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Damon Silvers on Investor Protection for Senate Banking Committee

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Good morning, Chairman Dodd and Senator Shelby. My name is Damon Silvers, I am an Associate General Counsel of the AFL-CIO, and I am the Deputy Chair of the Congressional Oversight Panel created under the Emergency Economic Stabilization Act of 2008 to oversee the TARP. While I will describe the Congressional Oversight Panel's report on regulatory reform, my testimony reflects my views and the views of the AFL-CIO unless otherwise noted, and is not on behalf of the Panel, its staff or its chair, Elizabeth Warren.

The vast majority of American investors participate in the markets as a means to secure a comfortable retirement and to send their children to college. Most investors' goals are long term, and most investors rely on others to manage their money. While the boom and bust cycles of the last decade generated fees for Wall Street – in many cases astounding fees—they have turned out to have been a disaster for most investors. The ten-year nominal rate of return on the S&P 500 is now negative, and returns for most other asset classes have turned out to be more correlated with U.S. equity markets than anyone would have imagined a decade ago.

While the spectacular frauds like the Madoff ponzi scheme have generated a great deal of publicity, the bigger questions are (1) how did our financial system as a whole become so weak how did our system of corporate governance, securities regulation, and disclosure-based market discipline fail to prevent trillions of dollars from being invested in value-destroying activities—ranging from subprime mortgages and credit cards, to the stocks and bonds of financial institutions, to the credit default swaps pegged to those debt instruments; and (2) what changes must be made to make our financial system a more reasonable place to invest the hard earned savings of America's working families?

My testimony today will seek to answer the second question at three levels:

1) How should Congress strengthen the regulatory architecture to better protect investors;
2) How should Congress think about designing regulatory jurisdiction to better protect investors; and
3) What are some specific substantive steps Congress and the regulators should take to shore up our system of investor protections?

Finally, I will briefly address how to understand the challenge of investor protection in globalized markets.

Regulatory Architecture

While there has been much discussion of the need for better systemic risk regulation, the Congressional Oversight Panel, in its Special Report on Regulatory Reform issued on January 29, 2009, observed that addressing issues of systemic risk cannot be a substitute for a robust, comprehensive system of routine financial regulation.[1] There are broadly three types of routine regulation in the financial markets—(1) safety and soundness regulation for insured institutions like banks and insurance companies; (2) disclosure and fiduciary duty regulation for issuers and money managers in the public securities markets; and (3) substantive consumer protection regulation in areas like mortgages, credit cards, and insurance. These are distinct regulatory missions in significant tension with each other.

Investors, people who seek to put money at risk for the prospect of gains, really are interested in transparency, enforcement of fiduciary duties, and corporate governance. This is the investor protection mission. It is often in tension with the equally legitimate regulatory mission of protecting the safety and soundness of insured financial institutions. A safety and soundness regulator is likely to be much more sympathetic to regulated entities that want to sidestep telling the investing public bad news. At the same time, investor protection is not the same thing as consumer protection – the consumer looking for home insurance or a mortgage is seeking to purchase a financial service with minimal risk, not to take a risk in the hope of a profit.

Because these functions should not be combined, investor protection should be the focus of a single agency within the broader regulatory framework. That agency needs to have the stature and independence to protect the principles of full disclosure by market participants and compliance with fiduciary duties among market intermediaries. Any solution to the problem of

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[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 3 (Jan. 29, 2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

systemic risk prevention should involve the agency charged with investor protection, and not supersede it.

Since the New Deal, the primary body charged with enforcing investor protections has been the Securities and Exchange Commission. Although the Commission has suffered in recent years from diminished jurisdiction and leadership failure, it remains an extraordinary government agency, whose human capital and market expertise needs to be built upon as part of a comprehensive strategy for effective reregulation of the capital markets.

While I have a great deal of respect for former Treasury Secretary Paulson, there is no question that his blueprint for financial regulatory reform was profoundly deregulatory in respect to the Securities and Exchange Commission.[2] He and others, like the self-described Committee on Capital Markets Regulation led by Harvard Professor Hal Scott, sought to dismantle the Commission's culture of arms length, enforcement-oriented regulation and to replace it with something frankly more captive to the businesses it regulated.[3] While these deregulatory approaches have fortunately yet to be enacted, they contributed to an environment that weakened the Commission politically and demoralized its staff.

