Council of Institutional Investors Speech

I want to first thank Joe Dear for inviting me to speak at this event. I am grateful to have this opportunity to share with you my thoughts on the current crisis and what we in Congress can do to help get our country past this difficult economic moment.

A crisis of confidence in the markets

We face a crisis in our markets—as all of you here know all too well. It is primarily a crisis of confidence…in our economy, our financial institutions, and our regulators.

Just a quick glance at the numbers paints a grim picture for 2008.

· a drop in the Dow Jones Industrial Average of nearly 34%.

· S&P 500 down about 39%, the worst year since 1937.

· NASDAQ hitting its lowest record—an almost 41% drop.

This huge market downturn claimed institutions as well as investors.

· In March 2008, the imminent failure of Bear Stearns caused the Federal Reserve to hash out a weekend agreement with JP Morgan Chase.

· All but two of the major investment banks failed.

· Goldman Sachs and Morgan Stanley became bank holding companies.

· The largest bank failure in history with Washington Mutual.

All of these losses undercut our sense of financial security. Investors feel it, and the volatility of the markets shows it.

Many of our present challenges can be traced to bad mortgage lending and underwriting, securitization that occurred with little due diligence, and the inability of our financial institutions to manage their risks.

In an environment of record-low interest rates and soaring personal debt, we had the conditions for the perfect storm.

Our markets used to be a source of security for investors and for the American economy.

Now that security has been eroded and we must turn this around.

A crisis of confidence in our regulators

We have a regulatory system in this country that grew up around market crises. We put it in place because we believe there should be another set of eyes watching the market: eyes that are on something more than the quarterly bottom line.

Regulators also ensure that consumer and investor protections are in place to prevent people from being defrauded or otherwise led astray in financial transactions.

For securities, much of this regulatory structure was created in response to the Great Depression. Our country's leaders had the foresight to see that there was a need to prevent such economic devastation from coming to our country again.

But the last two years have taught us hard lessons about the effectiveness of regulatory oversight, and about the gaps that have prevented our regulators from being more effective.

As with the private market failures I outlined earlier, there were many significant regulatory failures as well.

Unfortunately we have seen disappointing performance from the Federal Reserve in supervising some of our nation's largest financial institutions that are now in perilous situations.

On consumer protection, I think the Federal Reserve has failed in a number of areas, from HOEPA legislation on mortgages to rules for credit cards, which will take 18 months to go into effect.

The SEC in 2008 closed the books on its Consolidated Supervised Entity (CSE) program, as the remaining investment banks became Bank Holding Companies under the Federal Reserve.

The CSE program was instituted by the SEC as a voluntary program to oversee large investment bank holding companies. Touted as the SEC's foray into prudential supervision—as opposed to enforcing rules—the program ultimately failed because it never had the resources it needed to fulfill its mission. Nor did it place enough limits on the excessive leverage of investment banks, which sometimes went as high as 30 to 1.

In addition, the Office of Thrift Supervision (OTS) failed in its oversight of AIG, Washington Mutual, and Wachovia.

This trend of lax supervision and oversight has impacted markets, investors, consumers, and indeed all citizens of this country. It must end by strengthening the regulatory structure in this country.

The importance of "competitiveness"

One of the driving forces leading to inadequate supervision was the implicit and, at times, explicit pursuit of "competitiveness" over investor protection.

All too often, "competitiveness" prescribed the same cure: loosen up the oversight and reduce the amount of regulation.

For example, an early 2007 report conducted by McKinsey & Co. on the competitive position of the U.S. and New York touted the need to move away from a "thicket of complicated

rules" and seriously consider moving to the principles-based model of the United Kingdom.

This is the same principles-based approach that has led to major losses and nationalization in the United Kingdom’s banking sector.

We need to move to strike a new balance that protects investors without stifling innovation or impeding capital formation.

Self-interest alone or the presumption that markets are always right will not suffice.

As Federal Reserve Chairman Alan Greenspan stated in October testimony before the House Committee on Oversight and Government Reform, "those of us who have looked to the self interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief."

How competitiveness became light-touch regulation

These concerns over competitiveness sometimes acknowledged, though certainly did not emphasize, that our competitive advantage was in part due to the strength of our regulation.

