

Testimony  
of  
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Former Chairman, U.S. Securities and Exchange Commission  
before the  
Financial Crisis Inquiry Commission

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\* Chairman Angelides, Vice Chairman Thomas, and Members of the Commission: Thank you for the opportunity to submit views on the subjects of today's hearing from my perspective as a former Chairman of the Securities and Exchange Commission.

### *The "Shadow" Banking System*

You have asked me to address the "shadow" banking system and the role that it played in the financial crisis, as well as my perspective on the SEC's efforts through a voluntary program to supervise one portion of that system.

First, I would note that the term "shadow banking" is an apt description of a massive, but often opaque, portion of our financial services sector that otherwise defies easy classification. Some analysts have used the term in reference to the major investment banks. Others mean it to refer to hedge funds, structured investment vehicles and other non-bank financial institutions that play a role in lending.

Attempting to define shadow banking in terms of institutions, however, is necessarily both over- and under-inclusive. It makes more sense to follow the money. Shadow banking is the business of borrowing and lending money – and equivalent non-monetary instruments – outside of the traditional banking system.

The diverse range of non-bank financial institutions that play central roles in that system include money market mutual funds, insurance companies, investment banks, securitization vehicles, hedge funds, and the government-sponsored enterprises Fannie Mae and Freddie Mac. Beyond those institutions, however, commercial banks too have been significant players in the "shadow banking" system through off-balance sheet entities, outside the scope of their traditional borrowing and lending activities.

Over recent decades, the shadow banking system has grown to a tremendous scale. As of the end of 2008, 84 percent of all credit in the United States was provided via capital markets instruments, with only 16 percent provided via bank loans.

The development of credit risk transfer instruments in recent decades fundamentally changed the structure of the financial system. Structured credit products, through which portfolios of credit exposures could be sliced and repackaged to meet the needs of investors, significantly expanded the creation of commercial credit. Not only non-bank institutions but commercial banks as well were substantial issuers of such instruments. In recent years commercial banks funded a growing amount of long-term assets with short-term liabilities in wholesale markets through the use of off-balance-sheet vehicles, exposing themselves to credit and liquidity risk outside of regulatory leverage limits by providing facilities to these vehicles. They also held structured credit instruments on their own balance sheet, exposing themselves to embedded leverage and increasing their asset-liability mismatch and their funding liquidity risk.<sup>i</sup>

The financial crisis culminated in many parts of this shadow banking system facing a “run on the bank,” as counterparties that provide funding and risk products refused to do business with entire entities. The shadow banking system, like the traditional deposit-taking banking system, depends on short-term liabilities to finance long-term assets. When short-term funding sources for these liabilities became scarce or completely unavailable, the institutions that depended upon them faced existential crises.

The shadow banking system is not neatly separated from the traditional banking system, because during recent decades commercial banks — following their large corporate clients which were selling more debt, rather than borrowing directly from banks — have developed large investment banking businesses. In the years preceding the financial crisis of 2008, banks and non-banks alike issued increasingly larger amounts of debt to fund everything from consumer loans, to high-yield corporate debt, to mortgage-backed securities. This represented a response both to the historically low interest rates that resulted from central bank policy and an increase in global savings flows to the U.S., and to the sustained increase in housing prices, fueled by increasingly readily available and inexpensive mortgage finance. The abrupt devaluation of these MBS and other credit risk transfer instruments contributed significantly to the loss of confidence in both commercial banks and non-banks.

The MBS devaluation was itself the result of an asset bubble in the residential mortgage market, exacerbated by the rise in the use of high risk mortgage products including the notorious “liar loans” and no-money-down financing. It is abundantly clear, as the SEC's former Chief Accountant Lynn Turner testified in Congress on the failure of AIG, that "if honest lending practices had been followed, much of this crisis quite simply would not have occurred." The nearly complete collapse of lending standards by banks and other mortgage originators led to the creation of so much worthless or near-worthless mortgage paper that as of September 2008, banks had reported over one-half trillion dollars in losses on U.S. subprime mortgages and related exposure. And while the first mortgage market to come under stress was subprime, other high-risk mortgage products contributed significantly to the financial crisis. These include subprime, Alt-A, negative amortization, interest-only, option ARM's, “low doc,” “no doc,” FICO's less than 620, original loan-to-value greater than 90%, and the combination of FICO's less than 620 and original loan-to-value greater than 90%.

