Testimony Concerning the Discussion Draft of
The Financial Stability Improvement Act of 2009
Elisse B. Walter, Commissioner
U.S. Securities and Exchange Commission
Before the Committee on Agriculture
United States House of Representatives
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Chairman Peterson, Ranking Member Lucas and Members of the Committee:

I am pleased to have the opportunity to testify concerning the Discussion Draft of the Financial Stability Improvement Act (Discussion Draft).[1] This legislation, currently being marked-up by the House Financial Services Committee,[2] would make significant changes to the regulation and resolution of large, interconnected financial firms whose disorderly failure might put the financial system at risk.

Lessons from the Recent Financial Crisis

There are many lessons we can learn from the recent financial crisis and events of last fall. In particular, these events demonstrated the need to watch for, warn about, and eliminate conditions that could cause a sudden shock to lead to a market seizure or cascade of failures that put the entire financial system at risk. While traditional financial oversight and regulation can help prevent systemic risks from developing, it is clear that this regulatory structure failed to identify and address systemic risks that were developing

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[1] This testimony is delivered on my own behalf, as a Commissioner of the Securities and Exchange Commission. The full Commission has not voted on this testimony, but Chairman Schapiro endorses this testimony.

[2] Because this legislation is being currently marked-up, this testimony relates to the circulated Discussion Draft. We recognize that the bill is changing and some of these issues may still be addressed by the Committee.

over recent years. The current structure was hampered by regulatory gaps that permitted regulatory arbitrage and failed to ensure adequate transparency. This contributed to excessive risk-taking by market participants, insufficient oversight by regulators, and uninformed decisions by investors.

Given the shortcomings of the current regulatory structure, I believe there is a need to establish a framework for macro-prudential oversight that looks across markets and avoids the silos that exist today. Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and a powerful council of regulators is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should adverse circumstances arise, and benefit from the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

The Discussion Draft is the latest in a series of significant legislative proposals designed to reform the financial system by filling regulatory gaps, improving investor and consumer protection and updating our financial regulatory apparatus to improve our ability to identify and reduce systemic risk. The Discussion Draft would enable regulators to raise capital requirements and impose heightened prudential standards on large, interconnected firms, and unwind – in an orderly fashion – those that have failed. It also would establish a council of regulators to identify certain large interconnected firms that require additional oversight, provide significant new information to the Federal

Reserve Board, and empower the Federal Reserve Board to impose a host of additional requirements on institutions and activities deemed systemically important.

Strengthening the Discussion Draft

Given the recent financial crisis and the weaknesses in our financial regulatory framework that it helped identify, new comprehensive oversight over systemically important institutions and activities is needed, and the Discussion Draft is an important step toward achieving that goal.

In establishing (and implementing) such an approach, however, policymakers should fully consider its limitations and risks. Because no one – not even a systemic risk regulator or council – can perfectly forecast future events, and free markets can be faster and more informed than regulators, even an improved system will not identify every risk and fashion perfect solutions before financial crises develop. Moreover, there are also risks that, in an effort to craft a more stable system, policymakers might unintentionally foster a system that is unfair or unworkable. This can occur over time: for example, focusing on "systemic risk" could slowly weaken other important protections or lead to over-regulation. It can also take place quickly: for example, in times of crisis, regulators might feel compelled to change rules or pick winners and losers.

To minimize these risks, we recommend that the Discussion Draft be strengthened and clarified in several key areas to ensure that it does not unintentionally sacrifice other important market protections or create new regulatory arbitrage opportunities or

competitive advantages that could foster – rather than reduce – systemic risk. To address these issues, Congress should consider the following:

1. ***Strengthen the Council to Improve Risk Management Rules and Reduce Moral Hazard.***

Policies and standards designed to address systemic risk should benefit from the perspectives of multiple regulators with different expertise, experience and missions, be formulated with an understanding of their direct and indirect impacts on other parts of the markets, and be tailored so that they do not inadvertently favor large institutions relative to small institutions (thereby unintentionally fueling, instead of reducing, systemic risk). To help ensure more robust risk management policies that fully consider and minimize any competitive imbalances and unintended consequences that might flow as a result of certain large institutions being "systemically important," Congress should vest greater prudential risk management policymaking power with the Federal Services Oversight Council ("Council"). Vesting such power in the Council would assure that these policies benefit from the input and experience of multi-disciplinary experts with authority over, and experience in dealing with, various types of financial institutions.

