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CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

OCTOBER 6, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–84

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CONTENTS

	Page
Hearing held on:	
October 6, 2009	1
Appendix:	
October 6, 2009	85

WITNESSES

TUESDAY, OCTOBER 6, 2009

Abraham, Janice M., President and Chief Executive Officer, United Educators Insurance, on behalf of the Property Casualty Insurers Association of America (PCI)	56
Atkinson, David B., Executive Vice President, Reinsurance Group of America (RGA), on behalf of the Reinsurance Association of America (RAA)	58
Bullard, Mercer E., President and Founder, Fund Democracy, Inc.	11
Chanos, James S., Chairman, the Coalition of Private Investment Companies (CPIC)	45
Crawford, Denise Voigt, Texas Securities Commissioner; and President, North American Securities Administrators Association, Inc. (NASAA)	8
Herchel, Dennis S., Assistant Vice President & Counsel, Massachusetts Mutual Life Insurance Company, on behalf of the American Council of Life Insurers (ACLI)	60
Houldin, Spencer M., President, Ericson Insurance Advisors, on behalf of the Independent Insurance Agents & Brokers of America (IIABA)	62
Kaswell, Stuart, Executive Vice President and General Counsel, Managed Funds Association (MFA)	41
Ketchum, Richard G., Chairman and CEO, the Financial Industry Regulatory Authority (FINRA)	10
Lowenstein, Douglas, President/CEO, the Private Equity Council	43
Maisel, Bruce W., Vice President & Managing Counsel, Thrivent Financial for Lutherans, on behalf of the American Council of Life Insurers (ACLI)	17
McGuire, Terry, Co-Founder and General Partner, Polaris Venture Partners; and Chairman, National Venture Capital Association	46
Taft, John, Head of U.S. Wealth Management, RBC Wealth Management, on behalf of the Securities Industry and Financial Markets Association (SIFMA)	13
Tittsworth, David G., Executive Director and Executive Vice President, Investment Adviser Association (IAA)	15
Vaughan, Therese M., Chief Executive Officer, National Association of Insurance Commissioners (NAIC)	64
Zielezienski, J. Stephen, Senior Vice President & General Counsel, American Insurance Association (AIA)	66

APPENDIX

Prepared statements:	
Kanjorski, Hon. Paul E.	86
Garrett, Hon. Scott	88
Abraham, Janice M.	89
Atkinson, David B.	97
Baker, Hon. Richard H.	104
Bullard, Mercer E.	120
Chanos, James S.	126
Crawford, Denise Voigt	147
Herchel, Dennis S.	161

Page

Prepared statements—Continued
Houldin, Spencer M. 168
Ketchum, Richard G. 175
Lowenstein, Douglas 188
Maisel, Bruce W. 194
McGuire, Terry 211
Taft, John 227
Tittsworth, David G. 241
Vaughan, Therese M. 273
Zielezienski, J. Stephen 280

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Kanjorski, Hon. Paul E.:
Written statement of the Financial Services Institute 294
Written statement of the National Association of Insurance and Financial Advisors (NAIFA) 300
Written statement of the National Association of Mutual Insurance Companies (NAMIC) 306
Written statement of the National Association of Small Business Investment Companies (NASBIC) 314
Chanos, James S.:
Written responses to questions submitted by Representative McHenry 317
Tittsworth, David G.:
Written responses to questions submitted by Representative Cleaver 318

CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE

Tuesday, October 6, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Moore of Kansas, Miller of North Carolina, Scott, Green, Cleaver, Bean, Klein, Perlmutter, Foster, Carson, Speier, Minnick, Adler, Himes, Maffei; Bachus, Royce, Manzullo, Biggert, Capito, Garrett, McCarthy of California, and Posey.

The CHAIRMAN. This hearing will come to order.

It is the next in a series in which I have lost count of specific legislative hearings on pending legislation. It is a long day. The gentleman from Pennsylvania, the chairman of the Subcommittee on Capital Markets, and his staff, along with the staff of the full committee, have done a great deal of work; and there will be a great deal presented today.

I am now going to recognize the chairman of the Subcommittee on Capital Markets for 5 minutes.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Today, the Financial Services Committee will examine the three legislative discussion graphs on investor protection, private fund adviser registration, and insurance information that I released last week.

If we have learned anything from the financial crisis, it is that excessive deregulation is dangerous. My three bills work to reverse this trend by closing loopholes and fixing problems in the broken regulatory structure, especially in our securities and insurance markets.

As we work through these drafts and the many other pieces encompassing financial services regulatory reform, we should listen to commonsense ideas and seek out consensus where it exists. I am, therefore, open to making changes in these draft bills.

In working to enact meaningful regulatory reform, however, we must ensure that special interests do not weaken particular solutions to the point of becoming toothless. Looking ahead to next year

and beyond, after this round of reform is done, we must remain diligent guardians of the public interest and of the financial system's health as a whole. Financial innovation and capitalism always seek to outpace the development of laws and regulations. This is the nature of our system. To correct this bias, vigilance is our only hope.

That said, the three draft bills before us today will no doubt enhance regulatory authority and improve access to information. For example, the Investor Protection Act provides the U.S. Securities and Exchange Commission with more firepower to perform its mandated duties. Like the Administration's reform plan, this bill includes the requirement that all securities professionals providing advice have a fiduciary duty toward their customers. Through a harmonized standard, brokers, dealers, and investment advisers will have to put investors' interests first.

The draft Investor Protection Act also significantly expands the ability of the Commission to reward those whistleblowers whose tips lead to successful enforcement actions. This legislation will further permit the Commission to adopt rules to bar the inclusion of mandatory arbitration clauses in securities contracts.

Additionally, this legislation significantly expands upon the proposal put forward by the Administration by closing loopholes identified by the Madoff and Stanford financial frauds, updating the Securities Investor Protection Act, and modifying the authorities of the Public Company Accounting Oversight Board. Moreover, the bill doubles the Commission's available funding over the next 5 years.

But enhancing the Commission's firepower and providing more money are simply not enough. As a result, the draft bill calls for an independent, comprehensive study of the entire regulatory structure that oversees the securities industry by a high-caliber body with expertise in organizational change that will identify further improvements to the implementation of our securities laws.

The second draft bill, the Private Fund Investment Advisers Registration Act, requires advisers of hedge funds, private equity firms, and others who have previously escaped direct regulatory oversight to register with the Commission and disclose certain vital information. Transparency has been nonexistent in this area for far too long, and the financial crisis revealed that our system cannot tolerate such omissions going forward.

The third bill would create a Federal Insurance Office to provide national policymakers with access to the information and resources needed to respond to crises, mitigate systemic risks, and help ensure a well-functioning financial system. The credit meltdown highlighted the lack of expertise within the Federal Government regarding the insurance industry, especially during the collapse of the American International Group and last year's turmoil in the bond insurance markets. My bill would rectify these shortcomings and promote stability in our insurance markets.

In closing, Mr. Chairman, our job today is to swing the regulatory pendulum back toward the interests of hardworking Americans. The three draft bills before us will accomplish that objective. Billionaires on Wall Street have had their day, egged on by a culture of greed, deregulation, and a survival-of-the-fittest attitude

that ignored the harsh effects those things inflict upon larger society. Today's hearing advances the effort to correct these excesses.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Alabama is recognized for 3½ minutes.

Mr. BACHUS. Thank you.

The catastrophic failure of AIG and the Madoff and Stanford Ponzi schemes provide clear evidence that our current regulatory structure is in need of reform. Republicans and Democrats have both offered legislation to address these concerns.

Chairman Kanjorski's draft bill, which is the subject of today's hearing, incorporates key portions of the Republican financial regulatory reform plan, including providing the SEC with enhanced enforcement powers and giving victims of financial fraud additional relief. The legislation represents a solid foundation on which to build a bipartisan consensus on investor protection issues.

The draft bill also contains provisions sponsored by Representatives McCarthy, Lee, and Jenkins that have already passed the House this year on suspension and clarify and provide corrections to securities laws in addition to promoting transparency and financial reporting. It includes provisions of H.R. 2873, introduced by Representative John Campbell, to provide the SEC with increased enforcement powers.

All these provisions enhance investor protection, modernize our capital markets, and begin to restore investor confidence in our markets and in the SEC; and I commend Chairman Kanjorski for incorporating them.

Other elements of the draft bill require further study, in my view. For example, the bill could substantially increase dispute resolution costs for investors and compliance costs for firms by providing the SEC with the authority to restrict and eliminate arbitration agreements.

In addition, the discussion draft does not go far enough in restructuring the SEC. The Inspector General's report detailed a massive failure of the SEC and their staff to detect the Madoff Ponzi scheme and is the best evidence for the need of SEC reform. The Office of Compliance, Inspections, and Examinations needs to be eliminated, in my view, and its functions returned to the divisions from which it was created.

Chairman Kanjorski has released draft legislation to address private pools of capital and insurance. The Private Fund Investment Advisers Registration Act mandates SEC registration for previously unregistered advisers of hedge funds, private equity, and other private pools of capital.

While no private pool of capital was the source of systemic risk or contributed to the current financial crisis, greater transparency in this part of our capital markets could serve as an important safeguard in the future if done right. However, we must ensure that any new regulatory powers granted the SEC are appropriate and do not interfere with the comprehensive due diligence that investors already perform or discourage innovation and capital formation.

Finally, today's hearings will examine the Federal Insurance Office Act of 2009, which would create a new Federal Insurance Of-

fice housed within the Treasury Department to deal with insurance issues. This draft builds on the bipartisan insurance legislation reported by this committee in the 110th Congress. Judy Biggert and Chairman Kanjorski introduced that.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

Now the gentleman from California, Mr. Royce, for 2 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Earlier this year, in an op-ed in the Washington Post, Secretary Geithner and Larry Summers noted the importance of international coordination among regulators; and they wrote this in the Post. They said, "We live in a globalized world, and the actions we take here at home, no matter how smart and sound, will have little effect if we fail to raise international standards along with our own standards. We will lead the effort to improve regulation and supervision around the world."

Well, with our fragmented regulatory regime over insurance, I think it is very clear that we are lagging behind the rest of the world. Solvency II will be implemented by the EU in the coming months, and that will bring all of Europe under one market for insurance. Yet the United States continues to struggle with 50 individual markets.

Certainly, creating a Federal Insurance Office would be a beneficial first step, but I am afraid that it will not go far enough. The current State-based regulatory system is, as the Treasury Department said in its White Paper when it did its analysis, they said: "It is highly fragmented, it is inconsistent, it is inefficient. In short, it costs consumers, and it makes our regulatory model weaker."

So, as Chairman Bernanke and Secretary Geithner have stated in previous hearings, we should consider establishing a world-class regulatory alternative to what is currently a fragmented State-based system.

I believe any regulatory reform effort will be incomplete without the inclusion of a world-class Federal insurance regulator, and I look forward to hearing from our panel of witnesses today. I hope some of them will comment on that.

I yield back, Mr. Chairman.

The CHAIRMAN. So as not to change the subject, the gentlewoman from Illinois is now recognized for 2 minutes.

Ms. BEAN. Thank you, Mr. Chairman, for yielding and for the time and for holding today's hearing.

I want to recognize the leadership of Subcommittee Chair Kanjorski and the three bills before us today as part of the broader financial regulatory reform designed to restore investor confidence, all of which are critical to making sure that what happened last year doesn't happen again.

I am proud to again be an original cosponsor of the National Insurance Office Act. I believe this bill is an important step towards addressing the lack of insurance expertise and oversight at the Federal level. It will establish for the first time a Federal voice for insurance matters and a Federal official who can negotiate international agreements that are important to the competitiveness of the U.S. insurance industry.

However, since last Congress, much has changed in our financial system. The collapse of AIG, the world's largest insurer, has proven to be one of the most costly and dangerous corporate disasters in our Nation's financial history. With nearly $180 billion of Federal tax dollars committed to AIG, plus billions more offered to other insurers, the Federal Government has made an unprecedented investment in an industry over which it has no regulatory authority.

There has never been a greater need for national insurance regulatory oversight. Not just an office to collect information, however. Through two Capital Markets Subcommittee hearings this year, we have heard general agreement that there should be a Federal role in the regulation of the insurance industry.

The call for reform was most recently echoed 2 weeks ago before this committee during a hearing on systemic risk. In his written testimony and during the question-and-answer period, former Chairman Paul Volcker advocated that establishing a national insurance regulator was a critical component to broader regulatory reform in order to ensure oversight of an important pillar of the U.S. financial system.

Mr. Volker's statement follows the call for insurance reform by the Obama Administration. The Treasury proposal specifically cited six principles for reform, including, "increased national uniformity," and recognized again our current—

The CHAIRMAN. The gentlewoman will get 30 additional seconds. It will come from my time.

Ms. BEAN. Thank you, Mr. Chairman.

—and recognized that our current insurance regulatory system is highly fragmented, inconsistent, and inefficient.

It supported consideration of a Federal charter. The creation of a National Insurance Office is helpful, but without the authority to require consistent regulatory rules enforcement and accountability, it falls short. As we work to modernize our financial regulatory structure, we should address the failure of the current insurance regulatory system that increases risks and costs to customers. Today, we have that opportunity. I look forward to working with my colleagues on the committee to do just that.

Thank you. I yield back.

The CHAIRMAN. The gentlewoman from Illinois for 1½ minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. I would like to thank you for holding today's hearing.

First, I would like to thank a few organizations represented on panel one—FINRA, Thrivent Financial for Lutherans, and ACLI—for their work to promote financial education.

As we all know, empowering consumers with financial education and the tools they need to thrive in today's complicated marketplace is the best kind of consumer protection. It is also important that we crack down on fraud.

Second, I would like to thank the witnesses on the second panel for their work to invest in America and America's entrepreneurs who create jobs.

Lastly, I want to say a few things about proposals to create a national insurance office, which will be the subject of panel three and something that Congressman Kanjorski and I are working on.

Through the last decade, it has become increasingly apparent that our Federal Government has little or no knowledge or understanding of the insurance industry. After 9/11, the Federal Government had to step in and provide terrorism risk insurance. Federal regulation lacked expertise and failed to completely understand a multifaceted business like AIG, a global company with savings and loan and insurance and derivatives business.

Almost a year ago, we worked to stabilize the financial market's treasury. Due to a lack of understanding, dismissed proposals modeled after insurance and State guarantee funds. And, finally, there is no in-house expertise in the Federal Government to represent the U.S. positions on insurance during international negotiations.

I look forward to today's discussion.

The CHAIRMAN. By the way, we have very outdated equipment. Let me explain to people. It does not do 30 seconds. It only does minutes. I am going to see if we can get the Legislative Branch to spring for a more modern one. So that is why, before the red light goes on, it may happen sometimes. But we are working on that.

The gentleman from New Jersey is now recognized for 1½ minutes.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you to this panel and all the panelists who are coming here.

The first item on the agenda, the investor protection piece, I think really offers us an opportunity for bipartisanship as we work forward; and I look forward to doing so.

But I think we need to be clear about what we are doing here today and what this panel and panels are all about and the hearing. It is really just checking the boxes. In order to stay in line with some artificially imposed deadline, really, the Majority has scheduled today's hearing on a Members' travel day. That is why we have so few people here. Today's hearing is not one, not two, but three completely separate issues over the course of three panels. Also, the Majority can say we have had a legislative hearing on each one of these items and they are fully examining these important issues.

Unfortunately, what we have here before us today is, rather than fulfilling a good-faith commitment to a deliberative process, some people are saying it makes a mockery of it; and there is a risk in making a mockery of the entire hearing process.

These witnesses, for instance, only had one business day to review a 114-page draft before having to submit their testimony yesterday; and witnesses won't give their due consideration like they otherwise should to their testimony if they don't think the committee will take it seriously.

Secretary Geithner already said that he doesn't take seriously the testimony of independent regulators. But that is another issue.

The issues before us today really are all very important. In another Congress, they would each receive careful deliberation. But not in this one. Here, we set unrealistic politically imposed deadlines which rush the legislative process and threaten really unintended consequences throughout large swaths of our market and our broader economy as well.

I thank you.

The CHAIRMAN. I now recognize myself for 2½ minutes.

I apologize to the gentleman from New Jersey. We gave him no substance to complain about, so he had to manufacture some artificial complaints about process.

First he said, wholly inaccurately, that this was scheduled for a travel date. When this hearing was scheduled, we did not know that there would be no votes last night. So, no, it was not scheduled that way.

Second, I do not apologize for telling members that we have to have more than 2 days a week in which we can work. This defense of a work ethic that says, oh, we can't be expected to sit at a sensible important hearing because there aren't votes until 6:30 leaves me wholly unimpressed. If members choose not to—there was only recently an announcement that today would be a no voting day.

So, secondly, as to arbitrary deadlines, in April of 2008, George Bush's Secretary of the Treasury urged us to start acting. Many people think we have delayed longer than we should. We have a lot of hearings, and I guess for some members it is a problem. They were elected to Congress. We have legislative responsibilities. But leaving their home districts or whatever political activity they are engaged in or specific activity to come to a hearing to the gentleman of New Jersey is an imposition on them. No, I think it is part of our responsibility. Yes, it will be a day of hearings. In fact, it will work out well, because we will not be interrupted by votes. We will have a full day to have these hearings. These are not new subjects.

And, again, I stress that the gentleman from New Jersey appeared to me to be a little frustrated because he could not find anything to disagree with. He began by saying that this could be bipartisan. But that moment of bipartisanship apparently unsettled him to the point where he had to then launch into a wholly inaccurate and unjustified partisan attack: We are having too many hearings. We are trying in a financial crisis to adopt legislation too quickly. We have, as he said, got a bipartisan agreement here. The gentleman from Alabama noted that there is a great deal of bipartisan agreement, that this bill incorporates a number of things that had been presented by members on both sides. There is a difference over arbitration. I think we have a very good debate about that. We have talked about that, and we have had hearings about it before.

So I want to say that the gentleman from Pennsylvania in particular I think does not deserve that kind of partisan attack. He has, as the gentleman from New Jersey knows, reached out to try to be cooperative. The result is a product that people say is bipartisan but I must say a very unfair attack on the procedure by which we will move it into law.

The gentleman from California is now recognized for 1½ minutes.

Mr. McCarthy of California. Thank you, Mr. Chairman.

I look forward to the testimony of all the witnesses and hearing their thoughts on the issues before the committee. Specifically, I am interested in their views on harmonizing the duty of care for all financial investors and how that would affect the entire investment advising community and their customers, from individuals to sophisticated institutional investors.

Additionally, I am concerned about the draft's movement to restrict arbitration. I look to our panelists to provide additional comments about how this significant change will affect the marketplace.

I also have a particular interest in the SEC's structural issues. I see that section 304 of the Investor Protection Act requires the SEC to hire an outside consultant to inform the SEC on how to better organize itself. While this may be helpful, I would like to point out that I have introduced legislation that would solve some of the structural problems within the SEC without additional studies.

The SEC Inspector General's Report regarding the Madoff Ponzi scheme was a colossal regulatory failure. It is perfectly clear to me that reform is needed now, not more studies. H.R. 2622 would move the Office of Inspection and Examinations back to the original functional location within the Division of Investment Management and Trading and Markets. This would streamline operations at the SEC and reduce their current stovepipe structure where those charged with inspecting and examining organizations are entirely separate from those who set the policy.

Thank you, Mr. Chairman, and I yield back.

The CHAIRMAN. We will begin with the testimony.

Our first witness is Denise Voigt Crawford, who is the Texas Securities Commissioner; and she is here on behalf of the North American Securities Administrators Association.

STATEMENT OF DENISE VOIGT CRAWFORD, TEXAS SECURITIES COMMISSIONER; AND PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION (NASAA)

Ms. CRAWFORD. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. I am so honored to be here today to discuss legislative changes that are most relevant to Americans who are looking to rebuild and safeguard their financial security.

While the recent financial crisis was the result of many failures, I am very proud to say that a failure of State securities regulation was not one of them. Today, I will focus on several proposals.

First, fiduciary duty. Financial service providers, generally stockbrokers and investment advisers, are regulated under two different statutes. The migration of stockbrokers to the advisory business has fueled confusion among investors. This is such an important issue for investors that Congress should explicitly direct the SEC to adopt rules no later than 1 year from passage of the Act mandating compliance by broker-dealers with the fiduciary duty standard established by the 1940 Investment Advisers Act. There should be no equivocation in the language, And any rulemaking should be limited to simply effectuating this requirement.

As you note, some industry groups have also called for the imposition of a fiduciary duty. However, their "new Federal fiduciary standard," a harmonized standard, is not the 1940 Act standard.

Second, increased States' regulation of investment advisers. As evidenced by the Inspector General's report of the Madoff affair, the bulk of federally covered investment advisers are examined infrequently. When examinations are conducted, the SEC has dem-

onstrated a lack of understanding as to the business of these registrants. An oversight gap exists.

NASAA members, State securities regulators are fully prepared and equipped right now to fill this gap by accepting responsibility for the oversight of investment advisers up to $100 million in assets under management. Investors can walk into our offices so that proximity ensures accessibility. Plus, NASAA members are the only regulators that actually license the investment adviser representatives, the individuals who actually provide the investment advice.

I would add that the lengthy experience of NASAA members in the application of fiduciary duty sets us apart from SROs.

Third, securities arbitration. Today, virtually every broker-dealer's customer account contains a pre-dispute mandatory arbitration provision that forces investors to submit all disputes to mandatory arbitration run by FINRA. The only chance of recovery for most investors who fall victim to wrongdoing on Wall Street is through a single securities arbitration forum controlled by the securities industry. This clause in brokerage accounts is inherently unfair to investors. It is time to end mandatory industry-run arbitration.

Short of an outright congressional prohibition, section 201 of the discussion draft is a positive step. NASAA believes it should be amended, however, to require that the SEC prohibit this mandatory predispute arbitration and offer a meaningful choice to investors, including civil litigation. If arbitration really is as fair, inexpensive, and quick as its proponents claim, then these benefits will prompt investors to choose arbitration. If, on the other hand, arbitration does not offer these advantages, then this mode of dispute resolution should not be forced upon the investing public.

Fourth, establishment of a systemic risk council. Any solution must provide enhanced communication among State and Federal regulators. A systemic risk council would establish a crisis management protocol with clear and regular lines of communication among all regulators. Generally, since State regulators are the first to identify risks and trends that contribute to systemic risk, we really do need some State banking insurance and securities regulators to serve on the systemic risk council.

Fifth and last, aiding and abetting. One of the purposes of the original securities laws was to establish higher standards of conduct. Sections 206 and 207 of the draft further this purpose by explicitly providing the SEC the authority to prosecute secondary actors who aid and abet violations of these acts. However, the interests of investors would be best served by amending these sections to remove the language "brought by the Commission." The current language may be misinterpreted as an explicit or implicit exclusion of private rights of action. Certainly, this is what the defendants will argue.

Deceptive and manipulative transactions that are intended to defraud investors really should not be classified as ordinary business decisions, and secondary actors such as accountants and lawyers should not be allowed to skirt responsibility for their wrongdoing.

In conclusion, NASAA greatly appreciates the opportunity to present our views today. Going forward, we are absolutely committed to working with you as you go forward to enhance and improve our regulatory framework. Thank you.

[The prepared statement of Ms. Crawford can be found on page 147 of the appendix.]

The CHAIRMAN. Thank you, Commissioner.

Next, Mr. Richard Ketchum, who is the chairman and CEO of the Financial Industry Regulatory Authority.

STATEMENT OF RICHARD G. KETCHUM, CHAIRMAN AND CEO, THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

Mr. KETCHUM. Chairman Frank, Ranking Member Bachus, Chairman Kanjorski, and members of the committee, on behalf of FINRA, I would like to thank you for the opportunity to testify. I commend you, Mr. Chairman, for having today's hearing on the critically important topic of improving investor protection in our regulatory structure for financial services.

Let me begin by saying I am deeply troubled by our system's failures during the past 2 years and eager to see changes that could improve the level of investor protection. When so many investors have been harmed, it is vitally important that all regulators take a hard look at their programs, identify lessons, and make changes that can better prepare them for the future.

At FINRA, that process is well under way. Already this year, we have enhanced our examination programs, procedures, and training in a variety of ways intended to help us better detect conduct that could be indicative of fraud. We established an Office of the Whistleblower to handle high-risk tips, and last week, we announced the creation of FINRA's Office of Fraud Detection and Market Intelligence. This new office provides a heightened review of incoming allegations of serious frauds, a centralized point of contact, internally and externally, on fraud issues, and consolidates recognized expertise in expedited fraud detection and investigation.

We will continue to develop plans to further strengthen our programs; and we also continue to believe that the broader financial reform that this committee is undertaking is vitally important, especially in terms of closing regulatory gaps that create exposure for investors.

One of the most glaring examples of this type of regulatory gap is the disparity in oversight between broker-dealers and investment advisers. FINRA supports the Administration's goal of harmonizing the regulation of broker-dealers and investment advisers. We believe that, in order to accomplish that goal, two steps are necessary.

The first is establishing a consistent fiduciary standard for investment advisers and broker-dealers providing investment advice. The second is harmonizing the enforcement of that standard and the other rules relevant to each channel to better ensure that participants in that industry actually comply with those obligations.

The Administration has proposed that the SEC write rules establishing consistent fiduciary standards of care for investment advisers and brokers providing investment advice. FINRA stands in agreement with numerous interested parties that the standard of care in both channels should be a fiduciary standard for the provision of advice.

Harmonization of the standard of care is an important first step. However, given the number of recently revealed frauds perpetrated

by investment advisers bound by the fiduciary standard, it is clear that the existence of the fiduciary standard of care alone is not a guarantee against misconduct. Compliance with that standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

FINRA believes that authorizing the SEC to designate an independent regulatory organization to augment the agency's efforts in examining investment advisers would create a structure that would better protect investors regardless of how their financial profession is registered.

To put this in real terms, there are nearly 5,000 broker-dealer firms registered with the SEC; and between the SEC and FINRA, approximately 55 percent of those firms are examined on an annual basis. By contrast, there are 11,000 investment adviser firms registered with the SEC, and the agency expects only 9 percent to be examined in Fiscal Years 2009 and 2010. No one involved in regulating securities and protecting investors can be satisfied with a system where only 9 percent of regulated firms are examined each year. It is a dramatic lack of coverage, and must be remedied.

Now, let me briefly turn to arbitration. We believe our forum provides efficient resolution of disputes in an impartial forum that is less costly and faster than traditional litigation. We focus our efforts on running a fair and efficient program, and we continually work to update and improve it.

On the question of mandatory arbitration, I would note that FINRA rules do not require investors to arbitrate disputes with their brokerage firms, though they do require brokers to submit to arbitration if their investors choose. This is a matter of contract between firms and their customers.

FINRA has long maintained that its determination about whether mandatory arbitration agreements should be allowable is a decision best made by Congress and the SEC. As such, we do not object to the proposal to authorize the SEC to restrict or prohibit mandatory arbitration agreements.

Before I conclude, let me briefly touch on the issue of self-funding for the SEC. I believe that any mechanism that could provide more resources and predictability to the SEC in support of its critical mission should be explored. Especially now, I don't think we are in an either/or environment for enhancing oversight of security markets. We stand ready to work with Congress and the SEC to find solutions and fill the gaps in our current regulatory system and create a regulatory environment that works properly for all investors.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Ketchum can be found on page 175 of the appendix.]

The CHAIRMAN. Next, Mr. Mercer Bullard, who is founder and president of Fund Democracy, Incorporated.

STATEMENT OF MERCER E. BULLARD, PRESIDENT AND FOUNDER, FUND DEMOCRACY, INC.

Mr. BULLARD. Chairman Frank, Ranking Member Bachus, and Chairman Kanjorski, thank you for the opportunity to appear before the committee today to discuss the protection of investors. It

is an honor and a privilege to appear to discuss these issues before the committee today.

I would like to comment on certain provisions of the October 1st draft of the Investor Protection Act of 2009.

I strongly support the Act's position that brokers should be subject to a fiduciary duty with respect to retail personalized investment advice. Section 103 accomplishes this goal by requiring the SEC to adopt rules making brokers subject to such a duty. Personalized investment advice creates a situation in which it is likely that a retail client will rely heavily on a broker's recommendation. The authority, therefore, is the proper standard in that context.

Under current law, brokers are subject to a suitability standard. Section 103 raises this standard. The duty requires, for example, that brokers disclose conflicts of interest that are not required to be disclosed under the suitability standard or other FINRA rules.

I am concerned, however, about the mechanism that Section 103 uses to establish a fiduciary duty for brokers. It amends the Exchange Act to impose the same standard of conduct for brokers that applies under the Advisers Act and then amends the Advisers Act to provide that standard shall be a fiduciary duty to act in the best interest of the client.

My concern is the interplay between the amendment to the Advisers Act and the fiduciary duty that currently applies to the advisers under the Act. The amendment could be read to create a new and, more importantly, different fiduciary duty from the current Advisers Act fiduciary duty. For example, the imposition of a statutory fiduciary duty as to retail personalized investment advice raises the question of whether and how the existing fiduciary duty owed to nonretail clients survives the amendment.

If the amendment to the Exchange Act simply provided that, with respect to retail investment advice, brokers were subject to the same fiduciary duty that applies to investment advisers under the Advisers Act, then no amendment to the Advisers Act would be necessary. Brokers and investment advisers would be subject to the same fiduciary duty with respect to retail personalized investment advice. Advisers would still be subject to a fiduciary duty with respect to nonretail clients as well.

Imposing a fiduciary duty on brokers and investment advisers will amount to very little, however, if regulators lack the capacity to enforce it. The SEC has long been substantially underfunded, and the declining frequency of investor adviser inspections has been one result.

Section 302 of the Act takes an important step toward addressing the problem by creating an industry financed mechanism for the SEC's advisory inspection program. But this will not be enough. States also play a critical role in the enforcement of investment adviser regulation. The cutoff amount for State regulation of investment advisers should be increased to return the number of advisers subject to SEC inspection to pre-INISMIA levels.

Furthermore, the gap in inspections of advisers who are exempt from the Act should be plugged. Bernie Madoff was such an exempt broker for almost his entire career. The simplest mechanism would be to repeal the solely incidental exclusion for brokers. The SEC's overbroad interpretation of that exclusion has left brokers who pro-

vide a significant amount of investment advice unregulated under the Advisers Act.

Alternatively, brokers' unregulated investment advisory activities should be regulated by their regulator, FINRA. FINRA has argued it lacks the authority to regulate the advisory activities of its members who are not registered investment advisers. I believe that FINRA clearly has this authority. But whether FINRA will not or cannot assume responsibility for its own members' unregulated advisory activities, this situation needs to be remedied. Brokers' new fiduciary duty with respect to retail personalized investment advice will mean little if their primary regulator isn't capable of enforcing it.