The shadow banking system helped to spread this contagion to institutions in every sector — from commercial banks and thrifts such as Wachovia, Washington Mutual, and IndyMac, to investment banks such as Bear Stearns and Lehman Brothers, to the government-sponsored enterprises Fannie Mae and Freddie Mac, as well as the nation's largest insurance company, AIG. And as the bank and non-bank failures in Europe and Asia have made clear, regulated and unregulated enterprises around the world were susceptible as well.

By far the largest institutions in the shadow banking system are Fannie Mae and Freddie Mac.

The combined business of Fannie Mae and Freddie Mac represents approximately \$5.5 trillion. They stimulated the creation of the high risk products that were at the epicenter of the mortgage market meltdown, by encouraging mortgage lenders no longer to worry about the future losses on the loans: instead, lenders could cash out through securitization or direct sales to Fannie Mae and Freddie Mac. Increasingly, lenders focused on underwriting to the standards of Fannie Mae or Freddie Mac, which established the template for the entire securitization market. In this way, lenders could be assured of selling the mortgages they originated.

The meltdown of the mortgage market and the conservatorships of Fannie Mae and Freddie Mac highlighted the fact that not only did these shadow banking institutions effectively establish the underwriting standards for the mortgage market through the standards they set for lenders who wanted to sell them mortgages, they also established the pricing which failed to meaningfully discern between the high risk products and the mortgages identified in their congressional charter. By statute, Fannie Mae and Freddie Mac were intended to purchase “mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors.” But it was their activities and pricing in high risk mortgage products, for which they did not have any historical experience, which substantially fueled the market, and the resulting bubble, for these high risk mortgages.

As we now know, Fannie Mae and Freddie Mac, which got affordable housing credit for buying subprime securitized loans, became a magnet for the creation of enormous volumes of increasingly complex securities that repackaged these mortgages. The market that they created was typified by conduits and structured investment vehicles that borrowed in the commercial paper market and bought longer-term asset-backed securities; investment banks and other institutions that financed overnight in the so-called repo market; and hedge funds.

The failure and near-failure of so many regulated commercial banks as well as non-banks since mid-2008, and the extravagant taxpayer cost of bailing them out, highlights the pre-crisis inadequacy of capital and liquidity in both categories of institutions. A lack of capital and liquidity was a common failing in both the traditional and shadow banking systems. It afflicted both commercial banks and investment banks, not to mention the insurance giant AIG and the GSEs, Fannie and Freddie.

Since a definitional distinction between the traditional and shadow banking systems is that the former is heavily regulated, why did the system of banking regulation in place in the United States fail to predict or preempt the crisis in commercial banks? Why weren't impending bank crises not identified soon enough as capital adequacy red lines were tripped? To answer this question, a good starting point is to look to the capital standards in place for commercial banks. In 1988, U.S. commercial banking supervisors implemented the international Basel standards for capital adequacy (“Basel I”). These

standards, still in place today, assign "risk weights" to bank assets. Most claims are risk-weighted at 100 percent. But residential mortgages are ranked as only half as risky. And securities issued by Fannie Mae and Freddie Mac have a risk weight of only 20 percent — a powerful incentive to move assets into Fannie and Freddie securities.

In addition to this strong incentive to move commercial bank assets in what eventually became the shadow banking system, U.S. commercial banks have had a leverage ratio computed on the basis of their on-balance-sheet assets. Because the leverage ratio does not count off-balance sheet assets, this created incentives to hide risky assets off the banks' balance sheets. Commercial banks funded a growing amount of long-term assets with highly risky short-term liabilities in wholesale markets through the use of off-balance-sheet vehicles. They further exposed themselves to credit and liquidity risk by providing lending facilities to these vehicles. Beyond this, they also held structured credit instruments on their own balance sheet, exposing themselves to embedded leverage and increasing their asset-liability mismatch and their funding liquidity risk.<sup>ii</sup>

The inadequacy of the Basel I standards became manifest with the bailouts of Wachovia, Citigroup, Bank of America, and hundreds of other banks whose regulators, such as the Federal Reserve, relied upon Basel I. The failure of over 200 traditional banks since the crisis began is further evidence. But even without the benefit of hindsight, commercial bank regulators had recognized the incentives in Basel I for moving risk off-balance sheet, which prompted the eventual promulgation of the Basel II standards, now in use around the world. As Fed Vice Chairman Don Kohn testified before the Senate Banking Committee in March 2008, Basel II was designed to eliminate the incentive to move an asset off the balance sheet, which "clearly gave banks a sense that they did not need to manage that risk as intensely as they would have if it was directly on their balance sheet."