In particular, the Council should have the tools needed to identify emerging risks, be able to establish more stringent standards for leverage and risk-based capital for systemically important institutions, and be empowered to serve as a ready mechanism for identifying emerging risks and minimizing the regulatory arbitrage that can lead to a regulatory race to the bottom. This authority could include the ability to direct functional regulators to

promulgate rules or review potentially systemic risks or the risks posed by systemically important institutions.

The Council should have authority to identify institutions, practices, and markets that create potential systemic risks and set or recommend standards for liquidity, capital, and other risk management practices at systemically important institutions. The Federal Reserve Board could be responsible for monitoring risks at particular institutions and ensuring that these standards are implemented. This hybrid approach can help minimize systemic risk in a number of ways:

- The Council would ensure that different perspectives are brought to bear in identifying risks that an individual regulator might miss or consider too small to warrant attention. These perspectives also would improve the quality of systemic risk requirements by increasing the likelihood that second-order consequences are identified and considered.

- The financial regulators on the Council would have experience regulating different types of institutions (including smaller institutions) and different products, so that the Council would be more likely than any single regulator to ensure that risk-based capital and leverage requirements do not unintentionally foster systemic risk by advantaging the largest institutions.

- The Council would include multiple agencies, thereby significantly reducing potential conflicts of interest (e.g., conflicts with other regulatory missions).

The Council also would monitor the development of financial institutions to prevent the creation of institutions that are either "too-big-to-fail" or "too-big-to-succeed." We must remain vigilant against the risks posed by institutions whose businesses are so large and diverse that they have become, for all intents and purposes, unmanageable. Given the potential ongoing oversight role of any individual systemic risk regulator, it is important to have another level of impartial analysis take place through a multi-member Council. Accordingly, the Council is vital to ensure that our desire to minimize short-term systemic risk does not inadvertently undermine our system's long-term health. To ensure the independence of the Council, Congress should also consider requiring it to have an independent Chair and permanent staff.

Although the Discussion Draft strengthens the Council in a number of important ways, a real risk remains that market participants will favor large interconnected firms, particularly those identified as systemically important, over smaller firms of equivalent creditworthiness, because of the belief that the government will step in and support such an institution, its bondholders, or counterparties in times of crisis. Although the Discussion Draft seeks to address this imbalance through heightened prudential standards and a new resolution regime, the new requirements are not set forth with sufficient specificity to determine whether they will adequately address the risks. Similarly, the new resolution regime does not clearly set forth how bondholders or counterparties will

be treated. If bondholders or counterparties believe they can get a better deal under the new resolution regime, they may be more willing to lend to these institutions even if, relatively speaking, they are less credit worthy than other, smaller institutions. This would lower the cost of capital for larger interconnected institutions, increasing their size and potentially creating more systemic risk.

2. ***Ensure That New Systemic Risk Rules Do Not Undercut Needed Consumer and Investor Protections***.

Although the Discussion Draft states that new rules can only *supersede* existing conflicting less stringent regulatory requirements to the extent of the inconsistency, Congress should make clear that needed investor and consumer protections remain fully in place. The best approach to the application of new systemic risk powers is to ensure that any new systemic risk framework be appropriately tailored to such risks, *additive* to existing and future rules and protections, and works through an open and transparent process to avoid unintended consequences.

3. ***Ensure that Existing Clearing Agency Requirements are Not Eliminated*.**

A new systemic risk regulator should act as a second set of eyes over all systemically important entities (such as systemically important securities clearing agencies and other clearinghouses for financial products), participate in examinations, review risk management practices, and evaluate whether the existing functional regulation is sufficiently protective. However, Subtitle E of the Discussion Draft as currently formulated could fundamentally undermine the existing regulation and oversight of

clearing agencies that are crucial to the overall competitiveness of U.S. securities markets. As currently drafted, Subtitle E would provide the Federal Reserve Board with the authority "by regulation or order" to "prescribe or issue risk management standards governing the operations of identified financial market utilities and the conduct of identified activities by financial institutions." This language would include clearing agencies and a host of other entities that might be subject to other regulatory requirements, and could be exercised subject only to "consultation" with the Council and existing supervisory entities.

In addition to potentially being a wholesale change in the way such institutions are regulated and supervised, it is unclear how these new standards would interact with existing risk management requirements or other important policy goals. For example, under existing laws, securities clearing agencies must provide fair access to and cannot discriminate among market participants seeking to become members of the clearinghouse. This requirement fosters competition and addresses potential conflicts of interest, but is not clearly protected under the language in Subtitle E. Although there may be a benefit to Congress empowering a regulator to act as a second set of eyes to reduce risks over certain institutions, this authority should not automatically override other important policy goals like transparency and fair competition that promote investor protection and the competitiveness of U.S. securities markets.

