 13.

<sup>349</sup> Id.

<sup>350</sup> Id. at 13, 72.

<sup>351</sup> Id. at 71 – 84.

<sup>352</sup> Id. at 13.



The Committee also made recommendations to improve the availability of pricing data. Once again, these recommendations are taken directly from the Report's executive summary:

- Broader, more widely available and easily accessible price utilities.
- Appropriate controls over prices submitted to such utilities.
- Inputs from as broad a range of sources as possible.
- Ensure that model validation and price verification are a regular part of the firm's conduct of business.
- Ensure that valuations are subject to sensitivity analysis, taking care to recognize that dealer quotes and market prices may become dated and unreliable during periods of low liquidity.
- Have appropriate infrastructure in place to allow them to move from observable market prices to other valuation techniques when necessary given market conditions.<sup>353</sup>

The Committee also recommended a comprehensive, high-level technical dialogue between firms and auditors, rating agencies, investors, analysts, accounting standard setters, and supervisors on topics such as valuations in the mark-to-market environment. The Committee suggested that this dialogue should include a number of topics relating to valuation. These recommendations also are quoted directly from the Report's executive summary:

- Use of indirect inputs.
- Sound practice for model-based valuations.
- Clarification of boundaries between levels in the valuation hierarchy.
- Examination of the valuation of financial instruments in highly volatile or illiquid markets.<sup>354</sup>

### **Credit Underwriting, Ratings, and Investor Due Diligence In Securitization Markets**

With respect to underwriting, rating and investor due diligence, the Committee found that during the run-up to the current crisis, standards weakened throughout the process, with cost pressures leading to the use of an excessively model-driven process to assess risk.

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<sup>353</sup> Id. at 13 – 14.

<sup>354</sup> Id. at 14.

The Committee found that credit rating agencies did not effectively convey the risks of structured products, nor did they provide sufficient information on assumptions used to assess risks. The Committee observed that while certain sophisticated institutional investors made their own risks assessments, less sophisticated investors relied exclusively upon ratings when making credit decisions. The Committee found that the decline in lending and due diligence standards in the U.S. mortgage and mortgage-backed securities markets weakened the broader “originate-to-distribute” model and undermined market confidence more generally. Accordingly, the Committee proposed a number of recommendations targeting issues raised by credit underwriting, ratings and investor due diligence for three constituencies – originators/sponsors/underwritings/distributors, rating agencies and investors:<sup>355</sup>

### **Originators/Sponsors, Underwriters and Distributors**

- When participating “in the originate-to-distribute process, [firms] should apply the same credit due diligence standards at all stages regardless of whether assets are to be held on the books or distributed.”<sup>356</sup>
- Firms should monitor and disclose “the performance of underlying collateral . . . on an ongoing basis.”<sup>357</sup>
- “Firms should consider the general appropriateness of products for specific types of institutional investors. [Review] sales processes within firms to ensure proper consideration of the risk factors of products and risk profiles of investors at the time of sale.”<sup>358</sup>
- “All originators of assets underlying securitized instruments, whether regulated as banks or not, should adhere to basic credit principles, such as making a reasonable assessment of the borrower’s ability to pay and documentation should be commensurate with such basic requirements.
  - Non-bank originators should be held to the same standard as banks with regard to consumer protection and loan origination.”<sup>359</sup>
- During negotiations between borrowers and lenders (including underwriters, sponsors and other agents), pay careful attention to basic credit principles when dealing with leveraged loans and other corporate obligations.
  - Carefully consider the risk implications of negotiated terms of lending transactions.

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<sup>355</sup> Id. at 85 – 98. See also 15 – 17.

<sup>356</sup> Id. at 15.

<sup>357</sup> Id.

<sup>358</sup> Id. at 87.

<sup>359</sup> Id. at 88, 147.

- Firms should establish procedures for dealing with potential conflicts or contradictions between trading and placing strategies, including process for escalating potential issues to senior management.

### **Rating Agencies**

- Increase the independence of the credit rating process, along with the transparency and quality of credit ratings.<sup>360</sup>
- For complex structured products, ensure that credit rating reports articulate key risk factors and provide greater clarity on issues such as the definition of default and probability of default.
  - Adopt standards regarding internal processes for independent internal validation and monitoring of the models used to rate structured products.
  - Ensure that independent monitoring units within the agencies review the reasonableness of the assumptions and stress tests for structured products against ongoing performance data .
- Create an external mechanism to develop standards and review rating agencies' internal processes to assess their adherence to such standards.
- “Develop a different or additional scale (and/or system of symbols) for rating structured products.”<sup>361</sup>

### **Investors**

- Institutional investors and investment divisions within banks that invest in structured products should “conduct their own due diligence on structured products with respect to their investment mandates, horizons, and risk appetites and not rely solely on ratings in making investment decisions.”<sup>362</sup>

### **Transparency And Disclosure Issues**

While recognizing that different disclosure rules and regimes target the needs and objectives of different market participants, the Committee made a number of recommendations focusing on the transparency of structured products.<sup>363</sup>

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<sup>360</sup> Id. at 15.

<sup>361</sup> Id. at 16.

<sup>362</sup> Id. at 17.

<sup>363</sup> Id. at 98 – 105.

- “Develop a short-form summary of the offer document that would highlight key characteristics of an offering and make it simpler for investors to understand the risks of products they are purchasing.”<sup>364</sup>
- Harmonize market definitions and structures across markets.
- “Develop harmonized principles for transparency and disclosure of structured products across major markets.”<sup>365</sup>
- Adopt “common platforms and technology— such as data portals—to improve access to information on structured products.”<sup>366</sup>
- For officials, develop clear and consistent accounting and financial reporting standards.

The Committee also recommended that firms provide more useful disclosure to shareholders, counterparties, and regulators regarding their exposure (whether director or indirect) to securitized products:

- “Ensure that their disclosure provides a sufficient overview of current risk profiles and risk management processes and highlights key changes (from previous periods) to their current risk profile — including their securitization activities.”<sup>367</sup>
- “Include substantive quantitative and qualitative information about the valuation process.”<sup>368</sup>
- “Actively participate in efforts with the official sector and standard setters to develop meaningful and comparable disclosures on valuation uncertainties and sensitivities, with a materiality threshold to limit information overload.”<sup>369</sup>
- “Ensure appropriate disclosure of qualitative and quantitative information about their liquidity risk management practices and provide meaningful disclosure for material funding requirements for off-balance-sheet vehicles.”<sup>370</sup>

### **Systemic Risks and The Creation Of A Market Monitoring Group**

Finally, the Report notes that the IIF Board of Directors approved the formation of a Market Monitoring Group (MMG), under the auspices of the IIF. The Report states that

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<sup>364</sup> Id. at 18, 99.

<sup>365</sup> Id. at 18.

<sup>366</sup> Id.

<sup>367</sup> Id. at 18, 102, 151.

<sup>368</sup> Id. at 18.

<sup>369</sup> Id.

<sup>370</sup> Id.

the MMG “will serve as a forum for member firms to monitor global financial markets for early detection of vulnerabilities having systemic implications, to examine market dynamics that could lead to financial market strains, and to discuss ways to address such risks.”<sup>371</sup>

**M. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS  
TECHNICAL COMMITTEE (IOSCO), REPORT ON THE SUBPRIME  
CRISIS (MAY, 2008)**<sup>372</sup>

IOSCO’s *May Report on the Subprime Crisis* identified causes of the market crisis similar to those covered in earlier reports. These include declining credit and underwriting standards; widespread failures to understand complex structured financial products, particularly in combination with declining credit and underwriting standards; inadequate disclosures of the risks of transactions; a deterioration of the credit ratings process and uncritical reliance on credit ratings by investors, reliance unintentionally fostered by some regulations; consequent losses from subprime mortgage defaults; and a feedback cycle of losses, diminished confidence in markets, and market disruptions.<sup>373</sup>

**Issuer Transparency and Investor Due Diligence**

IOSCO pointed out that the disclosure problem combined failures to disclose information with investor failures to perform due diligence on transactions. It outlined information that investors should request about complex transactions and that firms should provide as a matter of course. “Given that the Task Force has found that (1) the recent market turmoil had relatively less effect on publicly traded structured finance products in some markets, and (2) that secondary trading of structured finance products, for a variety of reasons, is opaque,” it recommended further study in four areas.<sup>374</sup> It would compare typical structures and disclosures for private placements of asset-backed securities to such transactions in public markets. It would examine the reach of current disclosure standards to asset-backed securities and develop further principles if necessary. It would review the extent to which investment managers offering structured products to retail investors have performed due diligence on them, and how the market turmoil affected retail investors and investment managers in these circumstances. Finally, it would examine, with the financial services industry, how a secondary market reporting system for structured transactions might operate.<sup>375</sup>

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<sup>371</sup> Id. at 19.

<sup>372</sup> International Organization of Securities Commissions (IOSCO) Technical Committee, REPORT ON THE SUBPRIME CRISIS (2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf>.

<sup>373</sup> Id. at 1 – 7.

<sup>374</sup> Id. at 11.

<sup>375</sup> Id. at 7 – 12.

## **Firm Risk Management And Prudential Supervision**

In addition to its own experience, IOSCO drew on the Senior Supervisors Group *Observations On Risk Management Practices In The Recent Market Turbulence* (discussed below) to examine how failures in risk management contributed to the crisis. These failures included inadequate risk modeling and internal controls, over-reliance on credit ratings, inadequate balance-sheet liquidity, and off-balance sheet entities with liquidity puts. With respect to the last point, the Report observed:

[O]ne of the principal concerns that has arisen as a result of the subprime turmoil involves the quality of the disclosures provided by some investment banks, commercial bank holding companies and the financial guarantors about their exposures to unconsolidated conduits, SIVs or CDOs. In particular, some firms, for either contractual or reputational reasons, guaranteed liquidity for off-balance sheet entities they controlled, creating poorly disclosed obligations that neither investors nor even the firms themselves appeared to have understood. In some cases, triggers associated with the issuers' obligations were also poorly disclosed to regulators and investors, and liquidity puts factored poorly into the firms' own risk analysis.<sup>376</sup>

It outlined how standing committees of IOSCO would examine and consider recommendations in each of these areas.<sup>377</sup>

### **Valuation**

IOSCO noted that as “the recent market turmoil unfolded, issues relating to asset valuation and accounting treatment also became increasingly important [w]hile valuation and accounting are conceptually separate issues from risk management and internal controls, firms with stronger risk management systems and more robust internal controls also appeared better able to address the valuation and accounting issues that arose. Furthermore, in the case of both valuation and accounting, the core issue for regulators is whether the current approach—mark-to-market valuation and fair value accounting—is sufficient to the tasks to which they are put, or whether, as some critics have suggested, better alternatives exist.”<sup>378</sup> It reviewed the debate over mark-to-market accounting in circumstances where market prices are not readily available. Echoing the Senior Supervisors Group *Observations*, it also highlighted how some firms performed more effectively than others in trying to establish valuations, having sufficient qualified staff to assess valuations of securities they were charged to review, and maintaining systems to support these activities.<sup>379</sup>

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<sup>376</sup> Id. at 14.

<sup>377</sup> Id. at 12 – 16.

<sup>378</sup> Id. at 16.

<sup>379</sup> Id. at 16 – 19.

## **Credit Rating Agencies**

This section of the Report summarized IOSCO's *The Role of Credit Rating Agencies in the Structured Finance Markets* (May 2008), and we discuss that report separately below.<sup>380</sup>

### **N. INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS TECHNICAL COMMITTEE (IOSCO), THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (MAY 2008)**<sup>381</sup>

In May 2008, the Technical Committee of the International Organizations of Securities Commissions released its final report on the role of credit rating agencies in structured finance markets. The Report noted that during the first quarter of 2007, "observations relating the market for certain structured finance instruments, residential mortgage-backed securities (RMBSs) and collateralized debt obligations (CDOs) collateralized by or referencing RMBSs raised questions about the quality of CRA [credit rating agency] ratings and the independence of the CRAs rating RMBSs and CDOs."<sup>382</sup> As a result of these questions, the IOSCO Technical Committee asked its CRA 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<sup>383</sup> are the outgrowth of this efforts.

As the Report notes, unlike securities trading on deeper and more transparent markets, CRAs "have had an inordinate impact on the valuation and liquidity of subprime RMBSs and RMBS-backed CDOs."<sup>384</sup> In part, this happened because investors and market participants tended to outsource valuation and risk analysis to the CRAs. CRAs appear to have had little incentive to discourage this trend, given the growth and profitability that

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<sup>380</sup> Id. at 20 – 31.

<sup>381</sup> International Organization of Securities Commissions Technical Committee (IOSCO), THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS, (OICU-IOSCO) (2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>. In 2003, the Technical Committee of the IOSCO formed a task force to study issues relating to CRAs and issued a report describing the roles that CRAs play in the global capital markets and issues that may impact the quality of published ratings. At the same time, the Technical Committee also published a set of principles that regulators, CRAs and other market participants might follow to guard the integrity of the ratings process. The IOSCO later published a Code of Conduct Fundamentals for CRAs discussing how the 2003 principles might be applied in practice. In February 2007, the Technical Committee published as a consultation document a "Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies." As noted above, in the first quarter of 2007, market developments relating to RMBS and CDO prompted further review.

<sup>382</sup> Id. at 2.

<sup>383</sup> Technical Committee of the International Organization of Securities Commission, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES, (OICU-IOSCO) (2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

<sup>384</sup> Id.

CRA's have experienced in this market over the past several years.<sup>385</sup> While noting that responsibility for the current crisis rests in many quarters, the Technical Committee found that there are "serious questions" about whether credit ratings of RMBSs were based on incorrect information and faulty or dated models. Likewise, many have questioned whether CRA's should have reassessed the "quality of their methodologies and underlying assumptions when rating subprime structured finance instruments in light of credible information regarding housing market bubbles in the United States, the lack of incentives for mortgage lenders to conduct proper due diligence, and a possible increase in mortgage fraud, among other things."<sup>386</sup>

The Report points to several changes in the structured finance industry as contributing to the current crisis. The Committee found that as originally envisaged, structured finance was a way to diversify risks held on the balance sheets of issuers. Over time, however, structured finance debt securities such as RMBSs and CDOs began to be used as a funding mechanism for financial institutions whereby they packaged and sold assets that they either originated or purchased from another originator.<sup>387</sup> Instead of merely holding a portfolio of assets on firms' balance sheets, this so-called "originate-to-distribute" or OTD business model earned fees from distributing the re-packaged assets.

According to the Report, problems can arise when investors view ratings "as not only a CRA's opinion of the loss characteristics of a security, but also as a seal of approval."<sup>388</sup> The perception raises concerns because CRA's typically do not confirm the validity of the underlying data that issuers provide to them. Indeed, the Committee found that "some CRA's use quantitative models that rely entirely on publicly available information or quantitative information provided by the originator or even a third party."<sup>389</sup> The Committee found that while CRA's cannot be expected to uncover issuer fraud or obtain the level of confirmation required by independent auditors, the use of information that failed to pass even a basic "sniff test" and/or that failed to account for changes in the market "fundamentally undermine investor confidence in the rating process."<sup>390</sup> When ratings on RMBSs and CDOs began to be downgraded, investors were left with no independent means to assess risk, causing the market for these securities to "dislocate."<sup>391</sup> In light of these developments, the Technical Committee found that the role of CRA's in structured finance raises a number of regulatory concerns, including:

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<sup>385</sup> Id.

<sup>386</sup> Id. Among other issues, the Technical Committee noted that there are serious questions about whether institutional investors relied excessively on CRA's with little regard for the underlying risks of the financial instruments that they designed, bought and sold. The Technical Committee also noted that originators likely bear responsibility as well, since they employed progressively lax underwriting standards, may in some cases have provided inaccurate or misleading information to CRA's and may have "rating shopped" among the CRA's to ensure desired ratings regardless of risk.

<sup>387</sup> Id. at 5.

<sup>388</sup> Id. at 8.

<sup>389</sup> Id.

<sup>390</sup> Id.

<sup>391</sup> Id. at 9.



- CRA transparency and market perceptions
- Independence and avoidance of conflicts of interest
- CRA competition and the interaction of this competition may have on CRA independence<sup>392</sup>

## **Transparency and Market Perceptions**

### **Transparent and Comparable Ratings Performance Data**

Though noting that CRAs publish information about their rating methodologies, the Report cited concerns that many CRAs do not publish verifiable and easily comparable historical rating performance data. While noting industry concerns about data comparability, the Technical Committee found that “if the publication of ratings performance data is to have any meaningful use, the CRAs should endeavor to make it transparent and capable of some level of comparison.”<sup>393</sup>

### **Limitations on CRA Ratings**

The Committee noted that some have accused CRAs of being too slow to modify methodologies and assumptions despite rapid market changes. Likewise, some have questioned whether CRAs adequately disclosed assumptions used when rating structured finance products. Given these concerns, the Committee questioned whether some investors took “too much comfort” in CRA historical performance statistics, noting by way of “example that statistics regarding long-term default rates do not necessarily provide information about short-term default probabilities.”<sup>394</sup>

### **Credit vs. Liquidity Risk**

The Committee found that subprime market turmoil has highlighted misperceptions about credit as compared to liquidity risks. While noting that higher-rated securities historically have been more liquid and less subject to price volatility than their lower-rated counterparts, the Technical Committee emphasized that the “links between low default rates, low volatility and high liquidity are not logical necessities.”<sup>395</sup>

### **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, 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.

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<sup>392</sup> These concerns are reproduced verbatim from page 9 of the IOSCO Report.

<sup>393</sup> Id. at 10

<sup>394</sup> Id.

<sup>395</sup> Id.

