TESTIMONY OF
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SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"INDUSTRY PERSPECTIVES ON THE OBAMA ADMINISTRATION'S FINANCIAL REGULATORY REFORM PROPOSALS"

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I. Introduction

Chairman Frank, Ranking Member Bachus and members of the Committee:

My name is Randy Snook and I am Executive Vice President of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. I will present SIFMA's views on some of the proposed regulatory reforms set forth in Treasury's June 17, 2009 White Paper, *A New Foundation: Rebuilding Financial Supervision and Regulation,* and certain related legislative proposals.

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C. and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

Even before the financial crisis, many people, including members of this panel, recognized that the U.S. regulatory framework for financial regulation was in need of modernization. The financial crisis has made the need for reform more pressing than ever. We should all recognize that there will not be many opportunities to get it done right, that is, in a way that protects consumers and investors, supports constructive innovation, returns our financial sector to a position of strength and ensures our country's competitiveness as a leading financial center, while providing a durable platform for steady economic growth, employment and investment. We must take advantage of this unique opportunity to make the changes that are necessary to meet the challenges of the 21st century marketplace.

In addressing the imperatives of a modern financial system, we must recognize that financial markets are global in nature. Individual U.S. and non-U.S. banks, securities firms, insurance companies, hedge funds and other financial institutions operate in all major markets around the world. Non-U.S. financial institutions operate in our financial markets just as U.S. firms operate off-shore. Investors around the globe invest in multiple markets either directly or through financial intermediaries. As a result, we need a global approach to financial regulatory reform – one that promotes common regulatory standards and minimizes the opportunities for cross-border regulatory arbitrage.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue – in the U.S. and abroad – to restore confidence in the global financial system. Our members understand that a well-designed and implemented regulatory system fosters robust and stable financial markets.

II. Supervision and Regulation of Financial Firms

Systemic risk has been at the heart of the current financial crisis. SIFMA has devoted considerable time and resources to developing a coherent conceptual framework for dealing with systemic risk, and specifically what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future. We have come to a consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our financial regulatory system. Generally, we support Treasury's recommendations for reforming supervision and regulation of financial firms and would like to detail some of SIFMA's thinking.

1. Creation of a Systemic Risk Regulator and a Financial Services Oversight Council

We believe that Treasury's White Paper proposal for a single, accountable systemic risk regulator, balanced with a newly created Financial Services Oversight Council (the "Council"), would improve upon the current system. At present, no single regulator (or collection of regulators) has the duty, authority or resources to collect information system-wide or to use that information to take corrective action in a timely manner across all financial institutions and markets regardless of charter. A systemic risk regulator that has access to information about any systemically important financial institution – whether a bank, broker-dealer, insurance company, hedge fund or private equity fund – could have the necessary perspective to ensure firms are not exploiting the gaps between functional regulators, or posing a risk to the larger system. While a systemic risk regulator will not be able to identify the causes or prevent the occurrence of all financial crises in the future, the combined work of the systemic risk regulator and the Council would provide an overview of the aggregate risk in our financial system.

A. Creation of a Systemic Risk Regulator

We strongly endorse designating a single oversight body as systemic risk regulator. We note that the regulator could be the Federal Reserve, as proposed by the White Paper, or another entity. A single systemic risk regulator, in combination with the Council, would be best positioned to efficiently and effectively assess threats to financial stability and ensure that appropriate action is taken promptly. An alternative approach of designating a panel of regulators, such as the President's Working Group or the Council, as the systemic risk regulator might bring together more collective expertise than a single entity would have, but it would raise issues of coordination and collective accountability. This model could perpetuate continued gaps, duplication, inefficiency and waste compared to a single oversight body. Centralizing the responsibilities for systemic risk regulation in a single entity, combined with the advisory, administrative and monitoring functions of the Council, is the right approach.

We understand that there are a number of tradeoffs involved in designating one entity over another as the systemic risk regulator, and we appreciate the advantages of Treasury's proposal to designate the Federal Reserve as such. The Federal Reserve already has a window into U.S. and global markets. It has an experienced staff and the ability to expand its resources with revenues from its open market activities. The Federal Reserve also has a long history of independence and credibility with the markets and regulators around the world with which the systemic risk regulator would need to coordinate. It possesses many of the tools that we believe are essential for the systemic risk regulator, such as the ability to act as a lender of last resort and to provide emergency financial assistance. The Federal Reserve also has experience and a credible track record of using these tools responsibly. Finally, expanding the Federal Reserve's powers to include those of a systemic risk regulator could be done relatively quickly.

