INVESTMENT COMPANY INSTITUTE

TESTIMONY OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

ON

"ESTABLISHING A FRAMEWORK FOR SYSTEMIC RISK REGULATION"

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I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively, "funds"). Members of ICI manage total assets of $10.6 trillion and serve over 93 million shareholders.

Millions of American investors have chosen funds to help meet their long-term financial goals. In addition, funds are among the largest investors in U.S. companies—they hold, for example, about 25 percent of those companies' outstanding stock, approximately 45 percent of U.S. commercial paper (an important source of short-term funding for corporate America), and about 33 percent of tax-exempt debt issued by U.S. municipalities. As both issuers of securities to investors and purchasers of securities in the market, funds have a strong interest in the ongoing consideration by policymakers and other stakeholders of how to strengthen our financial regulatory system in response to the most significant financial crisis many of us have ever experienced.

In early March, ICI released a white paper outlining detailed recommendations on how to reform the U.S. financial regulatory system, with particular emphasis on reforms most directly affecting the functioning of the capital markets and the regulation of funds, as well as the subject of this hearing—how best to monitor for potential systemic risks and mitigate the effect of such risks on our financial system and the broader economy.[1] At a March hearing before this Committee, I summarized ICI's recommendations and offered some of my own thoughts on a

[1] *See* Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf ("ICI white paper").

council approach to systemic risk regulation, based on my personal experience as the first Legal Adviser to and, subsequently, Executive Secretary of, the National Security Council. Since March, ICI has continued to develop and refine its reform recommendations and to study proposals advanced by others. I very much appreciate the opportunity to appear before this Committee again and offer further perspectives on establishing a framework for systemic risk regulation.

Section II below offers general observations on establishing a formal mechanism for identifying, monitoring, and managing potential risks to our financial system. Section III comments on the Administration's proposed approach to systemic risk regulation. Finally, Section IV describes in detail a proposal to structure a systemic risk regulator as a statutory council of senior federal financial regulators.

II. SYSTEMIC RISK REGULATION: GENERAL OBSERVATIONS

The ongoing financial crisis has highlighted our vulnerability to risks that accompany products, structures or activities; that may spread rapidly throughout the financial system; and that may occasion significant damage to the system at large. Over the past year, various policymakers, financial services industry representatives, and other commentators have called for the establishment of a formal mechanism for identifying, monitoring, and managing risks of this dimension—one that would allow federal regulators to look across the system and to better anticipate and address such risks.

ICI was an early supporter of creating a systemic risk regulator. But we also have long advocated that two important cautions should guide Congress in determining the composition and authority of such a regulator.[2] First, the legislation establishing a systemic risk regulator

[2] *See id.* at 4.

should be crafted to avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system that may stifle innovations, impede competition or impose needless inefficiencies. Second, a systemic risk regulator should not be structured to simply add another layer of bureaucracy or to displace the primary regulator(s) responsible for capital markets, banking or insurance.

Accordingly, in our judgment, legislation establishing a systemic risk regulator should clearly define the nature of the relationship between this new regulator and the primary regulator(s) for the various financial sectors. It should delineate the extent of the authority granted to the systemic risk regulator, as well as identify circumstances under which the systemic risk regulator and primary regulator(s) should coordinate their efforts and work together. We believe, for example, that the primary regulators should continue to act as the first line of defense in addressing potential risks within their spheres of expertise.

In view of the two cautions outlined above, ICI was an early proponent of structuring a systemic risk regulator as a statutory council comprised of senior federal regulators. As noted above, I testified before this Committee at a March hearing focused on investor protection and the regulation of securities markets. At that time, I recommended that the Committee give serious consideration to the council model, based on my personal experience with the National Security Council (NSC), a body which has served the nation well for more than sixty years. As the first Legal Adviser to the NSC in 1987, I was instrumental in reorganizing the NSC system and staff following the Iran-Contra affair. I subsequently served from 1987 to 1989 as chief of the NSC staff under National Security Adviser Colin Powell.