Noting that there are differences of opinion on this issue, the CRA Task Force recommended that CRAs study the efficacy and desirability of such an approach.<sup>396</sup>

### **Ratings Downgrades**

The Report notes that 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 that the decision making process for reviewing and potentially downgrading an initial rating of a structured finance instrument is conducted in an objective manner which could include separating the initial rating function from the monitoring function, or other suitable means.”<sup>397</sup>

### **Independence and Avoidance Of Conflicts Of Interest**

The Report notes that many market observers have expressed concerns about conflicts of interest in the credit rating industry. As the Report notes, many of the CRAs receive a substantial portion of their revenue from the issuers that they rate, giving rise to concerns that a CRA may have an incentive to downplay credit risk in order to obtain or retain issuer business. Many observers have suggested that conflicts of interest are particularly acute in the context of structured finance, given the volume of deals and related ratings business attributable to particular financial institutions. In this regard, the Report found that there is evidence to indicate that the growth in CDO market over the past several years made structured finance ratings a fast growing income stream for the major CRAs.<sup>398</sup>

A related concern is that CRAs are not simply rating structured finance securities, but also are advising issuers on how to design the securities’ trust structure. While noting that the IOSCO CRA Code of Conduct includes provisions designed to minimize the likelihood of conflict of interests from ancillary business operations, the Report questions whether CRAs have sufficient controls in place to minimize such conflicts.<sup>399</sup>

### **Competition**

The Report also cites concerns that lack of competition in the credit rating industry may have (i) hindered the development of new CRA methodologies; (ii) given rise to monopoly pricing by dominant established CRAs; and (iii) inhibited rating innovation and quality. While noting that concentration in the CRA industry may provide benefits to investors in some situation, the Report suggests that investment banks and structured finance issuers often ask CRAs to provide prospective assessments on products before deciding which CRA to retain, arguably engaging in ratings shopping. The Report

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<sup>396</sup> Id. at 11.

<sup>397</sup> Id.

<sup>398</sup> Id. at 12.

<sup>399</sup> Id.

concluded that it was “conceivable” that lack of competition in the CRA industry could undermine the integrity of the rating process for structured finance products.<sup>400</sup>

## **Recommendations**

In the face of these concerns, the CRA Task recommended several changes to the IOSCO CRA Code of Conduct. The revised Code of Conduct Fundamentals For Rating Agencies, also issued in May 2008, seeks to address concerns relating to the quality and integrity of the rating process, independence and avoidance of conflicts of interests, and CRA responsibilities to the investing public.<sup>401</sup> Certain of the amendments are summarized here, with the full list available on pages fourteen through sixteen of the Report and in the companion revised Code of Conduct:

### **Quality and Integrity of The Rating Process**

- Ensure that the decision-making process for reviewing and potentially downgrading the current rating of a structured finance product is conducted in an objective manner
- Establish and implement a rigorous and formal review function responsible for periodically reviewing methodologies and models and significant changes to those methodologies and models. Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent of the business lines that are principally responsible for rating various classes of issuers and obligations
- Adopt reasonable measures so that the information CRAs use is of sufficient quality to support a credible rating
- Ensure that CRA employees on ratings committees have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit
- Establish a new products review function made up of one or more senior managers with appropriate experience to review the 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. In cases where the complexity or structure of a new type of structured product or the lack of robust data about

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<sup>400</sup> Id. at 14.

<sup>401</sup> Technical Committee of the International Organization of Securities Commission, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES, (OICU-IOSCO) (2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security, the CRA should refrain from issuing a credit rating

- 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

### **CRA Independence and Avoidance of Conflicts of Interest**

- 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
- 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 as an industry 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 analyses of structured finance products independently of the CRA contracted by the issuers and/or originators to provide a rating. CRAs should disclose in their rating announcements whether the issuer of a structured finance product has informed it that it is publicly disclosing all relevant information about the product being rated or if the information remains non-public
- Define what is considered to be (and not to be) an ancillary business and why

### **CRA Responsibilities to the Investing Public and Issuers**

- Assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use. CRAs should clearly indicate the attributes and limitations of each credit opinion, and the limits to which it verifies information provided to it by the issuer or originator of a rated security
- Publish verifiable, quantifiable historical information about the performance of rating opinions, 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 (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product 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
- 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
- Disclose the principal methodology or methodology version in use in determining a rating<sup>402</sup>

**O. ROBERT KUTTNER, PREPARED FOR DĒMOS, FINANCIAL REGULATION AFTER THE FALL(JANUARY 2009)**

Robert Kuttner, founder and co-editor of the American Prospect, prepared this paper for Demos. Dēmos is a non-partisan public policy research and advocacy organization headquartered in New York City. It states that it focuses on four goals: “a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and a responsible U.S. engagement in an interdependent world.”<sup>403</sup>

Kuttner writes that “[t]his 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.”<sup>404</sup>

The paper maintains that financial de-regulation, a process dating back to the 1970s, produced the current financial crisis. Financial markets have evaded market controls in key ways for decades. These vulnerabilities, which Kuttner argues set the stage for the Depression and the current financial crisis, include “lack of transparency, insider

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<sup>402</sup> International Organization of Securities Commissions (IOSCO) Technical Committee, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (2008) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>

<sup>403</sup> Dēmos, <http://www.demos.org/about.cfm> (last visited Jan. 21, 2009).

<sup>404</sup> Robert Kuttner, PREPARED FOR DĒMOS, FINANCIAL REGULATION AFTER THE FALL at 4 (2009), [http://www.demos.org.pubs/reg\\_fall\\_1\\_8\\_09%20\(2\).pdf](http://www.demos.org.pubs/reg_fall_1_8_09%20(2).pdf).

conflicts of interest, and dangerously high levels of leverage—all of which he argues 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.”<sup>405</sup> In the current crisis, very low interest rates by the Federal Reserve enabled financial engineers to use cheap credit to speculate with borrowed money, and “[s]ince falling interest rates tend to stimulate increases in asset value, financial speculators and ordinary investors gambled that rising asset values (homes, common stocks, exotic securities) would allow them to realize gains on thinly capitalized investments. The whole logic of the bubble economy could continue only as long as investors believed that asset values would continue to rise. The damages and potential for catastrophic collapse was compounded as the Federal Reserve kept resorting to very low interest rates and weak regulation to rescue the casualties of earlier bouts of speculative excess.”<sup>406</sup>

### **The Crash of an Ideology**

Kuttner argues that the current financial crisis contradicts certain ideas underlying the push for deregulation. In particular, he suggests that the current crisis contradicts the idea that innovations in financial markets that attract buyers/ investors are almost always beneficial and enhance economy efficiency and economic growth. Kuttner likewise argues that current market difficulties call into question (i) the notion that financial markets can police themselves, and that government intervention undermines beneficial financial innovation; (ii) financial innovators can circumvent regulation by shifting to unregulated activities and organizations in the United States and/or shifting business operations overseas; and (iii) regulation is wasteful because it slows innovation and stimulates costly but successful efforts to avoid it. In this regard, Kuttner noted that a series of studies beginning in 2006 maintained that the U.S. was losing its competitive positions in financial markets because of such regulation and private litigation, reinforcing this argument.<sup>407</sup>

Deregulatory initiatives based on these ideas, he says, ultimately failed their own fundamental 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. Kuttner argues that efficient regulation could have prevented these losses:

Financial markets, left merely to the discipline of supply and demand, are not competent to detect frauds; are not capable of discouraging dangerously high levels of leverage; or squeezing out excess insider compensation; or detecting even flagrant conflicts of interest; or accurately pricing complex financial instruments. Even disclosure requirements, though salutary, are no substitute for direct regulation of

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<sup>405</sup> Id. at 1.

<sup>406</sup> Id. at 1-2.

<sup>407</sup> Id. at 2-3.

standards. The terms of sub-prime mortgages were ostensibly disclosed to borrowers, but it was child's play for pitchmen to misrepresent risks.<sup>408</sup>

Better financial markets will require more disclosure, but also will require more prohibitions. "It is also worth noting that although the New Deal regulatory schema was primarily one of disclosure, it also explicitly prohibited many practices. It limited the use of margin, regulated payment of interest on bank accounts, prohibited commercial banks from performing the functions of investment banks, and a great deal more. While the regulatory response to the excesses that caused the current financial crisis will include many forms of greater transparency, some outright prohibitions will be needed as well."<sup>409</sup>

### **Abuses and Remedies**

Kuttner notes that central public policy challenges at present include rebuilding the banking and credit systems; accurately valuing and removing toxic assets blocking the flow of transactions in financial markets; stabilizing the system of housing and home finance; and designing "a simpler and more transparent financial system (one that is far less vulnerable to speculative abuse and systemic risk), and a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both these efforts must be that any institution that creates credit and hence risk needs to be subjected to prudential regulation. It doesn't matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision."<sup>410</sup> The paper advocates changes in the practices discussed below.

### **Credit Rating Agencies**

Credit ratings agencies 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. Investigations and 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.

Kuttner criticizes the SEC's recent proposals for more disclosures and reporting as too weak, and notes that others have proposed changes in the compensation systems. 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

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<sup>408</sup> Id. at 3.

<sup>409</sup> Id. at 4.

<sup>410</sup> Id. at 5.

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.”<sup>411</sup>

### **Securitization of Credit**

Securitization had been used throughout the 20<sup>th</sup> century, with much of the activity between the 1930s and 1970s in governmental initiatives to encourage housing. In the 1970s investment banks became involved in securitization, became more complex, and regulators did not examine the process closely. Kuttner says that his research demonstrates that securitization did not in fact increase the availability of credit to borrowers: “[i]n studying the first generation of private mortgage-backed securities, I tracked the spreads between 30-year mortgages and comparable Treasury securities in the twenty years before and after private mortgage backed securities were invented. If these innovations truly increased liquidity and availability of credit to borrowers, the spreads should have narrowed. In fact, the spreads bounced around but there was no trend. I could find no evidence that private mortgage-backed securities made mortgages more readily available or cheaper to qualified consumers.”<sup>412</sup> “Mortgage-backed securities grew exponentially during the liquidity crunch of the early 1980s, but this was a unique circumstance that did not necessitate a large and permanent mortgage-backed securities sector.”<sup>413</sup>

He maintains that the government should restore underwriting standards and simplify the securitization process; furthermore, “there is even a case for prohibiting”<sup>414</sup> the use of complex tranching on the grounds that it generates large fees for financial intermediaries but no clear economic benefits to financing valuable activities. At the very least there should be careful assessments of whether or not this practice enables entrepreneurs to find investors, enables investors to fine-tune their portfolio strategies, whether it produces economic benefits exceeding costs, and what the consequences would be if tranching were disallowed or otherwise severely restricted.<sup>415</sup>

He says that research should examine the slicing of mortgage-backed securities into so-called tranches with different degrees of risk and yield. “Tranching” has not been limited to mortgage-backed bonds. It has become a pervasive practice with no clear benefit to economic efficiency. “At the very least, there needs to be a full investigation of the costs, benefits, and risks of tranching. How, if at all, does this practice truly enhance the ability of entrepreneurs to find investors, or the ability of investors to fine-tune their portfolio strategies? Is tranching mainly a convenience for middlemen? Does the complexity and opacity overwhelm the arguable benefits? What would the system suffer if tranching were, in fact, disallowed?”<sup>416</sup>

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<sup>411</sup> Id.

<sup>412</sup> Id.

<sup>413</sup> Id. at 8.

<sup>414</sup> Id.

<sup>415</sup> Id.

<sup>416</sup> Id.



## **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. “Going forward, there are three interconnected policy challenges.”<sup>417</sup> The first is to restore a simple system of mortgage finance, with supervised banks and thrift institutions taking in deposits and making mortgage loans, and no product or originator permitted in the system unless it has sufficient capital reserves and is governmentally regulated. The second is to make housing affordable to those of moderate income; if public policy supports this goal, it should pursue it through direct governmental subsidies to homeowners rather than regulatory tolerance of exploitive and wasteful practices of private financial intermediaries seen in the past two decades. The third problem is to mitigate the current wave of defaults and disclosures. This could involve direct governmental refinancing, along with legal changes necessary to alter terms of mortgage-backed bond trades.<sup>418</sup>

## **Derivatives and Shadow Banks**

The paper suggests that much of the current activity in derivatives market consists of “bets on bets on bets”<sup>419</sup> without constructive economic purpose. It serves mainly to generate fees for financial intermediaries, producing excessive levels of leverage in the financial system—extremely high levels of “credit backed by no reserves,”<sup>420</sup> with no regulatory supervision. This violates the basic principle of “fractional reserve banking,”<sup>421</sup> in which banks are allowed to generate credit but maintain protective reserves in the event of loan loss, prudently restraining credit growth and maintaining appropriate lending standards.

Since the 1970s regulatory standards governing credit extension declined, producing a series of financial crises. Policy makers responded to the crises in various ways but did not increase the necessary long-term regulatory controls:

With the blurring lines between commercial and investment banks and the regulatory toleration of unregulated shadow banks such as hedge funds and mortgage brokers, the discipline of fractional reserve banking is badly compromised. Unlike a bank, a shadow bank is not required to keep reserves and is subjected to no examination. Unlike a portfolio of commercial loans, a portfolio of exotic derivative securities is much harder to value. Its market value can drop from its nominal worth to hardly anything, almost overnight. No reserves are held against the creation of

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<sup>417</sup> Id. at 9.

<sup>418</sup> Id. at 9-10.

<sup>419</sup> Id. at 10.

<sup>420</sup> Id. at 11.

<sup>421</sup> Id.

these bonds. There are further complications in the form of affiliated off-balance sheet entities created to hold such securities— nominally independent but actually liabilities of the bank. So the bank’s nominal balance sheet does not reflect its true risks.<sup>422</sup>

The high levels of liquidity in the past four years have more to do with declining regulatory standards for extensions of credit, including through derivatives transactions, than through high levels of savings in other nations; the “relationship of regulatory policy to monetary policy is worth further thought and exploration. Something is seriously wrong when monetary policy has to be used to compensate for the failure of regulatory policy, or when weak regulation becomes a de facto loosening of monetary policy. The two functions should be kept separate.”<sup>423</sup>

Kuttner suggests that, 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. Such action should be based on careful study of whether the collective economic benefits of such transactions exceed their costs. 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.”<sup>424</sup>

### **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.”<sup>425</sup> In contrast, exchange-traded derivatives such as traditional options and futures “have been relatively well-behaved.”<sup>426</sup> 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 did move them to exchanges, the CFTC, which likely would regulate them, must be strengthened.

In general, such derivatives should be registered as securities with related disclosure, examination, and reserve requirements. Requiring reserves would shrink the sector and, Kuttner says, that would be good. Further, the United States should consider many such derivative transactions entirely because otherwise financial engineers continuously will develop ways to circumvent restrictive regulations, allowing the underlying problems to persist. Kuttner argues that regulation can in fact constrain financial engineering in

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<sup>422</sup> Id. at 11.

<sup>423</sup> Id. at 11–12.

<sup>424</sup> Id. at 10–12.

<sup>425</sup> Id. at 12.

<sup>426</sup> Id. at 13.

socially valuable ways by “flatly and categorically” prohibiting certain types of transactions posing grave risks to the financial system.<sup>427</sup>

### **Credit Default Swaps**

Insuring bonds against default can facilitate socially valuable financing. However, Kuttner adds, the problem arises when 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.

Kuttner argues that at the end of the day, we may need strict limitations on the creation of derivatives, based on the degree of separation from the actual, real-world transaction. Writing insurance contracts against default of ordinary corporate and government bonds is straightforward and efficiency enhancing. But in the case of insurance contracts on the risk of other derivatives defaulting, the systemic risk, perverse incentives, and moral hazard may far outweigh the putative gains to “efficiency; these supposed gains, in any case, need to be defined rather than merely hypothesized. To put the proposition another way, how is the world worse off and the economy less efficient if entire categories of derivatives simply do not exist?”<sup>428</sup>

### **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 (for example, they deal with “sophisticated” investors not seen to need regulatory protection). Kuttner argues that they pose systemic problems because they account for a large share of financial market activity, intensify market disruptions by acting in similar ways, and support, by being counterparties, “dubious, highly-leveraged, and lightly regulated” transactions. Furthermore, they are “swamps” of conflicts of interest, facilitated by the fact that they are not subject to regulatory examinations or most other regulatory controls. He suggests that they should be regulated because they perform functions similar to regulated financial institutions.<sup>429</sup>

### **Short Selling**

Kuttner maintains that short sellers facilitate the marketing of risky, complex derivatives by acting as counterparties in such transactions, aggravate market volatility, and need to be examined critically. He writes, “if we don’t prohibit short selling outright, we need to further investigate the abuses and develop strategies to contain them—which is necessary in order to truly understand their impact on market volatility.”<sup>430</sup>

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<sup>427</sup> Id. at 12-14.

<sup>428</sup> Id. at 14-15.

<sup>429</sup> Id. at 16-17.

<sup>430</sup> Id. at 18.

## **TARP, Yardstick Competition, and Public Ownership**

The paper criticizes the Department of the Treasury's implementation of the TARP program as involving enormous public expenditures with few meaningful private concessions or restraints in exchange for the funding. Kuttner suggests that the TARP program 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 process, he writes, "has been to contract out...to other investment banks, creating new conflicts of interest. Part of the challenge is to rebuild, or build, new public capacity." <sup>431</sup>

During the New Deal, a popular concept in reform circles was "yardstick competition." President Roosevelt explicitly supported the idea when he sponsored public electrical power. If at least one publicly owned electrical utility operated in every market, the idea was, regulators could determine true costs and reasonable outlays for maintenance, marketing, construction of new capacity and pricing, and thereby have a yardstick to determine rates, performance standards, and reasonable levels of return for private competitors. In present circumstances, it would be salutary to have at least one commercial bank be a publicly owned institution, in the spirit of Roosevelt's Yardstick Competition. <sup>432</sup>

## **The Regulatory Architecture**

The paper refers to a "patchwork" nature of the United States financial regulatory system with its large number of federal and state regulators, and says that "few of these agencies distinguished themselves" <sup>433</sup> during the market crisis.

Were we designing a regulatory architecture from scratch, nobody would devise such a fragmented system (other than self-interested client industries that want as weak and divided a system as possible). But it is not yet clear how best to consolidate jurisdiction; and at this stage of the reform project, being clear about the principles of regulation is more important than rearranging the regulatory institutions. Ideally, there would be one agency in charge of all commercial bank examination. That agency would look a lot like a better- resourced FDIC. <sup>434</sup>

## **Securities Regulation and Self-Regulation**

Kuttner maintains that the "pervasive ideology of deregulation has weakened a once strong SEC." <sup>435</sup> He cites regulation 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

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<sup>431</sup> Id. at 20.

<sup>432</sup> Id. at 21.

<sup>433</sup> Id.

<sup>434</sup> Id.

<sup>435</sup> Id. at 22.

and registration, and stock options practices as needing more attention, also arguing for longer intervals between SEC service and relevant employment with regulated firms. He discusses the possibility of SEC/CFTC merger or related organizational changes, expressing concern over the weakness of CFTC regulation and opposing any weakening of the SEC's regulatory focus.<sup>436</sup>

The paper criticizes the operation of securities self-regulation (currently, the main securities SROs are the Financial Industry Regulatory Authority and NYSE Regulation), observing that “[t]here 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, such as PCAOB in the case of accountants.”<sup>437</sup>

### **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, regardless of the financial institution involved. Kuttner notes that the Federal Reserve has done so through 2007 without explicit authorization, and expresses concerns with the Fed taking such a role in the future.