To ensure that the supervision of these entities and concerns about systemic risk are appropriately balanced, these standards (as with others) could be established by the

Council, implemented by the functional regulator, and designed to supplement but not supersede existing regulation and protections. The Council should coordinate with the Federal Reserve Board and functional regulators to eliminate regulatory gaps in a manner that reduces duplicative requirements. To the extent a conflict exists between the Federal Reserve and the functional regulator regarding the standards to be applied, the Council should resolve the conflict so that all regulatory goals are achieved, including safety and soundness.

4. ***Ensure that Existing Capital Requirements are Not Lowered*.**

Although the Discussion Draft calls for heightened prudential standards for identified financial holding companies, the language should be clarified to ensure that these standards are heightened in a meaningful sense to reduce the risk to the system appropriately and ensure that counterparties do not favor large institutions because they are "too big to fail" – fueling greater size and risk at the expense of smaller more nimble competitors. The Discussion Draft currently defines heightened prudential standards as higher than for a normal financial holding company. It is not clear that this standard is higher than would apply today for a particular regulated entity. Accordingly, the Discussion Draft should be clarified to ensure that these new authorities cannot lower any standard that would otherwise apply to a company, including standards set by functional regulators.

For example, the Discussion Draft could permit the Federal Reserve Board to impose bank-like capital requirements on a broker-dealer subsidiary of a Bank Holding Company

(BHC). Such a requirement could (1) lower capital requirements for a broker-dealer in a BHC – potentially putting customer accounts at risk in the case of failure; and (2) provide a competitive advantage for broker-dealers within a BHC relative to broker-dealers outside a BHC. This could have the effect of increasing systemic risk by permitting the big to get bigger.

Therefore, the Discussion Draft should be clarified that Federal Reserve Board (or any other entity) cannot lower or reduce capital and other requirements for a regulated entity. This will better protect customers and investors and ensure that broker-dealers and other companies that are within large institutions do not receive an additional competitive advantage relative to smaller, less systemically risky, entities.

5. ***Revise Approach for Identifying and Regulating Systemic "Activities".***

The Discussion Draft permits the regulation of systemically important "activities" and establishes multiple mechanisms for doing so (see subtitles B and E). This language is very broad and could apply to many small institutions that do not themselves pose any systemic risk. To minimize confusion, reduce the potentially unlimited reach of this grant of authority, and give affected parties due process, Congress should:

- Ensure that the Council identifies systemically important "activities" and develops policies to address them. Where the affected entities are already subject to a regulatory regime, the Council could direct the functional regulators to implement these policies, with the Federal Reserve Board as a "second set of

eyes" over already regulated entities. This will ensure that the regulation of activities is not unchecked, and that transparent, traditional rulemaking requirements (including public notice and comment) are followed; and

- Consider defining what the term "activities" means in this context to provide more guidance to regulators and reduce the likelihood that this authority will expand over time.

6. ***Protect Independent Accounting Standards.***

I am pleased that the Discussion Draft does not alter existing protections that ensure the independence of accounting standard setting, but would like to raise the issue in anticipation of possible amendments on the topic. Investors must have transparent, unbiased and comparable information about the companies in which they choose to invest. Providing investors with this information, to assist them in allocating capital to its most efficient use, is essential to the health of our capital markets. High quality, consistent accounting standards provide the framework for investors to make the comparisons of investment opportunities and perform the analysis necessary to make informed investment decisions.

Some have argued that prudential regulators should have a greater role in the setting of accounting standards or that accounting standards should be tied to "systemic risk." This would be a grave mistake. Accounting standards are measurement and disclosure tools that convey information about financial performance and condition, tools for investors

and investor protection – not for institution protection. To continue to be useful, accounting standards should endeavor be the same across the markets and market participants, just as they should be consistently applied over time. As noted above, one key anchor in this process to guard against systemic risk must be a requirement that standards be raised, not lowered. Establishing a new process that would permit regulators to weaken accounting standards, reduce disclosure or allow the basis by which economic performance is measured to fluctuate with the economic environment, could provide a new avenue for particular institutions to lobby for – and potentially receive – special treatment.

Conclusion

While remaining vigilant to the inherent tensions and risks, I believe that we can do a great deal to protect against systemic risk by (1) filling gaps in our regulatory system; (2) reducing regulatory arbitrage by ensuring that similar products are regulated similarly; and (3) ensuring that a new macro-prudential oversight regime have the ability to raise standards for entities that might be systemically important.

Thank you again for the opportunity to present my views. I look forward to working with the Committee and the Congress as it considers these issues and I would be pleased to answer any questions.