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[2] Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure, at 11-13, 106-126 (Mar. 2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[3] Committee on Capital Markets Regulation, Interim Report (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; Committee on Capital Markets Regulation, The Competitive Position of the U.S. Public Equity Market (Dec. 4, 2007), *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

While there has been a great deal of attention paid to the Commission's failure to spot the Madoff ponzi scheme**,** there has been insufficient attention to the Commission's performance in relation to the public debt markets, where the SEC regulates more than $438.3 billion in outstanding securities related to home equity loans and manufactured housing loans, among the riskiest types of mortgages. Similarly, little attention has been paid to the oversight of disclosures by the financial and homebuilding firms investing in and trading in those securities, and perhaps most importantly, the lack of action by the Commission once the financial crisis began.[4]

But elections have consequences, and one of those consequences should be a renewed commitment by both Congress and the new Administration to revitalizing the Commission and to rebuilding the Commission's historic investor protection oriented culture and mission. The President's budget reflects that type of approach in the funding it seeks for the Commission, and the new Chair of the Commission Mary Schapiro has appeared to be focused on just this task in her recent statements.[5]

A key issue the Commission faces is how to strengthen its staff. Much of what needs to be done is in the hands of the Commission itself, where the Chair and the Commissioners set the tone for better or for worse. When Commissioners place procedural roadblocks in the way of enforcing the law, good people leave the Commission and weak staff are not held accountable. When the

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[4] Securities Industry and Financial Markets Association, Market Sector Statistics: Asset Backed Securities - Outstanding By Major Types of Credit

[5] *See e.g.* Speech by SEC Chairman: Address to Practising Law Institute's "SEC Speaks in 2009" Program *available at* http://sec.gov/news/speech/2009/spch020609mls.htm.

Chair sets a tone of vigorous enforcement of the laws and demands a genuine dedication to investor protection, the Commission both attracts and retains quality people.

Congress should work with the Commission to determine if changes are needed to personnel rules to enable the Commission to attract and retain key personnel. The Commission should look at more intensive recruiting efforts aimed at more experienced private sector lawyers who may be looking for public service opportunities – perhaps through a special fellows program. On the other hand, Congress should work with the Commission to restrict the revolving door – ideally by adopting the rule that currently applies to senior bank examiners for senior Commission staff—no employment with any firm whose matters the staffer worked on within 12 months.

Regulating the Shadow Markets and the Problem of Jurisdiction

The financial crisis is directly connected to the degeneration of the New Deal system of comprehensive financial regulation into a Swiss cheese regulatory system, where the holes, the shadow markets, grew to dominate the regulated markets. If we are going to lessen future financial boom and bust cycles, Congress must give the regulators the tools and the jurisdiction to regulate the shadow markets. In our report of January 29th, the Congressional Oversight Panel specifically observed that we needed to regulate financial products and institutions, in the words of President Obama, "for what they do, not what they are."[6] We further noted in that report that shadow market products and institutions are nothing more than new names and new legal

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[6] Senator Barack Obama, Renewing the American Economy, Speech at Cooper Union in New York (Mar. 27, 2008) (transcript available at http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?pagewanted=all); Congressional Oversight Panel, Special Report on Regulatory Reform, at 29.

structures for very old activities like insurance (read credit default swaps) and money management (read hedge funds and private equity/lbo funds).[7]

The Congressional Oversight Panel's report stated that shadow institutions should be regulated by the same regulators who currently have jurisdiction over their regulated counterparts.[8] So, for example, the SEC should have jurisdiction over derivatives that are written using public debt or equity securities as their underlying asset. The Congressional Oversight Panel stated that at a minimum, hedge funds should also be regulated by the SEC in their roles as money managers by being required to register as investment advisors and being subject to clear fiduciary duties, the substantive jurisdiction of U.S. law, and periodic SEC inspections.[9] To the extent a hedge fund or anyone else engages in writing insurance contracts or issuing credit, however, it should be regulated by the bodies charged with regulating that type of economic activity.