Kuttner’s concerns are that the Federal Reserve is not a public agency and thus 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. It has also refused to aggressively implement a number of regulatory mandates that it currently has.”<sup>438</sup> What he calls its relatively weak performance as a prudential regulator, due partly to its structure, makes it “questionable whether one institution, especially one not fully public, should be given so much concentrated power.”<sup>439</sup> Kuttner indicates that the Federal Reserve especially should not receive control over investor protection through its new powers, given that prudential regulation and investor protection overlap as functions:

Given the Fed’s dismal performance as a bank and bank-holding-company supervisor and its traditional coziness with the banking industry, one should be wary of proposals to make the Fed into an uber-regulator, absent radical reform of the Fed itself, and perhaps not even then... 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

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<sup>436</sup> Id.

<sup>437</sup> Id. at 23.

<sup>438</sup> Id. at 24.

<sup>439</sup> Id.

before it can be fully relied upon as a prudential regulator of universal banks and their holding company affiliates.<sup>440</sup>

### **Regulatory Havens and International Regulatory Harmonization**

Kuttner also argues that 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).”<sup>441</sup> Thus, effective regulation of complex firms requires international cooperation among regulators and some degree of appropriate standardization. The paper notes that achieving this cooperation can be difficult, and also maintains that the standards that are achieved can be weak, citing the Basel capital agreements as an example:

In practice, the Basel norms had the effect of reducing capital standards in many cases; and they created the perverse incentive of encouraging banks to creatively invent off-balance-sheet affiliates not subject to capital standards. In addition, the sole reliance on capital standards left regulators without any other form of regulatory harmonization or other strategies of prudential regulation. Capital adequacy was seen as an all-purpose risk metric; Basel provided no international regulation of financial *products*....[A]ll the cumulative abuses that led to the financial collapse were utterly missed by the Basel standards. Procedurally, the work of creating these standards was non-transparent, and largely unwelcoming of public comment. It took place under the auspices of the Basel Committee (an opaque and largely unaccountable body of experts created in 1974), relying on intensely engaged industry lobbyists and representatives of national regulatory authorities and central banks at a time when regulation itself was highly out of fashion, even among regulators. The Basel process was widely understood more as an effort to create a competitive level playing field for international banks domiciled in nations with divergent regulatory standards than as an exercise in prudential regulation.<sup>442</sup>

The agreement does demonstrate that international financial regulatory cooperation is feasible, but he does not view the agreement as a success story.<sup>443</sup>

### **Historic Memory, Genies, and Bottles**

The New Deal limited interest rates that banks could pay depositors. New Deal architects believed that banks competing for deposits on the basis of higher interest rates would excessively relax lending standards in order to obtain the higher yields allowing them to raise interest rates and remain profitable. Kuttner traces the push for deregulation to the inflation, financial innovation, and the resulting breakdown of such rules governing

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<sup>440</sup> Id. at 25.

<sup>441</sup> Id. at 25.

<sup>442</sup> Id. at 26.

<sup>443</sup> Id.

banking in the 1970s. Government removed the interest rate restraint during the inflation 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:<sup>444</sup>

By the 1980s, with the advent of the Reagan administration, piecemeal regulatory acquiescence in risky innovations, which at first had reluctantly been accepted as necessary accommodations to the inflationary environment, became pervasive and dogmatic. Ad hoc deregulation became an ideological counter-revolution. In the new climate of regulatory laxity, financial engineers took advantage to invent ever more exotic and opaque products. Middleman fees skyrocketed. The financial economy became ever further removed from the real economy.<sup>445</sup>

Kuttner maintains that deregulation produced excessive risk and economic difficulties for financial institutions; they called for more deregulation to deal with the problems, threatening that more regulation would be devastating. He suggests, in contrast, 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."<sup>446</sup>

The fact is that the standard regulatory instruments are timeless, and have not been overtaken either by globalization or technology. These instruments include registration and disclosure; transparency; prudential examination to assure that standards are being followed; explicit prohibition of insider conflicts of interest; capital-adequacy and reserve requirements; accurate accounting standards; convergent global regulatory standards coupled with international crackdowns on tax- and regulatory havens; effective private right of action to further deter fraud; and outright prohibition of behavior that adds more to systemic risk than to economic efficiency. Sorting out the details of the crisis will take time. But make no mistake: the challenge of putting genies back into bottles is political, not technical.<sup>447</sup>

### **The Case for Drastic Simplification**

The paper concludes by questioning the fundamental value of financial innovation.

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

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<sup>444</sup> Id. 26- 27.

<sup>445</sup> Id.

<sup>446</sup> Id. at 28 -29.

<sup>447</sup> Id. at 29.

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?<sup>448</sup>

A well-regulated system focusing on core financial functions, he maintains, would lose nothing in actual economic benefits, would avoid wasteful activities and the periodic serious breakdowns appearing since 1980, and service broader economic interests more effectively.<sup>449</sup>

**P. NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, PROCEEDINGS OF THE NASAA FINANCIAL SERVICES REGULATORY REFORM ROUNDTABLE (DECEMBER 11, 2008)**<sup>450</sup>

Organized in 1919, the North American Securities Administrators Association (NASAA) describes itself as the oldest international organization devoted to investor protection.<sup>451</sup> 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.<sup>452</sup> This document summarizes statements by state securities regulators in a discussion of regulatory reform. It stems from NASAA’s core principles for regulatory reform, which can be found at [http://www.nasaa.org/issues\\_\\_\\_answers/legislative\\_activity/9775.cfm](http://www.nasaa.org/issues___answers/legislative_activity/9775.cfm):

**Introductory Statement**

“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.”<sup>453</sup>

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<sup>448</sup> Id. at 29 -30.

<sup>449</sup> Id.

<sup>450</sup> N. AM. SEC. ADM’RS ASS’N, PROCEEDINGS OF THE NASAA FINANCIAL SERVICES REGULATORY REFORM ROUNDTABLE: A MAIN STREET AGENDA FOR WALL STREET REFORM, (2008)  
[http://www.nasaa.org/content/Files/Proceedings\\_NASAA\\_Regulatory\\_Reform\\_Roundtable.pdf](http://www.nasaa.org/content/Files/Proceedings_NASAA_Regulatory_Reform_Roundtable.pdf).

<sup>451</sup> Id. at 3.

<sup>452</sup> Id.

<sup>453</sup> NASAA, NASAA’s Core Principles for Regulatory Reform in Financial Services, [http://www.nasaa.org/issues\\_\\_\\_answers/legislative\\_activity/9775.cfm](http://www.nasaa.org/issues___answers/legislative_activity/9775.cfm) (Last visited Jan. 21, 2009).



### **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.”<sup>454</sup>

### **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.”<sup>455</sup>

### **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.”<sup>456</sup>

### **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.

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<sup>454</sup> Id.

<sup>455</sup> Id.

<sup>456</sup> Id.

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.”<sup>457</sup>

### **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.”<sup>458</sup>

### **Themes in the Proceedings Regarding These Principles**

- The Proceedings present the statements by state official supporting and expanding on NASAA’s principles quoted above. The comments in the Proceedings make the following key points across speakers.
- 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.<sup>459</sup>
- 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.<sup>460</sup>
- 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.<sup>461</sup>

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<sup>457</sup> Id.

<sup>458</sup> Id.

<sup>459</sup> See e.g., N. AM. SEC. ADM’RS ASS’N, PROCEEDINGS OF THE NASAA FINANCIAL SERVICES REGULATORY REFORM ROUNDTABLE: A MAIN STREET AGENDA FOR WALL STREET REFORM at 4 – 6.

<sup>460</sup> Id. at 5.

<sup>461</sup> See id. at 9 – 10.

- Knowledge of local conditions aids state securities regulators. For example, Texas is distinctively aware of conduct 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.<sup>462</sup>
- The presence of multiple regulators can induce regulatory competition and innovation.<sup>463</sup>
- 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 . . . . One of the challenges then is the lack of government-wide standards for information sharing among federal-to-federal and federal-to-state agencies . . . . Integrating the elements of national and state power by leveraging each agency's core expertise is going to require more than the past history of voluntary sharing of selective information . . . . 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.”<sup>464</sup>

- 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.<sup>465</sup>

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<sup>462</sup> See *id.* at 5 – 6.

<sup>463</sup> *Id.* at 6.

<sup>464</sup> *Id.* at 7 – 8.

<sup>465</sup> *Id.* at 13 – 14.

**Q. PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS (PWG),  
POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS  
(MARCH, 2008)<sup>466</sup> AND PROGRESS UPDATE ON MARCH POLICY  
STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (OCTOBER  
2008)<sup>467</sup>**

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. In March of 2008, the PWG issued a *Policy Statement on Financial Market Developments* identifying what it saw as central causes of the financial crisis, steps to mitigate it, and to prevent future crises (PWG March). The President’s Working Group released a *Progress Update on March Policy Statement on Financial Market Developments* in October 2008 (PWG October).

**Erosion of Market Discipline and Poor Risk Management**

The March 2008 Report noted that the “turmoil in financial markets clearly was triggered by a dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in late 2004 and extending into early 2007. But the loosening of credit standards and terms in the subprime market was symptomatic of a much broader erosion of market discipline on the standards and terms of loans to households and businesses. Following many years of benign economic conditions and plentiful market liquidity, global investors had become quite complacent about risks, even in the case of new and increasingly complex financial instruments.”<sup>468</sup>

Desires for higher returns created strong investor demand for structured products: “[o]riginators, underwriters, asset managers, credit rating agencies, and investors failed to obtain sufficient information or to conduct comprehensive risk assessments on instruments that were quite complex.”<sup>469</sup> “Serious weaknesses in risk management practices at several large U.S. and European financial institutions, especially with respect to the concentration of risks, the valuation of illiquid instruments, the pricing of contingent liquidity facilities, and the management of liquidity risk” produced financial losses and diminished confidence in undertaking further transactions.<sup>470</sup> Regulatory policies “failed to mitigate those risk management weaknesses” (italics omitted); for example, capital requirements indirectly “encouraged the securitization of assets through facilities with very low capital requirements and failed to provide adequate incentives for

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<sup>466</sup> President’s Working Group on Financial Markets, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (March 2008),

[http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil\\_03122008.pdf](http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf)

<sup>467</sup> President’s Working Group on Financial Markets, PROGRESS UPDATE ON MARCH POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (October 2008),

<http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf>.

<sup>468</sup> PWG MARCH at 1 – 2.

<sup>469</sup> *Id.* at 2.

<sup>470</sup> *Id.*

firms to maintain capital and liquidity buffers sufficient to absorb system-wide shocks without taking actions that tended to amplify shocks. Further, supervisory authorities did not insist on appropriate disclosures of firms' potential exposure to off-balance sheet vehicles."<sup>471</sup>

The PWG's October update noted the recent federal interventions dealing with these problems, including actions regarding Fannie Mae, Freddie Mac, and AIG, as well as the bankruptcy of Lehman Brothers, Bank of America's purchase of Merrill Lynch, and other market developments. It also described the increased unwillingness of various institutions to extend credit, the associated "chilling" of the financial system, and various steps taken to enhance liquidity in the system, including the Federal Reserve's expansion of lending and the Emergency Economic Stabilization Act.<sup>472</sup>

### **Recommended Reforms**

The President's Working Group March 2008 Report recommended measures in five areas.

#### **Reforming Key Parts of the Mortgage Origination Process**

The March 2008 Report recommended that "[a]ll states should implement strong nationwide licensing standards for mortgage brokers; Federal and state regulators should strengthen and make consistent government oversight of entities that originate and fund mortgages; . . . and [t]he Federal Reserve should issue stronger consumer protection rules and mandate greater disclosures."<sup>473</sup> These would include enhanced disclosure of affordability over the life of the mortgage and facilitate comparison with terms of alternative products. State and federal regulators would enforce rules across mortgage originators, coordinating as necessary.<sup>474</sup>

The October update indicated that a nationwide mortgage licensing system had been established by state mortgage regulators through the Conference of State Bank Supervisors [CSBS], with 15 states currently participating, 24 scheduled to participate by January 2009, and 46 indicating their intent to participate.<sup>475</sup> Additionally, Federal and state authorities had issued guidance on underwriting of subprime mortgages, and states had strengthened related examination systems.<sup>476</sup> Federal and state regulators were reviewing underwriting standards and oversight applying to non-depository lenders with significant subprime mortgage operations, states had adopted a Nationwide Cooperative Protocol for Mortgage Supervision, and the CSBS had instituted a system of mortgage

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<sup>471</sup> PWG MARCH at 8 – 10.

<sup>472</sup> PWG OCTOBER at 3 – 6.

<sup>473</sup> PWG MARCH at 3.

<sup>474</sup> *Id.* at 3, 11 – 12.

<sup>475</sup> As of January 3, 2009, the Conference State Bank Supervisors website lists 24 states participating in the system. See State Regulatory Registry Homepage,

[http://www.stateregulatoryregistry.org/NMLS/AM/Template.cfm?Section=Participating\\_States1](http://www.stateregulatoryregistry.org/NMLS/AM/Template.cfm?Section=Participating_States1)

<sup>476</sup> PWG OCTOBER at 7.

supervision accreditation modeled after its accreditation for banking departments.<sup>477</sup> The Federal Reserve had enhanced its regulatory efforts in mortgage supervision, and a number of collaborative law enforcement and prosecutorial efforts, involving federal and state governments, were underway.<sup>478</sup>

### **Improving Investors' Contributions to Market Discipline**

The March Report said that those overseeing institutional investors should require the investors, and their asset managers, to obtain better information about the risks of securitized credits on an ongoing basis.<sup>479</sup> These overseers should ensure that such investors not rely solely on credit ratings, but rather develop an independent view of the risks.<sup>480</sup> The President's Working Group would engage the private sector to create a committee to develop best practices regarding such disclosures.<sup>481</sup>

The PWG's October update noted the Senior Supervisors Group release in April 2008 of its Report "Leading-Practice Disclosures for Selected Exposures," and the subsequent letters to firms by participating United States regulators and supervisors asking that the firms enhance their disclosures in line with its recommendations as appropriate.<sup>482</sup> The Securities and Exchange Commission had sent to certain firms, and made public, letters regarding accounting and disclosure, initiated a number of subprime-related investigations, and proposed amendments to conflict of interest rules and other matters pertaining to rating agencies.<sup>483</sup> The SEC and the Department of Labor had examined, and issued guidance for, money market fund and fiduciaries' decisions regarding investments in derivatives and complex financial instruments, and the New York State Insurance Department and National Association of Securities Commissioners addressed similar issues with respect to insurance companies.<sup>484</sup> The update commented on the Counterparty Risk Management Group III's August Report (discussed above), the template for disclosure developed by the American Securitization Forum, and other events related to independent assessment of risks by investors, accounting and disclosure, and valuation.<sup>485</sup>

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<sup>477</sup> Id. at 7 – 8.

<sup>478</sup> Id.

<sup>479</sup> PWG MARCH at 12 – 13.

<sup>480</sup> Id.

<sup>481</sup> PWG MARCH at 4, 12 – 14.

<sup>482</sup> PWG OCTOBER at 9.

<sup>483</sup> Id. at 9 – 13. See U.S. Sec. And Exch. Comm'n, SEC APPROVES MEASURES TO STRENGTHEN OVERSIGHT OF CREDIT RATING AGENCIES (2008) ("The Commission approved revised rules governing credit rating agencies, and proposed additional revisions, on December 3, 2008."), <http://www.sec.gov/news/press/2008/2008-284.htm>

<sup>484</sup> PWG OCTOBER at 12.

<sup>485</sup> PWG OCTOBER at 9 – 14.

## **Reforming the Rating Agencies' Process For and Practices Regarding Structured Credit and Other Securitized Credit Products**

The PWG March Report said that “[c]redit rating agencies [CRAs] should disclose what qualitative reviews they perform on originators of assets that collateralize [asset-back securities] rated by [the agencies], and [the agencies] should require underwriters [of asset backed securities] to disclose the level and scope of due diligence performed on the underlying assets.”<sup>486</sup> The CRAs should improve the integrity and transparency of their rating processes.<sup>487</sup> They should prevent conflicts of interest; reveal their analytical assumptions so that users can understand the bases of ratings; clearly differentiate ratings of structured products from those of corporate or municipal securities; make available to the public ratings performance measures that would facilitate comparison across products and ratings; provide investors assistance and information required for them to make informed decisions about risks; and should allocate sufficient personnel and resources to monitor and update ratings. The President’s Working Group would help establish a private sector group to recommend further steps to ensure the integrity, transparency, and appropriate use of ratings, and the PWG, through supervisory policy and regulation, would reinforce all these steps as appropriate.<sup>488</sup> The PWG also would revisit the need for further oversight if required.<sup>489</sup>

The PWG’s October update reported that “[m]uch progress has been made” on this front.<sup>490</sup> In July the SEC issued a report demonstrating various weaknesses in CRA processes and the SEC had proposed new rules governing CRA practices and investor uses of ratings. The SEC finalized certain of these rules in December, with other proposals pending.<sup>491</sup> [IOSCO] and an industry task force led by the Securities Industry and Financial Markets Association [SIFMA] also had published recommendations regarding CRAs; we discuss the SEC, IOSCO, and SIFMA reports separately.<sup>492</sup>

## **Strengthening Global Financial Institutions’ Risk Management Practices**

The PWG March Report stated that global financial institutions should remedy weaknesses in their risk management practices. With PWG support, a private-sector group should assess implementation of the Counterparty Risk Management Group II’s principles and recommendations regarding risk management, modified as necessary based on recent information.<sup>493</sup> Supervisors should monitor firms’ efforts to address these weaknesses, intervening if necessary.<sup>494</sup> U.S. banking regulators and the SEC

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<sup>486</sup> PWG MARCH at 4.

<sup>487</sup> Id.

<sup>488</sup> PWG MARCH at. 4 – 5, 14 – 15.

<sup>489</sup> Id.

<sup>490</sup> PWG OCTOBER at 15.

<sup>491</sup> See <http://www.sec.gov/news/press/2008/2008-284.htm>.

<sup>492</sup> PWG OCTOBER at 14 – 16.

<sup>493</sup> PWG MARCH at 5, 15 – 16.