The deepening of the financial crisis after March 2008, which spread to many U.S. and European institutions that relied on the Basel II framework, would show that these standards, too, were inadequate to provide advance warning of danger. But in 2004, when the SEC considered the adoption of capital rules that would apply on a voluntary basis to the large investment bank holding companies comprising a key part of the shadow banking system, the internationally-accepted Basel standards were understood to be the strongest and most reliable regulatory tools for mitigating risk.

#### *SEC Regulation of Investment Bank Holding Companies*

In March 2004, 17 months prior to my joining the Commission, the SEC adopted rules establishing a voluntary regulatory regime for large investment bank holding companies with SEC-regulated broker-dealer subsidiaries. The rules were the product of extensive agency analysis and review, public notice and comment, the unqualified recommendation of the agency's professional staff, and a unanimous Commission vote.

In creating this program — voluntary because the Commission lacked statutory authority over investment bank holding companies — the SEC was explicit that this would not be a prescriptive regulatory regime nor an independent audit of the consolidated entity, but rather would rely on information reported by the investment bank holding companies themselves. Both the absence of a statutory mandate and the limited staff available within the Division of Market Regulation (subsequently renamed the Division of Trading and Markets) led to this architecture. “We are going to depend on the firms, obviously the front line. They're going to have to develop their entire risk framework. And they'll have to explain that to us, in a way that makes sense,” Associate Director Michael Macchiaroli told the Commission in describing the proposed rules to the Commission at the April 2004 open meeting on their adoption. The program was also premised on the investment banks using their own proprietary risk models: “And then we'll do the examinations of that process, in addition to approving their models, and their risk control systems,” he said. In so doing, the Commission would be “using the best available tools to manage risks,” according to then-Chairman William Donaldson.

The design of the Consolidated Supervised Entity program represented the best thinking of the agency's professional staff at the time. In addition to relying upon the internationally-accepted Basel II standards for computing bank capital, it also adopted the Federal Reserve's standard of what constitutes a "well-capitalized" bank, and required the firms in the program to maintain capital in excess of this 10% ratio. Indeed, the CSE program went beyond the Fed's requirements in several respects, including adding a liquidity requirement, and requiring firms to compute their Basel capital 12 times a year, instead of the four times a year that the Fed required for commercial banks.

During the unprecedented stress of the financial crisis, however, these borrowed approaches from commercial bank regulation had unfortunate results similar to those that were eventually experienced throughout the commercial bank sector in 2008. The creators of the CSE program in 2004 had designed it to operate on the well-established bank holding company model used by regulators not only in the United States but around the globe. But the market-wide failure to appreciate and measure the risk of mortgage-related assets, including structured credit products, demonstrated that neither the Basel I nor Basel II standards as then in force were adequate. Each had — and continues to have — serious need of improvement.

Bear Stearns demonstrated that the CSE program's reliance on the internationally accepted Basel standards to detect signs of impending danger was a fundamental flaw. The CSE rules provided that an "early warning" notice must be filed with the SEC in the event that the 10% capital ratio was breached or was likely to be breached. At all times during the week of March 10-17, up to and including the time of its agreement to be acquired by JPMorgan Chase, Bear Stearns had a capital cushion well above what is required to meet the Basel standards. As noted by the SEC's Inspector General, even at the time of its sale, Bear Stearns's consolidated capital, and its broker-dealers' net capital, exceeded relevant supervisory standards.

The fact that these standards did not provide adequate warning of the near-collapse of Bear Stearns, and indeed the fact that the Basel I standards used by the Federal Reserve and other U.S. banking regulators did not prevent the exceptionally costly failures and taxpayer-funded rescues of many other large commercial banks and financial institutions, is now obvious. But even in March 2008, after the Bear experience, it had become clear that the regulatory metrics used by the SEC, the Federal Reserve, and other commercial or investment bank regulators in the U.S. and throughout the world had not used risk scenarios based on a total meltdown of the U.S. mortgage market.