Given the scope of authority the systemic risk regulator may have, and regardless of which regulator is chosen to perform this function, Congress should consider a robust reporting regime for the systemic risk regulator including, at a minimum, annual reports to Congress. The systemic risk regulator might report on (1) the risks to the U.S. financial system, (2) the regulatory measures being taken or that will be taken to address such risks, (3) the costs and benefits of such measures, (4) any adverse effects from such measures on market discipline and (5) the steps being taken to maximize the benefits of market discipline.

B. Powers of the Systemic Risk Regulator

SIFMA supports the proposal for the systemic risk regulator to have a direct role in the oversight of systemically important financial institutions (referred to as Tier 1 FHCs in the White Paper) and markets, including the power to promulgate regulations establishing minimum consolidated capital, liquidity and risk management requirements, conduct examinations and take prompt corrective action.

The systemic risk regulator should also be able to override the judgments of functional regulators and impose stricter or different requirements on systemically important groups. If the systemic risk regulator receives enforcement authority, it should be required to coordinate the use of that authority with the relevant federal functional regulators. While we believe that the role of functional regulators should be preserved, we are in favor of designating the systemic risk regulator as the consolidated supervisor of such institutions, much as the Federal Reserve is the umbrella supervisor of bank holding companies now.

We do not believe that the activity restrictions that currently apply to financial holding companies under the Bank Holding Company Act should be extended to Tier 1 FHCs. Rather, we suggest that any limitation on the activities of Tier 1 FHCs, as well as financial holding companies under the Bank Holding Company Act, should be based on the relative riskiness of the activities rather than on whether a particular activity falls on one side or the other of the so-called wall between banking and commerce. Thus, whether a particular activity would be permissible, and the conditions under which it could be conducted, would be based on whether the particular institution had the risk management, internal controls, capital and liquidity necessary to conduct the activity in a safe and sound manner, and not on any classification system based on the wall between banking and commerce.

C. Coordination

In a regulatory system where functional regulation is overlaid by financial stability oversight, it is important to consider how the systemic risk regulator coordinates with functional regulators. As a general principle, we believe that the systemic risk regulator should develop processes for coordinating with the relevant functional regulators to avoid duplicative or conflicting regulation and supervision. The Council would be helpful in this regard through its role of facilitating information sharing and coordination among the principal federal financial regulatory agencies.

International cooperation on systemic risk regulation is also critical, in light of how quickly systemic risk can cross borders and the likelihood of regulatory arbitrage to arise if systemically important financial institutions are subject to stricter prudential regulation, as Treasury has proposed. Congress should therefore consider giving the U.S. systemic risk regulator a mandate to coordinate with its foreign and international counterparts, such as the European Systemic Risk Board, on systemic risk issues.

D. Scope of Authority

We support making all systemically important financial institutions and systems, regardless of their charter, functional regulator or unregulated status, subject to the oversight of the systemic risk regulator. Accordingly, we agree with Treasury's Proposal to give the systemic risk regulator access to information about any financial institution that might be systemically important, including banks, broker-dealers, insurance companies, hedge funds, private equity funds and others. This regulator should have authority to use the information it gathers to determine which financial institutions actually are "systemically important," meaning institutions that would likely have serious adverse effects on economic conditions or the financial stability of other entities if they were allowed to fail.

We support giving the systemic risk regulator discretionary authority to declare entities to be systemically important or to exempt any financial institutions from coverage or determine that an institution once designated as systemically important should no longer be classified that way. This discretion is necessary to ensure that systemically important institutions do not adopt organizational and operational innovations that would otherwise allow them to escape the risk regulator's consolidated supervision and regulation.

We believe that it would be a mistake for the systemic risk regulator's powers to focus exclusively on those financial firms that are systemically important. There may be sectors of the market where individual entities are not systemically important, but which entities in the aggregate can have a significant impact on systemic risk. The financial guaranty insurance industry is one such example. If the authority of the systemic risk regulator is limited to systemically important financial firms, any efforts to identify and control systemic risk will simply result in shifting the risky activity to other financial institutions or off-shore rather than reducing or controlling it. Congress should therefore consider giving the systemic risk regulator the authority to make uniform rules, where applicable, for any class of similarly situated financial institutions, markets, products or services to the extent necessary to reduce systemic risk and promote financial stability, or to encourage the relevant functional regulators do so. The systemic risk regulator should also have the mandate to gather information from the functional regulators as well as to share information relative to systemic risk issues.