<sup>494</sup> Id.

should issue new guidance on in firms' risk management practices.<sup>495</sup> The new guidance should cover information systems, including systems to aggregate exposures across business lines and rigorously value positions; management of risk concentration, liquidity risk, stress testing, and other preventions of damage from system-wide shocks; and governance of risk management, including compensation incentives.<sup>496</sup> U.S. authorities should encourage other supervisors of global firms to make complementary efforts.<sup>497</sup>

The October 2008 update pointed out that supervisors were establishing a template for benchmarking firms' risk management practices against the recommendations of the Senior Supervisors Group *Observations On Risk Management Practices In The Recent Market Turbulence* (discussed below) and the Counterparty Risk Management Policy Group III Report (discussed earlier).<sup>498</sup> Regulators also had undertaken enforcement or supervisory actions involving specific firms in the intervening months, and firms generally were strengthening their risk management procedures.<sup>499</sup> The New York State Insurance Department and National Association of Insurance Commissioners had implemented new programs to oversee risk management within firms, effective late in 2008 through 2010.<sup>500</sup>

### **Enhancing Prudential Regulatory Policies**

The PWG March Report said that regulators should align capital requirements with firm-wide exposure to on and off-balance sheet risks in ways that adjust effectively to market conditions, and “enhance guidance” related to managing risks of the originate-to-distribute model.<sup>501</sup> The Basel Committee on Banking Supervision [BCBS] should update its guidance on liquidity management, and the BCBS and IOSCO should review capital requirements for securitizations and off-balance sheet commitments “with a view toward increasing requirements on exposures that have been the source of recent losses to firms.”<sup>502</sup> Regulators should require financial institutions to improve disclosures regarding asset-backed commercial paper [ABCP] conduits and other off-balance sheet vehicles, and valuation procedures and estimates for complex and other illiquid instruments, including the relative uncertainty of valuations.<sup>503</sup> Regulators should review the use of ratings required by regulations and supervisory procedures, “at a minimum” distinguishing in their policies between ratings of structured credit products and of corporate and municipal bonds.<sup>504</sup> Regulators should encourage the Financial

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<sup>495</sup> Id.

<sup>496</sup> PWG MARCH at 5, 15 – 16.

<sup>497</sup> Id.

<sup>498</sup> PWG OCTOBER at 17.

<sup>499</sup> Id. at 16 – 19.

<sup>500</sup> Id. at 16 – 19; see also LETTER FROM MATTI PELTONEN, BUREAU CHIEF, CAPITAL MARKETS BUREAU TO NEW YORK AUTHORIZED INSURERS (Nov. 18, 2008), [http://www.ins.state.ny.us/circltr/2008/cl08\\_25.pdf](http://www.ins.state.ny.us/circltr/2008/cl08_25.pdf).

<sup>501</sup> PWG MARCH at 5 – 6, 17 – 18.

<sup>502</sup> Id.

<sup>503</sup> Id. at 17 – 18.

<sup>504</sup> Id. at 18.



Accounting Standards Board to assess the standards related to consolidation and securitization, and FASB and the International Accounting Standards Board to achieve convergence of accounting standards for ABCP conduits and other off-balance sheet vehicles.<sup>505</sup>

The PWG October update reported that “[m]any initiatives are underway.”<sup>506</sup> In July U.S. agencies issued final guidance under Basel Pillar 2 “to provide incentives for financial institutions to hold capital cushions (both forward looking and adjusting appropriately through peaks and valleys of the credit cycle) commensurate with firm-wide exposure (both on- and off-balance sheet) to severe adverse market events.”<sup>507</sup> The guidance also described banks’ needs to account for risks other than credit, market, or operational risk.<sup>508</sup> The PWG noted that “supervisors are currently reviewing firms’ models, underlying processes and systems, data, validation, and oversight and control mechanisms in preparation for the qualification process for the advanced approaches rule.”<sup>509</sup> The Basel Committee on Banking Supervision issued a report on best practices in liquidity management in September (discussed above), and the PWG referred to activities of the Senior Supervisors Group, NYSID, NAIC, and SEC mentioned above as examples of progress in prudential supervision as well.<sup>510</sup>

### **Improvements to the OTC Derivatives Market Infrastructure**

In March the PWG recommended that supervisors should insist that the industry set “ambitious standards” for submitting OTC derivatives trade data and resolving matching errors, “urge the industry to promptly amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event, in accordance with the terms of the cash settlement protocol that has been developed but not yet incorporated into standard documentation,” and improve the operational infrastructure supporting OTC derivatives.<sup>511</sup> Operational improvements should capture all significant events over the trade cycle; ensure reliability and scalability; maximize the benefits of standardization and interoperability components in automated processing systems; and improve portfolio reconciliation and accurate valuation of trades in netting and collateral agreements, thus enhancing counterparty risk management.<sup>512</sup> The improvements should address all major asset class and product types and encompass both the buy-side and sell-side dealer communities.<sup>513</sup>

The October update noted that in the summer of 2008 industry participants strengthened standards for the accuracy and timeliness of trade data submission and error resolution,

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<sup>505</sup> Id. at 18.

<sup>506</sup> PWG OCTOBER at 20.

<sup>507</sup> Id.

<sup>508</sup> Id. at 20 – 21.

<sup>509</sup> Id. at 21.

<sup>510</sup> PWG OCTOBER at 19 – 23.

<sup>511</sup> PWG MARCH at 6 –7, 18 – 19.

<sup>512</sup> Id.

<sup>513</sup> Id.

and the International Swaps and Derivatives Association had committed to establishing an auction-based mechanism to settle obligations in credit default swaps following a credit event.<sup>514</sup> Market participants had taken other steps to improve OTC derivatives processing, including development of a central clearing facility for credit derivatives.<sup>515</sup>

Finally, the October PWG update emphasized that “Notwithstanding the substantial progress that has occurred in implementing its recommendations, the PWG believes that further efforts are still warranted in each of the areas in which it made recommendations.”<sup>516</sup> It added that firms’ willingness to actually implement the newly-identified “best practices” would substantially determine the effectiveness of the initiatives to improve risk management, disclosure, and other operational areas: “the success of these steps ultimately depends upon market participants’ compliance and effective oversight by state and federal authorities . . . the success of some of these measures will depend on whether these proposals are accepted by the industry as best practices . . . Global financial institutions are identifying the gaps in their risk management practices; firms must dedicate sufficient resources to addressing the weaknesses that are identified . . . authorities must monitor firms’ progress in implementing guidance to ensure that the benefits of various reforms are realized.”<sup>517</sup>

**R. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA), RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE (JULY 2008)**<sup>518</sup>

Citing concerns about the quality of ratings and a decline in investor confidence, the Securities Industry and Financial Markets Association (SIFMA) Credit Rating Agency Task Force also published recommendations relating to CRAs and the ratings process in July 2008. Many of the recommendations track those set forth in the IOSCO and SEC Reports.

**Enhanced Disclosure of CRA Rating Methodologies**

The task force found that while CRAs published general descriptions of security rating methodologies, the information “was generally insufficient” for investors to understand CRA rating methodology with respect to structured securities.<sup>519</sup> The task force

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<sup>514</sup> PWG OCTOBER at 23 – 24; see also Int’l Swaps and Derivatives Ass’n, Inc., ISDA PROVIDES UPDATE ON HARDWIRING PROCESS (2008) *available at* <http://www.idsa.org/press/press2008.html>.

<sup>515</sup> PWG OCTOBER at 23 – 24.

<sup>516</sup> Id. at 24 – 25.

<sup>517</sup> Id. at 25.

<sup>518</sup> SIFMA, RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE (2008) *available at* [http://www.sifma.org/capital\\_markets/docs/SIFMA-CRA-Recommendations.pdf](http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf)

<sup>519</sup> Id. at 3. The SIFMA task force found that ratings of structured products generally were in large part based on CRA “statistical models that predicted future performance of the assets that

determined that because investors generally did not understand ratings methodologies, they “could not on their own determine any potential flaws in the CRA’s analyses, and were unable to monitor the performance of the securities (some of which proved to be more susceptible to ratings volatility than traditional rated corporate debt) in comparison to the assumptions underlying the CRAs; ratings.”<sup>520</sup> The task force concluded that greater disclosure by CRAs concerning the ratings process, including statistical models, would enhance transparency in the structured products markets, enabling investors to better understand and evaluate CRA analysis, and monitor the performance of rated securities over time.<sup>521</sup> Among other recommendations, the task force suggested the following additional disclosures listed on page four of the SIFMA CRA Report:

- A description of the CRA model and model outputs (including cumulative collateral loss assumptions and assumptions relative to the pre-securitized assets and loss curve over time, timing of losses, default frequency and severity expectations, the amount of loss coverage required at each rating level, and credit enhancement requirements)
- Inasmuch as ratings are not purely model-driven, and deviations from the model are common, a description of any material deviations from the rating or credit enhancement analysis called for by the CRA model, any material adjustments to the model for the purpose of the subject rating, and the reasons for such deviations/adjustments
- A description of qualitative factors relied upon by the CRA in its analysis
- A description of the key risks and sensitivities of the rating to key variables (as well as compensating factors) considered by the CRA in determining its rating, such as external changes that could cause a rating to change (*e.g.*, a decline in home prices), including any stress test results<sup>522</sup>

### **Enhanced Disclosure of Due Diligence Information**

The task force found that CRAs generally performed limited or no independent review or due diligence to confirm the accuracy of data provided to them regarding the assets underlying structured securities. Instead, CRAs substantially relied on publicly available information or the representations of other parties (including issuers) with regarding to the reliability of data. The task force found that in some instance, CRAs may have relied on information that may have been questionable on its face given market developments. The task force found that CRAs’ reliance on third party information “may have led to

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collateralized the rated securities, based on the past performance of apparently similar assets.” Id. The task force determined that certain of these models, particularly those relating to RMBS, “proved to be based on overly optimistic assumptions about asset performance.” Id.

<sup>520</sup> Id.

<sup>521</sup> Id. at 4

<sup>522</sup> Id. at 4.

ratings that were inaccurate reflections of the default risk of such structured securities.”<sup>523</sup> The task force therefore recommended that CRAs make a number of disclosures in pre-sale reports concerning due diligence and CRA reliance. These recommendations are taken from page five of the SIFMA CRA Report:

- Whether and to what extent the CRA has conducted or reviewed any independent examination and/or review to confirm the accuracy of underlying data and asset origination standards relating to a security
- If the CRA relied on the due diligence or examination of another (such as an issuer, underwriter, or third party) with respect to the rating of a security: who conducted the due diligence or examination, what their relation is to the transaction, and the extent to which such due diligence or examination was relied upon
- What the due diligence analysis entailed (*e.g.*, data accuracy, origination standards and processes, loan level due diligence, credit, or value)
- With regard to asset-backed securities, what due diligence was conducted on the individual securities or assets in the collateral pool underlying the structured deal, and what if any individual components did not receive any due diligence review
- The results of the due diligence review, including the exceptions that were noted

The SIFMA CRA Report notes that there are various views concerning who should disclose due diligence and examination information involved in the ratings process. The task force acknowledged that a number of CRAs are of the view that the “owners” of the information (*e.g.*, issuers) and not CRAs are best positioned to take on the responsibility of additional disclosure. The SIFMA CRA Report concludes, however, that the “CRA is the party best suited to disclose the due diligence and examination information that the CRA used in issuing its rating.”<sup>524</sup>

### **Disclosure of CRA Surveillance Procedures**

The task force found that more timely and diligent surveillance of rated securities would reduce the incidence of delays between deteriorating asset performance and ratings downgrades and uncertainty regarding downgrades. The task force recommended that CRAs disclose in pre-sale reports information about the nature and extent of surveillance to be performed after initial ratings are issued. The task force suggested that disclosure concerning surveillance include the following information (at a minimum) taken from pages eight and nine of the SIFMA CRA Report:

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<sup>523</sup> Id. at 5.

<sup>524</sup> Id. at 7.

- How frequently the CRA will review the rated security (*e.g.*, on a certain periodic or event-driven basis), and how often the rating will be updated, if the circumstances warrant an update
- Whether the timing and nature of a surveillance review will depend on external factors (*e.g.*, the frequency and quality of updated data received from the issuer or servicer of the security)
- How soon after the CRA receives updated data it will review the data and, if appropriate, act upon the new information by updating or confirming a rating
- The extent of the surveillance review (*e.g.*, review of a particular security, a particular sector, or, type of transaction)
- What the surveillance review will entail (*e.g.*, a quarterly assessment comparison of security performance to initial collateral loss expectations and assumptions; periodic or event-driven sector analyses)
- If the issue is a structured finance security, whether its rating will be periodically updated based on a re-analysis of the underlying assets or securities; if so, how often this re-analysis will be conducted; and how this will affect the surveillance of the structured finance security
- Whether the team or analyst conducting the surveillance is different from the party who was involved in assigning the initial rating, and if so why
- Whether different models are used for rating surveillance than for initial ratings, and whether changes made to rating models and methodologies, including their criteria and assumptions, are retroactively applied to existing ratings
- The status of current surveillance for each rating<sup>525</sup>

### **Disclosure of Comparable CRA Performance**

The task force found that CRAs have not routinely published easily verifiable and comparable historical performance data regarding their ratings, making it difficult (if not impossible) for market participants to compare the performance of different CRAs. The task force recommended that CRAs publish verifiable, quantifiable historical information about their ratings in formats that help investors compare CRA performance. The task force suggested that such disclosures should include “transparent historical ratings migration and default performance by asset class on a directly comparable basis.”<sup>526</sup>

### **Differentiation Between Core And Consulting Services**

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<sup>525</sup> *Id.* at 8 – 9.

<sup>526</sup> *Id.* at 9.

The task force found that there is perception by some market participants that the degree and nature of interaction between CRAs and issuers during the ratings process may result in conflicts of interest. While noting that the CRAs have committed to plainly indicating that they do not and will not provide consulting or advisory services to issuers that they rate, the task force recommended that CRAs clearly define “core” rating services and distinguish them from “consulting or advisory” services.<sup>527</sup> The task force identified the following activities, taken from page ten of the SIFMA CRA Report, as permissible core services:

- The assignment and monitoring of public, private, and private placement ratings
- Issuance of credit estimates and hypothetical ratings, including requested Rating Evaluation Service and Rating Advisory Service (RES/RAS) services regarding issuer-proposed structures of hypothetical securities, indicative, or preliminary ratings, and impact assessments
- Hybrid securities assessment services
- Internal assessments
- Ratings coverage of project and infrastructure finance transactions and hybrid securities
- Dissemination of press releases and rating reports (that include the rating opinion)
- Research reports and other publications, including methodologies, models, newsletters, commentaries, and industry studies
- Regular oral and written dialogue with issuers, intermediaries, investors, sponsors, regulators, legislators, trade organizations, and the media, and
- Conducting and participating in conferences, speaking engagements, and educational seminars<sup>528</sup>

Notably, the task force concluded that these core services “include the iterative process that occurs between an issuer, arranger, underwriter, and CRA during the rating of structured finance, project and infrastructure finance, and hybrid securities.”<sup>529</sup> The task force suggested that it is a “misperception” that this type of consultation amounts to consulting services giving rise to conflicts of interest.<sup>530</sup>

### **Creation of Global Credit Ratings Advisory**

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<sup>527</sup> Id. at 10.

<sup>528</sup> Id.

<sup>529</sup> Id.

<sup>530</sup> Id. at 11.

## **Board And Convergent Regulatory Framework**

The task force recommended the creation of a global, independent industry credit ratings advisory board under the auspices of SIFMA.<sup>531</sup> In addition, recognizing that credit rating issues are global in nature, the task force also recommended that governmental and regulatory bodies “act in accordance with the need for a more fully harmonized and convergent global regulatory framework.”<sup>532</sup>

## **Disclosure of CRA Fees**

The task force found that there is a perception among some market participants that the issuer pays model of CRA compensation creates inherent conflicts of interest. The task force noted that this perception is particularly acute in the area of structured finance, because an increasing amount of CRAs’ revenue streams have been attributed to this business over the past several years. The task force noted that the issuer pays model has given rise to concerns about client dependence and a perceived risk that CRAs may inflate ratings to ensure continued client relationships.<sup>533</sup>

To address these concerns, the task force recommended that CRAs be required to submit disclosure regarding their fee structures to applicable regulators for review. The task force also recommended that CRAs and issuers of structured securities agree that rating fees associated with surveillance be paid directly from the related transaction structures on a periodic basis.<sup>534</sup>

## **Consistent Ratings and Ratings Modifiers**

The task force found that market confidence in the rating of structured products has been undermined by the recent pace and extent of downgrades, particularly involving RMBS and certain CDOs, and by the inconsistency between ratings migration with respect to structured products and other asset classes such as corporate bonds. The task force recommended that CRAs review ratings processes for structured products to ensure that the performances of ratings are line with other asset classes. The task force also said that it supported CRA efforts to enhance disclosure relating to volatility,<sup>535</sup> but questioned whether using different symbology (or otherwise affixing a code to ratings of structured products to distinguish these ratings/ products from traditional asset classes such as corporate bonds) would accomplish desired goals.<sup>536</sup>

## **Independent Risk Analysis by Investors**

The task force found that investors’ increasing reliance on credit agency ratings, to the detriment of the investors’ own valuations, risk analyses and continuing review of

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<sup>531</sup> Id.

<sup>532</sup> Id. at 12.

<sup>533</sup> Id.

<sup>534</sup> Id. at 12 – 13.

<sup>535</sup> Id. at 13 – 14.

<sup>536</sup> Id. at 14.

structured products, caused credit agency ratings to have an inordinate impact on the valuation and liquidity of structured products, and RMBS 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.<sup>537</sup>

### **Disclosure by Issuers and Underwriters**

The task force affirmed that it is important for all market participants, including issuers and underwriters, to examine what measure they can take to improve processes affecting the ratings system. The task force recommended that issuers and underwriters consider giving greater disclosure to investors, including potentially, information regarding the following items listed pages seventeen and eighteen of the SIFMA CRA Report:

- Standardization of disclosure of the due diligence process undertaken by the issuer, underwriter, and/or third party due diligence provider on each securitization, including:
  - Who performed the due diligence
  - What the due diligence analysis entailed (*e.g.*, with respect to RMBS, rules defining the sample selection, sample size as a percentage of the pool, percentage of sample loans removed from the securitization for non-conformity to stated characteristics in offering documents, and the reasons for removal from the pool)
  - The results of this due diligence, including what exceptions were noted
- Standardization of initial or periodic disclosure of collateral characteristics, on an asset-class basis, in line with SIFMA/ASF/ESF-generated templates
- Historical performance of similarly underwritten pools, if relevant
- Disclosure of additional data elements in standardized periodic remittance reports (such as FICO or other consumer credit scores, loan to value ratios, and others), to enhance transparency and risk assessment of structured finance securities on an ongoing basis
- Standardization of remittance reports by asset class, to facilitate greater transparency in the market
- Standardization of commonly used definitions, to the extent feasible<sup>538</sup>

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<sup>537</sup> Id. at 16.