That is why, in March 2008, I formally requested that the Basel Committee address the inadequacy of the Basel capital and liquidity standards in light of this experience. The SEC immediately offered to help with this revision of international standards through our work with the Basel Committee on Banking Supervision, the Senior Supervisors Group, the Financial Stability Forum, and the International Organization of Securities Commissions. As of April 2010, however, that work has unfortunately yet to be completed by the Basel Committee. In my view, it remains a matter of the utmost urgency, in particular for commercial bank holding companies, whose ranks now include not only such large and systemically important entities as Citigroup and Bank of America, but also the nation's largest investment banks.

The realization in early 2008 that existing supervisory metrics did not provide an adequate early warning mechanism led the SEC and the Federal Reserve to work closely together on the development of more stringent and varied measures for large investment banks, including stress tests based on scenarios of much shorter duration and that were much more severe, such as denial of access to secured as well as unsecured funding. Those more stringent scenarios assumed no access to the Fed's discount window or other liquidity facilities, although in fact such facilities were then available to the major investment banks. The SEC also worked closely with the Federal Reserve in directing this additional stress testing. Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers were urged to maintain capital and liquidity at levels far above what would be required under the standards in the SEC rules. The SEC and the Federal Reserve also directed these firms to strengthen their balance sheets, in part by shedding or marking down illiquid assets. Despite these efforts and similar steps taken by the Fed in the commercial banking industry, the subprime contagion continued to spread.

Beyond highlighting the inadequacy of the pre-Bear Stearns CSE program capital and liquidity requirements, the early experience during the credit crisis also highlighted the importance of closer collaboration between the SEC and the Federal Reserve to close the regulatory gap that existed for investment bank holding companies. That is because there was then (and is now) no provision in the law giving the SEC, the Fed, or any federal agency the authority to regulate investment bank holding companies — whether by requiring them to compute capital measures, or to maintain liquidity on a consolidated basis, or to submit to limits regarding leverage. This is attributable to the decision of Congress in the 1999 Gramm-Leach-Bliley Act, following the formal recommendation of then-SEC Chairman Arthur Levitt to Congress at the time, to leave supervision of investment bank holding companies to voluntary regulation.

Notwithstanding the lack of statutory authorization, the SEC in 2004 created its voluntary program, stretching its authority over the broker-dealer subsidiaries of investment bank holding companies that the SEC does regulate by statute, to cover the entire global conglomerate. Congress also gave the SEC authority to regulate the investment companies and investment adviser subsidiaries within the investment bank holding company structure. But this still left a gaping hole in regulatory coverage. Lehman Brothers, for example, consisted of over 200 significant subsidiaries; the SEC was not the statutory regulator for 193 of them. Among the vast portions of unregulated terrain were some of Lehman's riskiest areas — including over-the-counter derivatives businesses, trust companies, mortgage companies, and offshore banks, broker-dealers, and reinsurance companies. Investment bank holding companies were effectively outside of the regulatory jurisdiction of any individual federal department or agency. This was a fundamental flaw in the statutory scheme that had to be addressed — but in the meantime, it was up to the SEC, the Fed, the Treasury and other regulators to improvise solutions.

To ensure close coordination between the Fed and the SEC, Chairman Bernanke and I negotiated a detailed Memorandum of Understanding aimed at better information flows between regulators, including the communication of market surveillance information, position reporting, and current economic data, so that both agencies could get a more comprehensive picture of capital flows, liquidity, and risk not only at individual firms but throughout the system. The MOU did not open up entirely new territory, but formalized and strengthened the ongoing cooperation between the SEC and the Fed. One reason the MOU was needed was that the Fed was reluctant to share supervisory information with the SEC, out of concern that banks would not be forthcoming with information if they thought it would be referred to the SEC for enforcement.

### *The Role of Over-the-Counter Derivatives in the Financial Crisis*

The financial crisis demonstrated how interrelated the markets for securities, futures, and unregulated derivatives had become. In the past, stovepipe regulation of different products could be justified on the ground that the boundaries in the marketplace were clear enough. By 2008, however, when derivatives were competing with securities and futures and insurance products being sold for their investment features, that was no longer true. Entire categories of derivatives were specifically exempted from regulation by statute. As a result, as we approached the end of the first decade of the 21st century, what had begun as a modest gap in our legal system of financial regulation had become yawning.