III. THE ADMINISTRATION'S PROPOSED APPROACH

The council approach to a systemic risk regulator has received support from federal and state regulators and others.[3] It is noteworthy that the Administration's white paper on regulatory reform likewise includes recommendations for a Financial Services Oversight Council (Oversight Council).[4] The Oversight Council would monitor for emerging threats to the stability of the financial system, and would have authority to gather information from the full range of financial firms to enable such monitoring. As envisioned by the Administration, the Oversight Council also would serve to facilitate information sharing and coordination among the principal federal financial regulators, provide a forum for consideration of issues that cut across the jurisdictional lines of these regulators, and identify gaps in regulation.[5]

Unfortunately, the Administration's proposal would vest the lion's share of authority and responsibility for systemic risk regulation with the Federal Reserve, relegating the Oversight Council to at most an advisory or consultative role. In particular, the Administration recommends granting broad new authority to the Federal Reserve in several respects.[6] The

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[3] *See, e.g.*, Statement of Damon A. Silvers, Associate General Counsel, AFL-CIO, before the Senate Committee on Homeland Security and Government Affairs, Hearing on "Systemic Risk and the Breakdown of Financial Governance" (March 4, 2009); Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on "Regulating and Resolving Institutions Considered 'Too Big To Fail'" (May 6, 2009) ("Bair Testimony"); Senator Mark R. Warner, "A Risky Choice for a Risk Czar," *Washington Post* (June 28, 2009).

[4] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ("Administration white paper"), at 17-19.

[5] *See id.* at 18.

[6] Under this new authority, the Federal Reserve would have: (1) the ultimate voice in determining which financial firms would potentially pose a threat to financial stability, through designation of so-called "Tier 1 Financial Holding Companies;" (2) the ability to collect reports from all financial firms meeting minimum size thresholds and, in certain cases, to examine such firms, in order to determine whether a particular firm should be classified as a Tier 1 FHC; (3) consolidated supervisory and regulatory authority over Tier 1 FHCs and their subsidiaries, including the application of stricter and more conservative prudential standards than those applicable to other financial firms; and (4) the role of performing "rigorous assessments of the potential impact of the activities and risk exposures of [Tier 1 FHCs] on each other, on critical markets, and on the broader financial system." *See id.* at 19-24.

Administration's white paper acknowledges that "[t]hese proposals would put into effect the biggest changes to the Federal Reserve's authority in decades."[7]

I believe that the Administration's approach would strike the wrong balance. Significantly, it fails to draw in a meaningful way on the experience and expertise of other regulators responsible for the oversight of capital markets, commodities and futures markets, insurance activities, and other sectors of the banking system. The Administration's white paper fails to explain why its proposed identification and regulation of Tier 1 Financial Holding Companies (Tier 1 FHCs) is appropriate in view of concerns over market distortions that could accompany "too big to fail" designations. The standards that would govern determinations of Tier 1 FHC status are highly ambiguous.[8] Finally, by expanding the mandate of the Federal Reserve well beyond its traditional bounds, the Administration's approach could jeopardize the Federal Reserve's ability to conduct monetary policy with the requisite degree of independence.

The shortcomings that we see with the Administration's plan reinforce our conclusion that a properly structured statutory council would be the most effective mechanism to orchestrate and oversee the federal government's efforts to monitor for potential systemic risks and mitigate the effect of such risks. Below, we set forth our detailed recommendations for the composition, role and scope of authority that should be afforded to such a council.

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[7] *Id.* at 25.

[8] The Administration proposes requiring the Federal Reserve to consider certain specified factors (including the firm's size and leverage, and the impact its failure would have on the financial system and the economy) and to get input from the Oversight Council. The Federal Reserve, however, would have discretion to consider other factors, and the final decision of whether to designate a particular firm for Tier 1 FHC status would be its alone. *See id.* at 20-21. This approach, in our view, would vest wide discretion in the Federal Reserve and provide financial firms with insufficient clarity about what activities, lines of business, or other factors might result in a Tier 1 FHC designation.