Some have suggested having such shadow market financial products as derivatives and hedge funds simply regulated by a systemic regulator. This would be a terrible mistake. Shadow market products and institutions need to be brought under the same routine regulatory umbrella as other financial actors. To take a specific case, while it is a good idea to have public clearinghouses for derivatives trading, that reform by itself is insufficient without capital requirements for the issuers of derivatives and without disclosure and the application of securities law principles, generally, to derivatives based on public securities regulations. So, for example, the SEC should require the same disclosure of short positions in public equities that it

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[7] Congressional Oversight Panel, Special Report on Regulatory Reform, at 29.
[8] *Id.*
[9] *Id.*

requires of long positions in equities, whether those positions are created through the securities themselves or synthetically through derivatives or futures.

The historic distinctions between broker-dealers and investment advisors have been eroding in the markets for years. In 2007, the Federal Appeals Court for the District of Columbia issued an opinion overturning Commission regulations seeking to better define the boundary between the two.[10] The Commission should look at merging the regulation of the categories while ensuring that the new regulatory framework preserves clear fiduciary duties to investors. As part of a larger examination of the duties owed by both broker-dealers and investment advisors to investors, the Commission ought to examine the fairness and the efficacy of the use of arbitration as a form of dispute resolution by broker-dealers. Finally, part of what must be done in this area is to determine whether the proper regulatory approach will require Congressional action in light of the DC Circuit opinion.

But there is a larger point here. Financial reregulation will be utterly ineffective if it turns into a series of rifle shots at the particular mechanisms used to evade regulatory structures in earlier boom and bust cycles. What is needed is a return to the jurisdictional philosophy that was embodied in the founding statutes of federal securities regulation—very broad, flexible jurisdiction that allowed the SEC to follow the activities. By this principle, the SEC should have jurisdiction over anyone over a certain size who manages public securities, and over any contract written that references publicly traded securities. Applying this principle would require at least

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[10] *Fin. Planning Ass'n v. Securities & Exch. Comm'n,* 482 F.3d 481 (D.C. Cir. 2007).

shifting the CFTC's jurisdiction over financial futures to the SEC, if not merging the two agencies under the SEC's leadership.

Much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, some investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Finally, while it is not technically a shadow market, the underregulation of the credit rating agencies has turned out to have devastating consequences. The Congressional Oversight Panel called particular attention to the dysfunctional nature of the issuer pays model, and recommended a set of options for needed structural change—from the creation of PCAOB-type oversight body to the creation of a public or non-profit NRSRO.[11]

<u>Substantive Reforms</u>

Beyond regulating the shadow markets, the Congress and the Securities and Exchange Commission need to act to shape a corporate governance and investor protection regime that is

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[11] *Id.* at 40-44.

favorable to long term investors and to the channeling of capital to productive purposes. There is no way to look at the wreckage surrounding us today in the financial markets and not conclude we have had a regulatory regime that, intentionally or not, facilitated grotesquely short-term thinking and led to capital flowing in unheard of proportions to pointless or destructive ends.

This is a large task, and I will simply point out some of the most important steps that need to be taken in three areas—governance, executive pay, and litigation.

First, in the area of governance, once again the weakness of corporate boards, particularly in the financial sector, appears to be a central theme in the financial scandal. The AFL-CIO has interviewed the audit committees of a number of the major banks to better understand what happened. We found in general very weak board oversight of risk—evidenced in audit committee leadership who did not understand their companies' risk profiles, and in boards that tolerated the weakening of internal risk management.

Strong boards require meaningful accountability to investors. Short-term, leveraged investors have been the most powerful voices in corporate governance in recent years, with destructive results. The AFL-CIO urges Congress to work with the SEC to ensure that there are meaningful, useable ways for long-term investors to nominate and elect psychologically independent directors to public company boards through access to the corporate proxy. I put the stress here on long-term—there must be meaningful holding time requirements for exercising this right.