2. Stricter Prudential Regulation for Systemically Important Institutions

SIFMA appreciates the need to impose certain additional regulatory requirements on systemically important institutions. While we believe that such regulation is important to ensure that institutions are adequately monitoring and managing risk, we are also mindful that stricter regulatory standards will create regulatory arbitrage between systemically important institutions and those institutions not so designated. Activities that are regulated more heavily when conducted by a systemically important institution may tend to migrate to less regulated institutions or flow off-shore. Instead of reducing overall risk in the system, this approach could simply shift risk from one group to another. We therefore urge caution when imposing disparate requirements on financial institutions so as to maintain to the extent possible a level playing field between systemically important and other financial firms.

3. Executive Compensation Standards

A responsible approach to executive compensation is key for restoring trust and confidence in the financial system and promoting growth and stability. SIFMA believes that compensation should be aligned with the best interests of shareholders, the financial system and the economy, and we are committed to structuring compensation arrangements to enhance long-term shareholder value and prevent undue risk-taking. In early June, SIFMA released Guidelines for Compensation in coordination with other industry groups and compensation and governance professionals.[2] The SIFMA Guidelines are in line with the executive compensation principles discussed in the White Paper. We fully support their integration into the supervisory process. We believe that firms should communicate their compensation philosophy, practices and policies, particularly as they relate to risk-taking and sustainable performance. At the same time, we believe it is necessary to balance this transparency with appropriate confidentiality to maintain competitive differentiation among firms and protect personal privacy. Compensation policies must be consistent with effective risk management and be designed to attract, motivate and retain the necessary talent.

III. Comprehensive Regulation of Financial Markets

SIFMA supports comprehensive, well-crafted regulation of financial markets and believes that we must work to rationalize the regulation of financial markets to eliminate regulatory gaps and inconsistencies. We welcome Treasury's proposals on this subject and would like to take this opportunity to address three areas of reform in particular: OTC derivatives, SEC and CFTC regulation of securities and futures and securitization.

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[2] Available at http://www.sifma.org/legislative/savings/pdf/SIFMA-Comp-Guidelines-06-09.pdf.

1. OTC Derivatives

We agree with the broad policy objectives laid out for OTC derivatives regulation in Treasury's White Paper: preventing risk to the financial system, promoting market efficiency and transparency, preventing market manipulation and fraud, and prohibiting inappropriate marketing practices. We also believe that Treasury has correctly identified the principal cause for concern in this area, namely "excessive risk taking" by a small number of market participants. We agree with Treasury that clearing is a useful tool for reducing risk, including in particular interconnectivity risk, and financial firms have taken steps to clear more and more types of OTC derivatives. We support clearing of standardized derivatives transactions by financial firms wherever this is possible without disrupting the thousands of companies across America that use derivatives to manage risk.

These non-financial companies use derivatives to hedge individualized risks arising in their day-to-day business activities, and the types of derivatives that are standardized sufficiently for clearing may not precisely match the risks they are hedging. Unless these companies can continue to enter into non-standardized derivatives, they would remain exposed to a portion of the risk or take on additional risk. In addition, their inability to match derivatives closely to underlying risks could prevent companies from utilizing hedge accounting under FAS 133 and thus add to apparent volatility in their earnings, which could increase their cost of capital. While these companies might provide collateral for their contracts, this collateral may not be in the form required by clearinghouses, generally cash or cash equivalents, and so requiring these companies to use standardized, cleared derivatives would necessitate allocating working capital away from investment in their businesses to fund margin requirements.

To the extent Congress determines that mandatory clearing of some transactions is necessary, we believe that mandate should be applied to derivatives dealers and other organizations that are systemically important and significant participants in derivatives markets. It is also important to recognize that clearing will not necessarily benefit all of these institutions' standardized OTC derivatives contracts. Although standardization is a necessary attribute of OTC derivatives that can be centrally cleared, it is not sufficient by itself to ensure clearability, and so clearing should not be uniformly mandated for all standardized contracts. A standardized contract also must be traded with sufficient frequency and volume (i.e., liquidity) that the clearinghouse can determine its value on a daily basis in order to calculate the amount of collateral it needs to protect itself against loss in the event of a default. Failure to collect an appropriate amount of collateral with this regularity could cause the clearinghouse itself to pose a risk to the financial system. Moreover, the clearinghouse itself must have the resources, operational competence, experience, risk management infrastructure, and broad-based participation by major market participants needed to clear the contract in a prudent manner. To help ensure a clearinghouse meets these conditions, market participants should have choice among clearinghouses for the clearing of their contracts. These considerations are critical to ensure that clearing improves, rather than undermines, financial stability.