IV. FASHIONING AN EFFECTIVE SYSTEMIC RISK COUNCIL

In concept, an effective Systemic Risk Council (Council) could be similar in structure and approach to the National Security Council, which was established by the National Security Act of 1947. In the aftermath of World War II, Congress recognized the need to assure better coordination and integration of "domestic, foreign, and military policies relating to the national security" and the ongoing assessment of "policies, objectives, and risks." The 1947 Act established the NSC under the President as a Cabinet-level council with a dedicated staff. In succeeding years, the NSC has proved to be a key mechanism used by Presidents to address the increasingly complex and multi-faceted challenges of national security policy.

a. Composition of the Council and its Staff

As with formulating national security policy, addressing risks to the financial system at large requires diverse inputs and perspectives. The Council's standing membership accordingly should draw upon a broad base of expertise, and should include the core federal financial regulators—the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, Chairman of the Securities and Exchange Commission, Chairman of the Commodity Futures Trading Commission, the Comptroller of the Currency (or head of any combined Office of the Comptroller of the Currency and of the Office of Thrift Supervision), the Chairman of the Federal Deposit Insurance Corporation, and the head of a federal insurance regulator, if one emerges from these reform efforts. As with the NSC, flexibility should exist for the Council to enlist other federal and state regulators into the work of the Council on specific issues as required—including, for example, self-regulatory organizations and state regulators for the banking, insurance or securities sectors.

The Secretary of the Treasury, as a Presidential appointee confirmed by the Senate and the senior-most member of the Council, should be designated chairman. An executive director, appointed by the President, should run the day-to-day operations of the Council and serve as head of the Council's staff. The Council should meet on a regular basis, with an interagency process coordinated through the Council's staff to support and follow through on its ongoing deliberations.

To accomplish its mission, the Council should have the support of a dedicated, highly-experienced staff. The staff should represent a mix of disciplines (*e.g.*, economics, accounting, finance, law) and areas of expertise (*e.g.*, securities, commodities, banking, insurance). It should consist of individuals seconded from government departments and agencies, as well as individuals having a financial services business, professional or academic background recruited from the private sector. The Council's staff should operate, and be funded, independently from the functional regulators.[9] Nonetheless, the background and experience of the staff, including those seconded from other parts of government, would help assure the kind of strong working relationships with the functional regulators necessary for the Council's success. Such a staff could be recruited and at work in a relatively short period of time. The focus in recruiting a staff should be on quality, not quantity, and the Council's staff accordingly need not and should not be large.

b. Mission and Operation of the Council

By statute, the Council should have a mandate to monitor conditions and developments in the domestic and international financial markets, and to assess their implications for the health of the U.S. financial system at large. The Council would be responsible for making threshold

[9] A Council designed in this way would differ from the Administration's Oversight Council, which would be staffed and operated within the Treasury Department.

determinations concerning the systemic risks posed by given products, structures, or activities. It would identify regulatory actions to be taken to address these systemic risks as they emerge, would assess the effectiveness of these actions, and would advise the President and Congress regularly on emerging risks and necessary legislative or regulatory responses. The Council would be responsible for coordinating and integrating the national response to such risks. Nonetheless, it would not have a direct operating role (just as the NSC coordinates and integrates military and foreign policy that is implemented by the Defense or State Department and not by the NSC itself). Rather, responsibility for addressing identified risks would lie with the existing functional regulators, which would act pursuant to their normal statutory authorities but—for these purposes only—under the Council's direction.

Similar to the Administration's Oversight Council proposal, the Council should have two separate but interrelated mandates—(1) the prevention and mitigation of systemic risk and (2) policy coordination and information sharing across the various functional regulators. Under this model, where all the functional regulators have an equal voice and stake in the success of the Council, the stronger working relationships and the sense of shared purpose that would grow out of the Council's collaborative efforts would greatly assist in sound policy development, prioritization of effort, and cooperation with the international regulatory community. Further, the staffing and resources of the Council could be leveraged for both purposes. This would address some of the criticisms and limitations of the existing President's Working Group on Financial Markets (PWG).

Information will be the lifeblood of the Council's deliberations and the work of the Council's staff. Having information flow from regulated entities through their functional regulators to the Council and its staff would appropriately draw upon the regulators' existing information and data collection capabilities and avoid unnecessary duplication of effort. To the extent that a particular financial firm is not subject to direct supervision by a Council member, the Council should have the authority to require periodic or other reporting from such firm as the Council determines is necessary to evaluate the extent to which a particular product, structure, or activity poses a systemic risk.[10]

Although the Council and its staff would continually monitor conditions and developments in the financial markets, the range of issues requiring action by the Council itself should be fairly limited in scope—directed only at *major* unaddressed hazards to the financial system, as opposed to day-to-day regulatory concerns. As noted above, the Council should be required, as a threshold matter, to make a formal determination that some set of circumstances could pose a risk to the financial system at large. That determination would mark the beginning of a consultative process among the Council members, with support from the Council's staff, to develop a series of responses to the identified risks. The Council could then recommend or direct action by the appropriate functional regulators to implement these responses.