I recommend that the committee resolve this issue by asking the SEC whether and to what extent FINRA lacks the authority to inspect its members' unregulated advisory activities. If it lacks such authority, then Congress or the SEC should take whatever steps are necessary to fix this regulatory gap. Then, if FINRA shows that it is capable of regulating the activities of brokers who are not registered investment advisers, then we can have the SRO discussion about whether FINRA might be capable of regulating the advisory activities of brokers who are registered investment advisers. But as long as Bernie Madoff continues to represent the most telling example of FINRA's oversight of brokers who are exempt from the Advisers Act, any discussion of expanding FINRA's role would be premature.

Thank you for your consideration of my views; and I would, of course, be happy to take questions.

[The prepared statement of Mr. Bullard can be found on page 120 of the appendix.]

The CHAIRMAN. Thank you.

Next, we have Mr. John Taft from RBC Wealth Management, who is testifying on behalf of the Securities Industry and Financial Markets Association.

STATEMENT OF JOHN TAFT, HEAD OF U.S. WEALTH MANAGEMENT, RBC WEALTH MANAGEMENT, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. TAFT. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I am pleased to testify this morning on behalf of the Securities Industry and Financial Markets Association on this important subject.

SIFMA and its members support your efforts to reform our financial regulatory system to provide strong and consistent safeguards, to protect individual investors, while preserving their ability to choose the widest range of products, services, and advice to meet their individual investment needs.

Building upon SIFMA's testimony before this committee in July, we support a harmonized, uniform Federal fiduciary standard for broker-dealers and investment advisers when they are providing personalized investment advice about securities to individual investors. The average consumer does not know the difference between the 1934 Act or the 1940 Act, and they should not have to worry

about different levels of protection when they are getting the same service.

We believe that now is the time for a strong Federal standard that should supersede the existing set of State common-law-based fiduciary standards which have developed inconsistently among the 50 States and which therefore are inadequate to serve as a harmonized standard for individual investors. At the same time, we support the important role that States play in protecting the individual investors, and we recommend that any new legislation clearly permit the States to investigate or bring enforcement actions consistent with the Federal fiduciary standard.

Mr. Chairman, we appreciate that the investor protection discussion draft embraces the term "personalized investment advice" by incorporating it into the definition of retail customer. We believe the term "personalized investment advice" is perfectly suited for clarifying the responsibilities that are the focus of this legislation.

The term was coined in a U.S. Supreme Court case nearly 25 years ago, where the courts sought to define the business of investment advisers. Since then, the term has been further clarified under various Federal securities regulations. Most recently, SEC Chairman Mary Schapiro invoked the term to define when a fiduciary duty should apply to both brokers and investment advisers. The SEC is well-positioned to ensure that a Federal fiduciary standard is clear, well-defined, and equally applied so that individual investors receive the same protection.

It is important that the legislation appropriately define the circumstances under which a Federal fiduciary duty would apply and harmonize the duties under the 1934 Act with those of the 1940 Act. The SEC should retain sufficient flexibility to craft broker-dealer regulations without being constrained by investment adviser rules. Such flexibility would protect investors by appropriately respecting and preserving investor choice, a necessary component of putting investors first. SIFMA would like to continue to work with the committee to ensure that the language provides the necessary flexibility from a technical perspective.

With respect to the provisions related to predispute arbitration clauses and the securities arbitration forum, we would urge that the language of the Investor Protection Act: one, be strengthened to support the fairness and efficiency of the current securities arbitration system; and two, include provisions consistent with the suggestion in the Administration's regulatory reform White Paper released in June that the SEC should study predispute arbitration clauses to determine whether they are beneficial to investors prior to making any changes to the current system.

For nearly 4 decades, the SEC has upheld securities rules that require securities firms to arbitrate at the election of the investor. Securities firms have gained the same right in return by entering into predispute arbitration agreements with their new customers. These agreements ensure that both sides are treated fairly and that disputes are handled in a timely and cost-effective manner. In addition, previous studies have demonstrated that securities arbitration is faster and less expensive than litigation, and it particularly benefits small investors.

In closing, Mr. Chairman, I would like to make the following point: Some have suggested that SIFMA's proposed fiduciary standard is somehow inferior to what has been described as the "authentic fiduciary standard." SIFMA's vision of a harmonized fiduciary standard is, however, stronger and more pro-investor than any other alternative we have heard advanced. A fiduciary puts investors' interests first, acts with good professional judgment, avoids conflicts, if possible, or otherwise effectively manages those conflicts through clear disclosure and investor consent. These principles lie at the heart of what it means to be a fiduciary. This is the standard SIFMA endorses and that individual investors deserve.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Taft can be found on page 227 of the appendix.]

The CHAIRMAN. Next, Mr. David Tittsworth, who is the executive director of the Investment Adviser Association.

STATEMENT OF DAVID G. TITTSWORTH, EXECUTIVE DIRECTOR AND EXECUTIVE VICE PRESIDENT, INVESTMENT ADVISER ASSOCIATION (IAA)

Mr. TITTSWORTH. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. On behalf of the Investment Adviser Association, I really appreciate this opportunity to be here today.

Our organization represents SEC-registered investment advisers. The advisory profession serves a wide range of clients, including individuals, trusts, and families, as well as institutions such as endowments, charities, foundations, State and local governments, pension funds, mutual funds, and hedge funds. There are about 11,000 SEC-registered advisers.

Contrary to public perception, most investment advisers are small businesses. About 7,500 employ 10 or fewer employees, and 90 percent employ fewer than 50 employees.

Our written statement addresses the Treasury Department's proposed Investor Protection Act and related issues. Mr. Kanjorski circulated a discussion draft at the end of last week, and we greatly appreciate his efforts to address these important issues as well.

In my brief time, I would like to focus on two topics that would directly affect all investment advisers: fiduciary duty; and SEC resources.

First, I wish to reiterate our strong support for the Administration's recommendation to require broker-dealers who provide investment advice to be subject to the same fiduciary standard as investment advisers. As fiduciaries, advisers must act in the best interests of all their clients and place their clients' interests before their own. The Supreme Court has stated that the Advisers Act reflects congressional intent to eliminate or at least expose conflicts of interest related to investment advice.

Our organization has worked closely with the State securities regulators, consumer groups, and financial planning organizations to ensure that the Advisers Act fiduciary duty remains a bedrock foundation of the advisory profession. Unfortunately, the Investor Protection Act, as drafted, would not achieve this laudable result.

Instead, it would open the door to watering down or weakening the current fiduciary standard by redefining fiduciary duty under the Advisers Act.

In addition, we are concerned that the proposal could impose a fiduciary duty only with respect to retail clients, rather than to all clients. Different standards for different types of clients, whether individual or institutional, would not be in the best interest of all investors. We strongly believe it would be a mistake to alter or narrow the existing fiduciary standard under the Advisers Act. One of the greatest strengths of a fiduciary standard is its breadth. The standard has allowed the regulation of advisers to remain dynamic and relevant in changing business and market conditions.

Second, I want to underscore our strong support for the critical missions of the SEC to protect investors, to maintain fair and orderly markets, and to facilitate capital formation. The SEC has the expertise and experience to regulate the diverse advisory profession, but it clearly needs adequate and appropriate resources to do its job. Accordingly, we believe the SEC should be fully funded and that Congress should examine alternatives to allow it to achieve long-term and more stable funding, including self-funding mechanisms.

I note that Mr. Kanjorski's discussion draft includes provisions that would authorize the SEC to collect user fees from investment advisers for inspection activities. Frankly, we would prefer a self-funding mechanism. But user fees may be an appropriate option in the absence of self-funding.

In addition, we believe the SEC or Congress should increase the $25 million threshold that separates SEC and State-registered advisers.

Finally, we oppose a self-regulatory organization for investment advisers. Non-governmental regulators pose serious investor protection questions, including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs. A single governmental regulator for advisers—the SEC, operating without the confusion of overlapping regulation and additional regulators—is directly accountable to Congress and to the public. We particularly oppose the idea of FINRA as the SRO for investment advisers, given its governance structure, cost, track record, and its stated preference for the broker-dealer regulatory model.

We look forward to working with you to ensure appropriate and effective regulation and oversight of investment advisers, and I would be pleased to answer any questions.

[The prepared statement of Mr. Tittsworth can be found on page 241 of the appendix.]

The CHAIRMAN. Finally, Mr. Bruce Maisel, who is the vice president and managing counsel, General Counsel's Office, of the Thrivent Financial for Lutherans, on behalf of the American Council of Life Insurers. And that doesn't come out of your time, that title.

STATEMENT OF BRUCE W. MAISEL, VICE PRESIDENT & MANAGING COUNSEL, THRIVENT FINANCIAL FOR LUTHERANS, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Mr. MAISEL. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee.

Thrivent is a fraternal benefit society, a membership group for Lutherans with a mission of helping to provide financial security to our members and serving communities. I greatly appreciate the opportunity to appear here before you to discuss strengthening investor protections.

Life insurance company product distribution involves determining customer needs and matching them with appropriate fixed insurance and annuity products. Similarly, many life insurance agents of affiliate broker-dealers provide essential retail investor needs analysis and the sale of variable life and variable annuity products.

Consistent with this needs-based approach, many of these broker-dealers offer a variety of other types of securities to meet the retirement, college savings, and other investment needs of retail investors. Many of these broker-dealers are also registered as investment advisers and offer investment advisory services to those investors.

In short, life insurers products, functions, and regulations fit within the scope of various initiatives that address broker-dealer and investment advisers standards of conduct.

As I will discuss further, while we support the establishment of fiduciary duty for broker-dealers and investment advisers and harmonization of their regulation, we do have some strong concerns with the proposed Section 913 of the Investor Protection Act and the recently released discussion draft.

ACLI is focused on seeking to ensure that the establishment of a harmonized standard of conduct will enhance retail investor protection while at the same time permit ACLI member companies to continue to meet investor needs across the broad economic spectrum. We are also focused upon preserving the variety of ways in which retail investors receive personalized investment advice about securities.

Many retail investors work with broker-dealers and investment advisers who provide personal investment advice and offer only those proprietary and nonproprietary securities available for distribution by the particular broker-dealer or adviser. In other cases, broker-dealers and advisers provide advice about proprietary securities exclusively.

ACLI does not seek to advance one distribution channel or method as opposed to another. Instead, we believe that the overriding goal of the establishment of a harmonized standard must be tailored to reflect and preserve the various relationships that exist between a broker-dealer or investment adviser and the retail investor. By doing so, investor choice will be preserved.

Regulators have urged that, to be effective, the imposition of a fiduciary duty must recognize the particular role in which a financial professional is acting. We agree. For example, SEC Commissioner Elisse Walter has suggested that, in developing a uniform

standard, regulators should not dwell on the label to be placed on the standard. She also noted that it is important that any standard be accompanied by business practice rules that provide practical guidelines regarding the standard's parameters and that what a particular fiduciary duty requires would depend on the functional role being performed by the financial professional. We agree with those points as well.

As I noted, we believe certain provisions to the Investor Protection Act and the discussion drafts are necessary to achieve a clear, workable standard under which broker-dealers and advisers can continue to meet the ever-increasing retail investor needs.

First, any harmonized standard should apply only to personalized investment advice, meaning advice that is based on the retail investor's personal financial information.

Second, the standard should be imposed only with respect to dealing with retail investors.

Third, the standard should require that broker-dealers and advisers that provide personalized investment advice about securities to retail investors act in the best interest of the retail investors.

Finally, the hallmark of the standard should be defined that broker-dealers and advisers make full, balanced, fair, and timely disclosure, including of material conflicts of interest and related information so that retail investors can make informed investment decisions. Advisers have historically made and currently do make such disclosures. Many broker-dealers have voluntarily adopted similar disclosure practices.

While we support the establishment of the best interest standard, we strongly oppose the tying of acting in the best interest with the notion of acting without regard to the financial or other interests of the broker or investment adviser providing the advice. As detailed in my written statement, that concept is at odds with the fiduciary duty to which advisers are currently subject and could have the unintended effect of chilling the provision of investment advice by brokers and investment advisers which would run counter to serving the investing public's needs.

We are also concerned that the requirement, if broadly construed, could even require that no compensation be paid or steps having to be taken to ensure that absolutely no disparity in comparison exists between similar or even different financial products.

We believe with the above-noted modifications a harmonized standard of conduct and related rulemaking can result in brokers and advisers enhancing their ability to meet the ever-increasing retail needs across the broad spectrum of U.S. retail investors while providing those investors with enhanced protections.

Once again, I appreciate being given the opportunity to appear before you today. The ACLI applauds the efforts of the committee, and we are committed to working toward strengthening investor protections.

[The prepared statement of Mr. Maisel can be found on page 194 of the appendix.]

The CHAIRMAN. Thank you.

I will begin.

The gentleman from Pennsylvania will be presiding for most of the day, but he is meeting with some constituents now.

I did want to refer again to the question of the scheduling of the hearing. We announced today's hearing on September 15th, at a time when we were expecting that there would have been votes last night. A week or 6 days later, on September 21st, the office of the leadership announced there would be no votes last night. So the question was, should we have cancelled the hearing that had previously been scheduled because there were no votes? Given the number of hearings that I think we are obligated to have and other business, we thought that would be a very bad idea. So, again, we scheduled this hearing at a time when we thought there would be votes last night, and then we accommodated. The fact is that they cancelled the votes.

I would say, by the way, in terms of having hearings on days when there are no votes, the gentleman from Texas, Mr. Paul, had been trying for years to get a hearing on his bill to audit the Federal Reserve during the period when the Republicans controlled the Congress. Not only couldn't he get a hearing, he couldn't get the chairmanship of that subcommittee, despite his seniority entitling him to it.

And so we did give a hearing for that. I thought it was worthwhile. And I worked with the gentleman from Texas, and by mutual agreement—and he thought it was a good time—we had it on a Friday when there were no votes. The gentleman from Texas thought the subject was important enough so that he and some other Members on both sides did show up on that date.

Now, let me reassure Mr. Bullard and Mr. Tittsworth, I have a phrase that I want to put on the bill keyboard: This bill does not do what this bill does not do. Nothing in this bill revokes any existing standard. So the question of, does it apply to nonretail? Yes. And you reinforce the view that I have: redundancy is preferable to ambiguity. So while the bill doesn't do it, we will say that the bill doesn't do it.

Now, there is a question that Mr. Maisel raised, and I talked to some people about it yesterday in my own district office. We want to make sure who is covered and who isn't covered. So I think it is not retail and nonretail but what kind of activities are covered, and we will make that distinction.

Now, let me go to Ms. Crawford.

Ms. Crawford, you are the Securities Commissioner for the State of Texas. You were appointed by the Governor?

Ms. CRAWFORD. No, sir, I am not.

The CHAIRMAN. Who appoints you?

Ms. CRAWFORD. I am appointed by a board that is, in turn, appointed by the Governor. I served for over 15 years.

The CHAIRMAN. The Governor appoints a board. How long have you been in that position?

Ms. CRAWFORD. Since 1993, under different Administrations, both Republican and Democrat.

The CHAIRMAN. And the first Governor under whom you served was?

Ms. CRAWFORD. Ann Richards.

The CHAIRMAN. And, since 1993, you were continued by every subsequent Governor, Governor George Bush and Governor Perry. So you have a kind of bipartisan representation I think that is very

important to have, because I do think we do have some bipartisanship here.

On the role of the States—not now, no one has raised it at this point. It did came up in some of the witness statements. But in previous Congresses, there were efforts to substantially diminish the role of State securities administrators. Mr. Spitzer got under some people's skin; and the securities administrator in the State of Massachusetts, Secretary of the Commonwealth, Bill Galvin, does a great job. What is your view on this? Do you think that the role of States as it now—as it exists, are you an obstacle to the harmonious enforcement of the national securities market?

Ms. CRAWFORD. With all due respect, Mr. Chairman and members, we are not an obstacle. In fact, we have been filling the gap for a number of years now. There has been less regulation on the Federal level for a variety of reasons. You may have read about the auction rate securities cases where we were able to free up $60 billion and other cases of national—

The CHAIRMAN. Right. And I would say Secretary Galvin of Massachusetts has done that as well. I think that is very important.

Now, look, we have the Federal supremacy clause. If anyone can show a conflict, then the Federal Government wins. But I agree with you that you have been collectively, as States, responsible for a significant improvement in the enforcement.

But now as to arbitration, and one of the witnesses said, well, it is good for the small investor. Is it your experience that small investors are so dumb that they would refuse to deal voluntarily with something that would save them time and money?

Ms. CRAWFORD. Mr. Chairman, arbitration is a problem that is recognized even by the—

The CHAIRMAN. I understand that. Our bill says it should be mutual. Nothing in this bill prevents the mutual agreement by the investor to arbitrate dispute by dispute. It does say that this supposed mutuality of an imposed clause in a contract, when you have no choice, is not really mutuality.

But if in fact you were to have a situation where you could have that agreement, that you would have a choice, if in fact there was a form of arbitration that was better for the investor, do you think they would refuse voluntarily to accept it?

Ms. CRAWFORD. Of course not. I think that investors want choices. They don't want to be captive to an arbitration board.

The CHAIRMAN. All right, let me take the last question. We are told while they have a choice, they can sign a contract that requires it in advance or not. If they decide they want to invest and they don't want arbitration, what options are open to them?

Ms. CRAWFORD. They have no options. They cannot go to court, even small claims court, nor can they go to an arbitration forum that is not industry-run. So they are essentially out of luck.

The CHAIRMAN. Thank you, Commissioner.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman.

I want to acknowledge Joe Borg, who is the past president of the State Securities Commissioners. He also, like Texas, has done a tremendous job in Alabama on protecting consumers. I think there is bipartisan agreement, at least between the chairman and I, that

State securities commissioners do a very good job of protecting consumers, and often when there has been a failure on the Federal level, there has not been at the State level.

I also believe that a lot of the questions will probably be on what standard. Let me start with a very elementary question that I am struggling with, because when I read the testimony and people visit my office from various associations, I can't even get them to say which is a stronger standard, fiduciary or suitability.

Just starting with you, Commissioner Crawford, tell me what you think the difference in the standards is?

Ms. CRAWFORD. Mr. Bachus, there is no question but that the fiduciary standard is the more stringent standard. It is simply a standard to put the clients' best interests first. Whereas suitability is a standard that focuses on whether or not the investment at issue is suitable for the investor.

Mr. BACHUS. All right.

Mr. KETCHUM. From our standpoint at FINRA with experience over the last 10 to 15 years, a standard that clearly provides a requirement to put the investors' best interest first is the right standard. There is great value for some specific rulemaking that provides guidance as to how you handle advertising, communication with customers and the rest, but there should be no question that the requirement should be to put the customer first, and we believe that a fiduciary standard is the right way to do that.

Mr. BACHUS. And you think the fiduciary is a higher standard?

Mr. KETCHUM. I believe the fiduciary is a clearer and higher standard. It is not enough in this environment to just determine a product is okay. The product needs to be in the best interest of the customer. That standard shouldn't make decisions from the standpoint of what type of business model should be okay. The standard should be business model neutral. It should encourage disclosure of conflicts. But the right question for anyone involved in providing advice to customers is, is this advice in the best interest of the customer.

Mr. BACHUS. All right.

Mr. BULLARD. I would essentially agree with Mr. Ketchum that the fiduciary duty for some purposes is clearly a higher example. An example is precisely the disclosure of conflicts of interest I think is of greatest interest to investor advocates. For example, when a broker is paid differential amounts of compensation for selling mutual funds, the fiduciary duty would require that be disclosed. The suitability standard, while it goes a long way towards protecting investors, would not protect the investor.

Mr. TAFT. No question, the fiduciary standard represents a raising of the bar in terms of the standard under which brokerage activities would be conducted, and we are proposing fiduciary standard with the intention of raising the bar. If I might elaborate on that for a minute.

Firms like mine, most brokerage firms are duly registered under the 1940 Act and as broker-dealers. We operate every day as investment fiduciaries under the investment advisory fiduciary standard. But unlike the businesses of registered investment advisers, those activities regulated by the 1940 Act only constitute a

small part of what we do for retail investors and only constitute a small part of what our clients ask us to do for them.

We are not proposing to water down or narrow the fiduciary standard. Quite the opposite. What we are proposing to do is extend its reach from the small set of activities it applies to, investment advisory activities, to all the activities and services we provide to individual investors. And doing that will require work if we want to preserve the ability of customers to retain the breadth and range of services they receive today.

Mr. BACHUS. Thank you.

Mr. TITTSWORTH. Fiduciary standard is well established under the Advisers Act and is a higher standard than suitability.

Mr. MAISEL. Fiduciary standard is a higher standard, but I think it brings up an issue of it becomes an argument of the labels. Investment advisers as fiduciaries have to make suitable recommendations just like registered reps, and there are obviously a slew of rules, including SRO rules for broker-dealers on the suitability side. And behind the label of fiduciary and acting in good faith and several others, there is not a lot of "there" there. So I think starting from the best interest point on both sides and following would be the way to go.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

My first question is to my fellow Kansan, Mr. Tittsworth. I appreciate the point you made on page 2 of your written testimony that while the SEC's regulatory inspection and enforcement efforts should be fully funded, Congress should "examine alternatives to allow the agency to achieve longer term and more stable funding, including self-funding mechanisms and user fees."

Do you have specific suggestions on how Congress should guard against regulatory capture, sir?

Mr. TITTSWORTH. Thank you, Congressman Moore. We do have several suggestions. The goal should be giving the SEC the resources it needs to do its job. Our first preference would be self-funding, which has received a fair amount of attention lately, tying the SEC in to a dedicated revenue stream.

Secondly, as Commissioner Crawford and Mr. Bullard have indicated, we strongly believe that the $25 million line that was established by Congress in 1996 and that has never been increased should be increased. I believe Commissioner Crawford suggested a level of $100 million. That would shift 4,200 advisers to State regulation from SEC regulation and basically put us back where we were when NSMIA was enacted in 1996.

Finally, Congressman, Mr. Kanjorski has put a provision in his draft bill, section 302, on user fees for investment advisers. If those are properly structured and if it is clearly in lieu of a self-regulatory organization, we would be happy to work with you on that funding source as well.

Mr. MOORE OF KANSAS. Thank you very much.

There seems to be a lot to learn from the Madoff scandal and other Ponzi schemes that have been exposed in the financial crisis. For example, the Inspector General for the SEC recently issued a sweeping report and the draft investor protection bill includes lan-

guage authorizing an independent, comprehensive study of how to improve securities regulation.

Mr. Taft, does the draft bill we are considering today answer all of the concerns raised by the Madoff and other investor fraud cases, in your opinion?

Mr. TAFT. Congressman, I would like to speak in support of the comments that Mr. Ketchum made earlier. The imposition of or creation of a fiduciary standard for brokers and investment advisers, a harmonized standard, is a first step towards preventing Madoff-like events from happening in the future. I think though you have to marry that first step with an acceptable and appropriate enforcement regime, and I think Mr. Ketchum spoke very articulately to that point, and that is a necessary second step if you want to prevent future Madoffs.

Mr. MOORE OF KANSAS. Mr. Tittsworth or other witnesses, do you have any comments in response to this question?

Mr. TITTSWORTH. Well, I assume what Mr. Taft is referring to is the creation of an SRO or, as Mr. Ketchum, my good friend, has argued, extending FINRA's reach over investment advisers. We are strongly opposed to that suggestion, Congressman.

I certainly agree that enforcement is absolutely key to any appropriate regulatory structure, but we believe that the SEC has the expertise, the experience to do the job. What it needs is to have appropriate resources, and in my previous response, I hope I gave you some of our ideas on that subject.

Mr. MOORE OF KANSAS. Do any other witnesses have comments?

Mr. KETCHUM. Congressman, if I could just briefly say, I do believe that there is a choice here between one way or another ensuring that there are enough boots on the ground and providing the SEC resources is absolutely critical if the determination is not to have an additional independent regulator with responsibility on the investment adviser side.

I suggest moving back to the NSMIA standard that perhaps moves the SEC from 9 percent to 15 to 20 percent is not even close to enough. So there needs to either be a realistic expectation of a huge increase from the standpoint of SEC resources or considering other alternatives.

Mr. MOORE OF KANSAS. Ms. Crawford, do you have a comment? We are just about out of time.

Ms. CRAWFORD. With all due respect to my friend Mr. Ketchum, I would say that the dividing line, if you raise that dividing line from $25 million to $100 million, you immediately address the bulk of the problem, because the SEC is left with the giant money managers, those more complex firms that need to be looked at by the Federal Government with their expertise, while the States take on those smaller shops, and that way you have governmental accountability, you have local accountability, and it would not cost the Federal Government more money.

Mr. MOORE OF KANSAS. Thank you very much.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

I remember talking to a British regulator and asking him, how do you think the SEC missed this? He said, how did you miss it? How did we miss some of the things we missed? He said, with the

financial services authority, the first thing we need to do is fire half the lawyers and hire somebody who knows something rudimentary about the market in Britain.

That brings me to the question, because as we look at the regulatory reform proposal issued by the Treasury Department, I think it is important that we fully understand the events of the past year, and I think one of the things that looking back is the most troubling is the SEC's handling of the Ponzi scheme of Bernie Madoff, the Ponzi scheme of all Ponzi schemes. And before we look at increasing the regulatory responsibilities of the SEC, we should make sure some of the systemic problems are addressed.

That takes me to the theme of Harry Markopolos' testimony here that I think riveted everyone when he said that it was his belief that the SEC was over-lawyered. He noted, and then subsequently the SEC officials affirmed it, he noted there was a fundamental lack of understanding of the more intricate aspects of our financial markets within the SEC which prevented the SEC year after year from uncovering the Madoff incident.

I would like each of you to comment on the idea of the SEC being over-lawyered and what else can the SEC do to address this problem, in your opinion. Maybe we can start with Mr. Taft.

I do think Mr. Markopolos is on to something inasmuch as the British seem to feel that part of their problem was the same lack of understanding of how the market works by the people who are supposed to regulate it.

Mr. Taft?

Mr. TAFT. Congressman, I have to say that I really have no informed opinion on that subject, and, more importantly, I am here speaking on behalf of the SIFMA, and it would be far beyond my ken if I spoke to that.

Mr. ROYCE. Well, that is all right. We will go down the line and see if any of the other witnesses would like to comment on it.

Ms. CRAWFORD. Congressman, I have an opinion. I think that the point was very well taken. The SEC has, no question about it, brilliant lawyers. They are very good at writing rules, they are very good at interpreting statutes, they are good at bringing complex cases, appeals, that sort of thing.

However, they are not what I would call nimble and scrappy. They don't have people on staff who really have the will to burrow into the facts and circumstances and analyze the numbers. They need more MBAs, they need more accountants.

Mr. ROYCE. Well, I am told by someone who has expertise in this area, and Harry Markopolos would certainly be one, that it doesn't take that much burrowing in to find a classic Ponzi scheme, especially of this magnitude. The question is, did they have anybody?

Well, as a matter of fact, we now know that the SEC did have someone who understood the market. He was in the Boston office. He had been a former portfolio manager and trader, and he was constantly trying to alert the New York office, he was trying to alert the home office, as to the nature of that particular scam, and he was constantly being ignored, because in that corporate culture, anybody with that background wasn't an attorney and wasn't to be listened to. At least that was Mr. Markopolos' summation of the problem.

Ms. CRAWFORD. There is a question of accountability. One of the differences between State and Federal regulation is when you have people literally walking in off the street, defrauded investors that you have to sit across the table from and talk with one-on-one and try to address their problem, it changes your sensibility, it changes your culture.

I think oftentimes the SEC, based as it is in Washington, doesn't have those types of encounters on a day-to-day basis. If you actually looked at the lawyers there—

Mr. ROYCE. Ms. Crawford, let me just stop you there. If we had somebody in the Boston office who understood it, why wouldn't you just change the equation so that you have people who understood the problem. Rather than arguing well, if down in Texas somebody walks into the office, it might be a lawyer, it might not, at least we would have more empathy, why not acknowledge, and maybe having somebody who understands the nature of the problem would be something of an assist here.

I think that is the bottom line. And changing that corporate culture is going to be necessary, I think, in order to get the kind of expertise necessary the next time to spot a Ponzi scheme. I don't think it is empathy. I think it is a question of having somebody on board who understands the basic rudimentary nature of a Ponzi scheme.

Ms. CRAWFORD. Well, in addition to empathy, I absolutely agree with you. You need those MBAs, you need those accountants, you need people with solid business experience employed at the SEC.

Mr. BULLARD. I would say, having worked at the SEC, Ms. Crawford is correct. I wouldn't necessarily call it over-lawyered, I would call it maybe under-quantified, and the staff needs to hire more experts in those quantitative areas, and it is my understanding that is Chairman Schapiro's intent.

Mr. KETCHUM. Congressman, if I could also say, having spent a large number of years at the SEC and then working closely with the SEC in time, I would just leaven that. I do believe that the SEC needs a broader diversity of capabilities. They do have a lot of MBAs, they do have a lot of accountants, they have a lot of people who know reverse conversions and conversions and understand the arbitrage. They failed in this particular case because of a stovepipe mentality and problem that needs to get fixed.

I think that Chairman Schapiro, and I would also note somebody who hasn't been mentioned so far, Robert Khuzami, is exactly the junkyard dog with the right type of experience to be able to cut through that. So I think you can feel that the SEC has already taken significant steps to move in the right direction.

Mr. KANJORSKI. [presiding] The gentleman's time has expired.

There is a choice now; the issue came up that I am particularly interested in. I was going to go to Mr. Green, but I am going to hold off for a second, Mr. Green, and take my 5 minutes, if I may.

In putting the Investors Protection Act together, we were particularly struck by some of the material that came out in the latter part of September in regard to the IG's report on the Madoff and Stanford frauds, and it seemed to me that any fair impartial reading of the IG report indicated that we were now dealing with a totally dysfunctional agency. We can all be sensitive as to whether

when we use that word, folks will be embarrassed, but I do not use the word for the purpose of embarrassing either the agency or its leadership, present or past. The fact of the matter is it does not really matter what the Congress does in passing new laws and encouraging new regulations at the securities level if the cop is incapable or not inclined to carry out those new laws. And that is what we have, we have a blockage of implementation, and it is so very clear.

So it became apparent to me that, unfortunately, we did not have all of the diagnosis in place to make recommendations or create authorities that are necessary to straighten that agency out, but it was with the understanding and the perception that we have a regulator now that is sensitive to what is necessary and desirous of removing a dysfunctional agency into a functional agency.

That being the case, she will need assistance and help, and it is my intention that our subcommittee and committee give that assistance and help as necessary. But in order to adequately accomplish that, a very thorough study is necessary, unless we are going to go down this path of acting like blind men, not knowing quite what we are doing, because that is what we are. We are not experts in securities or securities laws or the experiences of the SEC, but we do have the legal authority and ability to give experts better tools in which to accomplish a functional agency, and that we intend to do.

So we are asking basically for a total and complete study of not only the SEC, but its related agencies, so that we can get an entire picture of what the securities requirements of the United States are vis-a-vis 2010 and then from there do the necessary adjustments and implementation of new laws to equip them with the capacity to perform at a much higher rate.