In particular, despite its enormous size, the credit default swaps market operated in the shadows. There was in 2008, and is now, no public disclosure nor any legal requirement for these contracts to be reported to any regulator. So market participants and government regulators alike then and now have had no way to assess market-wide risk, whether credit default swaps have been honestly traded, and when those issuing and trading them have taken on risk that threatens others.



The explosive growth of the over-the-counter derivatives markets occurred outside of the statutory and regulatory system. Creatively engineered financial products touted for increasing the efficiency of the capital markets and offering new opportunities to manage risk drew the world's major financial institutions into a tangled web of interconnections. While there were undeniable benefits from legitimate uses of the products themselves, the lack of information about who was exposed to whom created a situation ripe for fear. Because the trillions of dollars in credit default swaps created to insure these risks were mostly hidden from public view, no one knew for sure which counterparties were most exposed, or whether those contracts would pay off in the face of the impending mortgage crisis. Once the mortgage bubble burst, the lack of transparency was then itself a reason for investors to flee the markets until the hidden complexities could be sorted out. Rational investors rushed to the sidelines not because of the mere existence of huge notional amounts of credit default swaps or because the contracts themselves were inherently faulty, but simply because of the lack of sufficient information about them.

In real time in 2008, the SEC undertook enforcement and examination action to limit the spread of intentionally false and misleading market rumors, which in any time of panic can run rampant, and which are especially likely in the absence of accurate market data. But the ultimate solution would lie not only in enforcement but in greater transparency that provides investors with better information.

The lack of transparency in the CDS market has been cited to justify the decision by the Federal Reserve and the Treasury to commit \$85 billion to the government rescue of the insurance conglomerate American International Group, because from their perspective, they could not determine whether those who held AIG's \$440 billion in credit default swaps might suffer crushing losses if those instruments weren't honored. It is certainly true that regulators, just as other market participants, lacked the necessary information to understand the risks that these exposures posed. The cost of this uncertainty, and the government's acting on the fear of what might ensue, was enormous in terms of taxpayer dollars. Less than three weeks after it was announced, the AIG rescue had escalated to \$123 billion, and four weeks later, to \$167 billion. Further taxpayer risk was added in March 2009, when Treasury exchanged its November 2008 investment of \$40 billion cumulative perpetual preferred shares for new preferred shares with revised terms that more closely resemble common equity. Treasury also committed to a new \$30 billion equity capital facility for AIG.

As large as AIG's swaps exposure was, it represented only 0.8 percent of the \$55 trillion notional value in credit default swaps then estimated to be outstanding — more than the gross domestic product of all nations on earth combined. This was a significant change from eight years earlier, when Congress specifically decided not to regulate credit default swaps in enacting the Commodity Futures Modernization Act. At that time, this market had not yet exploded in size.

Then-SEC Chairman Levitt testified against regulation of OTC derivatives before the House, and joined with two other members of the President's Working Group on Financial Markets, Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan, in their November 1999 report, "Over-the-Counter Derivatives and the Commodity Exchange Act." President Clinton's Working Group envisioned no systemic risk from such derivatives since "private counterparty discipline" — investors' natural desire to keep their own risks to a minimum — would work to protect the broader financial system. But the market for credit default swaps mushroomed toward the end of the decade, doubling in size in the two years before the market collapse. And as the market grew, private counterparty discipline could not substitute for publicly available market data.

Despite the growing size of the market, placing a value on credit default swaps and the mortgage-related securities they insured consisted largely of buyers and sellers of swaps relying on financial models that couldn't predict the mortgage market meltdown. (This same fundamental flaw undermined the approach of banks and bank regulators in the traditional banking system outside the SEC's jurisdiction, and of the investment bank holding companies within the SEC's voluntary program.) The CDS market also relied too much upon the credit ratings of the reference securities and of the firms selling the credit default swaps, and these ratings underestimated the risk.

A fundamental failing of the regulatory and market structure for OTC derivatives in 2008 — and still today — is that counterparty risk is not transparent. This lack of information about risk makes it difficult not only for market participants, but regulators as well, to understand and assess risk concentrations and interrelations. As it is now, it is often impossible even to know who stands on the other side of a swap contract, and this increases the risk involved.