But the regulators were at times limited in what they could accomplish.

Because of limited resources, the SEC examines only about 10% of broker-dealers in a given year. This is hardly enough to keep bad actors in check and discover problems.

Enforcement staff at the SEC also found themselves handcuffed.

Under a pilot program instituted by former SEC Chairman Christopher Cox, attorneys in the Division of Enforcement first needed to negotiate settlement amounts with the Commission before negotiating with those they sought to settle with!

This has had a chilling effect on attorneys in Enforcement and this policy must end with the new leadership.

Given all that has occurred in our markets, we need to know that the regulators have the tools and the confidence of their leadership to pursue enforcement actions.

I am confident that the nominees that President Obama has put forward, and that we have confirmed, will guide us out of this period of lax oversight of our financial markets.

The Road to Reform

The American people are demanding significant regulatory reform. As our new President stated at his inaugural address, our challenges “will not be met easily or in a short span of time…but they will be met.”

We must meet the challenges of our current times as did those of the generations before us. We must restore the confidence that has been shaken.

There are many places to start and ideas that I have explored through subcommittee hearings.

I want to share some of those ideas with you today.

As we learn more of the President's plans for regulatory reform, we will collaborate on that package with the President's team. We look forward to sharing our ideas with his team and working towards a stronger regulatory structure.

Regulatory Modernization

A significant first step involves the structural reform of our regulatory system.

We need a structure that supports and encourages better supervision. We must begin by empowering the SEC with the resources it needs to do its job and to do it well.

In fact, I had proposed last year to increase funding for the SEC by $50 million. Recent proposals in Congress set this amount at $20 million. We can do more, and we should.

This may even require bringing fees on transactions to their previous levels to support such vigorous enforcement.

Top-to-bottom review of the SEC

Since one of the first steps to regulatory modernization starts with the SEC, Congress needs to conduct a top-to-bottom review of the SEC's strengths and weaknesses.

I hope to hold hearings at the Securities Subcommittee to solicit views from a range of stakeholders and experts to discuss how to reform the SEC.

It is this kind of thorough and deliberative review that is required before we take on the task of reforming this important institution.

Charter rationalization

Regulatory arbitrage continues to be a source of concern in our markets. Charter rationalization, at least at the federal level, will ensure that we reduce the gaps and regulatory arbitrage that have brought us to this point. In particular, the continued role of the OTS must be examined.

This examination acknowledges two important issues.

First, that the OTS has underperformed in too many areas and has at times been too lenient with those it supervises.

Second, it acknowledges that the industry convergence that has occurred between thrift and banking institutions is significant and cannot be ignored.

It has not helped in the oversight of these financially significant institutions to allow companies to choose their regulators.

Similarly, we must avoid situations where entities flip a federal charter to a state charter in reaction to regulatory constraints.

Future Oversight of Under- and Un-Regulated Markets

Throughout this crisis we have faced challenges posed by new financial products and unregulated markets.

These are in some cases emerging markets but also at times they are markets that have been deliberately left untouched.

We must provide our regulators with visibility into those markets that pose systemic risks to our economy.

In this category I would include:

· products that currently are not regulated, such as credit derivatives;

· markets lacking transparency, such as dark pools, and

· institutions that do not have formal, structured oversight, such as hedge funds.

The questions I hope to better answer through hearings and further discussion are how such products and entities, and their supervision, fit with policy objectives such as the efficient execution of transactions, price transparency, and fair competition as set forth by Congress in the Securities Exchange Act.

In regards to credit derivatives, at the very least we need a central clearing mechanism—with strong risk management systems—to reduce counterparty risks and absorb unanticipated

shocks to the market.

In some cases, exchange trading of highly standardized products

should also be in order.

Credit Rating Agency Reform

The time has come to provide the SEC with the authority and resources it needs to oversee the credit rating agencies under their designation as Nationally Recognized Statistical Rating Organizations, or NRSROs.

The past year saw unprecedented ratings failures. The SEC recently issued new rules

to address some of these failures.

I do not see these rules as going far enough to address the fundamental problems with the credit rating agencies.

The ratings issued by such agencies have provided guidelines for many financial institutions, and even our regulators, to determine what investments pose greater or lesser credit risks.