I have to be honest to say that I was shocked because I heard a little of the discussion here in response to Mr. Royce about the need for lawyers, junkyard lawyers, MBAs, etc. I don't know what we need over there, but we don't need blind men leading the blind.

A very simple question in the Madoff case would have resolved the whole problem when they were doing some of the examinations that they were doing. They just asked the one question, where are the securities, and they totally failed to ask what I think is the most obvious question that should have been hornbook law for any lawyer or investigator or Master's of Business Administration. They just didn't know what to ask. Having not asked the proper question, they got not only inaccurate, but incredibly wrong answers, and they relied upon them and cost victims an awful lot of money, and I think brought somewhat of a disgrace to the agency.

That is in the past. We cannot change that. But we sure can change the future. And it is the clear intent of the subcommittee, while I am chairing it with its jurisdiction, and I believe there is no question that under Mr. Frank, the full committee, we are going to do everything necessary to give the tools to the leadership of the Securities and Exchange Commission to accomplish our end of good administration with a strong cop on the beat. That is going to be done.

Now, what I wonder about, is why we do not hear more as the committee and the Congress about inadequacies such as existed for

years in the SEC? Is there something we should do? We have the whistleblower implementation in the Act. But how about internal whistleblowers? What is wrong with people working in government who are observing what is happening. What is wrong with people who are clients of the agency who see what is happening?

I do not get the calls. Every now and then, if I have a long involved conversation with a regulated individual, after several drinks or some other sort of relaxation, they will break down and start talking the truth. But when they are in their formal mode, they just do not respond the same, saying you have a problem over there, stovepiping, we have all heard of those things, here is what happened to me and here is how bad it is. Now, I have to be honest, recently, some have come forth that way and it has been very, very helpful.

The reason we selected the witnesses here today, we know you have the expertise, the insight and the capacity to help us along this mode. May I urge you to grab the telephone, even in these processes, even in examining this draft legislation, if you see some ways we can strengthen it and make it fairer. We are not trying to just come down with a hard club. We are trying to do what is rational and reasonable, but at the same time not to dodge the responsibility of the Congress to oversight these areas of the government.

So please feel free, I see my time has expired, but please feel free to call us to talk to us. I know you all know our staff very well. Get to know them even better if you will. We will appreciate it.

Thank you.

I now recognize my friend, the gentleman from New Jersey, Mr. Garrett, a frequent visitor on CNBC. That just proves I was up at 6:30 this morning watching Mr. Garrett.

Mr. Garrett, you are recognized for 5 minutes.

Mr. GARRETT. I thank the chairman. Just to clarify my opening comments, I do appreciate the work that you have done on all of these areas we are talking about today. I guess my only wish is that they do just merit a subcommittee look, in my opinion, and probably the chairman might concur with me on that approach to doing these things so we can really delve into all the issues we look at. I do appreciate the hearing, the work you have done, and the information that we are learning today. I thank you.

The ranking member went through the panel before with regard to the issue of the difference between the two standards. All right, let me just throw out to the panel a couple of questions.

One is, there is talk about harmonization. Would someone just like to answer this question? When we talk about harmonization, does that always mean, maybe Mr. Maisel, does that necessarily mandate, require, that we get exactly the same standards?

Mr. MAISEL. I would suggest that for the same functions, regardless, for example, of how the customer pays for the service or the choice or the way they are served, that there be the same regulation, whether you are under the Advisers Act or the broker-dealer rules, and that is not the case today.

Mr. GARRETT. But how about this? Most of the panel here is talking about raising the standard to a higher standard, fiduciary standard. Could you, I will just throw this out, to say allow for dif-

ferent standards, fiduciary standard or the current standard for broker-dealers, but on this side of the broker-dealers simply change it in a way as far as additional disclosure requirements and "transparency," and would that then get to some of the points that some of the other members on the panel addressed as far as what me as the personal client would be able to look at and say, well, now I know what I am dealing with here, but because the broker-dealers' responsibilities are slightly different, they are selling some of their products, they are getting commissions, and that sort of thing, could that address the problem?

I will start there.

Mr. TAFT. Congressman, if your question is would there be other ways to raise the bar with respect to the products and services we provide to retail investors, other ways than harmonizing the fiduciary standard, the answer is yes, you could do that differently.

Mr. GARRETT. But still with a good result?

Mr. TAFT. Well, it depends what you do, but you could certainly engineer a good outcome.

The other thing you can do, and it was picked up actually in Mr. Maisel's comments, is that, and I think this is the intention of a harmonized fiduciary standard, is have the same umbrella standard applying to all activities, but then tailor the duties and responsibilities when it comes to fulfilling that standard in a way that matches with the specific service being provided, okay?

So, for example, you have heard unsolicited orders to sell or buy stocks should not be necessarily subject to the same requirements as the continuous discretionary management of a portfolio.

Mr. GARRETT. Mr. Maisel?

Mr. MAISEL. I would say that I agree with Mr. Taft. I think there are several ways to get there. At the end of the day, the basic consumer protections should be in place for similar services and functions that are provided, and the same obligations of the firm should be in place as well.

Mr. TITTSWORTH. Mr. Garrett, I would just reiterate a couple of points. Number one, I totally agree, similar functions, activities, should be regulated the same way. I think everybody would agree that is fundamental fairness.

I think the Administration's proposal to say brokers who are providing investment advice should have the same fiduciary standard under the Advisers Act as investment advisers, that makes sense. If they are doing what investment advisers are doing, let's treat them the same way.

But I would also agree with Mr. Taft, not all broker-dealer activities are giving advice, and we are not suggesting that the fiduciary standard should apply to execution of securities transactions, underwriting or other important activities that broker-dealers are engaged in.

Mr. GARRETT. My time is going by quickly.

Mr. Tittsworth, Mr. Royce was raising the issue as far as the problems and the chairman is also raising the problems that we have had at the SEC in the past. I know FINRA was out there. They would say, hey, we can handle this all. Some would argue on the other side of that the SEC hasn't done such a great job in what they have done and as far as the personnel necessary.

How do we actually get that done with an entity that so many people have pointed to the legitimate mistakes in the past to handle that huge broad authority if you have them sweep in all of this larger number?

Mr. TITTSWORTH. I guess I may not be able to give you all the answers you want, but I would suggest that the SEC missions are absolutely right. So whether you put them with the SEC or establish some new regulator or whatever, I think you must have: that protection of investors; maintaining fair and orderly markets; and facilitating capital formation. Those are the right missions. And I think it is partly a question of giving it the resources to do its job as fully as it can.

Ms. CRAWFORD. I would respectfully disagree. Resources are always important. You have to have them. But more important than that, you have to have a will to regulate.

Just as the gentleman previously indicated, you can make all the rules and laws in the world, but if you don't have people who are willing to enforce them, then you have a problem that you haven't solved. And what we have seen at the SEC for the past few years is a lack of will to regulate. There are some things that can be done about that, but the SEC won't like it.

Mr. GARRETT. Thank you.

Mr. KANJORSKI. The gentlelady from California is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

I am interested in the testimony that was filed with us from Ms. Crawford.

Ms. Crawford, your testimony mentioned aiding and abetting liability. When the Stoneridge case was before the Supreme Court in 2007, Chairman Frank and Chairman Dodd filed amicus briefs supporting the plaintiff's position that third parties could be held liable for their participation in fraudulent financial disclosures to the SEC. The Supreme Court ruled adversely to the shareholders, removing any private right of action against so-called secondary actors.

As you mentioned, the proposal before us clarifies aiding and abetting liability for the SEC, but does not create any private right of action for investors. Can you provide us with some additional information about secondary actors? You mentioned they are lawyers and accountants. How large a role do they play in corporate fraud when such fraud occurs? Why is it important that we allow investors to have private right of action? And what was the Stoneridge case's impact on investors? How much money or wealth is lost each year, now that investors are prevented from filing their own lawsuits against secondary actors?

Ms. CRAWFORD. You have asked a number of questions and I will take them in order.

The first one is the role that accountants and others, lawyers, play in connection with the entire process. Their role is unbelievably large and unbelievably important. The transparency that is required to make our markets operate effectively really boils down to two things: transparency and the verbiage that is in the disclosure documents; as well as transparency and the numbers that are put

before the investors. Accountants and lawyers are critical to that process.

So to the extent there is wrongdoing on the part of an accountant or a lawyer who is engaged in that process, it is very unfortunate that they are not held liable for that wrongdoing.

Why do we need aiding and abetting liability and why isn't it enough just to give this to the SEC? Because the SEC can't bring all of these cases. The SEC can't be everywhere at once.

You in this room today are demanding a lot of the Securities and Exchange Commission, as you should. But the Securities and Exchange Commission cannot be the private lawyer for every defrauded investor in the United States. The only way that an investor can effectively enforce his or her claims against a secondary actor would be remove that language in the draft so that it is not restricted just to the SEC's enforcement.

With regard to the decision in the Stoneridge case, we too at NASAA filed a brief and we were very dismayed at the outcome of the case, at the opinion of the Supreme Court, and it is extremely difficult to put a dollar figure on the amount that investors might have been able to recover had the case been decided differently. But I can tell you that it was a lot. We can try to provide numbers for you as best we can.

Ms. WATERS. Would it be safe to suggest that when many of these fraudulent schemes are being enacted, that it would be almost impossible to do them without some of the supporting actors such as lawyers and accountants? How do you present something? How do you record something? How do you report something? How do you document it? And those people have to know what is going on. Is that what you are suggesting?

Ms. CRAWFORD. Absolutely. It is impossible to conceive of CEOs and upper level management actually sitting down and putting these disclosure documents together. They of necessity must rely upon their accountants and lawyers to do that for them. Of course, they need to oversee the process, but the nitty-gritty details are left to the professionals. Those professionals need to be held accountable for any wrongdoing that they engage in.

Ms. WATERS. So you consider a private right of action extremely important?

Ms. CRAWFORD. Yes, ma'am.

Ms. WATERS. Thank you very much. I yield back.

Mr. KANJORSKI. The gentleman from California, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman.

In listening to the chairman's comments and also the questioning from Mr. Royce and Mr. Garrett, I would like to follow up a little on the SEC.

I know in this bill it provides more money, but also just provides another study, and I am a little concerned by that. I am one who believes that structure dictates behavior. Mr. Ketchum, in part of the questioning you brought up stovepiping, the idea that you have people who set policy in one place and those inspectors in a whole other place.

I guess my question, and I would like to start with Mr. Ketchum and go down the line, is does this really get the job done in the SEC? But specifically, what are some fundamental changes without

waiting for a study that we can change to change the structure to actually perform better?

Mr. Ketchum?

Mr. KETCHUM. Well, it is a great question, Congressman. I think points have been made with respect to diversity and skill sets. I think the point that you emphasized in your opening statement with respect to the bill, I wouldn't be pretentious enough to say I know exactly how to design the SEC. But I do know that the present environment in which the examination function doesn't have a direct accountability and in which the level of communication between that function and the two policy divisions from the standpoint of Trading and Markets and Investment Management is not good and should change.

There should be greater accountability between the three divisions. Perhaps there should be a single person with responsibility for all three. But, one way or another, there needs to be the assurance that there is effective communication between the persons interacting with those industry sectors on a daily basis and the exam program.

Mr. MCCARTHY OF CALIFORNIA. Should we wait until the study is done to make that move, or do you see any negative? I know I have H.R. 2622 that takes the office of inspection and examination and moves it back to the original function, location and division of investment management, trading and markets.

Should we wait to have a study done, or could we not make that move now? Don't you think it would be more important to have that done?

Mr. KETCHUM. Well, Congressman, I have a great deal of faith in Chairman Schapiro. I think, as mentioned by Chairman Kanjorski before, she brings a very different focus and commitment to the SEC. I think she is looking very closely at organization now. I think you should definitely demand that there should be a conversation between Chairman Schapiro and this committee and subcommittee.

I believe that a study may be useful, but I would give Chairman Schapiro a chance to work through, make her personnel decisions and make her organization decisions, and evaluate it after that has occurred.

Mr. MCCARTHY OF CALIFORNIA. I would like to go down the row, if there are any ideas specifically as to what the SEC can do for a structural change, be it small or not, to make sure that we make a fundamental change there, not a study.

Ms. CRAWFORD. Congressman, I would just mention that one of the overarching problems at the Commission is regulatory capture. There is so much interplay with the top people on Wall Street, and many, many of the employees of the SEC go there to get the necessary experience to then get jobs on Wall Street. And I think that it has a chilling effect sometimes at the agency in terms of the staff's willingness to vigorously pursue wrongdoers.

To the extent that you could address that, perhaps by limiting—or saying that an attorney who works for the SEC cannot go to work for a Wall Street firm for 1 year after departing the agency, or something like that, so that you don't have so much of a revolv-

ing door, that might go a long way toward addressing this regulatory capture problem.

Mr. MCCARTHY OF CALIFORNIA. Thank you. Mr. Bullard?

Mr. BULLARD. I would reinforce Mr. Ketchum's point about leaving it to Chairman Schapiro. Just to give you an example of why, having lived under the problems of OC being separate from the Division of Asset Management, where I was, if you move that function into investment management, which is responsible for regulating investment advisers, and you also move the broker function to the Trading and Markets Division, you have separated what are functionally similar, as Mr. Taft pointed out, because many of those people are dual registrants.

I think that there has to be a two-step process, and that is a major reorganization that is reflecting the actual functional and regulatory lines that the law draws, and those are generally kinds of retail sales issues. And I can tell you in investment management, the hardest thing to get done was something that we had to get sign-off on trading markets. Of course, it was always trading markets' fault. They might see the issue differently.

The other recommendation I would make is that not only structure, but also money drives behavior, and I was greatly disappointed to see that the increased compensation being paid to SEC staff as of a few years ago went to salaries rather than bonuses. If you really want to change the behavior of the staff, then provide for an enforced mechanism of rewarding quality, rather than simply giving automatic salaries and increases to staff who may not be as productive as others.

Mr. MCCARTHY OF CALIFORNIA. Mr. Taft?

Mr. TAFT. I have no comment, Congressman.

Mr. TITTSWORTH. Congressman, I agree with my good friends Mr. Ketchum and Mr. Bullard. I would leave it to Chairman Schapiro. I think in her testimony before this committee on July 14th, she bullet-pointed seven or eight different things that she is doing that could enhance the SEC's ability to prevent future Madoffs from occurring.

Mr. MAISEL. The only comment I would have is I believe the harmonization work that has been discussed earlier could certainly contribute to moving away from a false demarcation about one activity versus another and I think would be a factor in some of these improvements.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you, Mr. McCarthy.

We will now hear from the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the witnesses for appearing. I especially would like to thank Ms. Crawford, a fellow Texan. Thank you for being here today. I am honored to know you have been appointed and reappointed as many times as you have.

Ms. Crawford, I think that you are eminently correct. I really do believe that it is willpower that we are talking about. Mr. Ketchum, you spoke of a junkyard dog, a highly technical term. I understand it. But the unfortunate circumstance is that we have a lot of front yard dogs. When you have a front yard dog, you need

a junkyard dog. Then you would need a system. You need something that is going to cause a front yard dog to behave like a junkyard dog.

There is no question that the empirical evidence was before the SEC. Mr. Markopolos provided not only the evidence, he also provided the questions. He provided everything that a whistleblower could have provided. And the unfortunate circumstance is there was no one there who actually picked up on it and moved with it.

I think, Ms. Crawford, what you said about allowing the private right of action to exist would have made a difference if Mr. Markopolos had the right to sue. If he could have sued, I think we would not have had the same ending that we are currently confronted with.

Ms. Crawford, would you give me a brief response with reference to the right to sue as it would have related to Mr. Markopolos?

Ms. CRAWFORD. Well, it would have been extremely fraught with difficulty, and your assessment is correct. At the end of the day, he would not have been able to maintain a lawsuit.

What we are talking about right now is the aiding and abetting of these frauds by others who were involved, these secondary actors. And what we believe would be very helpful would be to not just limit these types of actions to the SEC, but to allow private individuals to bring these suits.

Mr. GREEN. Give me an example of a private individual. Would Mr. Markopolos have been a private individual?

Ms. CRAWFORD. He may well have been.

Mr. GREEN. If he had the right to sue, what impact would that have had?

Ms. CRAWFORD. Well, it would have had a major impact, for a number of reasons. For one thing, it would have been a very public action that would have put pressure on the regulators to perhaps take another different look at the activities of Bernie Madoff, and of course if he recovered, we would not have had as many wasting of assets, although there would have been huge losses, no question about that.

Mr. GREEN. Now, if we couple that with a stronger, more expanded whistleblower requirement, how would you see the whistleblower, expanding the power of someone who is within who is blowing the whistle, who is giving us intelligence, how would that be much more effective, if you could have your way with this?

Ms. CRAWFORD. Well, the problem isn't that people weren't coming to the Securities and Exchange Commission. They receive I think about 750,000 complaints a year. The problem is that they were ignoring them or at least not making good determinations with regard to those complaints that really needed to be followed up on.

So, the whistleblower provisions are very good and helpful, but the problem is not with people who are reticent to complain. The problem is more that they are not getting the response of the agency presently.

Now, I will say with regard to this question of the ability to file lawsuits, it is my understanding that while this has not yet been introduced in the House, there is a Senate provision, Senate 1551, called the Liability for Aiding and Abetting Act, that was recently

introduced. State securities regulators support that Act, and it has many of the types of things you are concerned about, Congressman Green. So I would commend it for your consideration.

Mr. GREEN. I thank you. I thank Chairwoman Waters for broaching the issue initially, because there is no question in my mind that the lack of willpower, coupled with the fact that there really weren't any penalties for failure to act, it is not that persons were necessarily engaged in aiding and abetting as much as it was that there was no penalty for those who decided that well, this really can't be the case. Assuming they were acting with the best of intentions, there were just no penalties. So if we don't have penalties, we obviously have to have some way to force the agency to look into these issues.

Thank you, Mr. Chairman. I know that my time is up. I yield back.

Mr. KANJORSKI. Thank you.

We will now hear from the gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. I will move down here.

Mr. Maisel, are there any outstanding issues, and we have had this discussion, in the latest draft bill that would place consumers in a worse position or might cause them more harm than they have today?

Mr. MAISEL. Yes. I believe in particular the language about without regard, acting in the best interests, we support on both investment adviser and broker-dealers. But tying it to without regard to the interest of the firm or the representative, is contrary to the Advisers Act, and I think one of the things that does work very well on the Advisers Act side and I think would be replicated somewhat as a result of this harmonization would be full and timely disclosure of information, including potential conflicts of interest, material conflicts of interest.

So I think that I worry about the potential and we worry about a chilling. People would be afraid to provide investment advice if the point was so rigid or could be construed so rigidly that no other regard could be taken into account the other than the customers. There are always going to be different factors, and I think the key is to get information in the place of consumers at the right time so they can make informed investment decisions.

Again, that would fall in the long-standing Adviser Act process, which I think is a very good and full disclosure regime.

Mrs. BIGGERT. Thank you. We have been talking about the willpower and everything. Nobody has really mentioned the technology, and I think we had a hearing in the Oversight Subcommittee to talk about technology. I also serve on the Science Committee, and we now have the fastest computers in the world, and it just seems like maybe more investigations could have been done in a more timely fashion, instead of the 9 percent a year or whatever it is. Is that a factor that should be addressed?

Mr. Ketchum?

Mr. KETCHUM. Congresswoman, I think you make a great point. I know Chairman Schapiro has spoken quite strongly about the need to upgrade technology at the SEC. It is a focus at FINRA. We need to be in an environment where we effectively can manage the records of a broker-dealer and do as much preparation as possible

away from site, and also ensure that all regulators are effectively communicating together.

I know this is a point that Ms. Crawford is concerned with as well. We can't have situations where complaints are coming in to one of us and the rest of us are not aware of it. We can't have situations where we are identifying problems with respect to a particular firm and others are not aware of it. We need to find ways to ensure our technology systems share better and our technology systems are better able to mine information with respect to the industry.

So I think your point is a great one.

Mrs. BIGGERT. I have heard about the big stacks of paper that are around everywhere. We try in our office to be a paperless office, but it is not possible. As you see on all these desks, all the paper.

But the other thing is the need to have technology that talks to each other. That seems to be the hardest thing to deal with.

Mr. KETCHUM. I think it is a great point. It is really critical for us to be able to talk and effectively work through information that exists from a record standpoint from the brokers and investment advisers, and similarly to be able to have technology that is more transparent between regulators. Your point is really well taken.

Mrs. BIGGERT. Is there any concern then with the transparency, that there might be people who would get into any proprietary information?

Mr. KETCHUM. You always have to be concerned from an information security standpoint. This should be sharing of information between regulators who both have responsibility to protect that information from a confidential standpoint, if it is public customer information, and have the responsibility to protect all information with respect to investigations of other regulators. Absolutely.

Mrs. BIGGERT. Thank you. Just one other question. Is there a need for the industry and the SEC to really increase financial literacy and education to consumers, and do you have a quick way to do that? I know we have worked on it here. But it still seems like there is such a need.

Ms. CRAWFORD. Congresswoman, we work on that all the time. In fact I am very pleased to say, and I say this every time I have the opportunity, financial literacy and investor education programs begin with State securities regulators. Now it has been embraced by everyone from the President of the United States out, and that is a very good thing.

The question for us today is to make sure that what we are doing is working, and we would love to talk with you about that going forward.

Mrs. BIGGERT. Thank you very much. I yield back.

Mr. KANJORSKI. Thank you very much.

Now, we will hear from Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman, and thank you for your work on this legislation.

Ms. Crawford, thank you for being here. I want to chat with you just for a minute about State regulations.

What size or the amount of assets under management by an investment adviser is currently under the responsibility of the State securities regulator?

Ms. CRAWFORD. Right now, it is $25 million assets under management or less. And what we are proposing to do, Congressman, and we hope that you will give this serious consideration, is raising that to $100 million. We have the infrastructure in place, we have the experience, and we are certainly willing to take that on.

Mr. CLEAVER. I am very much interested in that. In fact, I am going to chat with the chairman and the sponsor of the legislation, about perhaps some kind of an amendment. But I want to make sure that $100 million is in harmony with the inflationary rise over the time that was set and today. Was that a figure that you just came up with, or was it based on inflation?

Ms. CRAWFORD. Actually, Congressman, it wasn't so much based upon inflation as it was counting up the number of firms that fell within that group, the size of that universe. What we are seeking to achieve is to leave the SEC to address the big, big money managers, the big investment advisers, while we will take the bulk of the smaller ones. I know it is hard to believe, it is hard for me to believe sometimes, but $100 million assets under management is actually pretty small.

Mr. CLEAVER. Yes, very small. I agree with you, and thank you.

Mr. Tittsworth, to hang out a shingle that one is a financial planner requires what?

Mr. TITTSWORTH. Nothing, as far as I know.

Mr. CLEAVER. Yes. Therein, said Shakespeare, lies the rub. David Letterman could just say I am a planner and go out and get clients and handle their money, and nothing is required.

Mr. TITTSWORTH. There are no Federal competency standards for investment advisers, if that is what you are getting at.

Mr. CLEAVER. That is what I am getting at.

Mr. TITTSWORTH. I would point out that certainly with the vast majority of people, you still have the question of who is going to give their money to David Letterman or to me if I hang out my shingle, and the vast majority of people that I know in our industry, in our profession, are highly educated. There are a number of designations, including chartered financial analysts.

Mr. CLEAVER. I understand that. But you would agree, and I want Ms. Crawford to respond to this, you would agree that there are some bad people in the world?

Mr. TITTSWORTH. Yes, sir, I would agree with that.

Mr. CLEAVER. All right. So you are talking about the people who, like you, are trying to function inside some kind of moral code or ethical code, but you will also agree with me that there are people who with great intentionality would go out and do just the opposite in order to make money?

Mr. TITTSWORTH. I agree with you, Congressman. And not to change the subject necessarily, but I would point out that Bernard Madoff certainly had a Series 7 stockbroker license; he had taken an examination. So that in and of itself does not necessarily prevent the wrongdoers from doing what they want to do.

Mr. CLEAVER. Yes, I know. I agree. Except that when we know that nothing is required to be a financial planner—there is a guy in Kansas City, Missouri, the district that I represent, and I couldn't believe it. I am driving by a little strip shopping mall and I see his sign out doing financial planning, real estate development.

He doesn't even have his GED, but he probably has a bachelor's in "crooktivity" or something. But this guy is cleaning up, and it just troubles me.

Ms. Crawford? I am not even sure he is being prosecuted. He is out of business now because so many people reported him when the real estate market crashed.

Ms. CRAWFORD. I just want to clarify that the term "financial planner" doesn't really mean anything, just as you indicated, but if that person is giving investment advice and is receiving compensation for doing so, that person does have to be registered. A few years ago, the State securities regulators came up with an entry level competency exam for those folks. So if they are investment advisers, they fall within the regulatory regime.

But you are so correct, Congressman. If they are just out there calling themselves a financial planner, sometimes it is difficult to get to them, depending on precisely what it is they are doing.

Mr. CLEAVER. Thank you. Mr. Maisel?

Mr. MAISEL. My comments don't relate to the bad actors, but I also do want to say that I also raise the point that if financial planning somehow is separated, financial planning is one of various investment advisory services today, and I think it could be counterproductive to the harmonization discussion if somehow financial planning or financial planning client gets some kind of uber protections.

Again, I think it goes back to the point it shouldn't matter regardless of the type of broker-dealer service or investment advisory service, hopefully will be there a harmonized standard with the best interests and the rules of the road that we talked about, but not separating out one part of the industry.

Mr. CLEAVER. Yes. Thank you, Mr. Chairman.

Mr. KANJORSKI. Thank you. The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

I guess I just have more general questions. Mr. McCarthy from California has some general changes to the structure within the SEC that he thinks will assist in enforcement and review and things like that. And I think that is great. I think it also starts at the top. If you have an Administration that says let the market take care of it, and buyer beware and the regulatory agencies don't really have a rule, they just get in the way, well, then you have, in my opinion, a lot of the fraud that was committed over the last 8 years by Stanford and by Madoff.

Soon we have people who really do believe that regulation boosts certainty and trust in the marketplace, which I think we have with President Obama. My question to you is this, all the people who lost a bunch of money, either to Madoff or to Stanford or to some other of the Ponzi schemes, what recourse do they have now, or is there any?

So I know SIPC is part of the conversation here. And I am not looking for an education on this, but are we making it any better for the people that we are investing in the feeder funds to have some protection here?

I will start with you, ma'am. Does this bill help those folks in any way?

Ms. CRAWFORD. I am not familiar with any provisions in the bill that would address your question, Congressman. However, I will point out that in some jurisdictions, States are looking at the feeder funds, trying to determine whether or not they contributed to this problem and recoveries may be possible there.

But I wouldn't want to mislead you into assuming that there is a magic bullet to the problem of the defrauded investors, because I personally think that there is not going to be a lot of money there and wouldn't want to lead you to think otherwise.

Mr. PERLMUTTER. Mr. Ketchum?

Mr. KETCHUM. I would agree with Ms. Crawford. To your specific question, no. I don't believe there is anything in this bill that looks backward and addresses that issue. I would say that the SIPC provisions that are built in here are important steps to ensure the flexibility of how SIPC covers and its ability to cover investors going forward and it is a good thing.

Mr. PERLMUTTER. Do you think we should have something in this bill that protects secondary and tertiary investors, if I invest in this guy over here in Boulder, Colorado, who then invests in something here that then invests in Madoff, should they have any protection or how are they protected? Those are the guys who are getting clobbered in this thing.

I appreciate, we have to have better up-front watchdog kind of enforcement. But how do I, how do I help those guys at the back end of this thing? They are the little guys who were just wiped out?

Mr. KETCHUM. Well, I think where you can, as Ms. Crawford indicated, where you find complicity and serious failures by entities like feeder funds, they should be held accountable and they should be held actable monetarily. The key thing for all of us is to find these things more quickly before customers are exposed as they were in those tragic instances.

Mr. PERLMUTTER. Thank you. Mr. Bullard, do you have any thoughts?

Mr. BULLARD. There are clearly a wide range of private claims that can be brought against Madoff, both Madoff feeder funds. And I think, to a large extent, they are fairly adequate. The concern I have had with CPIC, is that I think they are taking a position on what constitutes a loss, which is both unreasonable and not consistent with fundamental financial theory. But that doesn't seem to raise anyone's eye, and it is clearly addressed by the bill.

I would say, though, that as far as this bill goes, Mr. Taft has suggested that it preempt State causes of action. That would significantly reduce the ability of investors to bring claims against investment advisors. I don't know whether he sees that as an implied preemption in the bill, in which case the committee certainly should make it clear in the legislative history that it does not preempt State law or if it is wishful thinking. But that would give a substantial hit to State claims.

Mr. PERLMUTTER. Okay. Let me ask Mr. Taft, what do you think?

Mr. TAFT. Well, as I said in my testimony, we believe there is tremendous merit to having a harmonized Federal fiduciary standard that applies to everyone providing investment, personalized investment advice to individuals, so that no matter which door an individual investor walks into, they can be assured that they are

going to receive the same protections they would receive if they walked in a different door.

As to a Federal standard, the consistency, the clarity that it brings, we are not suggesting that exist to the detriment of the ability of State regulators to enforce that law. So I want to make it clear that we think State regulators play an important role, and they would have the ability to pursue wrongdoers who violate fiduciary standard.

Mr. PERLMUTTER. Thank you. Thank you, Mr. Chairman.

Mr. BULLARD. To clarify, my point was about private claims, not State regulators claims. I didn't hear a response to that, but that is what I was getting at.

Mr. KANJORSKI. Thank you, Mr. Perlmutter. Now we will hear from the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. I have been going in and out and I am sorry I have missed most of the testimony. I had an opportunity to read it.

I have some people in northern Illinois who got caught up in some of these Ponzi scams, and we are always interested in knowing what, if anything, can be done to protect sophisticated investors from getting caught in something like that, and what, if anything, the Investor Protection Act of 2009 could do to help people who are sophisticated investors. Does anybody want to take a stab at that one?

Ms. CRAWFORD. Well, I will say this, and the statement has been made by Chairman Frank that the accredited investor standard is not working or, I am paraphrasing, but he said words to that effect.

And when you look at the universe of people who were where defrauded by Bernie Madoff as well as Robert Stanford, they were so-called accredited investors, which means that they have a very large net worth and/or a very large income and are presumed to be, because of that, sophisticated.

At some point, it may make good sense for the United States Congress to look at that concept. Should someone be presumed to be sophisticated simply by virtue of his or her wealth or income? That standard did not service very well recently, and there really is no reason to think that it will service very well going forward.

Mr. MANZULLO. Does anybody else want to take a stab at that? I know it is a little bit off the context, but it really is tied into it.

Mr. BULLARD. I will do it. I think there may be reluctance, to be really frank, about the question of sophisticated investors investing with someone like Madoff. But in my position, I can perhaps afford to be more frank.