<sup>538</sup> Id. at 17-18.



**S. JOEL SELIGMAN, TESTIMONY FOR A HEARING OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON THE FUTURE OF FINANCIAL SERVICES REGULATION (OCT. 21, 2008)**<sup>539</sup>

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?”

**Distinguish Time Pressures for Short Term Remedies and Long Term Restructuring**<sup>540</sup>

Seligman writes, first, 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 leading to the design of the laws in the 1930s.

Second, 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.”<sup>541</sup>

Third, 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.”<sup>542</sup>

Fourth, Congress must examine carefully the tradeoffs between having a single agency addressing systemic risk and having several expert specialized agencies. Seligman maintains that while a good case can be made for having the Federal Reserve or Treasury as a central crisis manager, to make either of them dominant federal financial regulators would be very risky.

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<sup>539</sup> Joel Seligman, Testimony for a Hearing of the House Committee on Financial Services on the Future of Financial Services Regulation (2008), [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/seligman102108.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/seligman102108.pdf).

<sup>540</sup> Id. at 2.

<sup>541</sup> Id. at 2 – 3.

<sup>542</sup> Id. at 3.

## **The Tradeoffs of Narrow and Broad Regulatory Jurisdiction**<sup>543</sup>

A focused agency with a high level of expertise in a particular area, such as the Securities and Exchange Commission, provides important benefits. (In fact, Seligman notes, one of the SEC's main architects, James Landis, originally favored the Federal Trade Commission to implement the securities laws as part of its broad jurisdiction, but after further thought changed his mind. "The broader an agency's jurisdiction the more likely it is to not have the resources or capability to address all appropriate priorities."<sup>544</sup> The SEC's own history shows how certain key functions can suffer when an agency is given too wide a range of tasks for its resources; the over-extension of its examinations for corporate disclosures contributed to accounting scandals in the late 1990s. Sarbanes-Oxley created the Public Company Accounting Oversight Board, assuring that a federal agency with a narrow agenda would oversee audit quality, not needing to weigh vastly different, competing priorities. But, Seligman notes, PCAOB might not have been necessary in the first place if the SEC's Division of Corporate Finance had been given sufficient resources for its tasks.

Seligman 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."<sup>545</sup>

He suggests that a Congressional Select Committee, drawing from the leadership of the several committees overseeing financial markets, should examine these organizational questions. Such a Select Committee would reduce the likelihood that individual committees, and individual agencies' perspectives, would inhibit full consideration of options.

## **The Place of Principles-Based Regulation and Overall Regulatory Strategy**<sup>546</sup>

Beyond the question of regulatory structure is how regulation should function. Seligman reviews the argument for "principles-based" regulation as a basic approach. He notes the practical difficulties of actually implementing principles without often detailed rules, citing a principle of futures contracts not being "readily subject to manipulation."<sup>547</sup> "What, for example, is manipulation? It is not a self-defining term. What records must be

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<sup>543</sup> Id. at 3 – 6.

<sup>544</sup> Id.

<sup>545</sup> Id. at 4.

<sup>546</sup> Id. at 6 – 7.

<sup>547</sup> Id. at 6.

retained? What form and manner will be acceptable to the [Commodity Futures Trading] Commission?”<sup>548</sup>

There are sometimes quite negative consequences of an overemphasis on core principles. To the extent that this may result in ambiguity in legal requirements, core principles may inspire greater litigation. The history of the SEC in areas such as the net capital rule suggests that without detail and customizing by type of transaction a principle or rule itself can be undermined by unexpected SRO or industry initiatives as was done in the late 1960s during the so-called back office crisis.<sup>549</sup>

### **The Need to Consider Thoughtfully the Details of Reorganization**<sup>550</sup>

While it makes sense to explicitly identify a crisis manager, Seligman questions the benefits of consolidating 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.”<sup>551</sup>

Existing federal financial regulatory agencies often have quite different purposes and scopes. Bank regulation, for example, has long been based on safety and solvency priorities; securities regulation largely focuses on investor protection. The scope of banking regulation addresses, among many other topics, consumer protection. Securities laws address full disclosure, accounting standards, audit quality, broker-dealer and investment adviser regulation, regulation of stock exchanges and fraud enforcement, among many other topics. Insurance and commodities regulation have similar distinctive purposes and scope. These differences in purpose and scope, in turn, are often based on the quite different pattern of investors (retail versus institutional, for example), different degree of internationalization, and different risk of intermediation in specific financial industries.<sup>552</sup>

The agencies’ political structures are also different. The Treasury is part of the Executive branch; the Federal Reserve and SEC are independent agencies, but the independence varies between the Federal Reserve as a self-funding organization and the SEC and other independent agencies whose budget is submitted by the administration.

Consolidating agencies should be considered, but if the Federal Reserve and Treasury explicitly are given crisis management powers then the case for more comprehensive

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<sup>548</sup> Id. at 7.

<sup>549</sup> Id.

<sup>550</sup> Id. at 7 – 9.

<sup>551</sup> Id. at 7 – 8.

<sup>552</sup> Id. at 8.

consolidation is weaker, and further consolidation should be done only after asking certain questions on a case-by-case basis. These questions include the purpose of the legislation underlying each of the affected agencies; the specific logistics of examination, trading rules, enforcement, and private legal action in each area; whether consolidated agencies should be independent or part of the Executive branch; whether independent agencies should be self-funding or subject to the budget process; the approach to rules in the consolidated agency; the impact of the reorganization on global regulatory coordination and action; and the role to be played by self-regulatory organizations in the reorganized agencies' jurisdictions. He concludes, "These and similar pivotal questions should inform the most consequential debate over financial regulation that we have experienced since the New Deal period. The answers are neither simple nor obvious, but one conclusion is inevitable: How well we develop the structure of financial regulation will help determine this nation's financial stability for decades to come."<sup>553</sup>

**T. SENIOR SUPERVISORS GROUP, OBSERVATIONS ON RISK MANAGEMENT PRACTICES IN THE RECENT MARKET TURBULENCE (MARCH 6, 2008)**<sup>554</sup>

In 2007 the Financial Stability Forum, which promotes international financial stability through information exchange and regulatory cooperation, initiated a study of risk management practices at firms, focusing on periods both before and during the current financial crisis. The resulting document by the Senior Supervisors Group, entitled *Observations on Risk Management Practices During the Recent Market Turbulence*, summarizes the review conducted by seven 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. The Senior Supervisors Group surveyed 11 global banking organizations and securities firms in 2007 regarding their oversight and risk management in 2007, and met with select firms' senior management in November 2007 and industry representatives in February 2008.

As the Senior Supervisors Group noted, unfamiliar market conditions beginning in 2007 tested firms' risk management practices:

After an extended period of ample financial market liquidity and generally low credit spreads in many economies, the sharp loss in the value of subprime mortgages and related mortgage-backed securities and the deterioration in investor appetite during the summer of 2007 led to broad and deep market distress. Because these and other innovative products had been created during the prior period of more benign market conditions, banks and securities firms had not

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<sup>553</sup> *Id.* at 9.

<sup>554</sup> The Senior Supervisors Group, OBSERVATIONS ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE (March 6, 2008) [SSG March 2008] [http://www.newyorkfed.org/newsevents/news/banking/2008/ssg\\_risk\\_mgt\\_doc\\_final.pdf](http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf).

observed how such products would behave during a significant market downturn and found their risk management practices tested to various degrees.<sup>555</sup>

Though the firms entered the second half of 2007 in relatively strong financial condition, many subsequently experienced serious losses, due in large part to concentrated and in many cases unexpected exposures to U.S. subprime mortgage-related credit. As the Report notes, “[w]hat drove most directly the absolute and relative dimensions of loss were the strategic decisions that some firms made to retain large exposures in super-senior tranches of CDOs that far exceeded the firms’ appreciation of the risks inherent in such instruments. Firms did not recognize the possibility that losses on the underlying MBS [mortgage backed securities] could reach levels that could impair the value of even the super-senior tranches of collateralized debt obligations of asset-backed securities [ABS CDOs].”<sup>556</sup> Based principally on their survey and access to information on the firms’ operations, the Senior Supervisors Group identified risk management practices that may have differentiating firms’ performance in weathering the crisis.

### **Summary of Key Observations And Conclusions**

The Report has four main sections: key observations and conclusions, and discussions of senior management oversight within firms, liquidity risk management, and credit and market risk management. The summary of key observations and conclusions sections covered three topics: (a) firm wide risk management practices that differentiated performance; (b) three business lines where varying practices differentiated performance; and (c) the response by supervisors to the Observations findings.

#### **Four Firm-Wide Risk Management Practices That Differentiated Performance**

The Report identified four firm-wide risk management practices that differentiated performance:

- ***Effective firm-wide risk identification and analysis.*** Firms varied in how effectively their senior management team, business line risk owners, and control functions shared quantitative and qualitative information. In firms with more difficulties, business line and senior managers did not engage with each other as well, leaving “business areas to make some decisions in isolation regarding business growth and hedging, and some of those decisions increased, rather than mitigated, the exposure to risks.”<sup>557</sup>
- ***Consistent application of independent and rigorous valuation practices across the firm.*** Firms that performed better were skeptical of rating agencies’ assessments of complex securities and so developed effective internal systems for valuing securities, making full use of their in-house expertise and looking

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<sup>555</sup> Id. at 1.

<sup>556</sup> Id. at 2.

<sup>557</sup> Id. at 3.

critically at information related to valuations. In contrast, firms that had more problems did not have internal systems to challenge valuations and relied relatively passively on external ratings.<sup>558</sup>

- ***Effective management of funding liquidity, capital, and the balance sheet.*** Firms that performed better actively monitored how decisions by individual business units affected the firm’s consolidated balance sheet, liquidity, and capital positions. In contrast, firms not performing as well did not closely align their “treasury functions . . . with risk management processes and lacked complete access to flows of information across all businesses in the firm and an understanding of the changing contingent liquidity risk of new and existing businesses . . . Accordingly, these firms failed to create incentives for business lines to manage such potential scenarios prudently.”<sup>559</sup>
- ***Informative and responsive risk measurement and management reporting and practices.*** Firms that performed better had information systems that used multiple tools and assumptions including both quantitative and qualitative analysis to estimate risks across business unit lines and the entire firm. In contrast, “[f]irms that encountered more substantial challenges seemed more dependent on specific risk measures incorporating outdated (or inflexible) assumptions that management did not probe or challenge and that proved to be wrong. Some firms that lacked alternative perspectives on risk positions lost sight of how risk was evolving or could change in the future and what that might mean for the aggregate size of their gross versus net exposures.”<sup>560</sup> Firms found that while value-at-risk (VaR) measures performing as expected in some respects, they suffered from reliance on historical data that did not reflect current circumstances. Some firms’ uncritical reliance on credit rating agencies’ assessments “stands in marked contrast to the sophistication of their existing internal credit assessment processes in other business lines.”<sup>561</sup>

### **Three Business Lines Where Varying Practices Differentiated Performance**

The *Observations* identified problems in three business lines in particular where varying practices resulted in differentiated performance. Firms experiencing severe losses had tried to expand their CDO and leveraged financing loans without critically assessing the true risk of exposures, and several firms “did not properly recognize or control for the contingent liquidity risk in their conduit businesses or recognize the reputational risks associated with the SIV [structured investment vehicle] business.”<sup>562</sup>

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<sup>558</sup> Id.

<sup>559</sup> Id. at 3 – 4.

<sup>560</sup> Id. at 4.

<sup>561</sup> Id. at 5.

<sup>562</sup> Id. at 5.

## Supervisory Response

Based on these findings, “primary supervisors are critically evaluating the efforts of the individual firms they supervise to address weaknesses in risk management practices that emerged during the period of market turmoil.”<sup>563</sup> Reforms included strengthening the Basel II capital framework by increasing incentives for firms to think about risk more adequately, improving guidance and standards for handling various dimensions of risk and necessary risk management systems, and addressing related disclosure, accounting, and compensation issues.<sup>564</sup>

## Senior Management Oversight

The *Observations* emphasize the importance of senior management oversight in firms, and identified four key differences in the quality of such oversight at firms both before and in response to the financial crisis:

- **The Balance Between Risk Appetite and Risk Controls.** Senior management varied in the extent to which they emphasized the importance of enforcing controls on the risks stemming from the desire to complete transactions.
- **Senior Management’s Role in Understanding and Acting on Emerging Risks.** Senior management differed in how actively they personally identified, understood, and acted to manage risks.
- **Timing and Quality of Information Flow up to Senior Management.** Some firms’ senior management dealt aggressively with organizational impediments to the flow of information necessary to identify and manage risk; others did not.
- **Breadth and Depth of Internal Communication across the Firm.** Senior management varied in how aggressively they required “cross-disciplinary discussions” regarding risks across the firm.

Business, risk management, and control offices worked together closely in better-performing firms, with risk management and control units playing an influential role in how the firms responded to emerging challenges. In these firms, senior management actively developed effective risk management and control structures across their firms in order to keep pace with the growth of risk taking. They “promoted a continuous dialogue between business areas and risk management functions at the top of the firm on whether the firm was achieving an appropriate balance between its risk appetite and risk controls. These discussions became more active as the market turmoil intensified.”<sup>565</sup> In contrast, senior management at firms with large unexpected losses pushed for increased market share and revenues without concurrently focusing on controls within the individual business units or the organization as a whole.<sup>566</sup>

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<sup>563</sup> *Id.* at 6.

<sup>564</sup> *Id.* at 6.

<sup>565</sup> *Id.* at 7.

<sup>566</sup> *Id.* at 6 – 10.

## **Liquidity Risk Management**

All firms experienced severe liquidity problems as investors were less willing to purchase assets, and firms were less willing to lend to each other because they needed the liquidity for themselves or were concerned about counterparties' exposure to losses. Some firms dealt with liquidity management more effectively than others both before the crisis and during it.

### **Planning and Managing Internal Pricing for Contingent Events**

Treasurers in firms that handled the crisis more effectively remained in close contact with business lines and understood and acted on risks across their firms. Other firms did not sufficiently assess the extent to which individual business lines' actions posed risks for the firm, and failed to plan for changes in obligations as the market crisis unfolded.<sup>567</sup>

### **Funding Liquidity Management During the Stress Event**

Effective funding managers monitored and managed their funding liquidity positions using quantitative and qualitative information, and could respond to rapidly changing market information. Experienced judgment, including a willingness to question built-in assumptions of models and to turn examine market conditions more directly and effectively, were important in dealing with this situation.<sup>568</sup>

### **Contingency Funding Plans**

Firms' contingency plans had not anticipated the scope and severity of problems experienced in 2007 and all the firms surveyed said that they were making improvements in their systems as a result. Even tests focusing on market-wide disruptions did not anticipate the ways in which market disruptions eventually impaired liquidity. Also, the tests did not foresee that firms "would need to make business decisions to maintain their reputation and position in the market. For example, firms did not anticipate the need to support entities for which they were not contractually obligated to do so, such as money market funds or SIVs. Firms had also not anticipated the need to deal with intense media coverage or to incorporate reputation risk considerations into funding decisions. Furthermore, firms had not fully anticipated the need to balance funding liquidity management needs with the desire to maintain business relationships with customers. For example, one firm noted that it needed to continue providing funding for certain customers in order to protect the business relationship."<sup>569</sup>

## **Credit and Market Risk Management**

Some firms performed better than others in using quantitative and qualitative information to actively question assumptions about the value and behavior of products.

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<sup>567</sup> *Id.* at 10 – 11.

<sup>568</sup> *Id.* at 11.

<sup>569</sup> *Id.* at 11 – 12.



## **Valuation Practices Relevant to Risk Management**

“Firms that adopted more active approaches to valuation typically devoted considerable resources to establishing specialized product financial control staff able to perform a fundamental analysis of the underlying positions. Some firms also enforced discipline internally in marking their assets to their estimated prices. This discipline was evident, for example, in the use of consistent marks across both proprietary positions and financed counterparty positions. Such firms furthermore factored position size (to account for the market impact of immediate sales of such size) and the dispersion of observed prices into their valuation marks. Other firms, however, had not created robust internal processes prior to the turmoil to verify or challenge their business units’ own estimates of the value of their holdings.”<sup>570</sup> For example, some firms, when trying to establish valuations, told trading desks to make sales in order to establish prices, or looked to disputes over the market value of collateral. Other firms did not question values as effectively, sometimes using values biased towards par values even later in 2007.<sup>571</sup>

## **Use of a Range of Risk Measures**

Firms that avoided major unexpected losses “used a wide range of risk measures to discuss and challenge views on credit and market risk broadly across different business lines in a disciplined fashion. Some firms gave particularly thorough consideration to the interplay of the market sensitivities of derivative exposures (the ‘greeks’), notional limits, value-at-risk, static single-factor stress tests, and historical and forward-looking scenario analysis in a way that the other firms did not. These firms tended to use processes and measures that could be adjusted to reflect new circumstances, and they understood the limitations of individual risk measures.”<sup>572</sup> Firms differed in the number of tools they used to assess risks and the number of indicators they used to assess risk concentrations, the extent to which they questioned Value-at-Risk figures given market conditions, and in their critical use of price data sets and measurement of volatility. They also varied in how actively they tried to anticipate unexpected correlations among asset classes, how thoroughly they tested for different correlations among market variables in different conditions, how well they understood the range of exposures across the firm in an integrated fashion; and the degree to which they connected profit and loss reporting systems with risk management systems.<sup>573</sup>

## **Stress Testing and Scenario Analysis**

Industry generally acknowledges the importance of using stress tests, including tests considering major changes and shocks. All firms in the survey emphasized the improvements they were making to their systems in this regard. “In some firms,” the report commented, “a particular challenge to risk managers was obtaining senior

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<sup>570</sup> Id. at 12 – 13.

<sup>571</sup> Id. at 12 – 14.

<sup>572</sup> Id. at 14.