While we want institutional investors to consult other sources and use their judgment, not

all investors have access to the same level of resources.

As such, credit rating agencies will continue to play important role.

While credit rating agencies cannot provide any guarantees about future performance, they should be held to basic standards of conducting due diligence on the information they review for such ratings.

The goal is to ensure that the rating agencies have all the incentives necessary to provide fair and accurate ratings that are not influenced by any other objective than providing a true representation of the credit risk of a security.

Enhanced Global Regulatory Framework

As we are undertaking international efforts to better cope with future crises, it will be imperative that agreements move towards the highest possible uniform international standards.

Just as we attempt to remove regulatory arbitrage domestically, it is critical that we remove opportunities for international regulatory arbitrage.

Take for example, the roadmap for International Financial Reporting Standards, or IFRS.

Efforts have been underway at the SEC and elsewhere to move the entire globe onto the IFRS accounting standard and away from US GAAP, a standard that has been in place for over 70 years.

What is unclear is whether we understand whether this change will assist investors in reviewing financial statements, or make it more difficult by suggesting a global uniformity that we have not yet achieved.

The CEO of a major company came to speak with me and shared some concerns about the IFRS roadmap. He is concerned that the principles-based approach of IFRS will allow companies even in the same industry to report their numbers differently. This does not provide greater comparability and consistency for investors.

SEC Chair Schapiro noted during her confirmation hearing that she will be revisiting the timetable for IFRS roadmap, and I look forward to a more deliberate approach to this monumental accounting change.

Other moves to international convergence include mutual recognition of broker-dealer oversight in other countries and Rule 15(a)6, which changes how foreign broker-dealers can market to U.S. investors.

In all of these areas, convergence must be made to the highest standards, and after thorough examination of the implications.

Risk management improvements

The last major area that I think needs action is in risk management. The problems are not just with the SEC. Many problems can be seen across the regulators, and need prompt

addressing.

Companies failed in this regard. And the safety net of our system, the regulators, also failed to oversee these firms.

My subcommittee hearing last June sought to bring these issues to light.

At the conclusion of the hearing, I felt that Congress needed more information so

I requested the GAO to review how regulators oversaw the flawed risk management functions at financial institutions.

This study will be completed in two months and I hope to incorporate the recommendations into reform in this area.

We need to ensure that supervisors have the right information they need to identify systemic risks as they build. Some have recommended, as did the Treasury's plan under Secretary Paulson, that such regulator should be the Federal Reserve.

We need to ask hard questions about whether our central bank should be handling monetary policy, regulatory oversight, and consumer protection issues.

I have asked Vice Chairman Kohn to review the Federal Reserve's actions in response to the systemic problems that emerged and whether they were effective.

One final piece on risk management is executive compensation. The compensation of executives—which has often been determined without shareholder input—has misaligned incentives for managing risks, with a focus on the short term.

It is time to address failures such as these by allowing investors to have a say on executive compensation and also to institute stronger clawback provisions so that managers do not retain compensation for financial results that disappear.

Firms should also consider whether the model set by Credit Suisse—to pay portions of bonuses with some of the illiquid assets that got us in this mess in the first place—might be good for them to follow.

Now is the perfect opportunity to reform completely and effectively the problems that have been identified in all these areas, from the structure of our regulation, to SEC's shortcomings, regulatory arbitrage, and risk management. I plan to take this opportunity for reform as the Chairman of the Securities Subcommittee.

Conclusion

The future is about confidence and robust capital markets that draw investors to the U.S. We gain that confidence by market strength and innovation that is reinforced with a robust supervisory regime.

As we strengthen our regulatory framework, we must engage with the rest of the world as well. The move towards high standards must be global for it to be effective, as we are globally interconnected. We must be leaders in this movement.

True competitiveness looks at the long-term return, not simply short-term gains. That short view was the model that led to our current crisis. We are now moving on from that model.

Wall Street is all about confidence and trust. With that shattered, our economy continues to feel the effects.

I believe that proper government oversight will help bring back to Wall Street the confidence and trust that it sorely needs. Much of this starts with the SEC, but it also impacts the other banking supervisors.

Comprehensive, positive change is possible, and we will be bringing that forward in the

111th Congress—for the protection of our markets, investors, and our country.