And my view is that in light of the Madoff scandal, a truly sophisticated investor would not have invested with Madoff. There were fundamental steps that any truly sophisticated investor should have made that would have led them not invest at least a substantial amount of their assets with Madoff. I think Madoff is ultimately a question of how we regulate those who don't take the steps, to some extent, to protect themselves. Exactly the same thing could be said of Stanford with respect to CDs being issued from a very small island in the middle of the Atlantic.

So I think that is really the answer, and as my testimony suggests, I think the focus should be on retail investors, personalized

advice and there has to be a point at which you draw the line and sophisticated investors would have to rely on the private claims that they have.

Mr. MANZULLO. The reason that I asked—

Mr. KETCHUM. I am sorry, I just agree with Professor Bullard. Two things to note. First, fraud standards remain the same no matter what the sophistication of the investor. Secondly, you are absolutely right. I think it deserves a careful analysis from a suitability standpoint at a minimum and perhaps from a fiduciary standpoint, with respect to what obligations are with regard to a range of institutional investors that don't have the level of sophistication that many other institutional investors do.

And time and time again, there are instances in which those persons who are categorized by standards that have been built for other reasons by the SEC are brought into schemes where they suffer serious harm. So I think your point is correct. I think it deserves some careful look and study and perhaps a valuable part of the study that is a part of this bill.

Mr. MANZULLO. The fact that the SEC had actually looked at Mr. Madoff, given him a clean bill of health on a couple of occasions, wouldn't that lend credence to a sophisticated investor that the Madoff investment was solid?

Mr. BULLARD. It might. I would say it should not, given that would be nearly a floor. But just to give you a concrete example of steps that any sophisticated investor should take, one of the rules that I suggest for any investor is never send the check to the person who is making the decision about the check, and what that means is you always have to make sure that there is a separate third party who has custody, who is a different person from the one who is making decisions about the account.

Mr. MANZULLO. But there were people who had contacted independent brokers, and investment advisers, who said the best place to invest your money is with Mr. Madoff.

And so I guess at what point, does the government get involved, when even the people who are supposed to be really sophisticated also may have relied upon some very poor information and gotten stung? Maybe I should just leave that as a rhetorical question and let it go at that and thank you.

Ms. CRAWFORD. Congressman, you might want to direct that question to the SEC.

Mr. MANZULLO. Well, they didn't even know about it. Their own internal investigation showed that when the whistleblower had contacted the lower echelon at the SEC, that it never made it all the way to the top. I guess my thought is, why didn't that man who testified here contact a Member of Congress or somebody in the Banking Committee, because we could have kicked it upstairs right away and worked on it. Thank you.

Mr. KANJORSKI. Thank you very much, Mr. Manzullo. Now we are faced with a problem. The problem is we could continue with this panel or take a break for lunch and come back and catch panel 2 and panel 3, and I see all the disappointed faces of this panel to get excused now and I would not want to disappoint them. But since we are down to three members here, four members, it probably is a good chance to take a break. So what I want to do is ex-

press the thanks of the committee and the subcommittee for this panel's participation. We appreciate it. I was particularly interested with the flow of some of the testimony and the comments. We will not refer to the gentlelady from Texas at all, so we cause her no embarrassment.

But all of you really were rather forthcoming, gave some very good insight in assisting us and coming up with conclusions, and, of course, you were willing to give critiques and criticism to the existing legislation, which you are always welcome to do.

Again, you are not discharged from your responsibilities to communicate some of your hesitations with the legislation or how we can improve it, but we do want to give you our tremendous thanks for having participated.

And at this point, we will discharge the panel. Thank you.

We are going to recess the hearing until 1:00, when we will take panel number 2 and then shortly thereafter, panel number 3. So no one try and escape from the committee room. Thank you, they are discharged. The committee stands in recess.

[recess]

Mr. KANJORSKI. The full committee will reconvene, and I will introduce our second panel, which will discuss enhancing oversight of private pools of capital. Thank you for appearing before the committee today and without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Mr. Stuart Kaswell, general counsel of the Managed Funds Association.

Mr. Kaswell.

STATEMENT OF STUART KASWELL, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION (MFA)

Mr. KASWELL. Thank you, Chairman Kanjorski, Ranking Member Bachus, and members of the committee.

I am Stuart Kaswell, executive vice president and general counsel of the Managed Funds Association. As you know, Congressman Richard Baker was invited to testify on behalf of MFA today, but weather-related delays in Baton Rouge kept him grounded. He sends his deep apologies for not being able to appear and sends his thanks to the committee for its invitation.

MFA is the voice of the global alternative investment industry and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Hedge funds provide liquidity and price discovery to markets, capital to allow companies to grow or to improve their businesses and sophisticated risk management to investors, such as pensions, to allow those pensions to meet their obligations to their beneficiaries. MFA appreciates the opportunity to provide its views on the registration and investor protection legislative proposals from this committee and the Obama Administration.

MFA is committed to playing a constructive role as the regulatory reform discussion continues. As investors, hedge funds have a shared interest with other market participants and policymakers

in seeking to restore investor confidence in a stable and transparent financial system. These important objectives can, in part, be accomplished through a thoughtful approach towards the goal of establishing a smarter financial regulatory system, a system that enhances investor protection and market efficiencies through strong but fair oversight, regulation and enforcement, and the promotion of industry best practices like MFA's sound practices.

With regard to the registration issue, MFA and its members support the general approach of requiring investment advisers, including those to all private pools of capital, to register under the Investment Advisers Act, which provides a comprehensive regulatory framework for investment advisers.

In considering the appropriate regulatory framework, we believe it is important to establish a narrowly tailored exemption from registration for the smallest investment advisers that have a de minimis amount of assets under management and coordinate with, and not duplicate, State regulation of investment advisers.

MFA believes that the approach taken in the draft proposals, notably requiring registration under the Advisers Act, is consistent with an intelligent approach to a complex issue. We also welcome the fact that the committee and Administration drafts both seek to preserve a de minimis exemption from Federal registration for advisers to all but the smallest of funds and would provide for confidentiality with regard to reporting systematically relevant information about a firm to the appropriate regulator.

While MFA supports the general thrust of the draft proposals, I would like to spend a few minutes discussing some areas of concern where we believe the draft proposals can be improved.

We believe that the proposed bills by imposing unnecessary overlapping regulatory requirements for commodity trading advisors, who are already registered with, and well regulated by, the Commodity Futures Trading Commission, is inconsistent with the goal of improving the current system of regulation.

As I noted, while we appreciate that the proposals provide for the confidential treatment of certain reports, we would encourage Congress to consider the Federal Reserve's model of protecting bank information.

We recognize and strongly support the fiduciary obligations that investment advisers owe their clients. We further recognize the SEC's challenges following the Goldstein decision and the need for additional legislation to clarify the SEC's authority.

We believe there are different ways to address those concerns without expanding the definition of client so broadly that advisers would become subject to the irresolvable conflicts that would result if an adviser were required to manage a pooled investment in the interest of each individual investor.

We support strong disclosure between counterparties, but we believe that there should be limitations on the information that an adviser is required to disclose to other market participants. For example, we believe that an investment adviser should not be required to reveal its proprietary trading strategies or other trade secrets.

We believe that Congress should provide an appropriate transition period to implement the registration requirement.

MFA also supports efforts to enhance investor protection and strengthen the authority of the SEC to enforce the Federal securities laws. I have a few suggestions. I will try to cover them quickly. We support giving the SEC authority to prohibit individuals who engage in improper conduct while associated with a broker-dealer or investment adviser, from being associated with any other securities industry participant.

Investment advisers are subject to an existing, robust fiduciary standard with respect to their clients. We support extending that standard to broker-dealers and believe it is unnecessary for Congress to establish a new standard.

I see I am just about out of time. We have a few additional points that are included in our written statement. Thank you, Mr. Chairman.

[The prepared statement of the Honorable Richard Baker, president, Managed Funds Association, can be found on page 104 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Kaswell.

Next, we have Mr. Douglas Lowenstein, president of the Private Equity Council. Mr. Lowenstein?

STATEMENT OF DOUGLAS LOWENSTEIN, PRESIDENT/CEO, THE PRIVATE EQUITY COUNCIL

Mr. LOWENSTEIN. Thank you, Mr. Chairman, and members of the committee. I appreciate being back here to testify and discuss the Private Equity Council's views on the proposed Private Fund Investment Advisers Registration Act of 2009. As I had previously testified before this committee, when applying the Obama Administration's systemic risk factors to private equity, it is hard to see how any particular PE fund could be considered to present a systemic risk.

Indeed, in testimony last week before this very committee, Federal Reserve Board Chairman Ben Bernanke said he would not think that any hedge fund or private equity fund would become a systemically critical firm individually. Though he did add that it remains important for the systemic risk regulator to monitor the industry as a whole, and we agree. Precisely for that reason, and notwithstanding the lack of a nexus between private equity and systemic risk, we are genuinely supportive of requiring registration of advisors to private pools of capital.

With respect to the specifics of the draft bill circulated last week, I have a few comments that I want to share with you and we covered in some detail in our written testimony. Section 204(b)(7) of the draft would add to the Investment Advisers Act the requirement that registrants provide reports, records, and other documents to investors, prospective investors, counterparties, and creditors if the SEC determines such disclosure is necessary.

We take no issue with requiring PE fund managers to disclose any and all information to the SEC regarding systemic risk, but this section's added authorization for the SEC to require registrants to make broad disclosures to third parties is unnecessary, problematic and will do little to advance the underlying objectives of the regulatory system. It is unnecessary because the Securities

Acts of 1933 and 1934 already impose a series of requirements obligating PE funds to make extensive disclosures to their investors.

Additionally, the contracts that PE funds negotiate with their investors typically require the funds to provide even more information than is required by the 1933 and 1934 Acts.

In short, given the highly sophisticated nature of our investors and our dependence on them for funding our investments, they have both the knowledge and the leverage to obtain the information they need to ensure they are fully protected. While the proposed law protects information provided to the SEC from disclosure under the Freedom of Information Act, the section has the perverse effect of neutering these critical confidentiality provisions by allowing the agency to compel disclosures to counterparties, creditors, and others.

These disclosures could result in exposure of proprietary information and trade secrets to those with whom we compete. For example, this provision could easily result in the disclosure of highly sensitive material, nonpublic information about our valuation of a current or prospective investment, information that creates the potential for the counterparty to trade on that information or pass it along to another client. There is no public or systemic risk interest served, as far as we can tell, by this additional disclosure section, and we hope that you will consider removing it from the draft.

We are also concerned about section 204(b)(3) of the draft which creates what we believe is a rather sweeping optional information-gathering authority for the SEC above and beyond the already extensive disclosures that are required by the Investment Advisors Act itself.

Given the fact that the prior section of the draft already authorizes the SEC in consultation with the Fed to collect such information as it deems necessary or appropriate in the public interests for the protection of investors or for the assessment of systemic risk, it would seem that should be sufficient to carry out the goals of the statute.

Finally, section 6 creates a venture capital exemption. I sympathize with the intent to offer relief to certain funds that may not have the resources or the infrastructure to absorb the administrative costs of a company registration, and which are also too small to create systemic risk individually or collectively. However, I think it will prove very difficult to define a venture capital firm and to distinguish these from most other investment firms. So I would suggest a simpler and perhaps even fairer approach would be to raise the threshold above which registration is required from $30 million to a level that Congress believes is appropriate.

This would ensure the registration requirement captures the larger firms more likely to pose the systemic risk, regardless of whether they are classified as a venture capital fund or private equity fund or some other investment advisor. And it has the virtue of treating all small advisers in the same way.

And, most importantly, it will help ensure the SEC can focus its scarce resources on overseeing those very firms, including those who are members of the Private Equity Council, that are most relevant to the public policy objectives that bring us here today.

Thank you for inviting me. I look forward to answering any questions you may have.

[The prepared statement of Mr. Lowenstein can be found on page 188 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Lowenstein.

Next, we have Mr. James S. Chanos, chairman of the Coalition of Private Investment Companies. Mr. Chanos?

STATEMENT OF JAMES S. CHANOS, CHAIRMAN, THE COALITION OF PRIVATE INVESTMENT COMPANIES (CPIC)

Mr. CHANOS. Thank you, Congressman Kanjorski, Congressman Bachus, and members of the committee.

My name is Jim Chanos, and I am testifying today as chairman of the Coalition of Private Investment Companies. I also run a $6 billion hedge fund. Thank you for the opportunity to testify.

As I testified before at your Capital Markets Subcommittee earlier this year, CPIC supports legislation to provide increased Federal regulation of private investment funds. We support the draft legislation before the committee today with some additional enhancements that I will outline briefly.

As this committee is aware, hedge funds and private pools of capital were not the source of the recent near meltdown in our financial system. The greatest threats to the world economy came from large, highly regulated, diversified investment and commercial banks, insurance companies, and the GSEs. Nonetheless, we recognize that you are working to expand and improve Federal oversight over the financial markets in which private funds play an important role. All significant market participants should participate in a regulatory framework that promotes transparency and accountability.

The benefits and risk mitigating features of private funds for investors in our economy are well-known at this point. There, of course, are risks associated with private funds. These risks center on relationships among fund managers, investors and individual counterparties. In rare cases, like Long-Term Capital Management in 1998, a fund may grow to a size, amount of leverage, and interconnectiveness that presents systemic risks.

CPIC has advocated that Congress develop a special stand-alone private investment company act tailored to the unique characteristics and risks of private funds. In our view, statutes like the Investment Company Act and the Investment Advisers Act were designed to protect retail investors and are not the right fit for private funds.

That said, the Administration's proposal and this committee's draft have chosen to develop private fund regulation oversight through amendments to the Adviser's Act. These proposals offer a way forward but only if they are sufficiently strengthened and tailored to private funds. To begin, both proposals require that private fund advisers register with the SEC under the Advisers Act and subject both the fund manager and the fund to SEC examination.

The committee's draft, however, exempts advisers to venture capital funds from registration. We question whether a category of private funds should be relieved of SEC registration, recordkeeping and inspection, solely by virtue of its self-proclaimed investment

strategy. Indeed, Ponzi schemes and frauds can be run with any asset class, and the lines between different categories of private funds have tended to blur over time.

Leaving the operations of some funds outside the regulatory purview based upon a stated investment strategy is an invitation for the growth of bubbles and frauds. The draft proposals grant broad general authority of the SEC to write rules in several areas, including disclosure to investors, counterparties, and creditors.

We recommend providing more specificity such as requiring disclosures for a fund's valuation methodologies, the type of assets it holds, the existence of side arrangements and trade allocation policies. We also believe that Congress could help combat fraud and theft by statutorily requiring managers to keep all client assets with qualified custodians and requiring audits by public accounting firms overseen by the PCAOB.

We commend the decision to explicitly direct the SEC to write rules relating to assessments of systemic risk. We support these provisions and also believe that any broader systemic risk regulation the committee develops should include private funds, depending upon their size, level of leverage, and interconnectedness.

With respect to systemic risk oversight, private funds should not be subject to the same type of regulation as is necessary for a Bank of America, Citigroup or Goldman Sachs. But what is fundamentally important is that systemic risk entity has the overarching authority to obtain information from any market participant when necessary and without the predicate of an enforcement action.

We would also urge the committee to consider whether it wants this new systemic risk regulator to apply the same disclosure contemplated in the Private Investment Act to the proprietary trading functions of all regulated financial institutions.

Proprietary trading resembles many of the same features as hedge funds using high levels of risk and leverage. The metrics used to assess risk stemming from private fund activity can also be used to better understand the risks being taken by significant taxpayer-backed financial institutions.

All of these provisions will benefit investors and private funds by enhancing regulators' ability to combat abuses while reducing systemic risk. CPIC is committed to working with you to build a better regulatory framework that will best serve all investors' interests.

Thank you very much for this opportunity.

[The prepared statement of Mr. Chanos can be found on page 126 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Chanos.

Next, we have Mr. Terry McGuire, co-founder and general partner of Polaris Venture Partners, and chairman of the National Venture Capital Association.

STATEMENT OF TERRY McGUIRE, CO-FOUNDER AND GENERAL PARTNER, POLARIS VENTURE PARTNERS; AND CHAIRMAN, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. MCGUIRE. Chairman Kanjorski, Ranking Member Bachus and members of the committee. On behalf of the venture capital industry, I would like to thank you for the opportunity to be part of this important process. We understand the need to address the

causes of the recent financial crisis, as well as eliminate regulatory gaps, so that our country is never surprised by massive financial failures again.

Last week, the Capital Markets Subcommittee, chaired by you, Chairman Kanjorski, released a discussion draft focusing on risk related to private pools. We would like to express our sincere appreciation for the work of the subcommittee under your leadership and the leadership of Chairman Frank in drafting legislation that recognizes that venture capital firms do not pose systemic risks.

We also appreciate your understanding that registering under the Advisers Act would place an undue burden on our industry. The legislative draft recognizes the important difference between entrepreneurial risks, which we take all the time, and financial systemic risks, which we do not.

Our investment model is simple. We invest in startup companies run by entrepreneurs using capital from ourselves and our investors. We invest cash to purchase equity and hold that equity, working side-by-side with the management for 5 to 10 years until the company is sold, goes public or fails. In the latter case, there is no multiplier impact of these losses.

While we lose our capital, there are no derivative transactions or leverage that would lead to a ripple effect. The elements identified by the Treasury Department as contributing to systemic risks are not part of the venture capital model.

We do not actively trade in the public markets. Our funds are not directly available to retail investors. While some of our investors are pension funds, under many State laws they are limited to the amount of money they can invest in venture capital. The number is often less than 5 percent in investable assets.

We do not use long-term leverage or rely on short-term funding. We do not create third party or counterparty risks. Lastly, the venture capital industry is small, just a fraction of other pool investment funds. But, for more than 50 years, our collective wins have far outpaced our losses.

Tremendous economic value has been created. Venture-backed companies say it counts for 12.1 million jobs and approximately 21 percent of the U.S. GDP. Entire industries, including biotechnology, semiconductors, and now clean tech have been built upon venture capital. By exempting venture capital funds from registering under the Advisors Act, this committee has eliminated a significant burden on our industry.

As you may know, the average venture capital firm employs less than 10 professionals, and the administrative staff is often a fraction of that. Registration could easily cost our firms hundreds of millions of dollars, which should be directed to growing new companies, rather than unnecessary compliance.

Finally, venture capital registration would not provide the government with meaningful insight into systemic risks and would divert government resources. With that said, we do recognize the ongoing need for ongoing transparency.

Today, venture capital firms provide information to the SEC that is publicly available when we seek to raise a new fund. This filing process, which involves the completing of a form which is known as form D, could easily be enhanced to include information that

would provide greater comfort regarding systemic risks. An enhanced form D, let's call it form D–2, for venture firms could answer questions annually on the use of leverage, trading positions and counterparty obligations, allowing regulators to continue to exempt firms that pose no systemic risks.

The D–2 solution could be a viable option because it does not require a lengthy regulatory process to test the definition of venture capital. It would cause firms to annually confirm that they are safe from systemic risks by responding to questions that reveal the nature of their investing activity. This would enable the SEC to quickly identify firms that do not meet the standard.

This process would also accomplish the Administration's goals of providing transparency and eliminating regulatory gaps. It would do so without unnecessarily burdening the venture industry or the SEC. We look forward to discussing these recommendations further.

We applaud the committee's intent to protect entrepreneurship and innovation. We stand ready to work with you to gain transparency as you require, without hurting our industry and the start-up companies we support.

I thank you for your consideration today, and I am happy to answer any questions.

[The prepared statement of Mr. McGuire can be found on page 211 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. McGuire.

And thank you all, gentlemen, for your testimony. Notice I said "gentlemen." There should be some young ladies sitting at that table too, so one of these days, we have to think about equality here.

No, all things being said, I take it for granted that nobody really has concluded that the bill as presented is too harsh for acceptance, but you would like to sit in a role of being an assistant and helping us to protect even a finer bill; is that correct?

Mr. KASWELL. That is correct. We applaud your efforts. We think there are opportunities for further enhancement, but we agree with the general thrust, that is right.

Mr. KANJORSKI. That is very good. The Congress doesn't hear that very often, so I thank you on behalf of the entire Congress.

I have been trying to propel an idea to the industry that is we regulate or sit in judgment of and create regulatory implementation for, and that is that too often we miss the advice of the experts and do not recognize very clearly that we all, Members of Congress and members of this committee, are generalists.

If I can extend to you—we all actually have telephones. If you call the gentleman from Alabama, he will get on that line and talk to you. Then he, in turn, will relate to us some of the objections you may have stated or, actually, make your argument a little more understandable.

Mr. BACHUS. Or not.

Mr. KANJORSKI. Or not. No, I have known Mr. Bachus for a long time, and he is going to be a very major player in trying to put this together. What this is, is an open invitation to you and your colleagues and your association members, etc., to please participate.

If we have done something that can be improved and corrected upon, do not hesitate to do that. That is what we are here for. We are not here to play "gotcha." We are not here to cost you a lot of money. Mr. McGuire, you mentioned it costing hundreds of millions of dollars to comply. That is the last thing we want to do.

We do really want you to take those hundreds of millions of dollars out there and invest in companies, those that are north of Philadelphia by 100 miles and east of Pittsburgh by 200 miles. If you get my measure, you can tell exactly where I am looking at that investment to occur.

We spent actually a lot of time trying to put this together so we could accomplish something. I take for granted that we have been partially at least successful. We want to work as this process goes forward, and we think it can go forward in a relatively reasonable period of time to get this done.

So without taking my full time, I am going to recognize the ranking member from Alabama to give his comments.

Mr. BACHUS. I thank the chairman.

Venture capital, hedge funds, private equity, all of those, I guess, private pools of capital or whatever you call them, I think have served the country well, and they have been a valuable cog in our economy, and it is an economy that is 3 times larger than the next biggest economy, which is the Japanese economy.

I think it was this diversity and different approaches to adding wealth creating jobs is a strength of the American economy. And we don't, in America, take the one-size-fits-all.

And as the chairman said, as we move forward on protecting investors, we do want your advice and input, because we don't want to put some restriction on what you do that is unnecessary and also limits your ability to aid the economy.

Our economy—I go to high school students and I ask them what the largest economy in the world is. Most of them today say China. Yet our economy is bigger than the Japanese, the German, the British, the French, the Chinese, and the Japanese economy put together.

We got there through choice and innovation and different approaches, and letting the market come up with, really, solutions. And our capitalistic market, it turned into a bad word, that and profits today, but I think they have generated tremendous wealth for the American people. Despite what we witnessed last year, I think we got ahead of ourselves on some of them.

The securitization, the different derivatives, all those things were actually, I think, good products that were just abused. But there is nothing fundamentally unsound or fundamentally wrong with the product itself, but you can abuse anything.

So I am just going to—I guess I will ask this, is registration with the SEC properly done, would that be a problem with any of the industry or you?

Mr. MCGUIRE. If I could make a comment, the truth of the matter is that the venture capital industry has been around for 50 years. We certainly submit SEC forms, form D, as I mentioned. We are prepared to do additional disclosure.

I do think, though, that the burden of the Advisers Act would be substantial and would be difficult for some of our members. Some

of our members are very small places in districts such as yours. As I mentioned, the average has nine professionals. There are some, though, with two and three professionals.

By the way, they are doing incredibly important work in companies that are coming from technologies generated from your local universities. And I think having an additional burden, the SEC burden, would not be helpful. In fact, over 50 years we have proven that, in fact, we are good citizens.

Our model is pretty simple. It is old-fashioned. We invest in companies. We expect to have our equity in those companies for up to a decade, and we work hand-in-hand with those companies. So I think we have proven to be good citizens. We have proven that our model works. As you point out, it has made an enormous contribution to the competitive positioning of the United States.

So I think it would be unfortunate if there was undue regulation. I don't think it would provide any particular insight into systemic risks. Things haven't changed in our business.

It is true that technology is unrelenting, and it is always changing. But the way we practice venture investing has really been tried and true for over 50 years. We would hate to lose some of these venture capital investors because of these undue burdens.

Mr. BACHUS. I think you make a good argument. I think the burden ought to be on us to prove that there is a reason for—even registration.

Mr. Lowenstein?

Mr. LOWENSTEIN. Yes, I think that for anybody, even the largest private equity fund, to suggest that registration isn't in some ways burdensome is not reasonable. It clearly is burdensome. That is distinguished—in fact, for even the largest funds, that might requiring hiring 7 to 10 compliance people at a cost of several million dollars. But that is a reasonable cost to impose on the members we represent in the private equity world.

I do think it is important and appropriate though to, as you go further down into the smaller firms—and there are about 2,000 private equity firms, and most of us all know the big names in private equity—but there are small private equity firms all around this country. And imposing, in the same way that the VC funds have, would be a burden, I think would apply to virtually any small fund regardless of what it does. And that is why we suggest in our testimony, the touchstone for whether registration is there, isn't what you say you are, it is a—an assessment of your size and what you do and whether you create systemic risk.

That is a reasonable standard. That is what this statute is all about. And so tying the registration to a reasonable targeting of registrants who actually are relevant to the underlying policy goals, I think, makes no sense. Just in the final point, as we say in our testimony, the characteristics of PE and the reality of what's happened would suggest that private equity wasn't relevant at all to the crisis.

I could make a case that we shouldn't have to register. I think it is entirely reasonable to require us to register and then to calibrate that registration so that it is most tied to what we do and what is necessary for the SEC to carry out its oversight responsibilities.

Mr. BACHUS. And I don't think venture capital, in any way, contributed to the events of last year, did it?

Mr. CHANOS. If I could take a stab also, I would just point out as a practitioner, as someone who runs a fund day-to-day, much of what we are talking about here in the form of so-called burdensome compliance issues to register, if you are accepting pension fund money in large pools of capital, which almost all the reasonably large members of our different groups do, you are already doing most of that which is necessary for compliance under registration.

So it would not be necessarily additive to what you should already be doing in your internal workings of your fund if you take pension fund money, ERISA money. That is something that is often lost in these discussions.

Number two, we can talk about various different types of self-described funds and whether or not they were the source of systemic risk. And the hedge fund industry, I think was a model of actually warning people about systemic risk back in 2006 and 2007.

But we also understand that markets look forward. And who is to say which group of funds is not going to be issued prospectively as opposed to retrospectively. And I know that we can all hold ourselves out to be paragons, I think, in the investing world—but for the purpose of the public good, I think that our group, CPIC, says don't make many exemptions. Make it comprehensive, set minimum standards for capital or risk standards as Mr. Lowenstein said. But when a lot of people opt-out through self-description, you also open up the door to the less than 1 percent of the actors out there that may take advantage of that.

Mr. BACHUS. Mr. McGuire?

Mr. MCGUIRE. Yes. Let me comment on that. Let me be very specific. In my opening statement, I made the comment that there are essential criteria which have been defined by Treasury which define what are systemic risks. They include the use of leverage, they including public trading positions, they include counterparty transactions.

Our model doesn't use any of those. Therefore, I am making an argument which is that any models that don't use those criteria which have been defined by Treasury are adequate for exception. Now I am not here to tell you which of these other organizations should be regulated. They, earlier on, said that they are happy to register. That is fine.

We have never taken a position that registration works for our industry because, in fact, as defined by these risks, none of these apply to us. So why should we now start registering just because the others are registering?

Mr. KASWELL. We also feel that there should not be regulatory gaps, that registration should apply to advisers to all private pools of capital with the exemption for only the de minimis based on the size of assets under management, not the nature of the operation.

We are afraid it will create regulatory gaps, which we know has been one of the touchstones of the Administration's concerns here, and also we are concerned about the opportunities for regulatory arbitrage.

One of the things we are worried about in the bill, and I mentioned this in my statement, is that it creates the possibility of

overlapping regulation, if you are principally engaged on the future side and registered with the CFTC, the bill would take away an exemption that exempts you from the Advisers Act. We think that just creates duplication and is not warranted. Thank you.

Mr. BACHUS. Thank you.

Mr. KANJORSKI. The gentleman's time has expired. We will now hear from the gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman, thank you, Mr. Chanos. Thank you for being here. Thank you all for being here.

In your testimony on pages 11 and 12, you say, "In my view, one of the most important recommendations of the report, of the asset manager's committee, is that managers should disclose more details going beyond the Generally Accepted Accounting Principles regarding how their funds derive income and losses from financial accounting standards."

Now I agree with the need to disclose more details, but can you be a little more specific on the change, what kind of change will take place with the overall risk to the financial system?

Mr. CHANOS. I helped write that section for the President's Working Group and the manager's report, so I am familiar with it.

What we suggested, and what my organization, CPIC, is embracing, is a level of disclosure beyond what we have right now under GAAP for the so-called level 1, level 2 and level 3 assets. And these are the various classifications of financial assets under the accounting standards. Very briefly, level 1 are things that have a very liquid national market, 100 shares of IBM, for example.

Level 2 assets are those assets which are priced off something else, which uses the term observable inputs. So, typically, a bond that might trade at a spread to Treasuries would be, in some historical pattern, would be a level 2 asset.

Level 3 assets are those which are the oxymoronic phrase unobservable inputs, and those are really subject mostly to management judgment and best guesses, quite frankly.

And what we advocated—and I think is good policy for every financial institution, not just hedge funds, by the way, would be not only a disclosure of the various levels of assets at a point of time on the balance sheet, but also how much of your profits and losses, both realized and unrealized, in your financial statements, have come from the three classifications. That goes well beyond the current accounting standards, but that would have helped us in 2006 and 2007 in seeing just how much of the profitability of various different actors on the stage were dependent on hard-to-value assets or assets in which management had large discretion over the valuation.

So, the President's Working Group committee, the managers, really, we did argue over that, exactly the point you highlighted. But we felt it was in the best interests of not only the hedge fund industry but the markets as a whole and regulation to shine more light in this area.

I really applauded the President's Working Group committee to take that step and go beyond what we are doing now.

Mr. CLEAVER. I do as well. I am requesting a subjective response, probably, but whenever we begin to discuss in this committee requiring more detail, we run into very, very rigid resistance.

You can predict it, it is coming, and it is going to, if we are told, if we do, that the Statue of Liberty will fall and the Washington Nationals would win the series, or all kinds of just unbelievable things will happen. Give me a response to what we have heard in here over and over again.

Mr. CHANOS. Well, I think that I would make the distinction between giving the information that your investors need to make good decisions about, for example, my fund, and that the industry feels that we could go a little bit further to telling our investors where we are making our money, how we are making our money, and also to tell regulators and enforcement individuals what they need to do to do their market policing and their market regulation.

We do draw the line in telling the broad public, because you then do cross over into the proprietary trading information. And if I have to disclose my whole portfolio to the public every 90 days, I really don't have a business because, that is what I charge people for.