<sup>573</sup> Id. at 14 – 16.

management and business line acceptance of stress tests—in particular, the hypothetical forward-looking scenarios—which seemed extreme to some senior managers.”<sup>574</sup> Most firms in the survey were making improvements in their stress testing and scenario analyses to balance more effectively the consideration of new scenarios while maintaining sufficient stability in the measures to allow them to monitor their risks over time.<sup>575</sup>

### **Hedging of Market and Credit Risks**

All firms used hedging to reduce exposure to market risks but varied in their success. Firms that were particularly effective used hedging “based on their consolidated risk positions across businesses and in light of a wide range of available qualitative and quantitative risk information. Some of these firms coordinated the short positions through active ‘macro overlay’ positions approved by senior management in dialogue with the business owners and risk control staff. By contrast, firms that did not maintain a consolidated perspective on risk and instead left hedging decisions to the business lines generally found their hedging strategies to be less effective, as different traders or business lines relied on the same hedge in an uncoordinated manner.”<sup>576</sup> Again, risk managers at several firms were rethinking their approaches to market risk hedging based on the experiences over the previous year.<sup>577</sup>

### **Credit Underwriting and Reporting**

The Senior Supervisors reported firms’ discussions of the decline of credits standards: “While risk measures and hedging techniques address exposures that firms have already assumed, firms also stressed the importance of understanding new credits that their business originated or purchased from others. Competition in underwriting new credits weakened the standards that some firms had applied. This was evident in both the underwriting of residential mortgages and leveraged loans.”<sup>578</sup> The firms also “relied too heavily on agency ratings in the CDO warehousing and packaging business and did not pay sufficient attention to internal assessment and the quality of the underlying assets. Some firms acknowledged that investors were likewise too dependent on rating agencies for assessments of the risk inherent in certain exposures or relied too heavily on assumptions regarding diversification benefits that turned out to be inaccurate.”<sup>579</sup>

### **Counterparty Risk Measurement and Management**

Firms generally indicated that they anticipated and understood the counterparty risks in the market crisis. They were able to generate estimates of counterparty risk exposures, and emphasized the importance of sustaining such systems; in general, “management

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<sup>574</sup> Id. at 16.

<sup>575</sup> Id. at 16 – 17.

<sup>576</sup> Id. at 17.

<sup>577</sup> Id. at 17 – 18.

<sup>578</sup> Id. at 18.

<sup>579</sup> Id. at 18.

teams indicated that the number of disputes with counterparties was not material through year-end 2007. Several firms cited the signaling value of disputes in assessing the conservatism of their own and their counterparties' marks."<sup>580</sup> The firms did, however, cite concerns about exposures to financial guarantors and particularly monoline insurers, noting that "[s]ubsequent to our meetings, these concerns have become more widespread and pronounced across the industry, with many firms' exposures continuing to grow through year-end 2007."<sup>581</sup>

#### **U. JOSEPH E. STIGLITZ, TESTIMONY FOR A HEARING OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON THE FUTURE OF FINANCIAL SERVICES REGULATION (OCTOBER 21, 2008)**

Professor Stiglitz argues in initial remarks that, first, 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. Second, the recession will deepen without more direct governmental assistance to homeowners.<sup>582</sup>

#### **Reasons for Market Failures**

Distorted incentives in financial markets have produced socially distorted behavior. They have produced enormous profits for financial firms (30% or more of corporate profits in the U.S. and some other advanced industrial nations) and extremely high levels of pay for executive and other individuals within firms; they did so by encouraging short-sighted, risky behavior jeopardizing the economy. Accounting rules, complex securitizations and derivatives have increased profits and concealed risks, and created a system which encourages deception of ill-informed investors and other individuals: "It is not a surprise that the problems first occurred in the sub-prime market, among less educated and lower income individuals. There was extensive predatory lending, and financial markets resisted laws restricted these abusive practices."<sup>583</sup> These information problems undercut competition as well, aggravating bad lending practices.<sup>584</sup>

#### **Regulations for the Twenty-First Century**

Effective regulations ensure the safety and soundness of financial institutions and the financial system, protect consumers, maintain competition, facilitate financing for diverse purposes, and maintain economic stability. 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

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<sup>580</sup> Id. at 19.

<sup>581</sup> Id. at 20.

<sup>582</sup> Joseph Stiglitz, Testimony For a Hearing of the House Committee on Financial Services on the Future of Financial Services Regulation 1 -2 (2008), [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/stiglitz102108.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/stiglitz102108.pdf)

<sup>583</sup> Id. at 4.

<sup>584</sup> Id.

given their collective impact. Stiglitz discusses establishment of a Financial Products Safety Commission that would oversee the activities of core financial institutions such as commercial banks and pension funds. “Consenting adults should be allowed to do what they like, so long as they do not hurt others. 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.”<sup>585</sup>

An effective regulatory system should be designed in such a way as to manage as effectively as possible inherent information asymmetries between the regulated and the regulator. Firms and individuals will try to circumvent regulations, and often will succeed, but the system should be designed to minimize this activity. The fact that people are trying to circumvent the rule does not imply that the rules should be rescinded. Stiglitz argues that we then should ask if the purpose of the rule is still valid and, if so, how to design and enforce the rule more effectively; for example, we can design the rule to alter incentives rather than trying to change behaviors directly, which may be far more difficult in a complex system. Regulations also have to adjust constantly to changes in the regulated environment and efforts to circumvent the rules.<sup>586</sup>

## **Key Elements of a Regulatory Structure**

### **Transparency and Disclosure**

U.S. financial markets must be based on transparency and disclosure, but complex derivatives and similar financial products are opaque and not susceptible to meaningful disclosure to most investors, including institutions. Derivatives and similar financial 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 (FPSC, discussed below) and unless their use conforms to the guidelines established by the FPSC.”<sup>587</sup> Regulators should encourage wider use of standardized products that increase the transparency of the economy. There will be a cost to this in the 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. He also argues that the financial services industry frequently has resisted efforts to increase transparency in financial markets because it restricts their marketing options and subjects them to greater scrutiny from investors, regulators, and others, so we should look critically at objections to this proposal and other efforts to increase the transparency of their activities.

Stiglitz also discusses mark-to-market accounting and other elements of disclosure:

Mark-to-market accounting was supposed to provide better information to investors about a bank’s economic position. But now, there is a concern

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<sup>585</sup> Id. at 7.

<sup>586</sup> Id. at 8.

<sup>587</sup> Id. at 9.

that this information may contribute to exacerbating the downturn. While financial markets used to boast about the importance of the “price discovery function” performed by markets, they now claim that market prices sometimes do not provide good information, and using transactional prices may provide a distorted picture of a bank’s economic position. The problem is only partially with mark-to-market accounting; it also has to do with the regulatory system, which requires the provision of more capital when the value of assets is written down. Not using mark-to-market not only provides opportunities for gaming (selling assets that have increased in value while retaining those that have decreased, so that they are valued at purchase price), but it also provides incentives for excessive risk taking. Realizing that there is no perfect information system, it may be desirable to have both sets of information provided. But at the very least, we should not abandon mark-to-market accounting. Doing so would undermine confidence in our markets. 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.<sup>588</sup>

### **Regulating Incentives**

The current system encourages excessive short-term risk taking. The system should move away from rewarding executives through stock options. Incentive pay should be designed in such a way as to be awarded over a longer term horizon than at present, and at least over five years. 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 that becomes apparent only after the current year. Compensation should be related to performance on both organizational and individual levels.

Three other reforms should be put in place. First, 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.

Second, policy should remove or reduce conflicts of interest in rating agencies. Regulations of rating agencies should be tightened, and a government rating agency could be established. Third, public policy should seek out and eliminate or reduce conflicts of interest throughout the financial sector; “there is, for instance, a clear conflict of interest when a mortgage originator also owns the company that appraises house values. This should be forbidden.”<sup>589</sup>

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<sup>588</sup> *Id.* at 10.

<sup>589</sup> *Id.* at 11.

### **Curbing Exploitive Practices**

Regulations and enforcement should target exploitive practices in the financial sector such as pay-day loans, predatory lending, rent-a-furniture, and similar tactics most often targeting lower-income groups. A usury law, also applying to credit cards, should limit the effective rate of interest paid by borrowers.<sup>590</sup>

### **Curbing Risky Practices**

Regulations and enforcement should target risky practices that also often are exploitive. These include 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. Stiglitz maintains that restricting the speed with which banks could expand their portfolio of loans or other assets would have prevented a large share of financial crises, as such rapid expansions indicate deteriorating screening of borrowers that may well forecast increases in defaults. Other options to restrict excessive expansion of lending include increased capital requirements, increased provisioning requirements, or increased deposit insurance for those who increase their lending at excessive rates.

Restricting derivatives would curb risky practices. When standardized, such products can help risk management by offsetting foreign exchange risks or in other hedging goals, but banks and other core financial institutions were speculating rather than hedging in many of these transactions.<sup>591</sup> Generally, commercial banks and other "core" financial institutions should be required to have adequate capital to guard against excessive risks; excessive leverage should be restricted. But capital rules must be designed and enforced carefully by regulators.

Many, looking for simple and simplistic rules, hoped that capital adequacy requirements would be all that was required—a minimal intervention in the market by those believing in free markets but recognizing that free banking has been a disaster everywhere that it has been tried. Capital adequacy standards alone, however, do not suffice; indeed, increasing capital adequacy standards may lead to increased risk taking. Moreover, while government provision of capital may provide a buffer against bankruptcy, so long as management focuses on the returns to themselves and non-governmental shareholders, depending on the form of the provision of capital, risks of excessive risk taking may not be mitigated. Capital adequacy standards are not a substitute for close supervision of the lending and risk practices of banks. Banks will have an incentive to engage in regulatory and accounting arbitrage, and regulators must be alert to this possibility. They must have sufficient authority to proscribe such behavior. Bad lending practices may increase in cyclical downturns; this

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<sup>590</sup> Id.

<sup>591</sup> Id. at 12.

necessitates closer supervision at such times. Regulators also have to be particularly sensitive to the risks of increasing leverage in booms.<sup>592</sup>

Regulators need to respond to changes in conditions in incentives at different points of the business cycle, aware of how leverage, pricing, and ratings of rating agencies will vary with economic conditions. Regulators can design countercyclical capital adequacy and provisioning requirements, adjust limits on loan-to-value ratios or 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. Stiglitz points out that “Such arrangements will reduce the cyclical patterns that have long been a part of credit market behavior.”<sup>593</sup>

### **Regulatory Institutions**

Professor Stiglitz suggests that “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 because 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.”<sup>594</sup>

“Regulatory capture” is not necessarily a matter of regulators consciously weakening their actions in the face of industry pressure or inducements, but also can be a matter of regulators coming to accept the ways of looking at issues favored by the industry. For example, regulators might accept as a matter of course the idea that they should encourage financial innovation unless there is compelling evidence of breakdowns from it, rather than looking critically at the prospective benefits and risks from financial innovation. However, the testimony also points out that much industry influence does come 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.”<sup>595</sup>

Activities will flow to unregulated parts of the financial system if regulation is not comprehensive. As financial markets are so interconnected, policy makers need to be aware of key parts of the system escaping regulation. Thus, he suggests, there should be an entity, a financial markets stability commission, overseeing the entire financial system and integrating regulation across it:

A Financial Markets Stability Commission (FMSC) would assess over-all risks, looking at the functioning of the entire financial system and how it would respond to various kinds of shocks; in contrast, the Financial

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<sup>592</sup> Id. at 13.

<sup>593</sup> Id. at 13.

<sup>594</sup> Id. at 14.

<sup>595</sup> Id. at 14.

Products Safety Commission (discussed below) would look at individual products and judge their appropriateness for particular classes of purchasers. Such a Commission should have identified, for instance, the risk posed by the breaking of the housing bubble. All of the regulatory authorities (those regulating securities, insurance, and banking) should report to the FMSC. We have seen how all financial institutions are interconnected and how an insurance firm became a systemic player. Similar functions can be performed by different kinds of institutions. There also needs to be oversight over the entire system to avoid regulatory arbitrage.<sup>596</sup>

The paper maintains that those currently embedded with the financial markets will not examine systemic risks in a sufficiently critical way. Thus, those who will lose from failed regulation, such as retirees, homeowners, and ordinary, should have a voice in regulation. The design of financial markets and their regulation has important distributional consequences for workers and small business as well as global financial firms; the stability and preferences of global financial firms should not dominate discussions of regulatory policy. While retirees, homeowners, ordinary investors, workers, and small businesses 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.”<sup>597</sup>

The Financial Products Safety Commission (FPSC) would 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.”<sup>598</sup> He cites problems in derivatives markets as an example of the costs of financial products being marketed or used in misleading ways, with great economic costs; the FPSC would try to regulate products to minimize the chances of such problems reoccurring.<sup>599</sup>

### **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. There should be mechanisms through which financial institutions that generated the crisis should compensate the society, comparable to the idea of polluters compensating society for environmental externalities. Tax and legal structures, including those affecting corporate governance, anti-trust, and bankruptcy, must be modified and/or enforced more effectively to remedy the problems surfacing in the credit crisis.

Crises may originate and extend throughout the world. Thus, just as the crisis emerging in 2007 began most visibly in the United States, future crises could be imported into the United States from other nations; other nations are in positions similar to ours. There is a

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<sup>596</sup> Id. at 15.

<sup>597</sup> Id.

<sup>598</sup> Id. at 16.

<sup>599</sup> Id.



need for cooperation among regulators, including, likely, an initiative comparable to the Bretton Woods agreement. Professor Stiglitz writes that “It would be best if we could get an agreement on a global regulatory structure. At the very least, we should strive for a modicum of harmonization. We are at a ‘Bretton Woods moment,’ a moment where the international community may be able to come together, put aside parochial concerns and special interests, and design a new global institutional structure for the twenty first century. It would be a shame if we let this moment pass.”<sup>600</sup> On the other hand, he argues, the United States should not wait for such an agreement before it establishes improvements in the system within the United States.<sup>601</sup>

But, Stiglitz argues, we cannot let reform of our own regulatory structure wait for global decisions. We can show leadership by showing what a good, comprehensive regulatory reform might look like. We can have good regulation in our country, even if others do not immediately follow. But that may well entail restricting dealings with those that have inadequate regulatory structures, as I have already suggested.

The changes advocated in the testimony, he maintains, will not stifle innovation. Rather, they will produce transparent, well-functioning mechanisms generating beneficial innovations without the catastrophic risks that were building within the system in recent years. The lack of transparency and breakdowns in risk management contributing to the current market crisis could be traced back to “financial innovation” that was not properly managed and regulated; this is what the recommendations seek to avoid. Stiglitz writes, “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.”<sup>602</sup>

**V. UNITED STATES CHAMBER OF COMMERCE COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21<sup>ST</sup> CENTURY, REPORT AND RECOMMENDATIONS OF THE COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21<sup>ST</sup> CENTURY (March 2007)**<sup>603</sup>

On March 12, 2007, the United States Chamber of Commerce released the report and recommendations of its Commission on the Regulation of the U.S. Capital Markets in the 21<sup>st</sup> Century (“Chamber Report”). Like the CCMR and Bloomberg/ Schumer Reports, the Chamber Report was written before the current crisis, and at a time when concerns over competitive threats to the United States’ role in capital markets dominated

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<sup>600</sup> Id. at 18.

<sup>601</sup> Id. at 17-18.

<sup>602</sup> Id. at 18.

<sup>603</sup> See United States Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century, (March 2007), <http://www.uschamber.com/publications/reports/0703capmarketscomm.htm>.

discussions of regulatory reform.<sup>604</sup> Thus, while the Chamber Report acknowledges that “strong regulatory oversight and our dedication to transparency and investor protection, combined with our independent judicial system, are the principal reasons for our historical global dominance in capital markets activity,” the Report makes a number of recommendations “designed to enhance coordination among financial service regulators and improve other aspects of our capital markets regulatory system.”<sup>605</sup>

- **Greater coordination of U.S. Financial Services Regulatory Policy:** According to the Chamber Report, the U.S. financial services industry “is handicapped in part by the fact that we lack a shared supervisory vision, actionable strategy, and unified regulatory structure for our financial services sector.”<sup>606</sup> The Report opines that the “fragmentation of our regulatory system leaves the U.S. markets open to the risk that gaps could develop where appropriate regulation is needed or that overlaps in regulation could lead to market inefficiencies.”<sup>607</sup> As a first step in encouraging greater coordination of U.S. financial services regulatory policy, the Chamber Report recommends that the President enhance the role of the President’s Working Group on Financial Markets (PWG) to increase coordination among the nation’s financial services regulators. In particular, the Chamber Report calls upon the PWG to develop (i) a unified, coherent vision for the financial sector and a more efficient and unified regulatory structure; (ii) a comprehensive, forward-looking strategy for the sector and its regulation; (iii) a set of shared values to support the vision and drive the strategy; (iv) mechanisms and policies regarding the U.S.’s interaction with foreign markets and regulators; (v) more effective definitions of the relationship between federal and state jurisdictions in different aspects of the U.S. capital markets, and (vi) a blueprint for a modern U.S. financial services regulatory regime that will ensure that our markets remain competitive and globally attractive.
- **SEC Rulemaking:** The Chamber Report calls upon the SEC to 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 Chamber Report suggests that the SEC should consider performing an independent review of the economic impact of new major regulations one to two years after enactment to assess whether the regulation was operating as expected and to determine whether changes are needed.
- **SEC Supervisory Practices:** The Chamber Report recommends that the SEC adopt a prudential approach to supervision akin to that used by the U.K.’s Financial Services Authority and U.S. federal banking regulators. In the Chamber’s view, such a “prudential framework” would include: (i) an open flow

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<sup>604</sup> See, e.g., Chamber Report at 1.

<sup>605</sup> Id.

<sup>606</sup> Id. at 116.

<sup>607</sup> Id.

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; (ii) full access by examiners to institutions coupled with an examination privilege; (iii) expert, practical examiners capable of sharing insights and information about industry best practices; (iv) lead examiners in residence at large, complex institutions; (v) no automatic enforcement referrals; (vi) focus on safety and soundness.<sup>608</sup> The Report also recommends that industry self-regulation be enhanced through the establishment of a federal “self-evaluation” privilege for SEC-regulated institutions and their independent audit firms.<sup>609</sup>

- **Reorganize the Structure of the SEC:** The Report recommends a number of organizational changes to the SEC, including the creation of new divisions responsible for regulation of market professionals, the regulation of market structure, and the regulation of securities products. The Report also suggests that Congress should consider transferring regulatory authority over the creation of trading of futures on securities from the CFTC to the SEC.<sup>610</sup>
- **Federal Insurance Charter:** The Chamber Report recommends that Congress enact legislation to establish an optional federal insurance charter to increase competitiveness within the insurance market on both a domestic and global basis and to reduce costs for consumers.<sup>611</sup>

#### **W. UNITED STATES DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (March 2008)**<sup>612</sup>

The Department of Treasury Blueprint for a Modernized Financial Regulatory Structure (“Treasury Blueprint” or “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. As the Treasury Blueprint notes, the current United States financial regulatory structure developed over more than 150 years, usually in response to financial crises and other important social, economic and political events. The Blueprint opines that under the current system, with its combination of different federal and state regulators, no single regulator “has all of the information and authority necessary to monitor systemic risk,” and 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. In addition, the inability of any regulator to take coordinated action throughout

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<sup>608</sup> Id. at 130 – 132.