As Chairman, I recommended that Congress urgently act to fill this regulatory hole by passing legislation that would not only make credit default swaps more transparent, but also give regulators the power to rein in fraudulent or manipulative trading practices and help everyone better assess the risks involved. Now, two years later, Congress is finally nearing action on this urgent priority. In addition to recommending legislation to provide for the use of one or more central counterparties and the on-exchange trading of standardized swaps, I recommended that Congress require dealers in non-standardized swaps traded over the counter to publicly report both their trades and the value of those trades. In addition, I recommended that the Securities and Exchange Commission be given explicit authority to issue rules against fraudulent, deceptive or manipulative acts and practices in credit default swaps.

Because of the truly global nature of the over-the-counter derivatives market, U.S. national legislation and regulation will need to be closely coordinated with governments in other major markets. The climate for such cooperation is good, because the cross-border impacts of the current market problems are obvious to all.

Transparency is a powerful antidote for much of what occurred in the financial crisis, and this is nowhere more true than in the derivatives markets. Our markets function best when everyone can see exactly which transactions are occurring and what the instruments being traded are worth. Addressing the lack of regulation and transparency was urgent two years ago, and it remains so today.

#### *Future Oversight of the Shadow Banking System*

As this Commission, the Congress, and the executive branch seek to infer lessons about regulation from the experience of the financial crisis, and to eliminate the current regulatory gaps in which there is no statutory regulator for investment bank holding companies and no regulation of the vast market for credit default swaps and many other derivatives, the analysis should begin with a recognition of each agency's core competencies.

The mission of the SEC is investor protection, the maintenance of fair and orderly markets, and the facilitation of capital formation. The mortgage meltdown and the ensuing credit crisis demonstrated that where SEC regulation is strong and backed by statute, it is effective — and that where it relies on voluntary compliance or simply has no jurisdiction at all, it is not.

The SEC's traditional strengths are law enforcement, public company disclosure, accounting and auditing, and the regulation of exchanges, broker-dealers, investment advisers, and other securities entities and products. This is a very different range of specializations than possessed by, for example, the Federal Reserve.

As former Chairman Alan Greenspan testified recently before this Commission, “the Federal Reserve is not an enforcement agency,” and “has no enforcement division, for example, as does the SEC.” The SEC's role in civil law enforcement is the reason that, in contrast to the Treasury and the Fed, it remained fiercely independent from the investment banks and other regulated entities. This point bears emphasis going forward. Strong securities regulation and enforcement requires an arm's-length relationship, and the SEC's sturdy independence from the firms and persons it regulates is unique.

The Fed's tradition of “prudential supervision,” shared by other commercial bank regulators, stands in contrast. Prudential supervision is focused on applying regulations in a manner consistent with the specific characteristics of each intermediary. It seeks to avoid an excessively prescriptive approach, preferring where possible general principles supplemented by guidelines for application, and recommendations on acceptable practices in widespread use by banks. This more subjective approach to regulation requires for its successful implementation a high degree of collaboration between the bank supervisor's staff and personnel of the banks themselves. The significant difference between this approach and the SEC's tradition of arm's-length, prescriptive rules and aggressive enforcement has historically been a barrier to complete information sharing between the SEC and commercial bank regulators.

The Fed's tradition of prudential supervision is reflected in its governance. For example, banks regulated by the Federal Reserve Bank of New York elect six of the nine seats on the Board of the New York Fed. During the financial crisis, both the CEOs of J.P. Morgan Chase and Lehman Brothers served on the New York Fed board. This is a significant difference from the SEC, which is completely institutionally independent from its regulated entities.

Current SEC Chairman Mary Schapiro recently testified in the House that the SEC's short-lived experiment with prudential supervision in its voluntary investment bank oversight program "was a substantial departure from the agency's traditional approach of establishing clear rules and enforcing compliance with them." I agree with this assessment, which highlights one of the reasons that the program was fundamentally flawed from the beginning. Likewise, it would be a substantial departure for the Commission, in any future regulatory reform, to be assigned responsibility for the oversight of systemic risk.