But to regulators, to enforcement, and to our own investors, who have put their money in the fund, we think we should be as broad as possible and as detailed as possible. And I think that is just sound business and sound regulation. It doesn't necessarily compromise my ability or our members ability or members of these organizations' ability to make money as long as they know they have some safeguards over that information, that it stays in the proper regulatory framework.

Mr. CLEAVER. I agree. I think that is what the American public wants too. Mr. Kaswell?

Mr. KASWELL. Yes, I just wanted to note that these principles are—as part of the President's Working Group recommendations—reflected in the MFA sound practices that we recommend as something for our members to consider. So I think we are not necessarily saying it should be a regulatory requirement—I am not sure we are going that far—but as far as what we think are sound practices for the hedge fund industry, we are very much on board.

Mr. CLEAVER. But you are not saying that they should be included in any regulatory form?

Mr. KASWELL. Right, not at this stage. But we are saying this is something our firm should seriously consider doing, and we have it as an industry sound practice that we commend to our members.

Mr. CLEAVER. Thank you. My time has about run out.

Mr. KANJORSKI. Thank you very much, Mr. Cleaver.

Now, the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. I thank you, Mr. Chairman, and I thank the panel.

Well, Mr. McGuire, you convinced me, although I was easy to be convinced, public coming in on this, as to why, as you described it, you would not be what this type of legislation is adept at trying to get at, which is systemically risk the institutions and, of course, you said a 50-year track record that we have before us.

But I think those points that you make also seem to apply to your colleagues on your right, to an extent, well, going to the issue of—the one seminal issue which I always bring up is how do we get here in the first place. Mr. McGuire, you would argue that it was not venture capital firms. I would think others would argue

that it was not the hedge fund industry as well. And if anyone disagrees with that—no.

So, part of the problem, then—and I found some of the testimony quite interesting—part of the problem is, can you do sometimes more good, more harm than good, and can you sometimes be adding disclosure that may actually open it up if it is not crafted in just the right way as far as, Mr. Chanos, your comments, as far as disclosing your practices and your portfolio, what have you?

So, that is one element that is a problem. And the other element, of the problem I guess, is that if you disclose information that becomes what someone indicated is duplicative, it is already out there anyway.

And I guess the third problem, as far as disclosure is, if you do disclose, and maybe it is not duplicative—and that would be one of my questions to you is what information would you be receiving potentially that is not duplicative—that is just overwhelming to the system. I am sitting here thinking on the personal level as far as all of the information that we require in Congress as far as the disclosure on credit cards and what have you—and no one ever reads that—all of us who are involved in mutual funds and what have you—and we get the reports every 6 months and no one ever reads that.

I am wondering we can—these aren't individuals here, but the Fed and the other regulators who look at this can, we would be giving them something they already have or information that is already overwhelming towards them. So if you would address those two points, duplicative information, new information, and whether there is an overwhelming factor. That is three points.

Mr. LOWENSTEIN. Let me take a quick crack at that and also link it back to the prior discussion.

I think if you actually take a look at the draft legislation, it provides the SEC with a pretty broad mandate beyond even what's in the existing Advisers Act to collect information, as is necessary, appropriate, in the public interest for the protection of investors or for the assessment of systemic risk as the committee determines in consultation with the Board of Governors of the Federal Reserve. That is a pretty sweeping grant of authority to the agency and could, in fact, compel considerably more disclosure than we have today.

I think the point that we have made all along, in answer to your question, is that what is helpful here is for the agency to be directed to calibrate the disclosure it requires based on the nature of what level of systemic risk you might present.

So it is less about a one-size-fits-all regulation and more about a more focused effort to look at what are the differences between different private pools of capital; and are there differences, therefore, in the kinds of information we need to carry out the responsibilities under this Act, which I think are important and reasonable.

Mr. GARRETT. And part of those requirements is fixed criteria that they are looking at for someone who has capital, someone who is leveraging. But in this industry, you are really not looking, actually, at an industry that is overly leveraged, certainly not in com-

parison to where the problems come, certainly not in comparison to what we do in the government with GSEs.

So, really, what are we looking at here, as far as a class of industry, a class of business that is potentially a problem area? Or, as one of you said in your statement, do we want to make sure that the SEC's resources are focused on those areas where they should be focused on. Is this an area we want them to be focused on? Or are there other, better places for them to focus on?

Mr. LOWENSTEIN. If I could comment, again, our practice is very simple—

Mr. GARRETT. Yes, well, yours shouldn't be. But I am wondering if they shouldn't be focused on at all. I am right there. I am also right there maybe to further than where the panel is, saying that maybe we should be focusing on some other area.

I am down to my last 30 seconds.

Mr. KASWELL. In some areas, we think there are opportunities for more disclosure. For example, amending ADV Part II, the information that goes to investors, we support providing information to investors on prime brokers, accountants, and custodians. We think that would be useful.

We are supportive of providing reasonable information to the regulator. We get concerned about public disclosure. We don't want to have to disclose our trading strategies. We are concerned about providing too much information in the way of trade secrets to counterparties.

We only deal with sophisticated investors. It is a very different market than the retail marketplace, and we want to keep it that way. We also favor raising the level of investment permitted so that we don't inadvertently become a retail product.

Mr. GARRETT. Can I go a little further?

On another note, for 30 seconds, Mr. Lowenstein, I thought you made some sort of comment with regard to the auditing requirements—I think it was you, I made in my notes—with regard to making sure that the firms are audited by a PCAOB. Oh, I am sorry, Mr. Chanos. Okay.

Mr. CHANOS. We said that, too.

Mr. GARRETT. There you are. Everybody but Mr. Lowenstein. Okay.

Mr. KASWELL. Funds should be audited by a PCAOB-regulated auditor.

Mr. GARRETT. Now, here is the problem, potentially, with that. Let me see what your response is.

That is okay for the big guys who are probably already in that mix already. But if we are going to either carve out exemptions by class or if we are going to carve out exemptions by size, doesn't—or, class and not size, doesn't that cause a problem, then, for those industries that are just now going to look for higher-priced audits being done? And, really, the benefit of that is just marginal?

Mr. KASWELL. Well, we favor a de minimis exemption for the truly small. But after that, when you are taking the investments from pension plans and so on, we think that a PCAOB audit is the appropriate thing to do.

Mr. GARRETT. What are the requirements right now if you are already doing a pension fund—handling a pension fund? What are the requirements, as far as any audits?

Mr. KASWELL. I don't believe it is required.

Mr. CHANOS. It is not required. But you will get very little pension fund money unless you do it. It is a practicality.

Mr. GARRETT. It is standard practice, is what I thought, already. So maybe, once again, we might be adding something on that is actually—for those industries that are already doing it, we are not really adding it on, but we are just creating all that murky middle ground as to where that exemption lies. Is this for a class of business or size of business as you folks would have to do? And all we are doing is just adding more uncertainty. But the best practices out there—or the real practices out there, it is already being done.

Am I right, understanding—

Mr. KASWELL. I think that is true. We think that, in this environment, you should have a PCAOB audit. We think that is a threshold issue at this juncture.

Mr. GARRETT. Okay.

Mr. KANJORSKI. Thank you very much, Mr. Garrett.

The overwhelming attendance on your side of the aisle there is—

Mr. GARRETT. They are all in the back room having coffee, waiting for—

Mr. KANJORSKI. Just going to run out here suddenly.

Mr. GARRETT. Suddenly, yes.

Mr. KANJORSKI. All right. Mr. Cleaver, do you have any further questions?

Mr. CLEAVER. No, Mr. Chairman.

Mr. KANJORSKI. Okay. Well, then we are going to give this panel a break.

Thank you very much for coming by and giving us your observations. We thank you very much and appreciate it.

And may I extend to you what I said before? If, as this process moves on over the next several weeks and couple of months and you have some more insights, please feel free to share those insights with the staff or myself or Mr. Garrett.

Thank you very much for appearing.

The committee will reconvene. I now introduce the third panel, which will discuss creating a Federal Insurance Office.

Thank you for appearing before the committee today. And, without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Ms. Janice Abraham, president and chief executive officer of United Educators Insurance, on behalf of the Property Casualty Insurers Association of America.

Ms. Abraham?

STATEMENT OF JANICE M. ABRAHAM, PRESIDENT AND CHIEF EXECUTIVE OFFICER, UNITED EDUCATORS INSURANCE, ON BEHALF OF THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA (PCI)

Ms. ABRAHAM. Thank you, Chairman Kanjorski, and Ranking Member Bachus. I am Janice Abraham, president and CEO of

United Educators, a reciprocal risk retention group. We are owned and governed by 1,200 educational institutions that we insure, including colleges and universities, public and independent schools, educational associations, foundations, and cultural institutions.

I am testifying today on behalf of Property Casualty Insurers Association of America, PCI, the leading P and C insurance trade association in the United States, representing more than 1,000 members.

The home, auto, and business insurance industry is healthy and competitive, and the current system of regulating the industry is working relatively well. In the past 5 years, our insurance companies have weathered Hurricanes Katrina, Rita, and Ike, in addition to handling our regular claims, without having to ask for a government bailout. We are not broke, we didn't cause the current financial crisis, and we don't need a duplicative system of Federal oversight that may ultimately increase costs to consumers.

PCI supports responsible regulatory reforms that reflect principles of good insurance regulation. We understand the need for a Federal insurance office with three primary roles: first, to support harmonization of State insurance regulations; second, to have a seat at the table during international negotiations regarding insurance issues; and third, to develop an expertise within the Federal Government to advise both Congress and the Administration on insurance issues.

While PCI has not taken a position on the Federal Insurance Office, our members have a number of questions and concerns about the ONI and FIO discussion drafts. PCI appreciates some of the changes made in the FIO draft. However, the proposed Federal Insurance Office still goes far beyond the limited scope of the original bipartisan congressional bill by you, sir, and Representative Biggert and several other committee members. Instead, it creates an office with extremely broad scope and powers that could lead to very costly duplication of State insurance oversight.

I will underscore four critical concerns that are more fully detailed in my written testimony.

First, there are virtually no limits in the bill on the types or volume of information the FIO may demand. While gathering information might sound like an innocuous activity, it can impose extraordinarily high costs and burdens on insurers, especially small insurers who must comply with data requests.

State regulators have some accountability in the information that they gather since they do so in pursuit of a regulatory function with the responsibility of insuring the solvency and stability of the marketplace. The FIO has no such balancing accountability or mission. Instead, the proposed language directs the FIO to require mandatory information reporting to "monitor all aspects of the insurance industry." This is an incredibly broad directive, duplicating what the States already effectively implement.

PCI appreciates your leadership, Representative Kanjorski, in dropping the explicit grant of subpoena authority from the ONI proposal. This is a significant improvement. However, to avoid inefficient duplication of reporting requirements, the FIO should look to State insurance regulators or other public sources to obtain information it needs for its analysis. If the information needed is not

available through these public sources, we suggest the data requests be voluntary, not mandatory.

Second, the FIO may exclude small insurers from its mandatory reporting requirements, but the exclusion is discretionary and undefined.

Third, the FIO proposal dropped critical due process protections that are standard administrative procedures and included in your congressional bipartisan bill, although we do appreciate that it reflects an improvement on the ONI proposal.

Fourth, and perhaps the most important concern, the scope of FIO goes far beyond the bipartisan congressional bill, with the potential to lead to mission creep and greater duplicative and costly oversight. Specifically, the new proposal would have the officer monitor all aspects of the industry and to have any additional related authority that Treasury wants to give it. We recommend refocusing the Federal Insurance Office on its unique role in international trade issues, liaison, and advisory to the Federal Government, as specified in the bipartisan congressional bill, as well as coordination to harmonize State insurance regulations.

In conclusion, PCI appreciates the committee's hard work and diligent consideration of this issue, especially the joint leadership of Representatives Kanjorski and Biggert on the original, widely supported, bipartisan proposal. PCI has strong concerns about the current legislative FIO draft but appreciates the improvements on the ONI proposal and looks forward to working with the committee on addressing the remaining concerns consistent with the past committee leadership.

Thank you very much, sir, for your consideration.

[The prepared statement of Ms. Abraham can be found on page 89 of the appendix.]

Mr. KANJORSKI. Thank you, Ms. Abraham.

Next, we will have Mr. David B. Atkinson, executive vice president and vice chairman of RGA Reinsurance Company, on behalf of the Reinsurance Association of America.

STATEMENT OF DAVID B. ATKINSON, EXECUTIVE VICE PRESIDENT REINSURANCE GROUP OF AMERICA (RGA), ON BEHALF OF THE REINSURANCE ASSOCIATION OF AMERICA (RAA)

Mr. ATKINSON. Thank you, Mr. Chairman. As you said, my name is David Atkinson. I am testifying today on behalf of not only my company, Reinsurance Group of America, Integrated (RGA), but also the Reinsurance Association of America, or RAA, a trade association representing life, property, and casualty companies that specialize in reinsurance.

Simply put, reinsurance is insurance for insurance companies. By spreading risk among many companies around the world, reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of insurance for U.S. citizens and businesses. My company, RGA, is the largest U.S.-based life reinsurer, the second-largest life reinsurer in North America, and the third-largest in the world.

I am pleased to appear before you today to provide the RAA's perspective on Congressman Kanjorski's legislation to create a Fed-

eral Insurance Office. We applaud the committee's interest in and we strongly support this legislation, and are especially grateful for Congressman Kanjorski, his leadership on this important issue.

We also applaud the Administration's acknowledgement that international aspects of the reinsurance business require Federal involvement to address the needs of the U.S. market as well as to assist and support U.S. companies doing business abroad. Encouraging the participation of global reinsurers in the U.S. market is essential, because reinsurance provides the much-needed risk-sharing capacity for life, property, and casualty risks in the United States. Without reinsurance, insurance prices would increase and the availability of insurance would decrease.

The current State-based system is primarily focused on regulating market conduct, contract terms and rates, and protecting consumers. None of these objectives apply to reinsurance, which is purely a business-to-business transaction. Instead, reinsurance regulation focuses mainly on financial solvency so that reinsurers can meet their obligations to their insurance company customers.

The RAA supports a reinsurance regulatory system that would create a single national regulator with a single set of rules focused on efficient and effective solvency regulation. We also support a process for the national regulator to evaluate and recognize non-U.S. regulatory regimes to boost international reinsurance transactions.

We believe a Federal Insurance Office is necessary to assist Congress and the Federal Government in making better decisions regarding international insurance policy and in enforcing international reinsurance agreements uniformly across the United States. Public policy issues are frequently raised at the Federal level which could have a significant impact on the reinsurance business, yet there is no Federal agency tasked with understanding the insurance industry. The Federal Insurance Office would fill this void.

The RAA believes it is critical that the Federal Insurance Office coordinate Federal efforts and establish Federal policy regarding global standards for international insurance matters. Currently, the U.S. voice is marginalized because of the fragmented nature of the current State system and the lack of a single national regulator with authority to speak on behalf of the United States. As a consequence, global insurance standards are evolving with minimal U.S. input. Furthermore, uniform application of these global standards in the United States is unlikely, since identical regulations would have to be adopted in each individual State. We suggest that the legislation be amended to make it clear that the Federal Insurance Office has the authority to represent the United States in all relevant international organizations on insurance issues.

The RAA also strongly supports the authority of the Federal Insurance Office to preempt State insurance measures that are inconsistent with international insurance agreements and that disadvantage non-U.S. reinsurers. It is critical that the Federal Insurance Office be empowered to ensure these international agreements are uniformly upheld throughout the States and that companies are not subject to dual and perhaps conflicting regulation. This is a significant step forward in creating a more efficient and effective regu-

latory system in the United States and enhancing U.S. dealings with foreign governments and regulatory bodies.

Now, in our drive to open the U.S. market to non-U.S. reinsurers, it will be important to not put U.S. reinsurers, such as my company, at a disadvantage in their home market. Preserving a U.S. presence in the U.S. reinsurance market should be a guiding principle of the Federal Insurance Office legislation.

Finally, the Federal Insurance Office must ensure a level playing field in the United States for both U.S. and non-U.S. reinsurers alike.

Thank you for the opportunity to testify. The RAA looks forward to working with members of the committee on this very important issue.

[The prepared statement of Mr. Atkinson can be found on page 97 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Atkinson.

Next, we have Mr. Dennis Herchel, assistant vice president and counsel of Massachusetts Mutual Life Insurance Company, on behalf of the American Council of Life Insurers.

Mr. Herchel?

STATEMENT OF DENNIS S. HERCHEL, ASSISTANT VICE PRESIDENT & COUNSEL, MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Mr. HERCHEL. Thank you.

Mr. Chairman, Ranking Member Bachus, and members of the committee, on behalf of the American Council of Life Insurers, I would like to thank you for the opportunity to appear here today to discuss the industry's position on the newly proposed Federal Insurance Office.

We support creating this office in the Department of the Treasury. As we testified last year on the Office of Insurance Information proposal, we believe this office would be enormously beneficial to Congress as it considers issues that are vitally important to our business and would facilitate the handling of international insurance matters and would provide a means for—

Mr. BACHUS. Mr. Herchel, could you pull the microphone up a little closer? Just grab it and pull it up. And I guess it is on. You have to turn them on.

Mr. HERCHEL. It was on. I am sorry.

The events of the last 12 months have only heightened the need for this office. The financial crisis illustrated the problems associated with the lack of insurance industry expertise at the Federal level.

As you know, for some time now, the ACLI has advocated for the creation of a Federal regulatory presence. In light of the recent crisis and the legislative proposals and response, and short of Congress enacting an optional Federal insurance charter, we believe it is imperative that Congress establish this office.

As proposed, the office would be the Federal Government's repository of insurance industry information and expertise and also act as the U.S. international representative on insurance issues. It would not have any supervisory or regulatory authority.

In addition, we believe the office should be elevated in status so it can participate actively and effectively with Federal financial industry regulators, including the systemic risk regulator, under any new systemic risk regulatory structure. This will ensure that actions affecting insurers are taken only after a systemic risk regulator has had direct consultation and coordination with the office.

The Administration's systemic risk regulation proposal places the Federal Reserve Board in the position of ultimate systemic risk regulator. The Board would be given broad authority to determine which companies pose systemic risk, designate them as Tier 1 financial holding companies, and exercise sweeping regulatory powers over those companies and their subsidiaries. This includes authority to require increased capitalization and changes in management activities.

This power is tempered only slightly, as the Board is required to consult and coordinate with the Federal functional regulator of a Tier 1 company or its subsidiary before instituting any action or proceeding against it. Since there is no Federal functional insurance regulator, there would be no equivalent consultation or coordination when it comes to Board decisions affecting Tier 1 companies that are insurers or insurance subsidiaries.

Since the Board is a banking regulator and has virtually no insurance regulatory expertise, we believe this is an inappropriate result. The Board is required to coordinate with other banking regulators even though it has strong expertise in that area. The fact that it would not be required to act similarly when it comes to insurers is a contradiction of sound regulatory policy.

Insurance is a highly regulated industry. Insurers that do business in more than one State are supervised by a functional regulator in each one. Insurers are subject to a strict financial solvency regime. Establishing a systemic risk regulatory system that ignores this is an imprudent approach for the Federal Government to take and will result in unintended negative consequences.

We believe one solution is to give the office a role equivalent to that of Federal functional regulators when it comes to dealing with the Board on all aspects of systemic regulation. The Board should be required to coordinate and consult with the office whenever Board supervisory or enforcement action is directed at an insurer. The office should be required to act as an intermediary between the Board and the insurer's domestic State regulator regarding any proposed Board action. And the office should be given a seat on the proposed Financial Services Oversight Council. These and other changes in the office's status will vastly improve any regulatory regime ultimately enacted by Congress.

We also support amending the proposal in a number of ways to effectuate the role originally envisioned by the office.

First, it should be made clear that the office's preemption authority will never be used in a way that results in a solvency regulation gap, nor should preemption result in any material, unfair discrimination against any U.S. insurer. While we do not believe use of preemption should be withheld if it can't be used to realize the benefits provided under mutual recognition agreements, it should not be used to disadvantage domestic U.S. companies. We support a clear

administrative due process to any preemption action to ensure prevention of these undesirable outcomes.

Second, it is important that a report of the funds appropriated to the office be used to secure and retain personnel with insurance industry experience and expertise. In order for the office to be successful, it will be necessary to staff it with personnel who are well versed in the workings of the industry.

Third, clarification that the office has no general supervisory or regulatory authority over insurance companies is important. As drafted, the proposal contains ambiguous language that could cause confusion on this issue, so a clear statement of this intent should be included in the final bill.

There are some additional recommended changes outlined for you in my written testimony, so I won't take the committee's time listing them again here.

Mr. Chairman and members of the committee, we believe the need to establish this office is self-evident and, with the addition of these changes we have outlined, fully support enactment of the proposed substitute to H.R. 2609. Thank you for giving us the opportunity to present our views, and we look forward to working with you as this legislation moves forward.

[The prepared statement of Mr. Herchel can be found on page 161 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Herchel.

We will now hear from Mr. Spencer Houldin, president of Ericson Insurance Advisors, on behalf of the Independent Insurance Agents and Brokers of America.

Mr. Houldin?

STATEMENT OF SPENCER M. HOULDIN, PRESIDENT, ERICSON INSURANCE ADVISORS, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA (IIABA)

Mr. HOULDIN. Thank you, Mr. Chairman.

Good afternoon. My name is Spencer Houldin. I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America. Thank you for the opportunity to provide our association's perspective on proposals to create a Federal Office of Insurance.

IIABA has long supported State regulation of insurance. And, especially during this difficult economic time, State insurance regulators have effectively ensured that insurers are solvent, that claims are paid, and that consumers are protected. State insurance regulation has a long and stable track record of accomplishment, especially in the areas of solvency regulation and consumer protection, but its benefits and merits have never been more apparent.

While State regulation is certainly in need of improvement, the economic crisis has highlighted serious deficiencies associated with creating an optional Federal insurance regulatory system. When financial services entities are permitted to select a regulator of their choice, they will select the path of least resistance and what best serves their business interests. That choice may not be what is in the best interest of the consumer.

Although we strongly support State insurance regulation and would oppose any effort to undermine that system, we recognize

the benefits that can achieved by establishing a nonregulatory, informational office at the Federal level. It is imperative, however, that any statute authorizing the establishment of an insurance information office be designed carefully and with the proper safeguards and not set the stage for Federal insurance regulation.

We support the Insurance Information Act as introduced in May but have significant concerns with several of the revisions unveiled in a recent discussion draft. The OII legislation introduced just several months ago was a carefully constructed and thoroughly vetted, bipartisan proposal with broad support in what is often a highly splintered insurance market. We strongly hope any legislation adopted by this committee will closely resemble the original bill.

There are several critical elements of the original version of OII that are, at a minimum, essential to any legislation that creates a Federal insurance information office. Specifically, any proposal should make clear that the office does not possess supervisory or regulatory authority over the business of insurance. We also believe the information gathering provisions of any proposal should ensure that the office does not collect information available elsewhere, and include important protections governing how certain data maybe obtained and utilized.

In addition, the discussion draft would have the unintended effect of enabling this office to require Main Street insurance agents to produce data and information upon demand. We, therefore, urge the committee to revise the definition of "insurer" so that it applies, as it should and is likely intended, only to insurers and reinsurers and not small businesses.

At the very least, we believe that this office should be required to establish an exemption to the submission requirements for all covered entities meeting the minimum size threshold, instead of only permitting the office to do so. Explicitly requiring such an exemption would ensure that small agencies and insurers are not unduly burdened by informational demands.

Any legislation should also include clear and meaningful administrative provisions for handling preemption, and we urge the committee to establish safeguards that would apply in those instances when the office is considering whether a State law should be preempted. We believe that these changes would ensure that the scope and power of this office are limited in focus and would eliminate any concern of regulatory mission creep.

Our main concern and focus is ensuring that the office does not operate as a de facto Federal insurance regulator or serve as a precursor to Federal insurance regulation. It has repeatedly been stated that such an office is not meant as a step towards Federal regulation. Our conditional support for this concept is tied directly to these commitments. Therefore, any overt or subtlest efforts to make the insurance office look more like a regulatory body or set it up to become a forerunner to Federal regulation would force us to vigorously oppose any such proposal.

State insurance regulation has a strong track record of regulating insurers and protecting consumers, and it has been particularly successful over the last year. Using targeted legislation to establish a nonregulatory insurance information office with limited and defined responsibilities would strengthen State regulation

while also filling the void of insurance expertise that currently exists at the Federal level and remedy many of the problems faced by the insurance industry participants in the global economy.

Thank you.

[The prepared statement of Mr. Houldin can be found on page 168 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Houldin.

We will now hear from Ms. Therese Vaughan, chief executive officer of the National Association of Insurance Commissioners.

Ms. Vaughan?

STATEMENT OF THERESE M. VAUGHAN, CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

Ms. VAUGHAN. Thank you, Chairman Kanjorski, Ranking Member Bachus, and members of the committee. Thank you for inviting me to testify today.

My name is Terri Vaughan, and I am the CEO of the National Association of Insurance Commissioners. Prior to joining the NAIC, I was a professor of insurance and actuarial science at Drake University. I also served as the Iowa Insurance Commissioner from 1994 to 2004 and as the NAIC president in 2002. I am pleased to be here today to offer the NAIC's perspective on establishing a Federal Insurance Office.

To address a Federal Insurance Office, we must first offer this context: State regulation of insurance has a proven track record of stability and effectiveness even in the face of great financial strain, having shepherded the U.S. industry through the recessions of the 1890's, the bankers panic of 1907, the Great Depression, and the dramatic credit crisis of the past year.

In light of this track record, particularly when compared to other aspects of the financial services industry, we strongly urge that any efforts to improve insurance regulation build on the proven legacy of State oversight and tread carefully when considering any amount of Federal preemption.

Having said that, certain fundamental improvements to State-based regulation may require targeted Federal assistance, and we are not adverse to this when appropriate. We worked closely with Congressman Kanjorski, Congresswoman Biggert, and others on H.R. 2609, which would create an Office of Insurance Information. That proposal was carefully crafted to protect effective State supervision while achieving two fundamental goals: first, increasing insurance knowledge and access to insurance sector information at the Federal level; and, second, enhancing international cooperation on insurance regulatory issues.

The proposed Federal Insurance Office Act generally preserves those two goals but has discarded a number of the key provisions from the original OII proposal that are critical to preserving the strong State regulatory system and, therefore, critical to our support.

In particular, we urge that any Federal Insurance Office not be empowered with day-to-day supervisory authority over insurance. Additionally, we have recently offered members of this committee a number of substantive suggestions which restore the protections

embedded in the original OII legislation. Our written statement goes into greater detail, but today I will focus on a few key points.

While insurance regulatory information and expertise has always been available directly from the States and collectively through the NAIC to those in Washington, a formal Federal interface is appropriate. However, this interface should provide a two-way, reciprocal flow of information, enabling insurance regulators to have equal standing with our Federal counterparts and access to information on federally regulated parents and partners of State-regulated insurers.

To avoid unnecessary expense and resources, any Federal Insurance Office should serve as a conduit for, and not a replacement of, the extensive information collected by the States, both individually and nationally through the NAIC. The recent financial crisis and our experience with AIG illustrates the need for financial regulators, whether State or Federal, to have in place a clear system for sharing information about complex institutions.

A key goal of legislation to create a Federal Insurance Office should be to enhance international cooperation on insurance regulatory issues without displacing the existing critical role of the States as the functional regulators in these discussions. Any binding discussion at the international level should respect and reinforce the States' authority to regulate insurer solvency and protect insurance consumers and, therefore, should be limited to agreements of regulatory equivalence or mutual recognition. These types of agreements serve to level the playing field for U.S. and non-U.S. insurers without preempting States' ability to prescribe the rules of the game for solvency and consumer protection.

Such equivalence seeks to harmonize treatment of insurers operating globally, but it does not require jurisdictions to give up sovereignty over their standards over minor differences. As such, any preemption of a State law stemming from an international agreement should be limited to reconciling material or substantive differences in treatment.

Strong capital and solvency protections have been embedded in State regulation of insurance and are a critical reason that insurers have weathered the financial downturn relatively better than other types of financial institutions. Our solvency system is national in scope. All 50 States are now accredited by the NAIC utilizing the same risk-based capital and baseline solvency standards. As such, State solvency regulation should be excluded from any possible preemption by a Federal Insurance Office.

Mr. Chairman, we support the goal of creating a National Insurance Office to serve as a resource for the Federal Government and a conduit for the States. But we will continue to strongly oppose any efforts to use such an office as a precursor to establishing a Federal insurance regulator, and we continue to have significant concerns with the current proposal before this committee.

We have offered substantive changes in good faith to improve the proposal, and we look forward to continuing to work with you on this effort and on the many other critical issues before this committee.

Thank you for the opportunity to testify, and I would be happy to answer your questions.

[The prepared statement of Ms. Vaughan can be found on page 273 of the appendix.]

Mr. KANJORSKI. Thank you, Ms. Vaughan.

And finally, we will hear from Mr. J. Stephen Zielezienski, senior vice president and general counsel of the American Insurance Association.

Mr. Zielezienski?

STATEMENT OF J. STEPHEN ZIELEZIENSKI, SENIOR VICE PRESIDENT & GENERAL COUNSEL, AMERICAN INSURANCE ASSOCIATION (AIA)

Mr. ZIELEZIENSKI. Thank you, Chairman Kanjorski, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to be here today to discuss the establishment of a Federal Insurance Office, as contemplated in Chairman Kanjorski's discussion draft.

While the discussion draft does not create the national regulatory option AIA has long advocated, we support the Federal Insurance Office because it accomplishes two major goals that I would like to explore today: increasing Federal insurance expertise; and empowering the United States in international negotiations on prudential insurance matters.

First, the important role of insurance in our economy compels the need for Federal insurance expertise. Insurance contributes 2.4 percent to the annual GDP and directly or indirectly employs 1.5 million hard-working Americans. And the unique focus of property casualty insurers on reducing societal risk has saved many lives, prevented countless injuries, and avoided billions of dollars in economic losses.

We believe that the Federal insurance office should be led by an assistant secretary appointed by the President and confirmed by the Senate. By having this position filled by a presidential appointee, the head of the office will be recognized here and abroad as an important senior government official with insurance sector responsibilities.

In its role as Federal insurance expert, the discussion draft also envisions that the office will identify regulatory gaps that might contribute to systemic risk and recommend whether any insurer should be subject to additional regulatory scrutiny. We agree that these are key functions.

The office should start from the premise that the property casualty sector has weathered the current crisis and remains strong overall today primarily because these are generally low-leveraged businesses, with lower asset-to-capital ratios than other financial institutions, more conservative investment portfolios, and more predictable cash outflows that are tied to insurance claims rather than on-demand access to assets.

Given this dynamic, the office should facilitate understanding of the insurance regulatory model and ensure that the industry and its customers are not adversely affected by the application of inappropriate bank-centric regulatory standards.