Recent statements by SEC Chair Mary Schapiro suggest she is focused on this area, and we urge the Congress to support her efforts.[12]

Second, effective investor protection requires a comprehensive approach to reform in the area of executive pay. Proxy access is an important first step in this area, but we should learn from the financial crisis how destructive short-term oriented, asymmetric executive pay can be for long-term investors and for our economy. The focus of the Congressional Oversight Panel's recommendations in the area of executive pay were on ending these practices in financial institutions.[13] Here Chairman Dodd's leadership has been very helpful in the context of the TARP.

But Congress and the Administration should pursue a comprehensive approach to executive pay reform around two concepts—equity linked pay should be held beyond retirement, and pay packages as a whole should reflect a rough equality of exposure to downside risk as to upside gain. Orienting policy in this direction requires coordination between securities regulation and tax policy. But we could begin to address what has gone wrong in executive pay incentives by (1) developing measurements for both the time horizon and the symmetry of risk and reward of pay packages that could be included in pay disclosure; (2) looking more closely at mutual fund proxy voting behavior to see if it reflects the time horizons of the funds; (3) focusing FINRA inspections of broker dealer pay policies on these two issues; and (4) providing for advisory

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[12] Rachelle Younglai, *SEC developing proxy access plans: sources*, REUTERS, Mar. 6, 2009, at http://www.reuters.com/article/bernardMadoff/idUSTRE52609820090307.

[13] Congressional Oversight Panel, Special Report on Regulatory Reform, at 37-40.

shareholder votes on pay packages. With respect to say on pay, any procedural approaches that strengthened the hand of long term investors in the process of setting executive compensation would be beneficial.

Finally, Congress needs to address the glaring hole in the fabric of investor protection created by the Central Bank of Denver and Stoneridge cases.[14] These cases effectively granted immunity from civil liability to investors for parties such as investment banks and law firms that are co-conspirators in securities frauds. It appeared for a time after Enron that the courts were going to restore some sanity in this area of the law on their own, by finding a private right of action when service providers were actually not just aiders and abetters of a fraud, but actual co-conspirators. In the Stoneridge decision, with the Enron case looming over them, the Supreme Court made clear Congress would have to act. The issue here of course is not merely fairness to the investors defrauded in a particular case—it is the incentives for financial institutions to police their own conduct. We seem to have had a shortage of such incentives in recent years.

<u>The International Context</u>

The Bush Administration fundamentally saw the internationalization of financial markets as a pretext for weakening U.S. investor protections. That approach has been discredited. It needs to be replaced by a commitment on the part of the Obama Administration to building a strong global regulatory floor in coordination with the world's other major economies. This effort is

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[14] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

vital not only for protecting U.S. investors in global markets, but for protecting our financial sector from the consequences of a global regulatory race to the bottom that will inevitably end in the kind of financially driven economic crisis that we are living through today. Congress can play a part by seeking to strengthen its relationships with its counterpart legislative bodies in the major world markets, and should look for opportunities to coordinate setting regulatory standards on a global basis. The Administration needs to make this effort a priority, and to understand that it needs to extend beyond the narrow confines of systemic risk and the banking system to issues of transparency and investor protection.

However, Congress must not allow the need for global coordination to be an impediment or a prerequisite to vigorous action to reregulate U.S. financial markets and institutions. That task is urgent and must be addressed if the U.S. is to recover from the blow this financial crisis has delivered to our private capital markets' reputation as the gold standard for transparency and accountability.

Conclusion

The task of protecting investors by reregulating our financial system and restoring vitality to our regulators is a large one. This testimony simply sketches the outline of an approach, and notes some key substantive steps Congress and the Administration need to take. This Committee has already taken a leadership role in a number of these areas, but there is much more to be done. Even in areas where the primary responsibility must lie with regulators, there is a much needed role for Congress to oversee, encourage and support the efforts of the Administration.

While I do not speak for the Congressional Oversight Panel, I think I am safe in saying that the Panel is honored to have been asked to assist Congress in this effort, and is prepared to assist this Committee in any manner the Committee finds useful. I can certainly make that offer on behalf of the AFL-CIO. Thank you.