<sup>609</sup> Id. at 141 – 142.

<sup>610</sup> Id. at 139-140.

<sup>611</sup> Id. at 142-144.

<sup>612</sup> United States Department of the Treasury, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (Mar. 2008), <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

the financial system makes it more difficult to address problems related to financial market stability.”<sup>613</sup>

The Blueprint maintains that other nations have simplified and streamlined oversight of financial institutions over the past few years, and suggests that financial services and products are likely to migrate to these nations when faced with jurisdictional disputes among regulators in the United States. By way of example, the Blueprint cites the prolonged development of rules pertaining to the Basel II capital rules for the United States, disputes over whether financial products are securities or futures and thus subject to SEC or CFTC regulation, and the regulatory treatment of banks’ insurance sales when different regulatory agencies and levels of government regulate banks and insurance companies.

In the face of foreign competition, the Blueprint suggests that the United States must modernize its system of regulation by adopting “short-term” and “intermediate-term” reforms and by moving to an objectives-based system of regulation. The Blueprint’s short term recommendations focus on regulatory coordination and oversight in wake of the credit crisis and include the following:

- **The Federal Government Should Strengthen the PWG:** An Executive Order and other steps should modernize and expand the President’s Working Group on Financial Markets (PWG). The 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. The PWG should elevate inter-agency coordination and communication among its members, particularly with respect to systemic risk, market integrity, consumer and investor protection, and efficiency and competitiveness in the financial sector, and consider broader questions of regulatory structure in the United States. Its membership should be expanded to include the heads of the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of Thrift Supervision (“OTS”). 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.<sup>614</sup>
- **Create 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. The Federal Reserve should write regulations implementing national mortgage lending laws, and the enforcement authority over these laws should be clarified and strengthened. Title V, Sections

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<sup>613</sup> TREASURY BLUEPRINT at 27.

<sup>614</sup> We noted that the PWG issued a press release on October 6, 2008 discussing its role in addressing these issues. <http://www.treas.gov/press/releases/hp1177.htm>

1501-1517 of H.R. 3221, the Housing and Economic Recovery Act of 2008 (the “Secure and Fair Enforcement [S.A.F.E.] For Mortgage Licensing Mortgage Disclosure Improvement Act), addressed this issue to a significant degree.<sup>615</sup>

- **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.

The Treasury’s intermediate term recommendations focus on what it describes as reducing regulatory duplication and modernizing the regulatory structure in banking, insurance, securities, and futures. These intermediate term recommendations include 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 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. (This would extend the current arrangements in which the Federal Reserve regulates, although does not charter, systematically important payment and settlement systems. The Federal Reserve, for example, is participating in the launch of clearing houses for credit default swaps in the United States. These are the New York State-chartered ICE U.S. Trust LLC, the Chicago Mercantile Exchange/Citadel clearinghouse, and an effort by NYSE Euronext to establish a clearing house.)

- **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. 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

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<sup>615</sup> This provision stipulated that, “[i]n order to increase uniformity, reduce regulatory burden, enhance consumer protection, and reduce fraud, the States, through the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, are hereby encouraged to establish a Nationwide Mortgage Licensing System and Registry for the residential mortgage industry.”

advisors should be harmonized, and a new self-regulatory organization overseeing investment advisors should be established. 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 also articulates for “long-term consideration” what it described as an optimal objectives-based regulatory structure that would include the following:

- **Market Stability Regulator:** Establish a market stability regulator overseeing financial market stability as it affects the economy. The Blueprint did not identify which organization would perform this function, or whether a new organization would be created. In the past the Federal Reserve, more than any other organization, has served in this role, and other suggestions—e.g., by the Brady Commission following the October 1987 market break—have identified the Federal Reserve as the likely candidate for such a responsibility.
- **Prudential Financial Regulatory Agency:** Establish a Prudential Financial Regulatory Agency (PFRA) overseeing problems of market discipline caused by government guarantees.
- **Conduct of Business Regulatory Agency:** Establish a Conduct of Business Regulatory Agency (CBRA) overseeing consumer protection and related business practices in financial markets.
- **Federal Insurance Guarantee Corporation:** Establish a Federal Insurance Guarantee Corporation (FIGC) to administer the deposit insurance program now overseen by the Federal Deposit 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:** Establish a Corporate Finance Regulator to 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.

The Blueprint maintains that this objectives-based system of regulation —which it saw as likely resulting only from a long-term debate of a decade or more — would “improve efficiency” by “more closely linking the regulatory objectives of market stability regulation, prudential financial regulation, and business conduct regulation.”<sup>616</sup> The Blueprint stated:

In particular, a major advantage of objectives-based regulation is that regulatory responsibilities are consolidated in areas where natural synergies take place, as opposed to the current approach of dividing these responsibilities among individual regulators. For example, a dedicated market stability regulator with the appropriate mandate and authority can focus broadly on issues that can impact market stability across all types of financial institutions. Prudential financial regulation housed within one regulatory body can focus on common elements of risk management across financial institutions. A dedicated business conduct regulator leads to greater consistency in the treatment of products, eliminates disputes among regulatory agencies, and reduces gaps in regulation and supervision.

In comparison to other regulatory structures, an objectives-based approach is better able to adjust to changes in the financial landscape than a structure like the current U.S. system focused on industry segments. An objectives-based approach also allows for a clearer focus on particular goals in comparison to a structure that consolidates all types of regulation in one regulatory body. Finally, clear regulatory dividing lines by objective also have the most potential for establishing the greatest levels of market discipline because financial regulation can be more clearly targeted at the types of institutions for which prudential regulation is most appropriate.<sup>617</sup>

As drafted, the Blueprint would transform the federal financial regulatory landscape and the agencies in it, particularly under its proposed long-term structure. In this regard, preemption of state government authority is central to the Treasury Blueprint:

As described above, CBRA [Conduct of Business Regulatory Agency] should be responsible for setting national standards for a wide range of business conduct laws across all types of financial services providers. The national standards established by CBRA should apply to all financial services firms, whether federally or state-chartered. In addition, field preemption should be provided to FIDIs, FIIs, and FFSPs, preempting state business conduct laws directly relating to the provision of financial services

In the optimal structure, states should still retain clear authority to enact laws and take enforcement actions against state-chartered financial service providers as long as the state laws do no conflict with federal laws. In practice, the standards set by CBRA will be applicable exclusively to federally chartered financial

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<sup>616</sup> TREASURY BLUEPRINT at 14.

<sup>617</sup> TREASURY BLUEPRINT at 14.

services providers but should represent a floor for state-chartered financial services providers. As noted previously, state authorities can play an important role in business conduct regulation. The more localized focus of state authorities often allows for more in-depth knowledge of local business practices. In considering the future role of the states, the optimal structure seeks to acknowledge more clearly than the current regulatory structure that a national market for financial products exists, while at the same time preserving an appropriate role for state authorities to respond to local conditions...

State authorities could be given a formalized role in CBRA's rulemaking process as a means of building off of their extensive local experience. Creating a State Advisory Board ("SAB") with a specific mandate to be a regular and transparent mechanism for providing input into the rulemaking process represents one way to accomplish this. Such a process could be used to bring issues of importance and relevance to the states to CBRA's attention. Given CBRA's wide responsibilities across all financial services, the composition of the SAB should likely have to be similarly broad, drawing on state regulatory experience across all financial services and states' attorneys general experience in business conduct areas ... States could also play a role in enforcement. As noted above, states should continue to exercise authority under state laws that apply to state-chartered financial service providers. In addition to that inherent function, state officials could also be given the authority to monitor compliance and enforce CBRA's regulations for state-chartered financial services providers. Providing state officials with the authority to monitor and enforce compliance with federal regulations helps to avoid gaps in the implementation of these regulations

Finally, states could also be granted some limited authority to address business conduct issues associated with federally chartered financial institutions. For example, given the experience of state officials with state-chartered financial institutions or other locally based knowledge of business conduct issues (e.g., complaints regarding certain business practices in local areas), state officials could bring these issues to CBRA's attention. Based upon that local information, state officials could be given the authority to proceed with full investigations and enforcement actions if approved by CBRA. An alternative to this grant of authority to state officials should be for CBRA (or the appropriate SRO) to use such information to further investigate compliance issues and take enforcement actions as necessary. In both cases, the goal should be to build off the local knowledge of state officials and to provide an appropriate role for states in business conduct oversight.<sup>618</sup>

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<sup>618</sup> TREASURY BLUEPRINT at 178-180.



**X. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE,  
FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND  
ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S.  
FINANCIAL REGULATORY SYSTEM (GAO-09-216) (JANUARY, 2009)**

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.<sup>619</sup>

**Financial Regulation Has Sought To Achieve Four Goals**

The report summarizes the goals of financial market regulation.<sup>620</sup>

- **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 consumer and investor harm.
- **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 taken by financial firms and related parties that could lead to major losses for firms, consumers, investors, and taxpayers.
- **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 GAO notes that the U.S. system of financial regulation developed over 150 years, often in response to specific historical events, and as a result is complex, fragmented, and not aligned well with current market conditions: "Our regulatory system has multiple financial regulatory bodies, including five federal and multiple state agencies that oversee depository institutions. Securities activities are overseen by federal and state government entities, as well as by private sector organizations performing self-regulatory functions. Futures trading is overseen by a federal regulator and also by industry self-regulatory organizations. Insurance activities are primarily regulated at the state level with little

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<sup>619</sup> United States Government Accountability Office, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 2-3 (2009) at 2-3, <http://www.gao.gov/new.items/d09216.pdf>

<sup>620</sup> Id.

federal involvement. Overall, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations (SRO), and hundreds of state financial regulatory agencies.”<sup>621</sup> The Report reviews this evolution in detail.<sup>622</sup> Thus, the regulatory system often does not deal with changes in market conditions effectively and needs to consider modifications, as outlined below.

## **Key Developments and Resulting Challenges That Have Hindered the Effectiveness of the Financial Regulatory System**

### **Emergence of Large, Complex, Globally Active Interconnected Financial Conglomerates**

Large financial conglomerates provide some benefits in that they 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 for the financial system that regulators have had difficulty handling in the current structure.<sup>623</sup>

*Regulators sometimes lack sufficient authority, tools, or capabilities to oversee and mitigate risks.* Regulators often do not have sufficient authority or regulatory tools to oversee the range of activities and related risks in diversified financial institutions. While the GAO did not focus on evaluating agencies’ performance, it did cite examples of instances in which agencies did not oversee such firms effectively both because of limits in their authority and tools and because of lapses in oversight, including the SEC’s oversight of Bear Stearns and the Federal Reserve’s and OTS’s oversight of AIG.<sup>624</sup>

The presence of large diversified financial firms makes 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.<sup>625</sup>

### **Less-Regulated Entities Have Come to Play Increasingly Critical Roles in the Financial System**

Many organizations in financial markets have organized themselves in ways that are not subject to existing regulatory laws. These less-regulated organizations and activities, such as nonbank lenders and “private label” securitizations, contributed substantially to the current financial market crisis.

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<sup>621</sup> Id. at 5 -7.

<sup>622</sup> Id. at 8 -12.

<sup>623</sup> Id. at 19.

<sup>624</sup> Id. at 19-22.

<sup>625</sup> Id. at 22-23.

These less-regulated entities carry out an increasingly important share of financial market activities. Until the last few decades, consumers since the 1930s have dealt almost entirely with regulated banks, broker-dealers, and insurance companies. However, “nonbank lenders, hedge funds, credit rating agencies, and special-purpose investment entities—that are not always subject to full regulation by such authorities have become important participants in our financial services markets.”<sup>626</sup> The GAO points out that these entities can provide useful products that otherwise would not be offered to consumers and investors, but regulators also cannot fully oversee their activities; thus, an important part of the financial system largely escapes the regulation seen as necessary for banks, broker-dealers, and insurance firms serving similar functions.<sup>627</sup>

For example, hedge funds, “which are professionally managed investment funds for institutional and wealthy investors,”<sup>628</sup> are major forces in financial markets and generate widespread risks that must be overseen effectively. Hedge funds can provide important economic benefits. “For example, hedge funds often assume risks that other more regulated institutions are unwilling or unable to assume, and therefore generally are recognized as benefiting markets by enhancing liquidity, promoting market efficiency, spurring financial innovation, and helping to reallocate financial risk.”<sup>629</sup> However, under law, they can avoid the types of regulatory oversight by the SEC to which mutual funds are subject on the grounds that their investors are “sophisticated”—generally as measured by wealth—and thus do not require the regulatory protection given to “retail” investors in mutual funds. (The GAO does point out that “Hedge fund managers that trade on futures exchanges and that have U.S. investors are required to register with CFTC and are subject to periodic reporting, recordkeeping, and disclosure requirements of their futures activities, unless they notify the Commission that they qualify for an exemption from registration.”)<sup>630</sup> While hedge funds largely escape regulation because of exemptions under securities laws, they play a very large role in the financial system and thus pose systemic risks. Operational or other types of failures in hedge funds could threaten the regulated commercial banks, broker-dealers, and similar regulated entities transacting business with them; “They act as trading counterparties with many of these institutions and constitute in many markets a significant portion of trading activity, from stocks to distressed debt and credit derivatives.”<sup>631</sup>

The GAO notes improvements in hedge funds’ transparency since the collapse of Long Term Capital Management in 1998. Creditors and counterparties, including regulated institutions, monitor the risks of their dealings with hedge funds more actively. Hedge funds also “have improved disclosure and become more transparent about their operations, including their risk-management practices.”<sup>632</sup> However, based on its prior

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<sup>626</sup> Id. at 23.

<sup>627</sup> Id. at 23-27.

<sup>628</sup> Id. at 27.

<sup>629</sup> Id.

<sup>630</sup> Id.

<sup>631</sup> Id. at 29.

<sup>632</sup> Id. at 30.

evaluations, the GAO observed that regulators remain concerned with the risks created by regulated institutions transactions with largely unregulated hedge funds.<sup>633</sup>

### **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 supervisors have discovered serious problems in credit rating processes.<sup>634</sup> Until recently—and to a large extent still—they 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.<sup>635</sup> 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.<sup>636</sup>

Congress had passed the Credit Rating Agency Reform Act of 2006, required CRAs to register with the SEC, maintain certain records and file certain reports, and be subject to inspection by the SEC. However, these new controls did not prevent the ratings failures contributing to the financial crisis. 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 recent years, ratings failed to reflect the risks of structured products because of flaws in the credit rating process, leading to overinvestment in those products, subsequent collapse of the products values, and then the market crisis.<sup>637</sup>

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.<sup>638</sup> The GAO notes that “Determining the most appropriate government role in overseeing credit rating activities is difficult. For example, SEC has expressed concerns that too much government intervention—such as regulatory requirements of credit ratings for certain investments or examining the underlying methodology of ratings—would unintentionally provide an unofficial ‘seal of approval’ on the ratings and therefore be counterproductive to reducing overreliance on ratings. Whatever the solution, it is clear that the current regulatory system did not properly recognize and address the risks associated with the important role these entities played.”<sup>639</sup>

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<sup>633</sup> Id.

<sup>634</sup> Id.

<sup>635</sup> Id. at 31.

<sup>636</sup> Id.

<sup>637</sup> Id. at 31 - 32.

<sup>638</sup> Id. at 32.

<sup>639</sup> Id.

**Financial Institutions’ Use of Off-Balance Sheet Entities Led to Ineffective Risk Disclosure and Exacerbated Recent Market Instability**

Many regulated financial institutions create and transfer assets to special-purpose entities “as part of securitizations for mortgages or to hold other assets and produce fee income for the institution that created it—known as the sponsor. For example, after new capital requirements were adopted in the late 1980s, some large banks began creating these entities to hold assets for which they would have been required to hold more capital against if the assets were held within their institutions. As a result, these entities are also known as off-balance sheet entities because they generally are structured in such a way that their assets and liabilities are not required to be consolidated and reported as part of the overall balance sheet of the sponsoring financial institution that created them. The amount of assets accumulated in these entities resulted in them becoming significant market participants in the last few years. For example, one large commercial bank reported that its off-balance sheet entities totaled more than \$1 trillion in assets at the end of 2007.”<sup>640</sup>

The GAO notes that these off-balance sheet entities were vulnerable to market disruptions. For example, many financial institutions that had created these entities had to take back loans and securities in certain types of these off-balance sheet entities, and in some cases took them back voluntarily to maintain their reputations in markets.<sup>641</sup> 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. As a March 2008 study by the President’s Working Group on Financial Markets noted, before the recent market turmoil, supervisory authorities did not insist on appropriate disclosures of firms’ potential exposure to off-balance sheet entities.”<sup>642</sup>

**New and Complex Products Pose Challenges to Financial Stability and Investor and Consumer Understanding of Risks**

*Complex structured finance products have made it difficult for institutions and their regulators to manage associated risks.*

The rapid development of more complex financial products has provided “certain benefits to financial markets and consumers. For example, the creation of securitized products such as mortgage-backed securities increased the liquidity of credit markets by providing additional funds to lenders and a wider range of investment returns to investors with excess funds. Other useful product innovations included OTC derivatives, such as currency options, which provide a purchaser the right to buy a specified quantity of a currency at some future date, and interest rate swaps, which allow one party to exchange a stream of fixed interest rate payments for a stream of variable interest rate payments. These products help market participants hedge their risks or stabilize their cash flows.

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<sup>640</sup> Id.

<sup>641</sup> Id. at 33 -35.

<sup>642</sup> Id. at 35.