Typically, the Council should be able to reach consensus, both on identifying potential risks and developing responses to such risks. To address the rare instance where Council members are unable to reach consensus on a course of action, however, there should be a mechanism—specified in the authorizing legislation—that would require the elevation of disputes to the President for resolution. There likewise should be reporting to Congress of such disputes and their resolution, so as to assure timely Congressional oversight.

[10] The Administration likewise proposes to grant its Oversight Council the authority to require periodic reporting from financial firms, but the authority would extend to all firms, with simply a caveat that the Oversight Council "should, wherever possible," rely upon information already being collected by Council members. *See* Administration white paper, *supra* note 4, at 19.

To ensure proper follow-through, we envision that the individual regulators would report back to the Council, which would monitor progress and ensure that the regulators are acting in accord with the policy direction set by the Council. At the same time, to ensure appropriate accountability, we recommend that the Council be required to report to Congress whenever it makes a threshold finding or recommends or directs a functional regulator to take action, so that the relevant oversight committees in Congress also may monitor progress and assess the adequacy of the regulatory response.

c. Advantages of a Council Model

We believe that the council model outlined above would offer several important advantages.

First, the Council would avoid risks inherent in designating an existing agency like the Federal Reserve to serve essentially as an all-purpose systemic risk regulator. In such a role, the Federal Reserve understandably may tend to view risks and risk mitigation through its lens as a commercial bank regulator focused on prudential regulation and "safety and soundness" concerns, potentially to the detriment of consumer and investor protection concerns and of non-bank financial institutions. A Council with a diverse membership would bring all competing perspectives to bear and, as a result, would be more likely to strike the proper balance. In ICI's view, such perspectives most certainly must include those of the SEC and the CFTC. In this regard, we are pleased to note that the Administration's reform proposals would preserve the role of the SEC as a strong regulator with broad responsibilities for overseeing the capital markets and key market functions such as clearance, settlement and custody arrangements, while also maintaining its investor protection focus. It is implausible that we could effectively regulate systemic risk in the financial markets without fully incorporating the SEC into that process.

Second, systemic risks may arise in different ways and affect different parts of the domestic and global financial system. No existing agency or department has a comprehensive frame of reference or the necessary expertise to assess and respond to any and all such risks. In contrast, the Council would enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. These diverse perspectives are essential if we are to successfully identify new and unanticipated risks, and avoid simply re-fighting the "last war." Whatever may be the specified cause of a future financial crisis, it is certain to be different than the one we are now experiencing.

Third, the Council would provide a high degree of flexibility in convening those federal and state regulators whose input and participation is necessary to addressing a specific issue, without creating an unwieldy or bureaucratic structure. As is the case with the NSC, the Council should have a core membership of senior federal officials and the ability to expand its participants on an ad hoc basis when a given issue so requires. It also could be established and begin operation in relatively short order. Creating an all-purpose systemic risk regulator, on the other hand, would be a long and complex undertaking, and would involve developing expertise that duplicates that which already exists in the various functional regulators.

Fourth, with an independent staff dedicated solely to pursuing the Council's agenda, the Council would be well positioned to test or challenge the policy judgments or priorities of various functional regulators. This would help address any concerns about "regulatory capture," including those raised by the Administration's proposal concerning the Federal Reserve's exclusive oversight of Tier 1 FHCs. Moreover, by virtue of their participation on the Council, the various functional regulators would themselves likely be more attentive to emerging risks or regulatory gaps. This would help assure a far more coordinated and integrated approach. Over time, the Council also could assist in framing a political consensus about addressing significant regulatory gaps and necessary policy responses.

Fifth, the functional regulators, as distinct from the Council itself, would be charged with implementing regulations to mitigate systemic risks as they emerge. This operational role is appropriate because the functional regulators have the greatest knowledge of their respective regulated industries. Nonetheless, the Council and its staff would have an important *independent* role in evaluating the effectiveness of the measures taken by functional regulators to mitigate systemic risk and, where necessary, in prompting further actions.