Instead, regulatory reform should build on existing strengths. Not only the current crisis, but the significant corporate scandals such as Enron and WorldCom that preceded it, have amply demonstrated the need for independent, strong securities regulation and enforcement. The SEC requires public companies to disclose to the public their financial statements and other information that investors can use to judge for themselves whether to buy, sell, or hold a particular security. Companies do this through annual and quarterly reports, as well as real-time announcements of unusual events. Administering this periodic reporting system has been a fundamental role of the SEC since its founding 76 years ago.

The SEC regulates the securities exchanges on which stocks, bonds, and other securities are traded. The SEC makes rules that govern trading on the exchanges, and also oversees the exchanges' own rules. While the significant stress of the financial crisis exposed dangerous weaknesses in other areas of the regulatory system, the fact that U.S. securities exchanges remained open throughout the crisis (as they did not in some countries) is silent testimony to what worked.

The SEC has also long regulated the securities brokers and dealers who trade on the exchanges. Its authority to do this comes from the original Securities Exchange Act, written in 1934. Although the law has been amended several times in the intervening 76 years, it lays out today essentially the same role for the SEC that the agency has always had in this area. During the financial crisis, the SEC's responsibilities in this core area were well met. Despite remarkable blows to the investment bank parents of the major U.S. broker-dealers, customers' securities and cash were protected.

The agency's Investment Management Division regulates investment advisers, and also investment companies such as mutual funds, under statutes written in 1940. During the financial crisis the Division dealt ably with the potential crisis in money market funds following the Lehman bankruptcy, and worked closely with the Treasury to facilitate its Money Market Mutual Fund Guarantee Program.

The Office of the Chief Accountant oversees the independent standard setting activities of the Financial Accounting Standards Board, to which the SEC has looked for accounting standards setting since 1973. It also serves as the principal liaison with the Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act to oversee the auditing profession. During the financial crisis this part of the SEC worked closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets, and the accounting treatment of bank support for money market funds.

Above all, the SEC is a law enforcement agency. Each year the SEC brings hundreds of civil enforcement actions for violation of the securities laws involving insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them. In the runup to the financial crisis, many of these enforcement actions prefigured the gathering storm in the shadow banking sector. In my second year as Chairman, in May 2006, the SEC charged Fannie Mae with securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, resulting in a fraud injunction and a \$400 million penalty.

The SEC charged Fannie Mae with issuing materially false and misleading financial statements for over six years. The SEC action also targeted Fannie Mae's failure to revalue its derivatives every reporting period, and reflect the changes in its income statement. The effect of its various violations overstated its income by least \$11 billion — requiring one of the largest restatements in American corporate history. Likewise, the \$400 million penalty on Fannie Mae was one of the largest in SEC history.

This action was followed, in September 2007, with securities fraud charges against the other financial giant in the GSE sector of the shadow banking network: Freddie Mac. The SEC charged that Freddie Mac engaged in a fraudulent scheme over a five year period to deceive investors about its true performance and profitability. Like Fannie Mae, Freddie Mac was subjected to a fraud injunction and a large corporate penalty, but also separate penalties against its officers.

If adherence to core competencies is the touchstone for sound regulatory reform, the experience of the financial crisis demonstrated just the opposite: collectively, the federal government took a dramatic departure from the statutory norms in response to the events of 2008. Most significantly, prior to the Federal Reserve's unprecedented decision to provide funding for the acquisition of Bear Stearns, neither the Fed, the SEC, nor any agency had as its mission the protection of the viability or profitability of a particular investment bank holding company. Indeed, it had been a fact of life in Wall Street's history that investment banks can and will fail. Wall Street is littered with the names of distinguished institutions — E.F. Hutton, Drexel Burnham Lambert, Kidder Peabody, Salomon Brothers, Bankers Trust, to name just a few — which placed big bets and lost, and as a result ended up either in bankruptcy or being sold to save themselves.

Not only is it not a traditional mission of the SEC to regulate the safety and soundness of diversified financial conglomerates whose activities range far beyond the securities realm, but Congress has given this mission to no agency of government. In the future, the roles and the powers of regulators must be clearly defined, their responsibility to intervene to save specific institutions or to let them fail must be clearly delineated, and regulatory gaps such as those that existed for investment bank holding companies must be closed.