I don't mean to imply that our insurance regulatory system is perfect. In fact, Treasury has called it "highly fragmented, inconsistent, and inefficient." Despite the best of regulatory intentions,

States are inherently limited in their ability to resolve issues that go beyond their borders. But until Congress decides to establish a national regulatory alternative, a result the AIA would welcome, the expertise promised through the Federal Insurance Office is essential to prevent unintended consequences.

We would also urge the office to focus its monitoring activities on unregulated or lightly-regulated products or activities that could present broader systemic risk. This approach would allow the office to analyze the industry through the prism of risk aggregation and counterparty exposure generated by nontraditional products or activities rather than simply by company size.

We also strongly urge this committee to provide a seat for the Federal Insurance Office on any systemic risk council that is established so that the council gains a Federal stakeholder offering a national perspective on insurance issues.

Second, the discussion draft grants the Federal Insurance Office authority to set national policy on prudential aspects of international insurance matters and to represent the United States before the IAIS. The office's international authority complements separate power given to the Treasury Secretary to negotiate international insurance agreements.

These are critical functions, given that the U.S. Constitution grants the Federal Government exclusive power to conduct foreign affairs. Both the discussion draft and the Treasury White Paper document ongoing frustrations with the inability of the United States to negotiate authoritatively with foreign counterparts on pressing insurance issues.

The most oft-cited example of the need for robust U.S. involvement is the EU Solvency II initiative. Solvency II is moving forward, while the current U.S. insurance regulatory system remains fragmented among 57 separate jurisdictions. The ability of U.S. insurers to remain globally competitive may well rest on Federal engagement on this prudential issue in every relevant forum as it evolves and to have our financial regulatory system deemed equivalent on a national level.

Indeed, we believe that the discussion draft compels the conclusion that the office can preempt State insurance measures that are inconsistent with international agreements concluded on behalf of the United States to the extent those agreements involve financial supervision.

Let me close by thanking the committee again for circulating Chairman Kanjorski's discussion draft and for engaging in an open dialogue on the substantial merits of a strong Federal Insurance Office. Establishing such an office, properly empowered, represents a key step in ensuring that the critical role of insurance is recognized at the national level and that the Federal Government retains the ability to preserve a viable private insurance market and maintain U.S. competitiveness in a changing global economy.

Thank you.

[The prepared statement of Mr. Zielezienski can be found on page 280 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Zielezienski.

I thank the panel for their testimony. We have a few questions. I will take mine initially to begin with, and then we will get the other members in.

If I had to summarize what I have just heard in the opening statements, 50 percent of you love it and 50 percent of you hate it. I could concede that maybe that means we should do it.

I think it is fair to say it has stiffened considerably from its original introduction. It has also changed its name from "National" to "Federal." It is not intended to do anything that is regulatory in nature; I think that should be made clear to everyone. It is, however, something that has been requested for various reasons from the Administration and others that we make the changes.

But I want you all to know that they manufacture that thing called a telephone that allows you to every now and then ring us up, either myself or the staff or even the other side of the aisle, if you will, to give us some good critiques of what is in there, how it could be changed in a better light.

On the other hand, do not just call to make a compelling argument to tone it down or dumb it down because that won't be very successful. I think it is already dumb enough, so what we really want to do is try to smarten it up. And that is where we will ask members of the panel to participate with us.

I, quite frankly, thought that it was going to be so great today that we would just have a roar from the panel, no statements necessary, and we would go on to unanimous passage. I expected my colleague on the right here to just announce his bipartisan support of the legislation, that it would be all over and we would lock hands and sing. But I think I am now looking at the gentlelady from Illinois, and she is not too happy. Now I am in trouble. So we will go down and take the legitimate criticisms that are there and see what has happened.

Actually, if I had to ask a question now, those who think they can favor the legislation as is, could you show your hands?

Thank you, Mr. Cleaver.

And those who are absolutely abject opponents of the legislation as it presently is?

Okay. And we have two neutrals. Is that it? Maybe yes and maybe no?

Ms. ABRAHAM. I am not sure where you counted, whether—in your 50 percent.

We think there are good reasons to have a Federal Insurance Office. I articulated those: a seat at the table on international issues; and harmonization of State regulations. We think there needs to be expertise. We are concerned about the breadth, the scope, and the potential for mission creep. And those are concerns. And we think there can be areas where your stated goals can be articulated. I am concerned about small insurance companies, small to mid-sized companies.

So we understand why this is needed. We think the intent is strong. But there are very specific issues and concerns that we have that we think can be addressed. And I articulated those in my testimony, my written testimony. So I am not agnostic, not a flag bearer, but very willing to work with you on making improvements to this, sir.

Mr. KANJORSKI. We do appreciate that. And, believe me, we do want to work on that, and we will.

Ms. ABRAHAM. Thank you.

Mr. KANJORSKI. But you have to admit that we are successful—did somebody say—oh, yes, your testimony said that 50 of the States have now joined in. That is amazing. We are getting some people to stand up and be counted, are we not? So we are slightly successful there. Maybe we can get some other activity and finding out what can happen both in State regulation as it impacts on potential Federal regulation. That would be very healthy.

But we are not trying to sneak an end run here. We are really—and I think everybody agrees with at least this whole idea that a Federal Government devoid of adequate information on the insurance industry, as large as it is, is really a great risk to our system of systemic risk in the future if we do not have: one, an understanding; and two, a methodology to handle it.

Right now, it almost was a complete disaster with AIG insofar as it was not the insurance part of the business that went awry, it was the financial products part of the business, but the insurance part almost got dragged in. Because, as you recall, there was a request to allow the utilization of about $30 billion in assets to support the counterparty positions of AIG in Europe, and the regulator in New York actually gave the authority for that to happen. Luckily, circumstances and events passed beyond the authority being exercised. But if it had been exercised, it probably would have precipitated the largest financial disaster for the insurance industry in the history of the country. And whether it could have been stopped is an open question when I discuss with people.

And now, Professor, if you will give us a shot on that?

Ms. VAUGHAN. Well, thank you, Chairman Kanjorski.

I was not around at the time. I was safely ensconced in Des Moines, Iowa. But my understanding is that there were extensive discussions among the regulators. And, actually, I think the story around AIG is a very positive one, because the States got very organized. They had constant communication, regular conference calls. They had a game plan for what was going to happen so that there was going to be action taken by all States at the same time if it was necessary. They agreed on what that was going to be.

And in terms of the request by New York to use the money, my understanding is that it still had to go through some approval processes in other States and that had not yet—they hadn't agreed to that.

So it is not entirely clear to me that would have happened. In fact, I like to use that as an example of the strength of our system, in that New York, I do not believe, could have unilaterally taken that money. I think they would have had others that would have had to look at it and decide whether that was a good idea or not. And that is a good thing.

Mr. KANJORSKI. I would hope that in the future—and I know I am over my time—that we don't have little entities in far-off countries like London carrying on adventures in the insurance industry that, in my estimation, were never intended to be engaged in by insurance companies.

But to the tune of, I think, your testimony is that the counterparty positions held by AIG Financial Products in London was $7.8 trillion. How that ever happened, to that size and magnitude.

And the fact that we obviously now know that we have not had a sufficient system to have that disclosed within the system, whether we could call that systemic risk or for some other purposes, we just cannot afford to continue or to allow that to happen in the future. Luckily, it did not precipitate the type of disaster, perhaps, that could have occurred, but I do not know how we meet that challenge.

Anyway, I have exhausted my time, and I guess I will move to my friend from New Jersey—incidentally, a recent television star in his own right.

Mr. GARRETT. If you were up at 6:00 this morning.

Mr. KANJORSKI. That is right. I was viewing it at 6:30 in the morning. That is the point. I have just been mentioning that so that everybody knows I was up at 6:30 in the morning watching Mr. Garrett on TV.

Mr. GARRETT. Thank you.

To the panel, Ms. Abraham, one of your opening comments just struck me when you read it. It said, "We are not broke, we didn't cause the current financial crisis, and we don't need a new Federal oversight that may ultimately increase the costs for consumers."

I don't know if you were sitting in the rows before the other panel who was here. They could probably have said the same things, the hedge funds and the venture capital: They weren't broke, they didn't cause a problem, and they don't need any oversight. But, gee, almost everybody, except for a man there, sitting at the panel said they were all willing to have the Federal Government step in and oversight them anyway.

Ms. ABRAHAM. Well, I didn't mean to say we didn't need oversight. What I said is, we already have oversight. We have good oversight in the State system. And what we are concerned about is duplicative oversight or conflicting oversight, so that the Federal Government is asking for information that is already produced, already given to the State regulators. So that is what I meant by "we have oversight." I think we have extensive oversight.

Mr. GARRETT. Actually, I was going to jump to that in a minute, but you brought it up, so I will raise it out to other people, as far as the duplication of information.

And, Ms. Vaughan, you can chime in here, or others.

The information as far as that is already being collected by the States and then through the NAIC, is there other information that would be going to this new entity that is not going to the NAIC or not going to—yes, not going to the NAIC right now? And, if so, what?

Ms. VAUGHAN. I would say that is a good question to ask the Treasury, is what other information they might envision in this. I have a hard time imagining that there would be issues that are needed in order to understand the risk posed by the insurance industry that the insurance regulators wouldn't already be asking and gathering information about.

We periodically go to our companies and say, give us information on this. Because of the environment that we are in right now, there is a new thing that we highlighted that we want to gather information on. I would say we could certainly do the same thing in working for a Federal insurance office, if they want to work through us.

What we would really like to get to is a partnership, where they come to us, we go to them, we have good communication. We think we can make something like that work.

Mr. GARRETT. Thank you.

I only have a couple of minutes.

Another question that you brought up that raised a point—I will let you chime in on this. Maybe you can answer this question as well. She also said, we ultimately don't want to increase costs for the consumers, so maybe this goes to the question of collecting information and more information.

Has anybody on the panel—are there are groups or entities that have gone out there and looked to see, if we do do this, either in this version or the other version, whether or not this actually raises costs to the consumers?

Ms. ABRAHAM. I think one of the concerns—just to jump in quickly—to Dr. Vaughan is, because the scope is so broad, we don't know what we would be asked for. We already supply to 50-plus different regulators information. I have no doubt that if we would require additional information, we would have to hire additional staff in order to compile the information and send it in, in addition to what we already do. So it is the broad scope. It is the unlimited mandate that is of deep concern to us.

Mr. GARRETT. Does anybody know of information on the studies as far as whether this raises costs or maybe lowers costs? I can see that argument being made.

No? Okay.

Just another general—Mr. Atkinson?

Mr. ATKINSON. If I could just comment on that.

If we get into international negotiations with foreign regulators, they may well come up with some items of information they require from U.S. companies to get comfortable with our situation. So that is one area we don't know about, but it is a possibility.

Mr. GARRETT. Mr. Herchel?

Mr. HERCHEL. Thank you.

One point that was made about oversight, I think of this office as not just being one of oversight but also one of gathering information and developing expertise at the Federal level. So not to say that there won't be some oversight that will be taking place, but I think there is a dual purpose there.

Mr. GARRETT. On that line as far as oversight, one question is the issue of solvency, which to me is the issue when it comes to insurance regulation. Everything else is secondary to that.

Does anyone want to chime in on the thought that this language is tight enough or too broad as to giving the Fed the authority to get into the area of solvency? A, should we—and I can imagine your answers—and, B, whether the language is on point or goes in different directions?

Ms. VAUGHAN. I would say the concern—one of the concerns we have about the language is the ability of the office to enter into

international insurance agreements is not constrained in the sense that it should be focused on the kinds of agreements that reflect our own solvency system. That is one of the things we want. We have a system that works. Let's not go out and make agreements and let people come in under weaker solvency systems.

Mr. GARRETT. For the folks who are proponents of this, generally speaking, on the other side—I will close on this—do you see that as an issue? Do you see the language could be tightened up to address those concerns? Or shouldn't it be tightened up?

Mr. HERCHEL. We have concerns about making sure that our solvency regime stays intact so that we can withstand the trials and tribulations as we go through. However, we think there probably has to be some type of flexibility there for this Federal insurance office to be able to sit at the table and try to understand different issues on an international solvency basis.

But in our testimony, you will see that we have caveats in there about making sure that we don't create any type of solvency gap. We don't want to have any unfair discrimination amongst foreign insurers and domestic insurers and things of that nature. Maybe we are saying it in a little different way than the NAIC today, but we recognize that is an important issue. But we don't want to necessarily completely take the whole discussion off the table for this Federal office.

Mr. ZIELEZIENSKI. I think we read the language "prudential measures" to be coextensive with the term "financial regulation." I think if you look at other titles of the Administration proposal, particularly title II, which deals with stricter capital standards on so-called Tier 1 financial holding companies, all of the measures that are identified as prudential standards are things that you would expect in a solvency regulatory regime.

So if one of the purposes of this legislation is to help the United States engage effectively at the international level and be at the table when Solvency II discussions evolve to make sure that not only are we well-represented but that, when the equivalency determinations get made—and European spokespersons have said they are going to be made at a national level, not a State-by-State level—that they have the ability to carry that out.

Mr. GARRETT. Okay. I thank the panel.

Thanks, Mr. Chairman.

Mr. KANJORSKI. Thank you, Mr. Garrett.

Now we will hear from the gentleman from Missouri, Mr. Cleaver. I am sorry—Mr. Scott. I avoided an assault there.

Mr. SCOTT. That is okay. When you get me confused with Mr. Cleaver, you have gotten me confused with a tremendous gentleman, a scholar, and a great American. Thank you.

Allow me to pose a few questions here, because I just want to make sure we are clear here.

Is this a Federal Office of National Insurance we are proposing? Is it a Federal Office of Insurance Information or is it a Federal Insurance Office?

There are a variety of different terminologies that we have been throwing around with what this is. But, most definitely, I hope that we will come to the conclusion that this is not a precursor to a Federal charter for insurance.

What disturbs me about the plan also is the words in this as I read it that states there will be preemption power over State insurance matters in this. So I think we ought to really make sure we are moving down a road that we have fairly clearly mapped out and that we don't have unintended consequences.

Let me start with you, Mr. Houldin, if I may. You are with the Independent Insurance Agents & Brokers of America. You have consistently been a strong supporter of State regulation of insurance and an opponent of Federal regulation, optional or otherwise, is that correct?

Mr. HOULDIN. That is correct.

Mr. SCOTT. Do you see a danger here? We all know that everything is not perfect. Let me ask you, how would you propose modernizing or reforming the State system for the benefit of the consumer?

Mr. HOULDIN. That is a great question, Congressman. Thank you.

The State system has proven to be extremely efficient; and, using targeted Federal legislation, I think we can make that State system better. We look at the surplus bill that recently passed the House, the NARAD bill which you have recently introduced, which would make agent licensing more efficient. And the original OII bill from Chairman Kanjorski is a good piece of legislation. It brings data and information to the Federal Government, and it does solve some preemption problems. This current draft legislation goes a little bit further than that and starts to bring in regulation and supervision of the industry, so we have a problem with that. But using targeted Federal legislation to enhance the State system in our opinion is the best of both worlds.

Mr. SCOTT. Let me ask you, are you familiar—I am sure you have read this—with the preemption language in this?

Mr. HOULDIN. Yes.

Mr. SCOTT. How do you interpret this? If this new Federal insurance office is granted broad preemption authority, and let's say foreign insurers are able to operate under different rules, would this create a potential harmful environment for the consumer?

Mr. HOULDIN. We certainly have concerns that the preemption in the new draft goes a little bit further and may put the foreign companies in different consideration than the domestic companies. The original draft or original OII only treated when there was a difference and put everybody on a level playing field. We are afraid this new language may have gone too far and made it unlevel.

Mr. SCOTT. And with this new preemption authority, is there a real concern that all of the insurance companies domiciled, let's say, in a certain State would be significantly disadvantaged by these international companies?

Mr. HOULDIN. It certainly could happen when the international companies are going to be given different treatment and play by different rules. Certainly.

Mr. SCOTT. Now, so that we know for sure, what is your major concern? What is your major concern with Federal regulation?

Mr. HOULDIN. Well, with Federal regulation on this particular bill and where it goes, our major concern is that the bill goes be-

yond just information and preemption and it gives regulatory authority to Treasury.

We also have a concern in that the definition of insurer in the bill is anybody who engages in the business of insurance. That would bring mainstream agents like myself, mom-and-pop shops, into the fold. So we think there should be some exemptions to exempt smaller businesses and insurers.

Mr. SCOTT. I just want to note for the record in the White Paper that the President submitted, he says in the last sentence here, "Given the importance of a healthy insurance industry to the well-functioning of our economy, it is important that we establish a Federal Office of National Insurance."

Do you worry that this kind of language would be a precursor to Federal control? Especially when it says within Treasury and that we develop a modern regulatory framework for insurance.

Mr. HOULDIN. Certainly, that concerns us. It was nice to see that the Blueprint left out Federal regulation of insurance completely and just talked about this particular office. We do need to make sure we don't have mission creep through this bill. That is exactly what the original OII was intended to do.

Mr. SCOTT. Thank you very much, Mr. Houldin.

I yield back the balance of my time. Thank you.

Mr. KANJORSKI. Now, we will hear from the gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Normally, I would not ask you all to give me a yes-or-no answer, so I am going to give you another choice, and that is, you can answer "yes," "no," or "I don't have an opinion." How about that?

My first question is, State regulation—this is just a statement. You tell me whether you agree or disagree with this statement, or you don't have an opinion.

State regulation of insurance functions is significantly better than Federal regulation of securities and banking over the past 5 or 10 years. How many think it did a better job of regulating the State—okay.

How many of you think it did a worse job?

How many of you don't have an opinion?

Okay. To the three who said that you don't have an opinion on whether State regulation of insurance was better than Federal regulation of, say, securities or financial services, what were the failures of State regulation of insurance?

I will start with Mr. Atkinson. What do you see as the most significant failure? I can give you 100 failures of Federal regulation of banking and securities.

Mr. ATKINSON. I wouldn't say they are failures. They are probably inefficiencies and frustrations and so forth. It is not a very fast system. Things evolve very, very slowly. We are 30 years behind most developed countries in our regulations.

Mr. BACHUS. The bottom line, how did that affect customers? Was it increased—

Mr. ATKINSON. Increased price is probably the main thing.

Mr. BACHUS. Was it increased over what the costs were, like the insurance in other countries?

Mr. ATKINSON. The products are not too comparable between countries. Each country has their own regulations which dictate what kind of products are available.

Mr. BACHUS. I can't think of any instance where someone didn't have an insurance contract, they contracted for insurance, and it paid off. Were there any instances where that didn't happen?

Mr. ATKINSON. There have been insolvencies. We do have a State guarantee system that backs up—

Mr. BACHUS. So there were no losses?

Mr. ATKINSON. Insolvency regulation has worked well. It has been a success.

Mr. BACHUS. They didn't in banking and securities?

Mr. ATKINSON. I am not that close to banking, but certainly, reading the papers, there have been huge problems in banking and securities.

Mr. BACHUS. We talk about inefficiencies in insurance, driving up the cost to consumers. National regulation in banking, has that brought down the cost to consumers of different banking fees? Does anybody have an opinion?

Okay. Do you think that national regulation of financial services products or securities, do you think that offered the type of protection it should have? Anybody?

It was a pretty profound failure, wasn't it?

I am just trying to figure out how, after what we witnessed the last 10 years, we would want to say that national regulation would do a better job than State regulation. To me, clearly, the answer to that first question was that the States did a much better job of regulating insurance than the Federal Government did of regulating securities, investments, and banking.

Let me say this—and I appreciate those who came down on both sides. Maybe you all would elaborate in a letter to me why you don't have an opinion as to which worked best.

Mr. ATKINSON. I am just not that familiar with Federal regulation of banking.

Mr. BACHUS. But you read the papers.

Mr. ATKINSON. But there is also State regulation of banking, and I don't know where the failure lies, perhaps it is at both levels.

Mr. BACHUS. We were talking about State regulation of insurance.

Mr. ATKINSON. Right. So I don't know that either has a license to be better than the other.

Mr. BACHUS. Let me ask you this: International insurance agreements, that has quite an appeal to me, that we need an office that can negotiate those. But does the Federal Government have better expertise to know whether those agreements will protect insurance customers in those States?

Ms. ABRAHAM. One of the issues that we are concerned about on this is to ensure that, if preemption does occur, that there is due process associated with it. So there can be a full hearing through the judicial process to understand what the preemption means, the impact on the States and the consumers, obviously. So we are concerned that preemption can occur. And as the draft proposal currently stands, there isn't that due process. We think that is very

important. So we would encourage as this evolves, that is built into any final legislation that is put forward.

Mr. BACHUS. I would think there is something worse than not having an international insurance agreement, and that would be having a bad one that impacted customers negatively.

Mr. ATKINSON. The whole reason for this measure is to build expertise at the Federal level, and it may take years; and it may also take more than a few years to negotiate our first international insurance agreement, and probably prudently so.

Mr. BACHUS. I am really asking questions. I am seeking to better educate myself. Thank you.

Mr. KANJORSKI. Mr. Zielezienski wanted to respond.

Mr. ZIELEZIENSKI. There are a couple of responses, one in the context of international insurance agreements. The U.S. Government is the only one that can do that, vested solely with the foreign affairs power by the Constitution. The fact of the matter is these international agreements are being concluded between other countries every day, and every day we don't sit at the table is another day lost.

Mr. BACHUS. A lot of those international agreements have turned out fairly badly for some of our companies.

Mr. ZIELEZIENSKI. And, to date, there has been no ability or authority on behalf of the Federal Government to conclude an agreement on insurance matters.

Mr. BACHUS. I am not sure that is all bad. I understand it is bad on occasion. I give you that. There are legitimate cases. With reinsurance, there have been some tremendous problems. I do think last year's legislation went about where it should have, and I am afraid that this year's legislation may be an overreach.

Thank you.

Mr. KANJORSKI. Thank you very much.

Now, we have the gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman.

Let me thank all of the witnesses for being here, but particularly Mr. Atkinson. Thank you for being here.

I will just restate something that the chairman stated earlier. You are from the Reinsurance Group of America, RGA. The business journals, which actually was started in Kansas City by Mike Russell and "Doc" Worley, Bill Worley, but now they are all over the country and one is in St. Louis, the St. Louis Business Journal said that people get you confused with the RCGA as well, which is a civic, economic development oriented organization; and if you come near the Potomac, the RGA is the Republican Governors Association. I am not mad or anything. I am just saying that is what people think, particularly on this side. So it may be of some value for you to help us clear up some things, particularly about reinsurance.

How would your member organizations differ from some major company like AIG?

Mr. ATKINSON. Well, first of all, we are specialists in life reinsurance, so we pay money when people die. We only pay life insurance companies, and all of our negotiations and dealings are with life insurance companies. We also are a buyer of reinsurance ourselves. We deal with other life insurance companies behind us. The net ef-

fect of all this is, when someone famous with a lot of insurance dies, no single company is put in jeopardy. The claim is spread around, with sometimes as many as 40 or 50 companies paying a share of a large claim.

On top of that, we work with a lot of companies on new products, new ideas in the industry, and help to further the process, speed up the process of innovation and lower the price of insurance over time because of that.

Mr. CLEAVER. So AIG, which is "too-big-to-fail," would not be in any way or should not be confused with your group. You are not "too-big-to-fail?"

Mr. ATKINSON. We do insure AIG. But one thing to note about our business, too, we charge premiums each year, and we pay claims each year, and those largely offset. So there is not a lot of money tied up somewhere that could evaporate.

Mr. CLEAVER. You said that right now, the multi-State system of insurance regulation is cumbersome.

Mr. ATKINSON. Yes, it is.

Mr. CLEAVER. And extremely inefficient.

Mr. ATKINSON. Look at things like new product introductions. You have to file your product in every State. Every State has different things they want changed on your application and your policy wording. It is a nightmare. It takes up to a year sometimes to get 1 product approved in all 50 States.

Mr. CLEAVER. So you would be opposed to a 50-State system?

Mr. ATKINSON. That is just the way it is today. I think U.S. companies are used to dealing with that. It is a frustration. It is an inefficiency, but it is livable.

Mr. CLEAVER. What would you do to correct it? To make it more livable?

Mr. ATKINSON. I don't know that you can do anything. When you have insurance regulated at the State level, you are going to have at least 50 different voices with different ideas, and sometimes they can come together and adopt a uniform regulation. Even there, there are usually some tweaks in each State.

Mr. CLEAVER. I got a BlackBerry message a few minutes ago from someone who said to me, you guys should not do anything to help AIG, assuming that is what is going on here. That is why I wanted to get some clarity.

I have no other questions, Mr. Chairman. Thank you.

Mr. KANJORSKI. Thank you very much, Mr. Cleaver.

Next we will hear from the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you. Thank you, Mr. Chairman.

Well, one of the biggest failures I think was AIG in our recent history, and the securities lending division was overseen by the various State insurance regulators. Now, that portion of AIG has cost the taxpayers dearly, and no one here I don't think is arguing that there aren't problems with State regulations or Federal regulations. We understand there are problems with both, and it is getting to a solution of this I think we are focused on.

One of the particular problems with AIG in terms of their insurance contracts over the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, was the government intervention directly in

the market, in the sense that we prevented regulators from regulating Fannie and Freddie for safety and soundness.

I carried legislation on the behalf of the Federal Reserve to try to do something about this, but it was defeated over an argument that it would be injurious to affordable housing if we didn't have those zero down payment loans, if we didn't have those 50 percent requirements for Fannie and Freddie to hold that much subprime in their portfolios, and it was AIG that made the bet or insured this. So when Fannie and Freddie went down, when that $1 trillion was lost, AIG lost that money as well. But a lot of that money, again, was the securities lending division over seen by the various State insurance regulators, so they miss THAAD too.

As I mentioned in my opening statement, the European Union continues to move closer to passing the Solvency II directive which will create one market for insurance throughout all of Europe. Another aspect of Solvency II is meant to increase the global cooperation effort by bringing equivalent regulators from around the world into closer consultation with each other.

Unfortunately, we have not held up our end of the bargain. The various State insurance regulators simply do not have the authority to negotiate with foreign regulatory bodies on behalf of the U.S. market. As a result, the regulators in the EEU will not recognize U.S.-based firms under the oversight of the various State regulators.

So I would ask Mr. Atkinson, are you concerned that our regulatory model will punish U.S.-based institutions trying to operate overseas, and what are steps likely to be taken by EEU regulators against U.S. firms should they follow through on our violation of that agreement?

Mr. ATKINSON. I wouldn't use the word "punish," but we have been disadvantaged by our situation for some years now in many of the leading countries that we operate in. We have had to set up subsidiaries and capitalize those subsidiaries, rather than deal directly from our U.S. base. So that has created a lot of extra costs.

Mr. ROYCE. If I could interrupt, Mr. Atkinson, that was in a situation where we as a Nation have 50 separate regulators, but France didn't have 50 regulators for every province, so they took some decisive action then. But now the EEU is all one market, because they have decided instead of having 50 regulators, they are going to have one world-class regulator. But they are looking at the United States and saying we have an agreement for equivalency on regulation, and you are going to be in violation of it unless you figure out a way to have a regulator that can effectively regulate and stop things like AIG from happening in the future. So your observation on that?

Mr. ATKINSON. Well, the way around that is you set up another company in another jurisdiction and operate it in harmony with the local laws. Like I said, it is not a good way to do business, but it is a way to do business.

Mr. ROYCE. As I noted in my opening statement, the current State-based regulatory system is highly fragmented, it is inconsistent, and it is inefficient. That is the judgment of the Treasury Department. It costs consumers and makes our regulatory model weaker.

What will a Federal insurance regulator do that the proposed Federal insurance office cannot? Could I ask if Mr. Herchel has any observation on that?

Mr. HERCHEL. Yes, Congressman. I think there is a big difference between the legislation that is in front of this committee today and an optional Federal insurance charter would call for. What we are just talking about here today is about a Federal insurance office that is going to have information gathering potential and expertise so they can consult with the systemic regulator or other Members of Congress to make sure that there is a knowledge base about the insurance business and also on the side with reinsurance, as an example, with respect to international agreements.

You are correct that these rules will not have any way of regulating the business of insurance in the United States. This office would not have any role in taking care of product development or product approvals, which is some of the issues that national insurance companies, insurance companies that do business across the country do; have nothing to do with market conduct requirements; have nothing to do with agency licensing issues, making sure that products are distributed appropriately throughout the States; and also the financial standards that are applicable to those companies, what reserves they have to have in place and how they invest their assets that they take in.

Mr. ROYCE. Mr. Zielezienski, you wanted to comment on this?

Mr. ZIELEZIENSKI. Yes. You have heard today, I think, from a variety of panelists that the Federal insurance office won't be a regulatory body. Adopting an optional Federal charter would create that national regulator that we lack today.

On the issue of the fragmentation and inconsistency and inefficiency that pervades the State system today, that would be eliminated in favor of a strong set of uniform national standards that would apply to those who were federally chartered.

If the bill follows your legislation, that focus would be squarely on financial solvency and market conduct, where it ought to be. And I have no doubt that under such a system, even if it replicated the standards that are at the State level today on financial solvency, that would be judged to be equivalent.

Mr. ROYCE. Thank you, Mr. Zielezienski.

Now, we will hear from the gentlelady from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman, and to all of the witnesses who are testifying before us today.

First, I just want to point out in reference to my colleague from Alabama's questions about State versus Federal oversight, my colleague from California did point out some of the failures at the State level relative to AIG. I would like to add to that McKenzie & Company found that State regulation creates an added cost of over $13 billion in inefficiency to the industry, which does get passed on to the consumers.

Also relative to banking oversight that came up as part of his questions to the panel, two-thirds of the subprime loans that were originated came from nonbanking, State-regulated loan originators. So, that clearly had a lot to do with the overall financial crisis.

But moving forward, I have a question for the NAIC. As you know, the National Insurance Office Act was included in the

Obama Administration's June proposal for regulatory reform. The Treasury proposal further called for modernization of our insurance regulatory structure, stressing the need for "increased national uniformity through either a Federal charter or effective action by the States." The Treasury also recognized the failures of the State-based system, stating, "Our current insurance regulatory system is highly fragmented, inconsistent and inefficient."

My question to you is, since June, what actions have the State commissioners and the NAIC taken to create a uniform system of insurance regulation?

Ms. VAUGHAN. Thank you very much, Congresswoman Bean.

First of all, let me say that I have to respectfully disagree with Treasury's statement that the structure is highly fragmented, inconsistent, and inefficient. In fact, we have a highly coordinated system, and we work very hard through the NAIC to be coordinated. And I think history demonstrates that we have been coordinated and have done a pretty good job, certainly in the environment we are in.

We do recognize that there are things—

Ms. BEAN. Specifically what have you done?

Ms. VAUGHAN. Specifically what we have done, in September we adopted, we came up with a new proposal for modernizing our reinsurance regulatory structure. That is something that—

Ms. BEAN. So a proposal. Anything else?

Ms. VAUGHAN. Boy, I would have to go back and look at all of the various things. We work constantly, and I would be happy to answer your question in more detail in writing.