We understand that improving regulatory reporting of derivatives transactions is an essential part of a robust prudential supervisory regime. We believe that the transparency goals of Congress can be readily achieved without mandating exchange trading of derivatives products. Exchanges and over-the-counter markets can compete to provide efficient execution services while still providing trade data to regulators. Timely information about market participants' transactions and open positions should be submitted to a data repository, but we caution against requiring TRACE-like real-time public reporting of trade data, which we believe can reduce market liquidity.

We agree with Treasury's view that derivatives dealers and other firms that have large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation, which includes capital requirements. We note that bank regulators already have procedures for setting capital levels that are adequate and believe these should be relied upon wherever possible. Recent instances of significant problems arising out of the credit default swap business involved firms that were not subject to bank capital requirements. Of course, the capital requirements that apply to derivatives dealers and other firms should be developed in concert with financial regulators in other countries so as to avoid competitive advantage or disadvantage on the basis of capital. We believe those requirements should be consistent with existing bank capital requirements for OTC derivatives. We also believe that bank regulatory requirements for collateral should be relied upon where possible and emulated where they do not currently apply.

One issue that was not addressed in Treasury's White Paper, but that we recommend Congress include in legislation, is ensuring that derivatives regulation is the clear purview of the federal regulators. In the recent past, several states and organizations of collected state officials have considered legislative or regulatory proposals to regulate credit default swaps as insurance. They often cite a lack of federal action as the primary cause for their efforts. We are concerned about these efforts for several reasons. In the first place, credit default swaps are not insurance. Among the characteristics that distinguish them are common provisions calling for credit default swap parties (both the seller and the buyer of protection) to post margin and the fact that a protection buyer generally does not have to incur a loss in order to demand payment from the protection seller. But even more important, state regulation of credit default swaps as insurance would be inconsistent with the comprehensive regulatory scheme being proposed by Treasury for the financial services industry generally and derivatives in particular. The burden imposed on market participants, including oversight by as many as 50 different state regulators, would give them a compelling incentive to move their business off-shore and would impair rather than improve the market. If Congress adopts legislation to create new derivatives regulation, it should consider including a provision that broadly preempts state law.

We also would like to take this opportunity to say that we agree with Secretary Geithner that credit default swaps should not be singled out for special, more restrictive treatment. In particular, we are concerned about proposals to prohibit credit default swaps that are not entered into for the purpose of hedging (so-called “naked” credit default swaps), including section 355 of H.R. 2454, the American Clean Energy and Security Act of 2009. Such swaps provide liquidity to the credit default swap market and active trading in that market provides economically useful data in the form of prices for credit protection with respect to specific companies. We believe that appropriate regulatory oversight and the enforcement of existing laws against market manipulation is the better approach to preventing adverse consequences from these transactions.

2. Harmonization of SEC and CFTC Regulation of Securities and Futures

SIFMA supports the White Paper’s proposal to harmonize the regulation of securities and futures. Under current law, certain economically equivalent financial instruments may be subject to very different regulation by the SEC or the CFTC depending on whether they are determined to be “securities” or “futures.” In addition, it may be difficult to determine in advance whether a particular instrument will be subject to SEC or CFTC regulation. This uncertainty can cause excessive delay in the creation of new products and even give rise to costly and wasteful litigation.

If Congress determines that a merger of the SEC and CFTC should not occur at this time, then in keeping with each agency’s regulatory functions, Congress should expressly delegate the regulation of financial products, such as broad market indices, currencies and interest rate swaps, to the SEC and non-financial products, such as commodities, to the CFTC. We are supportive of the SEC’s adopting some of the exchange oversight principles applied by the CFTC in its supervision of exchanges. SIFMA also supports granting the SEC express authority to regulate advisers to hedge funds.