Alternative mortgage products, such as interest-only loans, originally were used by a limited subset of the population, mainly wealthy borrowers, to obtain more convenient financing for home purchases.”<sup>643</sup>

However, despite these advantages, the products’ growth and complexity in recent years have overwhelmed systems in firms and regulatory organizations charged with evaluating them and monitoring their risks.<sup>644</sup> 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. CDOs had consisted of simple securities like corporate bonds or loans, but more recently have included subprime mortgage-backed securities, and in some cases even lower-rated classes of other equally complex CDOs. Some of these CDOs included investments in 100 or more asset-backed securities, each of which had its own large pool of loans and specific payment structures. A large share of the total value of the securities issued were rated AA or AAA—designating them as very safe investments and unlikely to default—by the credit rating agencies. In part because of their seemingly high returns in light of their rated risk, demand for these new CDOs grew rapidly and on a large scale. Between 2004 and 2007, nearly all adjustable-rate subprime mortgages were packaged into mortgage-backed securities, a large portion of which were structured into CDOs.<sup>645</sup>

***Growth in complex and less-regulated over-the-counter (OTC) derivatives markets have created systemic risks and revealed market infrastructure weaknesses.***

The SEC, CFTC, or other U.S. regulators do not regulate OTC derivatives in ways comparable to other financial products performing generally similar economic functions.<sup>646</sup> The SEC, CFTC, or other agencies may oversee the institutions conducting this business; however, regulated firms conduct their OTC derivatives activities in subsidiaries not subject to SEC oversight, although the Consolidated Supervised Entity program, abandoned in late 2008, allowed the SEC to examine such operations in five large firms.<sup>647</sup>

OTC derivatives are so pervasive in financial market that they necessarily raise concerns about risk. Regulators have especially been concerned about the infrastructure for clearing and settling OTC transactions. Several organizations, including the President’s Working Group on Financial Markets, have taken steps to improve these systems in the past three years, and especially in 2008 as a result of the market crisis, although many of the pending improvements have yet to be made operational.<sup>648</sup>

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<sup>643</sup> Id. at 36.

<sup>644</sup> Id.

<sup>645</sup> Id. at 36-37.

<sup>646</sup> Id. at 39.

<sup>647</sup> Id.

<sup>648</sup> Id. at 40 - 41.

***Investors have faced difficulty understanding complex investment products, either because they failed to seek out necessary information or were misled by improper sales practices. Consumers have faced difficulty understanding mortgages and credit cards with new and increasingly complicated features, due in part to limitations in consumer disclosures and financial literacy efforts.***

The complexity of many new financial products challenges regulations that investors and consumers receive enough information to make an informed decision regarding transactions. Financial firms often have not done enough to overcome this problem; in recent years (and previously), “market participants sometimes had difficulty obtaining clear and accurate information on the value of these assets, their risks, and other key information. In some cases, investors did not perform needed due diligence to fully understand the risks associated with their investment. In other cases, investors have claimed they were misled by broker-dealers about the advantages and disadvantages of products... Similarly, the introduction and expansion of increasingly complicated retail products to new and broader consumer populations has also raised challenges for regulators in ensuring that consumers are adequately protected. Consumers face growing difficulty in understanding the relative advantages and disadvantages of products such as mortgages and credit cards with new and increasingly complicated features, in part because of limitations on the part of regulatory agencies to improve consumer disclosures and financial literacy.”<sup>649</sup>

Regulators have not responded to these problems sufficiently quickly, partly because the disclosures involve the jurisdictions of multiple regulatory agencies, slowing negotiations over regulatory content. The GAO cited examples of rules governing mortgage lending and loan disclosure practices.<sup>650</sup> Similarly, the different perspectives of the 20 agencies involved have slowed the development of a federal initiative to improve financial literacy, although lack of funding has contributed to delays as well.<sup>651</sup>

***Accounting and auditing entities have faced challenges in trying to ensure that accounting and financial reporting requirements appropriately meet the needs of investors and other financial market participants.***

Assessing and managing risks of complex financial products requires effective accounting and financial reporting requirements, but regulators and others have had difficulties keeping pace with required improvements. Market participants and public and private regulators have discussed challenges and options regarding fair value accounting, special-purpose entities, and global convergence of standards. Getting to agreement on important changes in accounting systems is difficult under usual circumstances, but especially so when dealing with the types of complex financial technology involved in the market crisis.<sup>652</sup>

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<sup>649</sup> *Id.* at 41 - 42.

<sup>650</sup> *Id.* at 41 - 43.

<sup>651</sup> *Id.* at 44 - 45.

<sup>652</sup> *Id.* at 45 - 47.

## **Financial Markets Have Become Increasingly Global in Nature, and Regulators Have Had to Coordinate Their Efforts Internationally**

The GAO examined the need for international collaboration among regulators and related progress and continuing challenges.

*Standard setters and regulators also 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 negotiations on Basel II and certain insurance matters.*

Financial markets around the world are linked and interdependent and so regulators from multiple nations must cooperate to oversee financial markets effectively, including sharing information and conducting joint initiatives involving global financial firms. There are many examples of international cooperation among financial regulators, and regulators worked jointly on multiple fronts in 2008. However, the complexity of the United States regulatory structure has increased the difficulty of the U.S. in working in these joint efforts. The GAO cited the negotiations among multiple U.S. regulators regarding the Basel Accords process:

For example, the current U.S. regulatory system complicates the ability of financial regulators to convey a single U.S. position in international discussions, such as those related to the Basel Accords process for developing international capital standards. Each federal regulator involved in these efforts oversees a different set of institutions and represents an important regulatory perspective, which has made reaching consensus on some issues more difficult than others. Although U.S. regulators generally agree on the broad underlying principles at the core of Basel II, including increased risk sensitivity of capital requirements and capital neutrality, in a 2004 report we noted that although regulators communicated and coordinated, they sometimes had difficulty agreeing on certain aspects of the process . . . International officials have also indicated that the lack of a single point of contact on, for example, insurance issues has complicated regulatory decision making.

On the other hand, the GAO pointed out 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. In particular, one regulator noted that, in light of the magnitude of recent losses at banks and the failure of banks and rating agencies to predict such losses, the additional safeguards built into how U.S. regulators adopted Basel II are an example of how more than one regulatory perspective can improve policymaking.”<sup>653</sup>

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<sup>653</sup> Id. at 47-48.



## **A Framework For Crafting And Assessing Alternatives For Reforming The U.S. Financial Regulatory System**

The GAO Report suggests that organizations designing and evaluating proposals for financial regulatory reform should consider nine characteristics of an effective regulatory system. Different proposals could be compared on how well they fulfill each of these characteristics; those analyzing proposals could weigh all of them to make overall assessments, or examine specific considerations. The wording of the nine elements of the GAO’s framework and “Key issues to be addressed” are reproduced below verbatim from the Report.

### **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.<sup>654</sup> Key issues to be addressed:

- Clarify and update the goals of financial regulation and provide sufficient information on how potentially conflicting goals might be prioritized.
- Determine the appropriate balance of broad principles and specific rules that will result in the most effective and flexible implementation of regulatory goals.<sup>655</sup>

### **Appropriately Comprehensive**

A regulatory system should ensure that financial institutions and activities are regulated in a way that ensures regulatory goals are fully met. As such, 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.<sup>656</sup> Key issues to be addressed:

- Identify risk-based criteria, such as a product’s or institution’s potential to harm consumers or create systemic problems, for determining the appropriate level of oversight for financial activities and institutions.
- Identify ways that regulation can provide protection but avoid hampering innovation, capital formation, and economic growth.<sup>657</sup>

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<sup>654</sup> Id. at 49.

<sup>655</sup> Id. at 49-51.

<sup>656</sup> Id. at 51.

<sup>657</sup> Id. at 51-52.

### **Systemwide 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.<sup>658</sup> Key issues to be addressed:

- Identify approaches to broaden the focus of individual regulators or establish new regulatory mechanisms for identifying and acting on systemic risks.
- Determine what additional authorities a regulator or regulators should have to monitor and act to reduce systemic risks.<sup>659</sup>

### **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.<sup>660</sup> Key issues to be addressed:

- Determine how to effectively monitor market developments to identify potential risks; the degree, if any, to which regulatory intervention might be required; and who should hold such a responsibility.
- Consider how to strike the right balance between overseeing new products as they come onto the market to take action as needed to protect consumers and investors, without unnecessarily hindering innovation.<sup>661</sup>

### **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.<sup>662</sup> Key issues to be addressed:

- Consider the appropriate role of the states in a financial regulatory system and how federal and state roles can be better harmonized.
- Determine and evaluate the advantages and disadvantages of having multiple regulators, including nongovernmental entities such as SROs, share responsibilities for regulatory oversight.

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<sup>658</sup> Id. at 52.

<sup>659</sup> Id. at 52-53.

<sup>660</sup> Id. at 53.

<sup>661</sup> Id. at 53-54.

<sup>662</sup> Id. at 54.

- Identify ways that the U.S. regulatory system can be made more efficient, either through consolidating agencies with similar roles or through minimizing unnecessary regulatory burden.
- Consider carefully how any changes to the financial regulatory system may negatively impact financial market operations and the broader economy, and take steps to minimize such consequences.<sup>663</sup>

### **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.<sup>664</sup> Key issues to be addressed:

- Consider how prominent the regulatory goal of consumer protection should be in the U.S. financial regulatory system.
- Determine what amount, if any, of consolidation of responsibility may be necessary to enhance and harmonize consumer protections, including suitability requirements and disclosures across the financial services industry.
- Consider what distinctions are necessary between retail and wholesale products, and how such distinctions should affect how products are regulated.
- Identify opportunities to protect and empower consumers through improving their financial literacy.<sup>665</sup>

### **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.<sup>666</sup> Key issues to be addressed:

- Determine how to structure and fund agencies to ensure each has adequate independence, prominence, tools, authority and accountability.

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<sup>663</sup> Id. at 54-57.

<sup>664</sup> Id. at 57.

<sup>665</sup> Id. at 57-59.

<sup>666</sup> Id. at 59.

- Consider how to provide an appropriate level of authority to an agency while ensuring that it appropriately implements its mission without abusing its authority.
- Ensure that the regulatory system includes effective mechanisms for holding regulators accountable.<sup>667</sup>

### **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.<sup>668</sup> Key issues to be addressed:

- Identify institutions and products and services that pose similar risks.
- Determine the level of consolidation necessary to streamline financial regulation activities across the financial services industry.
- Consider the extent to which activities need to be coordinated internationally.<sup>669</sup>

### **Minimal Taxpayer Exposure**

A regulatory system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.<sup>670</sup> Key issues to be addressed:

- Identify safeguards that are most appropriate to prevent systemic crises while minimizing moral hazard.
- Consider how a financial system can most effectively minimize taxpayer exposure to losses related to financial instability.<sup>671</sup>

The GAO concludes its Report by emphasizing that transitions to new regulatory arrangements should be done in a way to minimize disruptions to financial markets, individual financial institutions' abilities to conduct their operations, and the ability of investors and consumers to access services. "For example," it notes, "if the changes require regulators or institutions to make systems changes, file registrations, or other activities that could require extensive time to complete, the changes could be implemented in phases with specific target dates around which the affected entities could

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<sup>667</sup> Id. at 59-60.

<sup>668</sup> Id. at 60.

<sup>669</sup> Id. at 60-61.

<sup>670</sup> Id. at 62.

<sup>671</sup> Id. at 62.

formulate plans.”<sup>672</sup> Additionally, on the basis of its past assessments of major administrative changes, “Congress and existing agencies should pay particular attention to ensuring there are effective communication strategies so that all affected parties, including investors and consumers, clearly understand any changes being implemented. In addition, attention should be paid to developing a sound human capital strategy to ensure that any new or consolidated agencies are able to retain and attract additional quality staff during the transition period. Finally, policymakers should consider how best to retain and utilize the existing skills and knowledge base within agencies subject to changes as part of a transition.”<sup>673</sup>

**Y. U.S. SECURITIES AND EXCHANGE COMMISSION STAFF, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATION OF SELECT CREDIT RATING AGENCIES (JULY 2008)**<sup>674</sup>

In August 2007, the Staff of the Securities and Exchange Commission conducted examinations of three leading credit rating agencies 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 issues identified by those examinations. Because the Commission’s Report mirrors the IOSCO Report in many respects, this summary will focus on additional insights, concerns and recommendations raised by the SEC.

As an initial matter, it is important to note that the Commission has announced (and continues to announce) regulatory reforms relating to CRAs. By way of reference, on July 1, 2008, the Commission published for public comment proposed rule changes to make limits and purposes of credit ratings clear to investors.<sup>675</sup> On July 11, 2008, the Commission voted to formally propose a comprehensive series of credit rating agency reforms to bring increased transparency to the ratings process and curb practices that contributed to recent turmoil in the credit markets.<sup>676</sup> More recently, on December 3, 2008, the Commission approved measures designed to increase the transparency and accountability at credit rating agencies and to ensure that forms provide more meaningful ratings and greater disclosure to investors.<sup>677</sup> The Commission’s brief description of these reforms is available at <http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm>.

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<sup>672</sup> Id. at 63.

<sup>673</sup> Id. at 62-63

<sup>674</sup> Office of Compliance Inspections, Division of Trading, and Office of Economic Analysis, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATION OF SELECT CREDIT RATING AGENCIES BY THE STAFF OF THE SECURITIES AND EXCHANGE COMMISSION (2008), <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

<sup>675</sup> See <http://www.sec.gov/news/press/2008/2008-127.htm>.

<sup>676</sup> See <http://www.sec.gov/news/press/2008/2008-110.htm>.

<sup>677</sup> See <http://www.sec.gov/news/press/2008/2008-284.htm>

## **SEC Findings**

### **Increase In Number and Complexity of Structured Finance Deals**

The Commission Staff found that “[f]rom 2002 through 2006, the volume of RMBS and CDO deals rated by the rating agencies substantially increased, as did the revenues the firms derived from rating these products.”<sup>678</sup> At the same time, the structured finance products that the CRAs were asked to evaluate became increasingly complex, with credit default swaps used more often to replicate the performance of mortgage backed securities. Likewise, during the same period, loans to retail borrowers being securitized into RMBS became more complex and less conservative. The Staff found that two of the three rating agencies examined struggled to adapt to the increase in the volume and complexity of the deals.<sup>679</sup> The Staff recommended that each examined agency 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.<sup>680</sup>

### **Aspects of The Ratings Process Not Disclosed**

Based on its examination, the Staff found that “certain significant aspects of the ratings process and the methodologies used to rate RMBS and CDOs were not always disclosed, or were not fully disclosed.”<sup>681</sup> For example, the Staff found that the examined firms used unpublished rating criteria and made “out of model” adjustments without documenting the rationale for the adjustment.<sup>682</sup> Pursuant to Section 15(a)(1)(B)(ii) of the Exchange Act, the Staff recommended that each NRSRO review its current disclosures relating to processes and methodologies for rating RMBS and CDOs to determine whether it is fully disclosing its ratings methodologies. The Staff also recommended that each of the examined firms review its policies concerning the timing of disclosures of significant changes to process and/or methodologies.

### **Information Provided To Rating Agencies**

The Report notes that there is no requirement that a rating agency verify the information contained in RMBS loan portfolios presented to it for rating. Rating agencies also are not required to insist that issuers perform due diligence, nor are they required to obtain reports concerning the issuer’s level of due diligence. Consistent with these principles, the Staff found that the 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

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<sup>678</sup> SUMMARY REPORT at 10.

<sup>679</sup> *Id.* at 11 – 12.

<sup>680</sup> *Id.* at 12 – 13. Each of the examined agencies had registered with the Commission as a nationally recognized statistical rating organization or NRSRO.

<sup>681</sup> *Id.* at 13.

<sup>682</sup> *Id.* at 13 – 14.

had implemented, or planned to implement, measures designed to improve the integrity and accuracy of the loan data received on underlying RMBS pools.<sup>683</sup>

### **Documenting Policies and Procedures for Rating RMBS And CDOs**

The Staff found that none of the examined firms had specific written procedures for rating RMBS and CDOs. The Staff also found that the agencies did not appear to have specific policies and procedures in place to identify or address errors in models of methodologies.<sup>684</sup> The Staff found that the examined agencies did not always document significant steps and participants in the rating process. By way of example, the Staff found that the rationale for deviating from models and out of model adjustments were not always documented in rating files. The Staff also found a lack of documentation of rating committee actions and decisions.<sup>685</sup> The Staff recommended that each examined firm determine whether its written policies and procedures used to determine credit ratings from RMBS and CDOs are fully documented in compliance with Exchange Act Rule 17g-2.<sup>686</sup>

### **Monitoring/Surveillance**

The Staff found that a lack of resources may have impacted the timeliness of surveillance/ monitoring efforts. At least one of the examined agencies could not provide documentation of surveillance. Two of the agencies did not have internal written procedures documenting steps that surveillance staff should undertake to monitor ratings on RMBS and CDOs.<sup>687</sup> The Staff recommended that each firm conduct a review to determine whether resources devoted to monitoring and surveillance are adequate. The Staff also suggested that firms adopt comprehensive written surveillance procedures and maintain surveillance records.<sup>688</sup>

### **Conflicts of Interest**

According to the Staff, each of the examined firms used the “issuer pays” model, in which the arranger/ issuer that is seeking the rating pays the CRA for the rating. The Staff found that while each rating agency had policies and procedures restricting analysts from participating in fee discussions with issuers, the policies allowed key participants in the ratings process to participate in fee discussions.<sup>689</sup> The Staff also found that analysts appeared to be aware of the agency’s business interests in securing the rating of deals when performing rating activities. The Staff concluded that the examined agencies did not take steps to prevent considerations of market share and other business interests from

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<sup>683</sup> Id. at 17 – 18.

<sup>684</sup> Id. at 16 – 17.

<sup>685</sup> Id. at 19 – 20.

<sup>686</sup> Id. at 20.

<sup>687</sup> Id. at 21 – 22.

<sup>688</sup> Id. at 22.

<sup>689</sup> Id. at 23 – 24.

influencing ratings or ratings criteria.<sup>690</sup> The Staff recommended that each firm review its practices, policies and procedures for managing and mitigating the “issuer pays” conflict of interest and consider implementing steps that would insulate or prevent the possibility that considerations of market share or other business interests could impact ratings or ratings criteria.<sup>691</sup>

### **Analyst Compensation**

Each of the examined agencies had policies providing that analysis may not be compensated or evaluated based on the amount of revenue that the rating agency derives from issuers or issues that the analyst works on, or with whom the analyst regularly interacts. The Staff’s review did not find indications that agencies compensated analysts in ways contrary to stated policy.<sup>692</sup> 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.<sup>693</sup> The Staff suggested that each firm review its policies and procedures to ensure compliance with regulatory requirements.<sup>694</sup>

### **Internal Audit**

In its review of each rating agencies internal audit programs and activities related to its RMBS and CDO groups, the Staff found that one firm’s internal audit program “appeared adequate in terms of assessing compliance with internal control procedures.”<sup>695</sup> 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.<sup>696</sup>

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<sup>690</sup> Id. at 24 – 25.

<sup>691</sup> Id. at 27.

<sup>692</sup> Id. at 27.

<sup>693</sup> Id. at 28.

<sup>694</sup> Id. at 29.

<sup>695</sup> Id. at 30.

<sup>696</sup> Id.