Ms. BEAN. Okay.

Ms. VAUGHAN. After I have a chance to—

Ms. BEAN. And what authority does the NAIC or any State commissioners have to enforce, number one, the collection of information from non-insurance affiliates like an AIG, or to enforce any kind of commitments out of a proposal towards consistency in rules?

Ms. VAUGHAN. What authority does the NAIC have, or does the State have?

Ms. BEAN. Or does any individual State commissioner have to actually make sure that: number one, collection of information happens; or, number two, that there is commitment to consistent rules that States will follow through?

Ms. VAUGHAN. Yes. We have laws in the States that call for companies to report information to the NAIC, so we collect that information and that is grounded in State law.

Ms. BEAN. So some States?

Ms. VAUGHAN. Normally, all States require that the companies file. That is one of our accreditation requirements, that companies file their financial information with the NAIC, and that is what creates our financial database.

Second, the interpretation and enforcement of laws in the States are the responsibility of the State insurance regulators.

So I am not sure that I understand the question exactly.

Ms. BEAN. Okay, let me move on to some other questions with some other folks.

We just heard the NAIC say they have a proposal to create further coordination. I guess I would ask Mr. Herchel and Mr. Atkinson, do you believe or should anyone here have any confidence that after 140 years of efforts by the NAIC to create uniform rules and their failure to actually have that happen, that a new proposal was going to change that?

Mr. HERCHEL. Congresswoman, I have been working in the insurance arena for decades now, and I have been working with the NAIC, and I have a lot of respect for the insurance regulatory community. They are very dedicated and work very hard.

But what we found is that there are constraints on how far they can go. The NAIC is a great organization, puts together great proposals and model laws and model regulations.

Ms. BEAN. To shorten up your answer so I can get to other questions, you don't have a lot of confidence that anything is going to be any different than it has for 140 years?

Mr. HERCHEL. I hope we move on, but it is going to be a tough road for them.

Ms. BEAN. Mr. Atkinson?

Mr. ATKINSON. I would add, it is hard. As diligent and dedicated as the NAIC and its members are, how do you get unanimous agreement from so many players?

Ms. BEAN. From 50 different bodies.

Mr. ATKINSON. But we are encouraged that they are trying hard. In fact, their latest proposal recognizes the need for a Federal role in international reinsurance matters.

Ms. BEAN. I would like to ask Mr. Zielezienski as well?

Mr. ZIELEZIENSKI. We have said this pretty often, it is not the fault of the State regulators, but the fact is you have to navigate 50 different political environments. If the NAIC produced a perfect model law, you still have to go to the State legislatures and get it passed, and our experience has been there is always going to be those inconsistencies, and, again, it is not their fault. That is just the way it is.

Ms. BEAN. Again, you don't have confidence that this is going to change that. I appreciate that.

I would like to ask Mr. Zielezienski another question, which is essentially that the Treasury proposal included six principles of reform for insurance reform. It included, and I will just summarize: effective systemic risk regulation; strong capital standards that specifically matched capital allocation with liabilities; meaningful and consistent consumer protections for insurance products and practices; increased national uniformity, which we just spoke about; to improve and broaden regulation of insurance companies and their affiliates; and international coordination.

Specifically, you have already said that we don't have confidence that what we are doing today addresses the national uniformity issue. Does it provide meaningful and consistent consumer protection for insurance products and practices nationally?

Mr. ZIELEZIENSKI. I think "meaningful" is subject to interpretation. But consistent, I think the answer is no. One of the frustrations for companies is that you have to deal with requirements that may differ and different definitions of consumer protection. Some

may view different aspects of regulation as providing consumer protection, when actually they are inhibiting solvency regulation.

Ms. BEAN. If I could ask another question, do you believe the National Insurance Office can potentially monitor systemic risk within the insurance industry without a seat on the Financial Services Oversight Council?

Mr. ZIELEZIENSKI. No.

Ms. BEAN. Given the significance of the insurance industry in our financial system, do you think this office would be better served by an individual that is appointed by the President and confirmed by the Senate to serve a set term in office, compared to serving more or less as a subordinate to the Treasury Secretary?

Mr. ZIELEZIENSKI. Yes, I have testified to that, that I believe the person ought to be viewed as much as an equal, absent the regulatory responsibilities that the discussion draft doesn't provide.

Ms. BEAN. Thank you. I yield back.

Mr. KANJORSKI. The gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I do have some concerns with the discussion draft that was circulated late last Thursday. Obviously, it has been mentioned that it is almost identical to the Administration's proposal, except the subpoena power has been removed. I am afraid that the new draft moves away from what I thought was really a great bipartisan bill that I worked on with you, Mr. Chairman. So, I just have a few questions and a few comments.

The new discussion draft requires that insurers provide that the new Federal Insurance Office with any information that it requests, and our bill sets up an Office of Insurance Information that made providing information beyond what is already provided to the State regulator voluntary. So there is a mandate versus voluntary.

Then I really worry about the mandatory requirement unfairly imposing significant costs and burdens, particularly on the smaller and medium-sized insurers.

Also, the draft could allow agreements entered into the USTR, and this concerns me that the head of the Federal Insurance Office would be able to preempt State law. We have already had agreements under GATT and worked with the WTO, and insurance was included in some of these agreements and there has been a carve-out of domestic laws to protect the consumer and the policyholder. The Treasury has an international office now that is already engaging in talks with trading partners, aimed at beefing-up the insurance part at the market, informed markets. Some have been informal, like the U.S.-China Joint Commission. Others are a little more formal.

My question would be, I believe there are existing trading agreements, both bilateral and multilateral, that involve insurance. Am I correct in that? Does anyone say no to that?

Well, then, would this new office require States to comply with these agreements and could States opt out? Anybody willing to take a shot at that? Mr. Atkinson?

Mr. ATKINSON. Where we are today, the U.S. Government can negotiate, but they can't follow through on any agreement because they have no power. There is no credibility for a U.S. negotiator where we are today. The EEU knows that no matter what the

United States says, the States control the outcome. So there is no way to implement it.

Ms. ABRAHAM. One of the issues, I agree with your statement that there is potential for preemption. I did mention earlier the need for due process to hear that. One issue I was specifically concerned about, Representative Biggert, is the collateralization issue. We are quite concerned about that, because this allows particularly small to medium-size insurance companies to be able to be confident that when they have claims to pay, when they have a judgment, that the collateral be there, the payment will be there from the reinsurance companies that are not U.S. reinsurance companies. These are foreign or non-domestic reinsurance companies.

We would be very concerned that there would be a preemption of the State collateral rules, and that particularly small-to-medium companies would be left disadvantaged, unable to collect on the collateral if that would go away.

So it is a concern we have, and one we appreciate your attention to.

Mrs. BIGGERT. Okay. Because it could erode consumer protections and decrease competition and really harm U.S. insurers or the reinsurers or raise the cost of insurance for consumers. Let me go on to one other thing I wanted to get to, and my time is running out.

If you could just give me one or two or two or three issues that are different in this draft versus the Office of Insurance Information that you have concerns about. I will start down here.

Mr. ZIELEZIENSKI. I will highlight one which I think we can all agree on, and that is to the extent there is an information collection function by the office, that it needs to ensure that data is gathered from existing sources. I think we can all agree that the best thing to do is create an efficient system of collecting that information, and protecting that information is also key as well. I think my concern is that should be a little bit tighter.

Mrs. BIGGERT. Ms. Vaughan?

Ms. VAUGHAN. Yes. First, the language that would limit the scope of international agreements to those that are substantially equivalent to regulation in the States, we think that is very important; second, the possible stay of preemption; And, third, the two-way information sharing, including sharing information through the NAIC.

Mrs. BIGGERT. Mr. Houldin?

Mr. HOULDIN. Two things. One, the definition of "insurer," not to include everybody engaged in insurance, including Main Street agents. Secondly, just the overstep of their regulatory and supervisory authority that it gives the office.

Mrs. BIGGERT. Thank you.

Mr. HERCHEL. A couple of things that we want to make sure are part of this process is making sure that the Federal Insurance Office is a member of the council, and the other thing is to make sure that they are on parity with other Federal regulators with respect to consulting and coordinating with the systemic risk regulator.

Mrs. BIGGERT. So that would be either the FOI or the OII?

Mr. HERCHEL. The FOI.

Mr. ATKINSON. I think the current proposal also works pretty well for the reinsurance market. As part of that, I think we do want to be at the table talking about collateral requirements, talking about capital requirements, talking about reserving requirements, all of the factors that enter into solvency. But I would just like to emphasize, the ability to preempt State laws when needed is absolutely necessary because you cannot negotiate in good faith unless you can actually follow through.

Mrs. BIGGERT. Ms. Abraham?

Ms. ABRAHAM. Retrieving information from established sources, from the existing State regulators or other public sources; voluntary submission of information, not mandatory; and a very distinct carve out for small insurance companies are things that are very important to us.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you very much.

I see no other questions are pending or members present. So that being the fact, I am going to thank the panel for having been here and call to the panel's attention that some members may have additional questions for this panel which they may wish to submit in writing.

Without objection, the record will remain open for 30 days for members to submit written questions to today's participants and to place their responses in the record.

Before we adjourn, the following written statements will be made part of the record of this meeting: The National Association of Mutual Insurance Companies; the National Association of Insurance and Financial Advisers; the Financial Services Institute; and the National Association of Small Business Investment Companies. Without objection, it is so ordered.

The panel is dismissed and this meeting is adjourned.

[Whereupon, at 3:32 p.m., the hearing was adjourned.]

A P P E N D I X

October 6, 2009

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE

OCTOBER 6, 2009

Mr. Chairman, today the Financial Services Committee will examine the three legislative discussion drafts on investor protection, private fund adviser registration, and insurance information that I released last week. If we have learned anything from the financial crisis, it is that excessive deregulation is dangerous. My three bills work to reverse this trend by closing loopholes and fixing problems in our broken regulatory structure, especially in our securities and insurance markets.

As we work through these drafts and the many other pieces encompassing financial services regulatory reform, we should listen to common-sense ideas and seek out consensus where it exists. I am therefore open to making changes to these draft bills. In working to enact meaningful regulatory reform, however, we must ensure that special interests do not weaken particular solutions to the point of becoming toothless.

Looking ahead to next year and beyond – after this round of reform is done – we must remain diligent guardians of the public interest and of the financial system's health as a whole. Financial innovation and capitalism always seek to outpace the development of laws and regulations. This is the nature of our system. To correct this bias, vigilance is our only hope.

That said, the three draft bills before us today will no doubt enhance regulatory authority and improve access to information. For example, the Investor Protection Act provides the U.S. Securities and Exchange Commission with more firepower to perform its mandated duties. Like the Administration's reform plan, this bill includes a requirement that all securities professionals providing advice have a fiduciary duty toward their customers. Through a harmonized standard, broker-dealers and investment advisers will have to put investors' interests first.

The draft Investor Protection Act also significantly expands the ability of the Commission to reward those whistleblowers whose tips lead to successful enforcement actions. The legislation will further permit the Commission to adopt rules to bar the inclusion of mandatory arbitration clauses in securities contracts.

Additionally, this legislation significantly expands upon the proposals put forward by the Administration by closing loopholes identified by the Madoff and Stanford Financial frauds, updating the Securities Investor Protection Act, and modifying the authorities of the Public Company Accounting Oversight Board. Moreover, the bill doubles the Commission's available funding over five years.

But, enhancing the Commission's firepower and providing more money are simply not enough. As a result, the draft bill calls for an independent, comprehensive study of the entire regulatory structure that oversees the securities industry by a high-caliber body with expertise in organizational change that will identify further improvements to the implementation of our securities laws.

The second draft bill, the Private Fund Investment Adviser Registration Act, requires advisers of hedge funds, private equity firms, and others who have previously escaped direct regulatory oversight to register with the Commission and disclose certain vital information. Transparency has been non-existent in this area for far too long, and the financial crisis revealed that our system cannot tolerate such omissions going forward.

The third bill would create a Federal Insurance Office to provide national policymakers with access to the information and resources needed to respond to crises, mitigate systemic risks, and help ensure a well functioning financial system. The credit meltdown highlighted the lack of expertise within the federal government regarding the insurance industry, especially during the collapse of American International Group and last year's turmoil in the bond insurance markets. My bill would rectify these shortcomings and promote stability in our insurance markets.

In closing, Mr. Chairman, our job today is to swing the regulatory pendulum back toward the interests of hard-working Americans. The three draft bills before us will accomplish that objective. Billionaires on Wall Street have had their day, egged on by a culture of greed, deregulation, and a survival-of-the-fittest attitude that ignored the harsh effects those things inflict upon larger society. Today's hearing advances the effort to correct those excesses.

EMBARGOED UNTIL DELIVERY
Tuesday, October 06, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Capital Markets Regulatory Reform Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services hearing entitled "Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office":**

"I thank the Chairman and welcome our first panel of witnesses to today's hearing.

"I think the first item before us today – the Investor Protection piece of the regulatory reform package -- offers a lot of potential for bipartisan agreement, and I look forward to having an opportunity to work with the majority on this important legislation.

"We need to be clear, however, about what this hearing today is all about – checking the box. In order to stay in line with artificially-imposed deadlines, the majority has scheduled today's hearing on a member travel day -- forcing members to choose between previously agreed-upon time to meet with constituents in their districts or returning early to DC. And today's hearing addresses not one, but three completely separate issues over the course of three panels. All so the majority can say we had a legislative hearing on each of these items and that we are "fully examining" these important issues.

"Unfortunately, what we have before us today, rather than fulfilling a good faith commitment to a deliberative process, makes a mockery of it. And there is a risk of making a mockery of the entire hearing process. These witnesses, for instance, had one business day to review a 114-page draft before having to submit their testimony yesterday. Witnesses won't give the consideration they otherwise should to their testimony if they don't think the committee will be taking it seriously.

"We already know that Secretary Geithner doesn't take seriously the testimony of independent regulators under the purview of the Treasury Department he oversees, but that's another issue.

"The issues before us today are all very important. In another Congress they would each receive the careful deliberation that they deserve. But not in this one, where the majority continues to set unrealistic politically-imposed deadlines, which rush the legislative process and threaten unintended consequences throughout large swaths of our markets and broader economy."

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Testimony of Janice M. Abraham
President and Chief Executive Officer
United Educators Insurance, A Reciprocal Risk Retention Group
On Behalf of the Property Casualty Insurers Association of America (PCI)

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

Committee on Financial Services
United States House of Representatives
Tuesday, October 6, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify today on the proposed creation of a Federal Insurance Office within the Treasury Department. I am Janice Abraham, President and CEO of United Educators Insurance, A Reciprocal Risk Retention Group. We are owned and governed by the more than 1,160 educational institutions we insure, including public and private two- and four-year colleges and universities, independent elementary and secondary schools, educational associations and foundations, public school districts and pools; museums and cultural institutions. I am testifying today on behalf of the Property Casualty Insurers Association of America (PCI), which is the leading property-casualty insurance trade association in the United States, representing more than 1,000 insurers, the broadest cross-section of insurers of any national trade association.

The home, auto, and business insurance industry is healthy and competitive and the current system of regulating the industry is working relatively well. In the past five years, our insurance companies have weathered hurricanes Katrina, Rita and Ike in addition to handling their regular claims without having to ask for a government bailout. We're not broke, we didn't cause the current financial crisis, and we don't need a new federal oversight that may ultimately increase costs for consumers.

PCI appreciates the leadership of Representatives Kanjorski, Biggert, and other members of the committee who began this discussion in this Congress with their proposed Office of Insurance Information (OII) (H.R. 2609). While PCI has some concerns with that bill, it was in many ways more restrained and had a more targeted focus than the two subsequent proposals – the Administration's Office of National Insurance (ONI) and the most recent Kanjorski draft which amends the Administration proposal and renames the office as the Federal Insurance Office (FIO).

PCI supports responsible regulatory reforms that reflect principles of good insurance regulation. While we have not taken a position on proposals to create an office of insurance information, our members have concerns and questions about a greatly expanded federal insurance oversight office.

Functions

The FIO proposal would grant the federal insurance office a broad scope of powers that goes beyond the more limited and focused scope of the OII proposal. For example, the FIO would have the authority to "monitor all aspects of the insurance industry. . ." and to "perform such other related duties and authorities as may be assigned to the Secretary." This gives the Secretary discretion to delve into any insurance issue that can be said to relate in any way to any of the functions of the FIO. The intent of the initial proposals was to coordinate federal and international insurance policy. However the recent drafts create a potential for regulatory mission creep over time. The Committee should take care to ensure that the FIO's mission and powers are limited to addressing gaps in federal and international policymaking coordination.

Unnecessary and Burdensome Information Requests

One of the principal missions of the proposed federal insurance office is to gather information on and from the insurance industry. There are virtually no limits in the bill on the types and volume of information the Office may seek. While gathering information might sound like an innocuous activity, it can impose extraordinarily high costs on burdens on insurers – especially smaller insurers – who must comply with data requests. State regulators have some accountability in the information they gather, since they do so in pursuit of a regulatory function and with the additional responsibility of ensuring the solvency and stability of the marketplace. The proposed FIO has no such balancing accountability, mandate, or mission. Instead, as noted above the proposed language directs the Office to require information reporting to "monitor all aspects of the insurance industry" – an incredibly broad directive duplicating what the states already effectively implement and potentially opening the door to costly and overreaching federal information requests.

To its credit, the proposal does require the FIO to "coordinate" with state insurance regulators "to determine if the information to be collected is available from, or may be obtained in a timely manner by, such State insurance regulator or other agency." However, this does not definitively prohibit the FIO from demanding information that is publicly available or otherwise available from state regulators. The language should be tightened to require the FIO to seek and obtain any needed information from state insurance regulators and other public sources and permit the FIO to request information from insurers only if the information is not available from those sources.

The Kanjorski/Biggert OII bill rejects such excessive reporting requirements, stating that "the submission of any non-publicly available data and information to the Office shall be voluntary." PCI commends that approach to the Committee as it considers the new FIO proposal.

Duplicative Subpoena Authority

The new FIO proposal and the earlier Kanjorski/Biggert OII proposal wisely exclude any grant of subpoena power to the federal insurance office. For the reasons outlined below, PCI recommends that any legislation creating a national insurance office should do so as well.

The Administration's proposal includes exceedingly broad subpoena powers for the ONI. The power to issue a subpoena is one of the most potent powers the Congress can grant to a government agency. That power should therefore be granted very cautiously and only in circumstances where it is clearly justified, appropriately limited, and where the need is compelling and outweighs the potential for abuse. The proposed ONI subpoena power exceeds any other subpoena power granted to Treasury and is particularly broad and unlimited for a non-regulator.

As is typical of most agencies, Treasury's current subpoena powers generally fall into three categories: (1) formal administrative proceedings; (2) criminal or civil investigations and enforcement of laws/regulations; and (3) Inspector General investigative powers.[1] The subpoena power proposed to be granted in Section 313 (allowing the ONI to require insurers and their affiliates to submit information) exceeds any of the above categories and is not constrained in any way other than that the ONI must believe that the information it wants is relevant to its very broad mission that includes "monitoring all aspects of the insurance industry." No suspicion of criminal or civil violations of a law or regulation is required and no formal administrative proceeding must be initiated.

[1] U. S. Department of Justice, Office of Legal Policy, *Report to Congress on the Use of Administrative Subpoena Authorities by Executive Branch Agencies and Entities*, (2001).

The proposed ONI subpoenas are particularly extraordinary since Administration has specifically stated that the ONI would not be an insurance regulator. Thus, as a non-regulatory entity, it would be inappropriate to grant the ONI subpoena power.

Imposing an additional layer of subpoena authority is also unnecessary, because it would duplicate existing powers that state insurance regulators already have to obtain information and data from insurers, either by subpoena or otherwise. (See, e.g., NAIC Model Law on Examinations, NAIC Insurer Receivership Model Act; NAIC Unfair Trade Practices Model Act). Indeed, as noted above, Section 313(e) (4) of the Administration proposal requires the ONI to coordinate with state insurance regulators and other agencies on the collection of information from insurers. In addition to their subpoena power, state insurance regulators have the ability to withhold or revoke licenses or to take other disciplinary action against uncooperative insurers. It is unnecessary and inappropriate to grant ONI subpoena powers that: (1) are virtually unlimited; (2) apply in circumstances outside of those for which subpoena powers are typically granted to Treasury; and (3) duplicate subpoena powers already held at the state level.

Due Process – Ensure Accountability on Preempted Law

Under the Administration proposal, the FIO can preempt state law if the FIO determines that the state law: (1) directly or indirectly treats a non-U.S. insurer that is subject to an International Insurance Agreement on Prudential Measures (IIAPM) less favorably than it treats a U.S. insurer in that state; and (2) is inconsistent with an IIAPM. Before making such a determination, the FIO is required to provide notice and an opportunity for public comment. Other than a requirement that the FIO must consider all comments received and notify states of determinations of inconsistency, there is no check on the FIO's preemptive

power whatsoever. Thus, the FIO would have substantial power to preempt state law without being accountable for its decisions in any significant way.

The bipartisan Congressional bill by Representatives Kanjorski and Biggert proposed a number of additional checks on OII power, and we believe that those additional prudent limitations should be included in any FIO legislation that moves forward. Most importantly: (1) states and other aggrieved parties should have the right to appeal "determinations of inconsistency"; and (2) determinations of inconsistency and preemption should be expressly subject to the Administrative Procedures Act and to judicial review.

Small Insurers

The information demands that the FIO can impose without limit on insurers have the potential to impose tremendous burdens on all insurers. These burdens can be especially crushing for small insurers. We are pleased that the Administration has suggested considering a small insurer exception. However, the FIO is not required to adopt a small insurer exception, and the FIO gets to determine what the threshold should be. We recommend that the exception for small insurers be made explicit, with a definition of "small insurer" included reflecting a threshold of at least several billion dollars in direct written premium, indexed for market growth, or perhaps a similar measure tied to market capitalization. We would be pleased to work further with your staff to help develop an appropriate and workable definition. We would also note that the bipartisan Congressional OII bill does not impose such costly information demands on insurers, specifying that submission of non-public information was voluntary.

Negotiation of International Agreements

The Administration proposal would authorize the Treasury, assisted by the new FIO, to negotiate and enter into International Insurance Agreements on Prudential Measures (IIAPMs). This would be coupled with FIO's proposed power to preempt state measures deemed to be inconsistent with such IIAPMs. While it may be appropriate for a federal insurance office to coordinate with state regulators on matters of international interest, the proposed federal agreement negotiation and state law preemption powers would permit Treasury and the FIO to preempt current state reinsurance collateral requirements for overseas reinsurers – a key solvency regulatory tool. Elsewhere in our testimony, we suggest a more collaborative role for the FIO in which it would liaise with state regulators on matters of national and international concern and promote state uniformity in key areas, but refrain from usurping state regulatory authority.

FIO Should Facilitate State Uniformity

We have outlined above the ways in which we believe the functions of the proposed FIO are overly broad. However, the Committee may wish to consider other potential functions not included in existing drafts that could, if properly limited, assist in a constructive, collaborative way in reaching the goal of greater uniformity in state insurance laws and regulations. PCI sees positive potential to the FIO if its scope were refocused on the unique international trade, advisory, and coordinating roles suggested by the bipartisan Congressional bill. The FIO could also serve as a liaison to help encourage more efficient uniformity in state regulation. Without such limits the Office may suffer potential federal agency mission creep over time, far exceeding original Congressional intent.

Conclusion

PCI has already shared with Committee staff suggested amendments to the FIO legislation that would accomplish many of the things we are recommending today, as well as a technical amendment to limit Treasury's

authority to exercise preemption powers with respect to International Insurance Agreements it enters into beyond the preemption powers granted to the FIO. We appreciate the Committee's hard work and diligent consideration of this issue and especially the joint leadership of Representatives Kanjorski and Biggert. Although PCI has strong concerns about the current legislative FIO draft, we look forward to working with the Committee on addressing those concerns consistent with past Committee leadership efforts.

We thank the Committee for the opportunity to offer our views and would be pleased to provide any additional information or assistance the Committee may require.

RAA
REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

DAVID B. ATKINSON
EXECUTIVE VICE PRESIDENT
REINSURANCE GROUP OF AMERICA

HEARING ON
"CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE"

BEFORE

THE HOUSE FINANCIAL SERVICES COMMITTEE

October 6, 2009

1301 Pennsylvania Ave., N.W.
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My name is David Atkinson and I am Executive Vice President of Reinsurance Group of America, Incorporated (RGA), the largest U.S.-based life reinsurer. I am testifying today on behalf of the Reinsurance Association of America (RAA), a national trade association representing life and property/casualty companies that specialize in assuming reinsurance. The RAA's membership is diverse and includes large and small, broker and direct, U.S. companies and subsidiaries of foreign companies.

Reinsurance is simply insurance for insurers. Reinsurance is usually available for all types of insurance. My company provides reinsurance to life insurers, or "life reinsurance." Life reinsurance is a global business. In 2007, worldwide net life reinsurance premiums totaled about $39.6 billion. Life reinsurance plays a critical role in maintaining the financial health of the life insurance marketplace and ensuring the availability of life insurance for U.S. citizens and businesses. Life reinsurance can be used to help an insurance company increase the volume of business it writes, reduce the volatility of its loss experience, assist in meeting its regulatory requirements, or enhance the company's financial strength. RGA is the largest U.S.-based life reinsurer, the second largest life reinsurer in North America, and the third largest in the world. In 2008, RGA had reinsurance premiums of about $5.4 billion, life insurance reinsured of about $2.1 trillion and assets of more than $21 billion.[1]

I am pleased to appear before you today to provide the RAA's perspective on Congressman Kanjorski's legislation to create a Federal Insurance Office (FIO). We applaud the Committee's interest in this legislation, and are especially grateful for Rep. Kanjorski's leadership on this important issue. We also applaud the Administration's acknowledgment that

[1] RGA 2008 Annual Report to Shareholders

the international aspects of the insurance and reinsurance business require federal involvement to address the needs of the U.S. market and to assist and support U.S. companies doing business abroad.

The RAA strongly supports the recently-released discussion draft of the Federal Insurance Office Act of 2009. This legislation lays the foundation to ensure that the federal government has: 1) the authority to gather information so that it has a more thorough understanding of the complexities of insurance and reinsurance issues and how policy decisions may affect those markets; 2) the authority to coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters; (3) the authority to enter into international insurance agreements on prudential matters; and 4) the authority to preempt state insurance measures that are inconsistent with these international insurance agreements.

As I previously mentioned, reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential because reinsurance provides the much needed capacity for life, property and casualty risks in the U.S. Although the majority of U.S. premiums ceded offshore is assumed by reinsurers domiciled in a dozen countries, the entire worldwide market is necessary to bring much needed capital and capacity to support the extraordinary risk exposure in the U.S. and to spread that risk across the globe.

Reinsurance is currently regulated in the United States on a multi-state basis, which is both cumbersome and highly inefficient for a global marketplace. The need to comply with the laws of fifty states, which are often inconsistent and conflicting, is burdensome for this global business. The current state-based system is primarily focused on regulating market conduct, contract terms and rates, and protecting consumers. Importantly, none of these objectives apply to reinsurance, which is a business-to-business transaction. Reinsurance regulation should be

coordinated by a single national regulator that focuses on ensuring the reinsurer's financial solvency so that it can meet its obligations to its ceding insurers.

The RAA supports a reinsurance regulatory system that would create this single national regulator with a single set of rules that will focus on efficient and effective solvency regulation. We also support a process for the national regulator to vet equivalence and recognize non U.S. regulatory regimes on a reciprocal basis. This process would facilitate cross-border transactions and address the collateral issue. Because of the global nature of our business, and the important role that reinsurers play in catastrophic events, the RAA wholeheartedly believes that a Federal Insurance Office is necessary to assist Congress and the federal government in making better decisions regarding international and national insurance policy and in enforcing international agreements uniformly across the U.S.

FEDERAL INSURANCE OFFICE

The RAA strongly supports the creation of a Federal Insurance Office (FIO) in the Department of Treasury. We also support authorizing the Director of the FIO to advise the Treasury Secretary on major domestic and international insurance policy issues. Public policy issues are frequently raised at the federal level which could have a significant impact on the insurance and reinsurance business, yet there is no federal agency tasked with understanding our industry. The global reinsurance industry plays a major role in the stability of the U.S. insurance marketplace and in the economic recovery of the U.S. following major natural and man-made disasters. The federal government has a strong interest in understanding this important market as it responds to these crises. The creation of the FIO will fill the current lack of a lead federal entity that understands how decisions made by the federal government, including Congress, can impact - both positively and negatively - the insurance industry. The Federal Insurance Office

would have the benefit of the National Association of Insurance Commissioners' (NAIC) information and experience, but would be empowered to conduct its own analysis and provide advice based on a perspective that is not driven by individual state interests. Creation of the FIO with responsibility for gathering and analyzing information and reporting to Congress is a significant step to ensure policymakers understand the industry during their deliberative process.

Authority to Coordinate Federal Efforts, Establish Federal Policy on International Insurance Matters and Negotiate International Agreements on Prudential Matters

The RAA also strongly endorses empowering the Department of the Treasury to: 1) coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters; 2) negotiate International Insurance Agreements on Prudential Matters; and, 3) preempt state insurance measures that are inconsistent with an International Insurance Agreement on Prudential Matters and that prejudice non-U.S. insurers subject to those Agreements.

The RAA believes it is critical that the Department of the Treasury be empowered to coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors (IAIS). There are significant efforts underway at international forums such as the IAIS to create global regulatory standards and international harmonization. The goal is for these standards to then be adopted in individual countries around the world. Currently, the U.S. voice is marginalized in these discussions because of the fractured nature of the current regulatory system and the lack of a single national regulator with authority to speak on behalf of the U.S. Furthermore, uniform application of these global standards in the U.S. is unlikely since the regulations would have to be adopted by each individual state. Given the size and

importance of the U.S. market, we would suggest that the legislation be amended to make it clear that the Federal Insurance Office has the authority to represent the United States in all relevant international organizations on insurance issues, not just the IAIS. This lack of a single national voice adversely impacts U.S. reinsurers in another specific way. The interaction between the U.S. and its foreign counterparts on issues like the European Union's Solvency II effort will impact not only the ability of U.S. firms to conduct business abroad, but also the flow of capacity to the U.S. For U.S. reinsurers, Solvency II will set forth a process for determining which countries are "equivalent" for purposes of doing business in the European Union by 2012. The possibility the current 50-state system in the U.S. will be deemed "equivalent" is seriously in doubt. Peter Skinner, a Member of the European Parliament and sponsor of the Solvency II legislation in the EU, testified in June before the House Capital Markets Subcommittee and explicitly stated that these equivalence decisions will have to be made at the country level. This fact alone will make it almost impossible to find the U.S. equivalent under Solvency II unless changes are made to the current U.S. insurance regulatory framework. Without federal involvement by a knowledgeable entity tasked with responsibility for international policy issues and with authority to bind the U.S., the U.S. reinsurance industry will continue to be disadvantaged in these equivalence discussions.

