SENATE TESTIMONY BY ARTHUR LEVITT, JR.
7 May 2008

Chairman Reed, Ranking Member Allard, members of the Subcommittee – thank you for the opportunity to testify in front of you today and for holding this hearing on such an important – and timely – topic.

The downfall of Bear Stearns…the uncertainty and volatility in the capital and debt markets…and the close to $300 billion in writedowns and the resulting losses by some of the world's largest financial institutions have created a crisis on Wall Street – one that rightly has gotten the attention of all of us who worry about the health of our capital markets.

Yet the current credit crisis is one that involves Main Street as much as it does Wall Street. It has directly touched the lives of millions of people – investors and homeowners alike.

And that's why it's so important that we understand what went wrong – to provide a basis for determining if there was a breakdown in regulation…and if any new regulatory structures and powers may be needed to restore trust in the markets and prevent this from happening again.

As David, Bill Donaldson, and I recently argued in the New York Times, we believe that a high-level, bipartisan, and impartial examination must be launched to explore a series of possible business and regulatory failures that produced the credit crisis. This is what President Reagan did after Black Monday in 1987, and I hope we soon have a similar presidential level task force to examine these complex issues.

But from where we stand today, it is apparent that a variety of players – including regulators, ratings agencies, standard-setters, and gatekeepers as well as institutional investors -- did not live up to their responsibilities.

In some cases – such as mortgage brokers – it was because there was a lack of meaningful regulation.

In other cases – such as ensuring banks had adequate underwriting standards for loans – the relevant regulators refused to act.

And in other instances, regulatory standards did not keep pace with financial engineering.

Those who bought these new complex, financial instruments had no idea as to the extent of the risks they were assuming since the creators of these instruments either: 1) purposely -- and legally -- hid these risks by placing them off the balance sheet in Structured Investment Vehicles…or 2) the banks themselves were clueless as to the magnitude of these risks.

At the same time, investors were basing investment decisions on the judgments of ratings agencies who either were conflicted or just careless in how they exercised their immense credit rating power.

Moving forward, there are some obvious holes that need to be plugged immediately – and none more glaring than the issues surrounding the credit rating agencies.

While the credits rating agencies have initiated a process of constructive self-analysis and reform, Congress must take these conflict-of-interest issues head-on or empower the SEC with the proper oversight and disciplinary powers so they can do the job.

This issue is critical to the proper functioning of our markets.

But looking to the longer-term, we also must consider whether new regulatory structures and authority may be needed to restore public confidence in the markets.

I am a great believer in free markets as the best way to allocate capital. At their best, markets are self-regulating and self-correcting.

Integral to the functioning of a free market is the presence of someone to ensure that the rules of the road are enforced fairly and swiftly. That's why we need to make sure that, moving forward, the market's referees keep pace with its players.

What worries me is that the creations of the financial engineers, while adding some liquidity and depth to the market, have not been self-correcting…but rather they have been destructively destabilizing.

Assessing and monitoring the risk that these products have introduced into the financial system goes beyond the ability of one nation's central bank. Indeed, it is a problem that begs for a global solution.

But that does not mean that solutions to the current crisis are beyond our reach. There is a series of steps that we can take in our own regulatory structure to improve the functioning of our markets.

That is why I welcomed Secretary Paulson's recommendations about the structure of our financial regulatory architecture. There are aspects to it that I like, some that I do not – but overall, it is an important starting point for a discussion about what we need and should demand from our market regulators.

Without getting in to the details, let me sketch out what I believe investors need from any capital markets regulator.

First and foremost, any capital markets regulator must put investor interests above all others. This is not only good for investors, but this focus is what has made our capital markets the envy of the world.

Second, as part of this commitment, this agency must ensure that the public gets whatever information it needs to make informed investing decisions. Information is the lifeblood of markets, and this agency must keep the information flowing freely.

Third, it must be a law enforcement agency. Vigorous enforcement of the rules of the road is a powerful deterrent to bad behavior – and usually prevents the use for heavy-handed regulation.

Fourth, to be effective in any of these roles, the regulator must have the resources in terms of funding, tools, staffing, and competencies to get the job done right.

Right now, I fear that the SEC does not have what it needs to meet the demands of the day.

The SEC's 2009 enforcement budget does not keep pace with inflation. Staffing levels have not kept pace with the urgent work that needs to be done. And the enforcement division, I believe, has been unnecessarily hamstrung in negotiating corporate penalties because of recent procedural changes at the Commission. The result has been a lessening of the imposition of corporate penalties against egregious wrongdoers and a reduction in the corporate penalty numbers over the past year.

Fifth, it's important that, by design, any capital markets regulator be independent – of the White House -- and de-politicized from the fights of the day.

Finally, as we consider the future of the SEC and financial regulation in general, let us not forget that more powerful than any rule that can be written, regulation that can be passed, or standard that can be set is the power of the bully pulpit.

Whatever leadership is chosen for a future agency, it needs to be led by an individual who understands the importance of public pronouncements and signals sent to the marketplace. This is something that SEC Chairmen have understood from its founding 75 years ago up until the present day -- and it must be preserved.

In sum, the future of the financial markets and of the regulatory structures we construct to oversee them is in flux – as it should be.

The gravity of the situation we are in today calls for everything to be on the table. Make no mistake: no agency, no existing structure, no gatekeeper should be immune from a thorough-going, hard-headed analysis of its relevance to today's extraordinarily complex electronic markets.

As we move forward with this review, we must keep in mind that the strength of America's capital markets lies in our high standards of transparency, independence, and accountability.

And no matter what changes we undertake, we must ensure that we have in place a market regulator that is as sensitive to the demands of the individual investor Main Street as it is to the demands of the institutional investors on Wall Street.

Thank you.