3. Securitization Market Reforms

We agree that targeted securitization market reforms are needed, and we are working actively on a number of fronts to strengthen the infrastructure for this critically important market in order to help to restore confidence and functionality to the securitization markets. Among other reforms, we support policymakers' efforts to find appropriate ways to require securitization market participants to have "skin in the game." One mechanism that can promote this goal is required retention of a meaningful economic interest in securitized exposures. Retention of a meaningful economic interest would help to align the incentives of originators and transaction sponsors with those of securitization investors. Retention would strengthen incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and eligibility criteria, which would promote responsible and efficient lending.

Further, we support Treasury's proposal that federal bank regulators should be given the authority to design and apply bank retention requirements in a manner that specifies permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of the retention requirements, whether and to what extent hedging of retained interests is permissible and other important implementation details.

We suggest that there are alternatives to mandated retention of credit risk in securitized assets that should be considered as methods to achieve the policy goal underlying a retention requirement. Many of the other proposals in the White Paper, such as policies relating to risk management, fraud protection and detection mechanisms, will work to improve the function of the securitization markets. In addition, policies previously considered by this Committee could also help better align the incentives of securitization market participants, including a stronger and broader scope of third-party due diligence and stronger, more standardized and more effective representations and warranties made by an asset originator or seller regarding the underwriting standards and performance of loans sold into securitization vehicles could also help better align the incentives of securitization market participants. We note that the industry has already taken steps towards such improved representations and warranties through the American Securitization Forum's Project RESTART.

IV. Consumer and Investor Protection

The consumer and investor protection proposals in Treasury's White Paper are among the farthest-reaching and most important. I would like to take this opportunity to comment on Treasury's proposals in three areas: the Consumer Financial Protection Agency, the regulation of investment advisers and broker-dealers and pre-dispute arbitration clauses.

1. Consumer Financial Protection Agency

SIFMA supports strengthening consumer protection regulation, including the promulgation and enforcement of national standards governing consumer credit products and lending practices. However, we are concerned that creating a new agency for these purposes might lead to wasteful and duplicative regulation while failing to deliver the hoped-for benefits due to the separation of consumer protection and prudential regulation. My comments will address specific concerns with certain provisions of the Consumer Financial Protection Agency Act of 2009 (the "Act").[3]

SIFMA believes the Consumer Financial Protection Agency (the "CFPA") could inadvertently encroach on the jurisdiction of the SEC and CFTC. The White Paper states that the CFPA would provide consumer protection in the financial products and services markets, "except for investment products and services already regulated by the SEC or CFTC." Treasury officials have reiterated in various public statements that the CFPA is not intended to supersede the broad investor protection mandate of the two agencies. Nevertheless, as proposed, the CFPA's jurisdiction would be broad and have uncertain boundaries, potentially overlapping with those of the SEC and CFTC. We believe the Act should provide a full exclusion for investment products and services regulated by the SEC or the CFTC. As currently drafted, it excludes only a narrow list of activities of some of the persons regulated by the SEC, such as broker-dealers and investment advisers. Arguably the SEC's authority over transparency and disclosure, including its exclusive ability to mandate issuer disclosure in proxy statements and annual reports, also would be called into question. To avoid overlapping jurisdiction, we urge Congress to exclude from the jurisdiction of the

[3] We are aware that Treasury has proposed one version of the Act and that Chairman Frank has introduced another version of the Act (H.R. 3126). The two versions of the Act are similar with respect to the provisions on which I will comment.

CFPA any securities activity and any person, product or other activity that is regulated by the SEC or the CFTC.

With respect to non-securities-related activities, we are concerned about the potential conflicts and redundancies that may arise if the States have concurrent enforcement authority with the CFPA. This would prevent the development of uniform enforcement policy and create fifty-one independent regulatory regimes. Because no one authoritative body would have a final say on what does or does not constitute a violation of the Act, it would be difficult for regulated firms to structure their businesses to ensure compliance. Nor would regulated firms know with which regulator to settle a potential enforcement action. This uncertainty could raise the cost of doing business and have the unintended consequence of driving up prices for consumers.

We believe any legislation establishing a CFPA should clarify that the agency is subject to the standard Office of Management and Budget process for budget approval. We also suggest that funding the CFPA by fees or assessments, as currently proposed, is inadvisable because such costs would ultimately be paid for by consumers in the form of higher prices – harming the people meant to benefit from the establishment of the CFPA. Rather, we believe that it would be better as a public policy matter for the agency's budget to be funded through the regular appropriations process.