Much speculation has focused on whether the government's extraordinary financial interventions, beginning with the relatively smaller Bear Stearns and ultimately extending to such enormous firms outside the SEC's regulatory jurisdiction such as Citigroup, Bank of America, and AIG, were on balance ameliorative or disruptive. And in the case of Lehman Brothers, the question has often been asked whether there was a legally available option to save the firm. The discrepancy between the rescue of the smaller Bear Stearns, avowedly on systemic grounds, and the abandonment of Lehman Brothers to bankruptcy is usually raised in this connection. In attempting to answer such questions, it is important to bear in mind that the impact from a regulatory action or inaction can have unintended consequences.

Many analysts have wondered why, following the collapse of Bear Stearns and the alarms that set off for every investment bank, Lehman's management did not agree to sell the firm at a lower price, or take other actions to save Lehman earlier during 2008. One possible reason is that Lehman — inspired by the fact that the much smaller Bear Stearns had been rescued on the grounds of its systemic significance — was expecting that the federal government would financially participate in any such transaction. As late as the weekend of September 12-14, 2008, when Treasury Secretary Paulson, New York Fed President Geithner, and I met with the chief executives of financial institutions concerning Lehman, the attendees at that meeting themselves appeared uncertain, at least initially, whether the announcement that there would be no federal help for Lehman was ironclad or negotiable. In recent testimony to the House Financial Services Committee, former Lehman CEO Richard Fuld testified that he had expected the federal government to provide a "liquidity bridge" that would stave off disaster.

Likewise, the U.K. government's unwillingness to support a Barclays-Lehman deal may have been influenced by the lack of such U.S. government participation. These expectations may well have been created by the earlier public announcement that Bear Stearns was too systemically important and interconnected to be allowed to fail. Not unreasonably, this could be taken to establish the proposition that larger investment banks would also be deemed too systemically important and interconnected to fail. Individuals and firms may have behaved differently if they had not been expecting the government to intervene.

An important lesson from these experiences is that clarity and consistency in policy making are often as important as the rules themselves. Individuals and firms can best order their affairs if they know what rules will apply. The lack of such clarity may have contributed to the demise of Lehman in September 2008, and to the panicked conditions under which the other investment banks sought strategic investment.

A final lesson is that statutory reform is necessary to close the regulatory gap that the SEC and the Fed attempted to fill through an ongoing, ad hoc collaboration. In this connection, current SEC Chairman Mary Schapiro has endorsed an Oversight Council that would be responsible for identifying risk across the system. Among her reasons for favoring this approach are that multiple sets of eyes would ensure that different perspectives are brought to bear on systemic risk analysis, that the inclusion of multiple agencies will reduce conflicts of interest, and that tapping the expertise of several regulators will ensure a higher level of sophistication in evaluating risks posed by different kinds of institutions. These are all sound reasons for favoring such an approach. But as the recent SEC-Fed experience has shown, the mere existence of a collaborative forum will not necessarily produce a high level of information sharing. Clear lines of authority and responsibility, drawn in statute, will be important, as will clear mandates for deeper inter-regulatory collaboration and timely access to information.

### *Conclusion*

The financial crisis exposed weaknesses in regulated and unregulated areas, not least of all the so-called shadow banking system. Failures in the shadow banking system highlighted regulatory gaps. It is urgent that these gaps be filled.

During the crisis, the SEC used its regulatory powers in support of other agencies and regulators, including the Federal Reserve and the Treasury, whose missions led them to act in extraordinary ways that have (one hopes temporarily) blurred the distinction between what is government and what is private. I am pleased that the legislative proposals the Congress is now considering will serve to strengthen the SEC in its fundamental mission of investor protection, and to address some of the significant problems that have already been identified. But many serious issues will remain for this Commission to confront and for future legislation to resolve, in particular the status of the GSEs which represent the largest element within the shadow banking sector.

As your Commission works to prepare recommendations for the wisest structural solutions to the problems that confront us, it will be important to assign roles to the SEC and other parts of the financial regulatory structure that build on their strengths. This is one of the most important lessons learned in the recent financial crisis. If we heed these lessons, I am confident that the financial regulatory system of the future will provide a bulwark for investor confidence and a more transparent and flexible set of authorities for the federal government to help restore and sustain American prosperity

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<sup>i</sup> Katia D'Hulster, *Crisis Response: The Leverage Ratio*, The World Bank, 2009, at <http://rru.worldbank.org/documents/CrisisResponse/Note11.pdf>

<sup>ii</sup> Id.