Finally, the council model outlined above would be sufficiently robust to ensure sustained follow-through to address critical and complex issues posing risk to the financial system. By way of illustration, consider the case of Long-Term Capital Management (LTCM), a very large and highly leveraged U.S. hedge fund, which in September 1998 lost 90 percent of its capital and nearly collapsed. Concerned that the hedge fund's collapse might pose a serious threat to the markets at large, the Federal Reserve arranged a private sector recapitalization of LTCM. In the aftermath of this incident, there were studies, reports, and recommendations, including by the PWG and the U.S. Government Accountability Office (GAO). But ten years later, a January 2008 GAO report noted "the continuing relevance of questions raised over LTCM" and concluded that it was still "too soon to evaluate [the] effectiveness" of the regulatory and industry response to the LTCM experience.[11]

Hopefully, had a Systemic Risk Council such as that described above been in operation at the time of LTCM's near collapse, it might have prompted more searching analysis of, and more

[11] United States Government Accountability Office, *Hedge Funds, Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed* (January 2008), at 3 and 8.

timely and comprehensive regulatory action with respect to, the activities that led to LTCM's near collapse—such as the growing use of derivatives to achieve leverage. For example, under the construct outlined above, the Council would have the authority to direct functional regulators to take action to implement policy responses—authority that the PWG does not possess.

d. Potential Criticisms—and How They Can Be Addressed

It has been argued that, because of the Federal Reserve's unique crisis-management capability as the central bank and lender of last resort, it is the only logical choice as a systemic risk regulator. To be sure, should our nation encounter serious financial instability, the Federal Reserve's authorities will be indispensable to remedy the problems. So, too, will be any new resolution authority established for failing large and complex financial institutions. But the overriding purpose of systemic risk regulation should be to identify in advance, and prevent or mitigate, the causes of such instability. This is a role to which the Council, with its diversity of expertise and perspectives, would seem best suited. Put another way, critics of a council model may contend that convening a committee is not the best way to put out a roaring fire. But a broad-based council is the best body for designing a strong fire code—without which we cannot hope to prevent the fire *before* it ignites and consumes our financial system.

Another potential criticism of the Council is that it may diffuse responsibility and pose difficulties in assuring proper follow-through by the functional regulators. While it is true that each functional regulator would have responsibility for implementing responses to address identified risks, it must be made clear in the legislation creating the Council (and in corresponding amendments to the organic statutes governing the functional regulators) that these responses must reflect the policy direction determined by the Council. Additionally, as suggested by FDIC Chairman Bair, the Council should have the authority to require a functional regulator to act as directed by the Council.[12] In this way, Congress would be assured of creating a Systemic Risk Council with "teeth."

Finally, claiming that a council of federal regulators "would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively," a recent report instead calls for the creation of a wholly independent board to serve as a systemic risk "adviser."[13] As proposed, the board's mission would be to: (1) collect and analyze risk exposure of bank and non-bank institutions and their practices and products that could threaten financial stability; (2) report on those risks and other systemic vulnerabilities; and (3) make recommendations to regulators on how to reduce those risks. We believe this approach would be highly problematic. It would have precisely the effect that its proponents wish to avoid—by adding another layer of bureaucracy to the regulatory system. It would engender a highly intrusive mechanism that would increase regulatory costs and burdens for financial firms. For example, duplication likely would result from giving a new advisory board the authority to gather the financial information it needs to assess potential systemic risks. And if the board's sole function were to look for systemic risks in the financial system, it almost goes without saying that it would surely find them.

V. CONCLUSION

I appreciate this opportunity to testify before the Committee, and I hope that the perspectives I have offered today will assist the Committee in its deliberations about the

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[12] *See* Bair Testimony, *supra* note 3.

[13] *See* Investors' Working Group, *U.S. Financial Regulatory Reform: The Investors' Perspective* (July 2009), available at http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf.

mechanism(s) needed to monitor and mitigate potential risks to our financial system. More broadly, I would like to commend Chairman Dodd, Ranking Member Shelby, and the other members of the Committee for their considerable efforts in seeking meaningful reform of our financial services regulatory regime. I—and ICI and its members—look forward to working further with this Committee and Congress to achieve such reform.