However, if Congress chooses to fund the agency by fees or assessments, we would suggest that the CFPA follow the SEC model and set fees at a level to recover a targeted amount, which could be its appropriation for the first full year.

Thereafter, the CFPA could recover this amount, indexed for inflation, unless Congress raised the targeted amount. This would give predictability to the fee-setting process and avoid imposing a costly burden on regulated firms. We would also suggest that Congress ensure that the CFPA applies its fees or assessments in an equitable manner across regulated persons and products and does not unfairly discriminate among them.

We also observe that separating consumer protection regulation from prudential regulation could have serious negative consequences. Situations could arise in which the CFPA demands changes in business practices that would negatively impact a firm's safety and soundness. Such a situation would pit regulators against one another in a tug-of-war over the regulated firm. Congress should consider addressing coordination between the CFPA and the relevant prudential regulators in any proposed legislation to create a consumer protection agency.

The Committee should also clarify ambiguity that could raise questions as to whether the CFPA has jurisdiction over employer-sponsored retirement plans subject to Employee Retirement Income Security Act ("ERISA") or tax-favored accounts such as Individual Retirement Accounts ("IRAs"). These accounts are already subject to significant regulation through ERISA, the Internal Revenue Code (the "Code") and multiple federal and state government agencies and self-regulatory organizations.

It is not only unnecessary for the CFPA to have regulatory authority over these arrangements, the plan sponsors or service providers, but permitting an ambiguity to exist regarding another layer of regulation to a system that already is subject to an extremely comprehensive set of regulations is very likely to harm the very people the CFPA is designed to help.

ERISA and the Code require plan fiduciaries and providers to provide participants with information about their plans, including significant disclosure to the participants and beneficiaries on a regular basis. The governing laws also provide participants and beneficiaries with the right to sue for breaches of duty or other failures to provide information or benefits. We believe that resolving this ambiguity is very important so that employers will not be discouraged from offering these plans to their employees and to ensure that services can be provided in the most cost-effective manner.

2. Harmonizing the Regulation of Investment Advisers and Broker-Dealers

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for brokers, dealers, investment advisers and other financial intermediaries.[4] When broker-dealers and investment advisers engage in the identical service of providing personalized investment advice about securities to individual investors, they should be held to the same standard of care. Conversely, when broker-dealers are not providing personalized securities investment advice to individual investors (such as, for example, when broker-dealers simply execute orders for customers, or engage in market-making,

[4] See, e.g., Testimony of T. Timothy Ryan, Jr. before the U.S. Senate Committee on Banking, Housing and Urban Affairs in the March 10, 2009 hearing titled "Enhancing Investor Protection and the Regulation of the Securities Markets," available at http://www.sifma.org/legislative/testimony/pdf/Ryan-03-10-2009.pdf.

underwriting or providing cash sweep services), there is no cause for modifying the existing, extensive regulatory regime that governs broker-dealers. We therefore welcome Treasury's newly proposed legislation, the "Investor Protection Act of 2009," which appears to acknowledge these important distinctions, and which would give the SEC the authority to establish rules for a new, uniform, federal standard.

Individual investors deserve – and SIFMA strongly supports – a new federal fiduciary standard of care that supersedes and improves upon the existing fiduciary standards, which have been unevenly developed and applied over the years, and which are susceptible to multiple and differing definitions and interpretations under existing federal and state law. Whatever label, if any, the SEC applies to this new federal standard, we must ensure that it functions as a unitary and exclusive standard that is uniformly and even-handedly applied – at the federal level – to both investment advisers and broker-dealers when they provide personalized investment advice about securities to individual investors. Congress successfully followed a similar approach when it restructured federal-state securities regulation through the National Securities Markets Improvement Act of 1996.

The hallmark of a new federal standard should be putting investors' interests first. At the very outset of the customer relationship, the duties, obligations and expectations of the customer and the financial service provider must be communicated and documented in plain English. Broker-dealers and investment advisers alike should seek to avoid conflicts of interest. If they cannot, then they must effectively manage conflicts through clear, unambiguous disclosure and, as appropriate, investor consent.

A new federal standard should also protect investors by respecting and preserving investor choice, which is part of putting clients first. This should include investor choice to select, contract for and receive any of the wide range of products and services offered by their financial services provider, and investor choice to define or modify relationships with their financial services provider based on the investor's preference. In light of the numerous, diverse and investor-beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today's investment advisers, a new federal standard should also recognize and preserve product and service innovation and capital formation. Yet another way to support choice, innovation and service is to provide firms with appropriate relief from the SEC's current prohibitions against principal trading, which in today's liquid and transparent markets no longer make sense and have had the effect of foreclosing opportunities for investors to obtain more favorable pricing on transactions because of the requirement of transaction-by-transaction consent. A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice about securities to individual investors.

We recognize the important role that States play in protecting investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions for fraud to the extent consistent with the new standard of care. Any new legislation, however, should make clear that subjecting a financial professional to the new federal standard does not create any presumption that the financial professional is providing investment advice or is a fiduciary for purposes of any other federal or state laws. This enables broker-dealers to continue to provide investors choice of investment products, particularly in IRAs.

We also hope that harmonization would involve a reaffirmation that pre-dispute arbitration clauses in advisory and brokerage contracts are valid. In the past, the SEC has prohibited the inclusion of such clauses in advisory contracts on the grounds that they may confuse clients by causing them to believe they have waived their rights under the federal securities laws, which would violate the antifraud provisions of the Investment Advisers Act of 1940.[5] As I will describe in further detail in the next section of my testimony, this opposition to arbitration clauses is at odds with federal policy, judicial precedent and empirical evidence.

3. Pre-Dispute Arbitration Clauses

Treasury has proposed giving the SEC authority to prohibit pre-dispute arbitration clauses in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors. Similarly, the CFPA, as proposed, would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the

[5] McEldowney Financial Services, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.

Congress has maintained a policy in favor of arbitration since the passage of the Federal Arbitration Act. The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency. The U.S. Supreme Court has expressly approved the use of pre-dispute arbitration clauses.

SIFMA supports the idea of conducting further study of securities arbitration and pre-dispute arbitration clauses. In fact, we conducted our own study of the matter in October 2007.[6] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them to pursue claims that they could not afford to litigate or that would be dismissed in court. Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system. In fact, it is our view that prohibiting such clauses would essentially be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical

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[6] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, seek "jackpot justice" or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of Treasury's proposal. We urge Congress to consider these factors in its deliberation over Treasury's pre-dispute arbitration clause proposals. We also suggest that further study of this subject might be particularly instructive.

V. Resolution Authority

One of the important gaps exposed during the current financial crisis was the lack of federal resolution authority for certain systemically important financial institutions. The Federal Deposit Insurance Corporation ("FDIC") has broad powers to act as a conservator or receiver of a failed or severely troubled bank. These powers include the ability to control the process, to repudiate burdensome contracts, to transfer certain assets and liabilities to a bridge bank and to enter into loss-sharing and other financial assistance arrangements designed to maximize the value of the failed institution for the benefit of its depositors, other creditors and other stakeholders. These are the powers the FDIC used to resolve WaMu, IndyMac and other thrifts. The Federal Housing Finance Authority exercised similar powers when it placed Fannie Mae and Freddie Mac into conservatorship.

No similar resolution authority is available to resolve other systemically important financial institutions. Neither the Bankruptcy Code nor state insurance insolvency codes gives the government sufficient control over the resolution of these firms. We therefore welcome Treasury's proposal to create a federal resolution authority for these other systemically important financial institutions. Such resolution authority is an essential tool in the government's financial crisis management toolbox. The White Paper's outline for the resolution authority is a good starting point for discussion. It has many elements that are generally well-designed. For example, we think it is sensible to model the resolution authority on the FDIC's current resolution powers over insured depository institutions, provided the authority is adapted to the very different institutions and context to which it would apply. We also believe it is appropriate for the resolution authority to extend to all systemically important financial institutions other than insured depository institutions, in contrast to Treasury's proposed legislation in March, which contained numerous carve-outs for entities such as broker-dealers and insurance companies.

However, the proposed resolution authority has the potential to change the "rules of the game" on the eve of bankruptcy, which would risk seriously disrupting the reasonable expectations of creditors, counterparties, customers and other stakeholders. The current proposal would allow Treasury, in consultation with the President and certain regulators, to designate a firm as systemically important and subject to the new resolution authority instead of the Bankrupcty Code on the eve of failure. Sections 11 and 13 of the Federal Deposit Insurance Act, upon which the new resolution authority is to be modeled, contain priorities, preference avoidance powers and other provisions that are fundamentally different from the corresponding provisions of the resolution regimes that would otherwise apply, including the Bankruptcy Code, the Securities Investor Protection Act and state insurance insolvency codes.

Congress should consider several steps to ensure that the new resolution authority does not disrupt the reasonable expectations of creditors and other stakeholders. Most importantly, Congress should harmonize the priorities, preference avoidance powers and other key substantive rights under the proposed resolution authority with their counterparts under the Bankruptcy Code or other laws it would be replacing. Second, Congress should make sure that all creditors within a given class are treated equally. Third, Congress should consider requiring the federal agency in charge of resolution to promulgate rules and regulations that provide *ex ante* legal certainty on all key legal issues. Fourth, Congress should consider requiring the agency to provide as much notice as possible that a particular firm would be treated as systemically important and subject to the resolution authority, rather than leaving that determination until the eve of failure. Fifth, the proposed authority should provide for better judicial review of the resolution process, particularly the claims process. Sixth, Congress should impose a duty on the resolving agency to maximize the value of the failed institution's assets for the benefit of creditors and other stakeholders. There may also be other steps that can be taken to ensure the reasonable expectations of the stakeholders.

The choice of which agency will resolve failing firms is a vital element of any resolution authority. Treasury has proposed that the FDIC play this role, unless the largest subsidiary of the failing firm is a broker-dealer or securities firm, in which case the SEC would do so. Whichever agency is selected, we believe it is essential that it be one with adequate experience with the sort of large, complex, cross-border financial groups to which the new authority would apply.

One aspect that Treasury's proposal does not treat but that is very significant to many market participants is the status that qualified financial contracts ("QFCs") would have under the resolution authority. The White Paper does not mention any provisions guaranteeing counterparties the right to terminate or close-out QFCs, although there are such provisions in the Bankruptcy Code, the resolution provisions that apply to banks and GSEs, and Treasury's March bill. Congress should make sure that the proposed authority contains such provisions.

Finally, it is worth noting what is at stake in the debate over the resolution authority. A poorly designed or unwisely administered resolution authority could increase the likelihood and frequency of seize-ups in the credit markets and otherwise undermine investor, creditor and public confidence during a financial crisis. It could also make credit less available and more expensive during normal times. It is therefore imperative to take the time necessary, and consult a sufficient array of experts, to create a robust and well-functioning federal resolution authority.

VI. International Coordination and Cooperation

As I noted in my introductory remarks, the global nature of financial markets calls for a global approach to financial regulatory reform. Unless common regulatory standards are applied and enforced across global markets, opportunities for regulatory arbitrage will arise. We must also consider the impact that our financial regulatory reform may have on other markets, as well as the possibility that any particular reform could, unless coupled with a coordinated global approach, give rise to disparate regulatory treatment as among U.S. and foreign markets, or create incentives to move U.S. jobs and businesses off-shore. Conversely, we need to carefully monitor the impact of major non-U.S. regulators or regions on U.S. domestic markets and financial institutions. Regulatory divergence can have a variety of ill effects, including raising costs to investors, unnecessarily complicating compliance, hindering global regulatory cooperation and coordination and, at worst, provoking retaliatory measures and counter-measures, causing a drag on global economic recovery.

Close cooperation among policymakers on an international basis, therefore, will be essential if we are to effectively addressing systemic risk and other challenges affecting the financial system. Accordingly, we strongly support the expanded membership and role of the Financial Stability Board, and the increased cooperation and coordination among regulators in major markets in the U.S., Europe, Asia and elsewhere around the world. We are also observing with interest the Financial Stability Board's Standing Committee for Supervisory and Regulatory Cooperation, chaired by Adair Turner of the U.K.'s Financial Services Authority, whose mandate is to address coordination issues that arise among supervisors and regulators and to raise any need for subsequent policy development. There are several other international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including the G-20, the Basel Committee on Banking Supervision, IOSCO and the Joint Forum. Congress should continue to support and encourage the efforts of these groups.

VII. Conclusion

Recent challenges have highlighted the necessity of a fundamental review of our regulatory system. SIFMA strongly supports these efforts and commits to being a constructive participant in the process. SIFMA stands ready to assist the Committee as it considers regulatory reform to minimize systemic risk, strengthen and streamline the prudential regulation of financial firms, protect consumers and investors and create a new resolution authority for large, interconnected firms. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but also help the investing public meet its financial needs and support renewed economic growth and job creation.