The RAA also strongly supports providing the Federal Insurance Office with the authority to preempt state insurance measures that are inconsistent with an International Insurance Agreement on Prudential Matters and that prejudice non-U.S. insurers subject to those Agreements. Because of the fragmented nature of the current 50-state regulatory system, it is critical that the Department of the Treasury be empowered to ensure these international agreements are uniformly respected throughout the states and that companies are not subject to

dual, and perhaps conflicting, regulation. To do otherwise would perpetuate the current patchwork system of regulations and undermine the ability of the U.S. to effectively participate in the international arena, including the ability to reach international agreements on insurance policy. This is a significant step forward in creating a more efficient and effective regulatory system in the U.S. and enhancing U.S. dealings with foreign governments and regulatory bodies.

In our drive to open the U.S. market to non-U.S. reinsurers, it will be important not to put U.S. reinsurers at a disadvantage in their home market. The importance of preserving a U.S. presence in the U.S. reinsurance market should be a governing principle of the Federal Insurance Office legislation. The Federal Insurance Office must ensure competitive equivalence in the U.S. market between U.S. and non-U.S. reinsurers, as well as open non-U.S. markets to U.S. interests.

CONCLUSION

The RAA thanks Chairman Frank and Ranking Member Bachus for this opportunity to comment on reinsurance regulation and the Federal Insurance Office. We look forward to working with all Members of the House Financial Services Committee as the Committee considers this most important issue and this legislation moves forward.

MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 6, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office
October 6, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, "Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office" held on October 6, 2009. MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies.

MFA appreciates the opportunity to express its views on financial regulatory reform, including the important subjects of investor protection and regulation for managers of private pools of capital, including hedge fund managers. In our view, any revised regulatory framework should address identified risks, while ensuring that private pools of capital are still able to perform their important market functions. It is critical, however, that consideration of a regulatory framework not be based on misconceptions or inaccurate assumptions.

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, a voice for shareholders, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

To perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other market participants, including retail investors and policy makers, in reestablishing a sound financial system. We support efforts to protect investors, manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were, and remain, substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn. The losses suffered by hedge funds and their investors did not pose a threat to our capital markets or the financial system.

Although hedge funds are important to capital markets and the financial system, the relative size and scope of the hedge fund industry in the context of the wider financial system helps explain why hedge funds did not pose systemic risks despite their losses. With an estimated $1.5 trillion under management, the hedge fund industry is significantly smaller than the U.S. mutual fund industry, with an estimated $9.4 trillion in assets under management, or the U.S. banking industry, with an estimated $13.8 trillion in assets. According to a report released by the Financial Research Corp., the combined assets under management of the three largest mutual fund families are at $1.9 trillion, which exceeds the total assets of the hedge fund industry. Moreover, because many hedge funds use little or no leverage, their losses did not pose the same systemic risk concerns that losses at more highly leveraged institutions, such as brokers and investment banks, did. A study by PerTrac Financial Solutions released in December 2008 found that 26.9% of hedge fund managers reported using no leverage. Similarly, a March 2009 report by Lord Adair Turner, Chairman of the U.K. Financial Services Authority (the "FSA"), found that the leverage of hedge funds was, on average, two or three-to-one, significantly below the average leverage of banks.

Though hedge funds did not cause the problems in our markets, we believe that the public and private sectors (including hedge funds) share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. We are committed to working with the Administration and Congress with respect to efforts that will restore investor confidence in and stabilize our financial markets and strengthen our nation's economy.

I. A "SMART" APPROACH TO FINANCIAL REGULATORY REFORM

MFA supports a smart approach to regulation, which includes appropriate, effective, and efficient regulation and industry best practices that (i) promote efficient capital markets, market integrity, and investor protection and; (ii) better monitor and reduce systemic risk. Smart regulation will likely mean increasing regulatory requirements in some areas, modernizing and updating antiquated financial regulations in other areas, and working to reduce redundant, overlapping, or inefficient responsibilities, where identified.

The first step in creating a smart regulatory framework is identifying the risks or intended objectives of regulation with the goal of strengthening investor protection and market integrity and monitoring systemic risk. Identifying the underlying objectives of proposed regulation will help ensure that proposals are considered in the appropriate context relative to addressing the identified risks or achieving the intended objectives. Regulation that addresses the key

objectives of efficient capital markets, market integrity and investor protection is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA, working with its members, has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices").*[1] As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee. MFA and other industry groups have also created global, unified principles of best practices for hedge fund managers.

Because of the complexity of our financial system, an ongoing dialogue among market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics.

Regulation is also not a panacea for the structural market breakdowns that currently exist in our financial system. One such structural breakdown is the lack of certainty regarding major public financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition. Investors' lack of confidence in the financial health of these institutions has been, and continues to be, an impediment to investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The comprehensive stress tests earlier this year on the 19 largest bank holding companies were designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. While those stress tests appear to have helped develop greater certainty, we believe that it is also important for policy makers and regulators to ensure that accounting and disclosure rules are designed to promote the appropriate valuation of assets and liabilities and consistent disclosure of those valuations.

Though regulation cannot solve all of the problems in our financial system, careful, well thought out financial regulatory reform can play an important role in restoring financial market stability and investor confidence. The goal in developing regulatory reform proposals should not be to throw every possible proposal into the regulatory system. Such an outcome will only overwhelm regulators with information and added responsibilities that do little to enhance their ability to effectively fulfill their agency's missions. The goal should be developing an "intelligent" system of financial regulation, as former Fed Chairman Paul Volcker has characterized it.

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[1] MFA's *Sound Practices* is available at: http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf

We believe that regulatory reform objectives generally fall into three key categories. Those categories are: investor protection, market integrity and regulation, including registration of advisers to private pools of capital; systemic risk regulation; and regulation of market-wide issues, such as short selling. In light of the focus of today's hearing, I will address the first key category -- investor protection, market integrity and regulation, including registration of advisers to private pools of capital.

II. REGISTRATION OF ADVISERS TO PRIVATE POOLS OF CAPITAL

In adopting a smart and effective approach to the regulation of unregistered managers of private pools of capital, it is important to recognize that many, if not all, of these regulatory issues will be relevant to all such managers, including firms that manage hedge funds, private equity funds, venture capital funds, commodity pools and real estate funds. The Obama Administration, in its release *Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation* (the "Administration Report"),[2] is supportive of this approach, calling for the registration of advisers of hedge funds and other private pools of capital with the SEC. MFA supports the registration of currently unregistered investment advisers to all private pools of capital, subject to a limited exemption for the smallest investment advisers with a *de minimis* amount of assets under management.

MFA has publicly supported this comprehensive approach to adviser registration over the past several months, even when the Administration called for a narrower registration requirement only for advisers to the largest and most systemically relevant private pools of capital. We strongly encourage policy makers also to consider the issue of registration in the context of all private pools of capital and the unregistered managers of those pools. Likewise, we strongly encourage regulators to consider regulations that apply to all private investment firms and not just hedge fund managers. This approach will both promote better regulation as well support the many benefits private investment firms provide to the US markets.

MFA and its members recognize that mandatory SEC registration for advisers of private pools of capital is one of the key regulatory reform proposals being considered by policy makers. We believe that the general approach set out in the Administration Proposal of requiring the registration of currently unregistered investment advisers, including advisers to private pools of capital, under the Investment Advisers Act of 1940 (the "Advisers Act") is a smart approach in considering this issue. I note that more than half of MFA member firms already are registered with the Securities and Exchange Commission (the "SEC"), as investment advisers. Applying the registration requirement to currently unregistered investment advisers to all private pools of capital, instead of focusing solely on hedge fund managers is also consistent with the objective of a "smart" approach to this type of reform. We believe that removing the current exemption from registration for advisers with fewer than fifteen clients would be an effective way to achieve this result.[3] The form and nature of registration and regulation of investment advisers to private

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[2] Available at: http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

[3] We note that this approach is consistent with the approach taken by H.R. 711 and S. 1276.

pools of capital should be evaluated in the context of how to best promote investor protection, market integrity and systemic risk monitoring, each of which may be best achieved by different types of regulation.

We believe that the Advisers Act provides a meaningful regulatory regime for registered investment advisers. The responsibilities imposed by Advisers Act registration and regulation are not taken lightly and entail significant disclosure and compliance requirements, including:

- Providing publicly available disclosure to the SEC regarding, among other things, the adviser's business, its clients, its financial industry affiliations, and its control persons;
- Providing detailed disclosure to clients regarding, among other things, investment strategies and products, education and business background for adviser personnel that determine investment advice for clients, and compensation arrangements;
- Maintaining of books and records relevant to the adviser's business;[4]
- Being subject to periodic inspections and examinations by SEC staff;
- Adopting and implementing written compliance policies and procedures and appointing a chief compliance officer who has responsibility for administering those policies and procedures;
- Adopting and implementing a written code of ethics that is designed to prevent insider trading, sets standards of conduct for employees reflecting the adviser's fiduciary obligations to its clients, imposes certain personal trading limitations and personal trading reports for certain key employees of the adviser; and
- Adopting and implementing written proxy voting policies.

In addition to registration and regulation of advisers through the Advisers Act, the hedge fund industry is subject to other, meaningful regulatory oversight. Hedge funds, like other market participants, are subject to existing, extensive trading rules and reporting requirements under the U.S. securities laws and regulations.[5] Increasing investor confidence and promoting market integrity are carried about by the SEC and other regulators through these regulatory requirements.

With a comprehensive registration framework comes additional burdens on federal regulators. A registration framework that overwhelms the resources, technology and capabilities of regulators will not achieve the intended objective, and will greatly impair the ability of regulators to fulfill their existing responsibilities, as well as their new responsibilities. Regulators must have adequate resources, including the ability to hire and retain staff with

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[4] Section 204 of the Advisers Act and rule 204-2 under that Act set out the required books and records that must be maintained by registered investment advisers. MFA can provide copies of the relevant rule upon request.

[5] We are also supportive of providing regulatory authorities, on a confidential basis, with information regarding trading/investment activities to promote better monitoring of systemic risk.

sufficient experience and ability, and improve the training of that staff, to properly oversee the market participants for whom they have oversight responsibility. The SEC, which is the existing regulator with oversight of investment advisers, has acknowledged that its examination and enforcement resources are already seriously constrained.[6] This raises the question whether the SEC would have the resources or capability to be an effective regulator when advisers to private pools of capital are required to register under an expanded registration framework. We strongly encourage policy makers, as part of their regulatory reform efforts, to ensure that the SEC has the resources and regulatory capabilities it needs to effectively meet its expanded regulatory mandate. Failing to do so will likely ensure that any regulatory reform effort will fail to achieve its intended objectives(s).

In addition to questions regarding the resources and capabilities of the SEC to regulate advisers to private pools of capital, consideration must also be given to the organization of the SEC, and whether changes to the current regulatory structure would lead to a more effective regulatory outcome. We applaud Chairwoman Schapiro, who has announced efforts to review such issues to make the SEC a more effective regulator. MFA has previously met with SEC staff to offer suggestions on ways to make SEC oversight of investment advisers more effective.

In considering the appropriate adviser registration framework, and in light of concerns about resources, capabilities and regulatory structure, we believe that it is important for there to be an exemption from registration for the smallest investment advisers that have a *de minimis* amount of assets under management. This exemption should be narrowly, though appropriately, tailored so as not to create a broad, unintended loophole from registration. We are supportive of a comprehensive adviser registration regime, however, we recognize that registration carries with it significant costs that can overwhelm smaller advisers and force them out of business. We believe that the amount of any *de minimis* exemption should appropriately balance the goal of a comprehensive registration framework with the economic realities of small investment advisers. As mentioned above, regulatory resources, capabilities and structure should also be considered as policy makers determine an appropriate *de minimis* threshold.[7] We are not proposing a specific *de minimis* amount, however, we encourage policy makers to determine an amount that is not so high as to create a significant loophole that undermines a comprehensive registration regime, and also not so low that the smallest investment advisers are unable to survive because of regulatory costs.

We would like to share with you today some initial thoughts on some of the key principles that we believe should be considered by Congress, the Administration and other policy makers as you consider the appropriate regulatory framework. Those principles are:

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[6] Speech by SEC Chairman Mary L. Schapiro: Address to the Council of Institutional Investors (April 6, 2009), available at: http://www.sec.gov/news/speech/2009/spch040609mls.htm.

[7] We believe that Congress should ensure that any approach in this regard is consistent with state regulation of smaller investment advisers and avoids duplication.

- The goal of any reform efforts should be to develop a more intelligent and effective regulatory framework, which makes our financial system stronger for the benefit of consumers, businesses and investors.

- Regulation should address identified risks or potential risks, and should be appropriately tailored to those risks because without clear goals, there will be no way to measure success.

- Regulation should not impose limitations on the investment strategies of private pools of capital. As such, regulatory rules on capital requirements, use of leverage, and similar types of restrictions on the funds should not be considered as part of a regulatory framework for private pools of capital.

- Regulators should engage in ongoing dialogue with market participants. Any rulemaking should be transparent and provide for public notice and comment by affected market participants, as well as a reasonable period of time to implement any new or modified regulatory requirements. This public-private dialogue can help lead to more effective regulation and avoid unintended consequences, market uncertainty and increased market volatility.

- Reporting requirements should provide regulators with information that allow them to fulfill their oversight responsibilities as well as to prevent, detect and punish fraud and manipulative conduct. Overly broad reporting requirements can limit the effectiveness of a reporting regime as regulators may be unable to effectively review and analyze data, while duplicative reporting requirements can be costly to market participants without providing additional benefit to regulators. It is critical that regulators keep confidential any sensitive, proprietary information that market participants report. Public disclosure of such information can be harmful to members of the public that may act on incomplete data, increase risk to the financial system, and harm the ability of market participants to establish and exit from investment positions in an economically viable manner.[8] Regulations should not force market participants publicly to reveal information that would be tantamount to revealing their trade secrets to competitors.

- We believe that the regulatory construct should distinguish, as appropriate, between different types of market participants and different types of investors or customers to whom services or products are marketed. While we recognize that investor protection concerns are not limited to retail investors, we believe that a "one-size fits all" approach will likely not be as effective as a more tailored

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[8] MFA also believes that regulators should also ensure that they share information with foreign regulators only under circumstances that protect the confidentiality of that information. For example, the SEC has adopted Rule 24c-1 under the Exchange Act (17 CFR §24c-1), which allows the SEC in its discretion to share nonpublic information with a foreign financial authority if the authority receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate. MFA believe that US regulators should employ this type of approach when sharing information with foreign regulators.

approach. One such relevant distinction is that between private sales of hedge funds to sophisticated investors under the SEC's private placement regulatory regime and publicly offered sales to retail investors. This private/public, sophisticated/retail distinction has been in existence in the United States for over 75 years and has generally proven to be a successful framework for financial regulation. We do not believe this distinction should be lost, and we strongly believe that regulation that is appropriate for products sold publicly to retail investors is not necessarily appropriate for products sold privately to only sophisticated investors.

- Regulation regarding market issues that is applicable to a broad range of market participants, such as market manipulation and insider trading, should be addressed in the broader context of all market participants. Market issues are not specific to the hedge fund industry and, therefore, regulatory reform regarding these issues should be considered in the broader context and not in the context of hedge fund regulation.

- Lastly, we believe that industry best practices and robust investor diligence should be encouraged and recognized as an important complement to regulation. Regulators will tell you that their oversight is no substitute for a financial firm's own strong business practices and investors' robust diligence if we are to promote market integrity and investor protection concerns.

MFA Views on Administration's Proposed "Registration of Advisers to Private Funds" (the "Administration Proposal") and the Proposed "Private Fund Investment Advisers Registration Act of 2009" (the "Discussion Draft"

As mentioned above, MFA is supportive of the general approach taken in the Administration Proposal – a comprehensive registration regime under the Advisers Act designed to ensure that there is appropriate regulatory oversight over investment advisers to private pools of capital. We recognize and appreciate the Administration's objective of registering and regulating important market participants that have previously been exempt from registration. It is critical that this objective be done in a way that creates a "smart" regulatory framework, and we believe the removal of the so-called 'private adviser' exemption currently in the Advisers Act achieves that objective with respect to investment adviser registration. We have a concern, however, that the Discussion Draft would continue to leave a gap in the oversight of investment advisers by providing an exemption from registration and reporting requirements for advisers to private pools of capital that engage in certain investment strategies. Though we are generally supportive of the Administration Proposal, we do have concerns with respect to certain provisions in both the Proposal and the Discussion Draft, which are discussed in detail below.

➢ Ensuring that the registration framework is comprehensive is an important component of a "smart" regulatory framework; however, it is equally as important to ensure that any new regulatory framework does not impose unnecessary, duplicative and costly requirements on advisers to private pools of capital. Such action would have adverse consequences for markets and investors while providing little to no benefit with respect to enhancing investor protection and market integrity, promoting greater

transparency to either markets or regulators, or monitoring systemic risk. In that regard, we believe that eliminating the current exemption from registration in section 203(b)(6) of the Advisers Act, for certain commodity trading advisors ("CTAs") which are registered with the Commodity Futures Trading Commission (the "CFTC") (*i.e.*, those whose business is not primarily acting as an investment adviser), would create unnecessary, duplicative and costly requirements for those CTAs.

Section 203(b)(6) of the Advisers Act provides a limited exemption from registration as an investment adviser with the SEC for CTAs that are registered with the CFTC and which do not primarily act as an investment adviser (as defined in the Advisers Act). This exemption does not create a regulatory gap, nor does it leave advisers to private funds outside of a registration framework. It ensures that CTAs to private funds, which are primarily engaged in the business of providing advice regarding futures[9] and are already subject to a comprehensive registration and regulatory framework, do not have to be subjected to a dual registration and regulatory framework. Requiring these CTAs to register with both the SEC and the CFTC would, at best, subject them to a duplicative regulatory framework and, at worst, subject them to potentially inconsistent regulatory requirements. We are not aware of any regulatory failure or other public policy justification to warrant this change.

➢ We appreciate the inclusion of confidentiality with respect to information reported to regulators under section 404 of the Administration Proposal and section 4(b)(8) of the Discussion Draft (both of which amend section 204(b) of the Advisers Act). Confidentiality of this sensitive information is critical. We believe that the Federal Reserve's protection of bank information received through their examination authority provides a good model for the type of protection that should be provided with respect to information provided under this section. It is also important that any final legislation make clear that confidential information shared with any agency (for example, under subparagraphs (5) and (7) of section 404 of the Administration Proposal and sections 4(b)(6) and (8) of the Discussion Draft) be protected by those agencies as well as the agency which originally receives the information.

➢ There is some uncertainty with respect to some of the reporting requirements in the Administration Proposal and the Discussion Draft. For example, it is unclear what type of information that the reporting of trading practices is intended to address. To the extent that legislation establishes new reporting or recordkeeping requirements, we believe that it is important for the legislation to define or otherwise clarify what information or records are being required.

➢ We recognize the importance of an adviser's fiduciary obligation to its clients. We also understand that following the United States D.C. Circuit Court of Appeals

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[9] On September 25, 2009, MFA submitted a letter to the SEC and the CFTC suggesting a methodology by which the agencies could determine whether an adviser registered with the CFTC is primarily acting as an investment adviser pursuant to section 203(b)(6) of the Advisers Act. MFA's comment letter is available at http://www.managedfunds.org/downloads/MFA%20response%20to%20SEC.CFTC.9.25.09.pdf.

decision in *Goldstein v. SEC*, the agency had concerns regarding their authority appropriately to regulate advisers to private funds. Though we understand that concern, we believe that a broad delegation of authority to the SEC to define the term "client" in any manner for purposes of the Advisers Act raises concerns, specifically with respect to an adviser's fiduciary obligations to its clients.

We have concerns with imposing fiduciary obligations on an adviser with respect to investors in pooled investment funds managed by that adviser. Imposing such an obligation on advisers to pooled investment vehicles raises several concerns. An adviser to a pooled investment fund likely would not have the information about the underlying investors in the fund necessary to be able to determine whether an individual investment made for a fund's portfolio would also be appropriate for an individual investor. Further, applying fiduciary obligations to the investor and the fund can create potential conflicts between an adviser's obligations to the fund and obligations to investors.[10] In light of this concern, we believe that the current language in the Administration Proposal and the Discussion Draft, which delegates broad authority to the SEC to define the term "client," is overly broad.

➢ We appreciate the importance of good disclosure to counterparties and creditors, but we have concerns about imposing such disclosure standards on private fund managers, which we believe do not apply to any other financial institutions. It is unclear how disclosure from a private fund adviser to its counterparties and creditors raises either investor protection or systemic risk concerns. Creditors and counterparties are not investors; they are sophisticated market participants capable of protecting their own interests in negotiating a transaction.

We also believe that there should be some limitations on the types of information that an investment adviser should be required to disclose to other market participants. For example, we would oppose a requirement that broadly forces an investment adviser to reveal its proprietary trading strategies or algorithms. In general, U.S. law respects the rights of businesses to protect trade secrets from other market participants. We believe that policy makers should design any required disclosures by investment advisers to other market participants to achieve the objective of enabling market participants to make informed decisions, while affording advisers the well-recognized right to protect their trade secrets and other proprietary information.

Likewise, systemic risk assessment does not seem to be a strong basis to require disclosure to counterparties. Counterparties are not responsible for assessing systemic risk, nor would disclosure from only an entity's clients provide the type of information necessary to adequately assess systemic risk concerns. To address concerns about the systemic risk posed by the connections between financial institutions, we believe that imposing standards on those who extend credit would be more effective than imposing disclosure obligations on institutions. If such Congress were to impose such disclosure

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[10] We note that this concern is also relevant to the Administration's proposed "*Investor Protection Act of 2009*",, which establishes a new and potentially different fiduciary standard for investment advisers than the fiduciary standard to which advisers are already subject.

standards, it would be equally important to require counterparties to provide disclosure to private fund advisers and we would recommend amending section 404(b)(6) of the Administration Proposal and section 4(b)(7) of the Discussion Draft to require disclosure from both parties, not just from private fund advisers.

➢ We believe it is important for there to be an appropriate transition period for implementation of the registration requirement to ensure market participants have an appropriate period of time to comply.

Investor Protection Recommendations

In addition to a comprehensive registration regime for investment advisers to private pools of capital, we encourage policy makers to make certain enhancements to the Advisers Act, which we believe would make the Advisers Act a "smarter" framework for the regulation of advisers to private pools of capital. Set out below are recommendations that we believe could be incorporated into both the Administration's and discussion draft of the *"Investor Protection Act of 2009"*.

Congress or the SEC should increase the net worth requirement for investors in private funds to ensure that only experienced individuals with sufficient resources to put their money at risk are able to invest in hedge funds and other private funds. Current rules under the Advisers Act effectively require an investor to be a "qualified client" – a person who has a net worth, together with a spouse, of more than $1.5 million – to invest in most private funds managed by a registered adviser. We recommend that Congress or the SEC prospectively increase the net worth threshold to $2.5 million and automatically adjust the threshold for inflation (rounded up to the nearest $500,000) every five years.[11]

Policy makers should also enhance the existing framework for the protection of client assets to prevent an unscrupulous manager from misappropriating investor funds or securities. Many private fund managers currently engage independent public accountants to perform annual audits and to certify their private funds' financial statements. Providing annual audited financial statements to investors is a longstanding best practice in the hedge fund industry (as reflected in MFA's *Sound Practices*), but private fund managers are not required to do so. Congress or the SEC should require each SEC-registered private fund manager with custody of client funds or securities to arrange for each private fund it advises to: (1) be subject to an annual audit conducted by an independent public accountant registered with, and subject to inspection by, the Public Company Accounting Oversight Board; and (2) distribute audited financial statements to each investor in the fund, except in cases where a manager does not have the authority to require an audit.[12]

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[11] Pursuant to Regulation D under the Securities Act of 1933, hedge funds and other private pools of capital are sold to "accredited investors". MFA also supports increasing the sophistication standards contained in Regulation D. In 2007, MFA submitted a comment letter to the SEC supporting an increase in the test to be an accredited investor. A copy of MFA's comment letter is available at [insert cite].

[12] MFA recommended an independent audit requirement for private funds in its letter commenting on the SEC's proposed amendments to its custody rule under the Advisers Act. MFA's letter is available at http://www.managedfunds.org/downloads/MFA%20Comments%20to%20Custody%20Proposals.pdf.

In addition to accountants, other service providers play an important role in many components of a private fund manager's risk management system. The existing disclosure report for registered advisers under the Advisers Act, the SEC's Form ADV, should be enhanced to require that private fund managers disclose to investors their key service providers. Managers should disclose on Part II of Form ADV, the section that is delivered to investors, their accountants, principal prime brokers and custodians employed within the prior twelve-month period. Under existing law and regulation, hedge fund investors are sophisticated, experienced high net worth individuals and institutions. These investors request and receive a substantial amount of information from hedge fund managers prior to investing and during their investments, pursuant to agreements between the investors and the funds.[13] Although hedge fund investors already request and receive substantial amounts of information, we believe that a requirement that managers disclose their key service providers would enhance the existing disclosure framework and ensure that all investors have information necessary to make informed investment decisions.

Finally, we recommend that the SEC be given authority to prohibit individuals who engage in improper conduct while associated with a broker, dealer or investment adviser from being associated with any other securities industry participant, including a broker, dealer, investment adviser, municipal securities dealer transfer agent, or nationally recognized statistical rating organization. To further ensure that only appropriate individuals manage investor assets, the Advisers Act should also be amended to automatically bar a person who has engaged in criminal violations of the federal securities from associating with a registered investment adviser, subject to an appeal to the SEC.[14] An automatic bar would reduce the administrative costs caused by existing law requiring the SEC to issue an order to bar such persons from associating with a registered investment adviser.

(l) **ADDITIONAL REGULATORY ISSUES**

International Coordination

The International Organization of Securities Commissions ("IOSCO"), policy makers and regulators in the United States and the European Union, as well as policy makers and regulators in other countries are currently undergoing reviews of the regulation of financial entities, including hedge funds, and financial markets. It is critical for policy makers and regulators to coordinate these regulatory reform efforts to eliminate, when possible, unnecessary duplication and inconsistency in regulation, and to avoid creating inappropriate barriers to participation within their respective jurisdictions, so that hedge funds can continue to provide benefits to markets and investors around the globe. We encourage policy makers and regulators in the

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[13] MFA has published a model due diligence questionnaire that illustrates the types of information commonly requested by investors prior to investing. The questionnaire is available at http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

[14] Section 9 of the Investment Company Act of 1940 contains an automatic bar prohibiting certain persons who engage in wrongful conduct from associating with a registered investment company.

United States, the European Union, Asia and elsewhere to continue to engage in an active dialogue on international financial regulation and to cooperate in their regulatory and enforcement efforts.[15] This approach is consistent with the Administration's approach to international coordination on regulatory reform.[16]

We believe that an example of the adverse consequences that can result from a lack of international coordination can be seen in the European Commission's Directive on Alternative Investment Fund Managers (the "Directive"). A number of the provisions in the Directive go far beyond the principles established by IOSCO and the G-20 and many of those provisions are inconsistent with a globally harmonized approach to the regulation of private pools of capital and their managers. We believe that these provisions in the Directive would have significant, adverse consequences for managers of private pools of capital, as well as their European investors. In particular, we are concerned about provisions in the Directive that would effectively ban U.S. fund managers from managing European-based private funds, or even having European investors in non-European based funds managed by U.S managers. MFA has produced a white paper analyzing key provisions of the Directive.[17]

Enhanced Protection of Customer and Client Assets

One of the lessons learned from the past year's crisis is that customer and client assets held by financial institutions need to be protected. A regulatory structure that fails to adequately protect customer and client assets not only harms investors, but can also increase systemic risk.

The case in point is the failure of Lehman Brothers. The losses resulting from the failure of Lehman Brothers are astronomic. Even with respect to customer and client assets that may eventually be recovered, the delays will be substantial, into the many years. Further, the process of recovery will undoubtedly generate numerous disputes over valuation and conflicting rights that seem likely to deplete a good portion of what otherwise might have been available for distribution to the directly injured parties.

A large share of the money that was lost by the failure of Lehman Brothers was not that of Lehman Brothers' shareholders or even of its ordinary creditors who had made an investment decision to lend money to that firm. Rather, the money lost was that of Lehman Brothers customers, including its swaps customers, who had posted collateral with Lehman Brothers that

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15 MFA has submitted several letters to IOSCO, in response to that organization's requests for public comment on the following areas of regulatory reform: Direct Electronic Access, Hedge Funds Oversight, Regulation of Short Selling and Unregulated Financial Markets and Products. MFA's comment letters are available on its website, www.managedfunds.org.

16 See June 29, 2009 speech by Treasury Assistant Secretary for International Monetary and Financial Policy, Mark Sobel to the European Forum of Deposit Insurers at the Fédération Bancaire Francaise, available at http://www.ustreas.gov/press/releases/tg196.htm.

17 MFA's white paper is available at http://www.managedfunds.org/members/downloads/MFA%20White%20Paper%20on%20AIFMD.pdf

was not segregated.[18] MFA believes that the financial markets cannot perform their purpose of capital formation if customers that are seeking safe custodial treatment of their assets are subject to the same risks, or even disproportionate risks, to the shareholders and creditors of a company. Custodial customers ought to be protected from the imposition of investment risk. For example, the initial margin posted by end-users on swaps is intended as a safeguard against failure; it ought not to be transformed by a swaps dealer into a disguised and forced investment by a customer into the assets of the swaps dealer.

We do not believe that it is sufficient merely to mandate that the custodian of the initial margin be a separate legal entity from the registered swap dealer. As we have seen since Lehman Brothers failed, entities that are under a common holding company are near to inextricably related. If one entity under the holding company fails, that failure is very likely to spread to the other members of the group. If a swap dealer fails, it is likely that so will its affiliated custodian. Nonetheless, we do not believe that it would be necessary to eliminate entirely the possibility that an affiliated custodian might hold initial margin pledged to a swap dealer. For example, where the custodian is an entity that is engaged solely in a trust or custody business, and so does not require any material amount of financing to operate from day to day, it may be able to continue operations at least long enough to return collateral it holds to the appropriate owners. While some amount of flexibility is appropriate, it is important for policy makers and regulators to consider ways in which client and customer assets can be better protected than was the case in the Lehman Brothers failure.

Engagement with Market Participants

As discussed above, we believe that a smart regulatory framework includes regular discussions among policy makers, regulators and market participants. MFA and its members have been active and constructive participants with regulators and policy makers regarding a variety of regulatory and market issues. Though the subject of my testimony today relates primarily to registration and regulation of advisers to private pools of capital, MFA and its members are committed to being constructive participants with respect to any of the other issues, including, among others, over-the-counter derivatives, short selling, systemic risk, and market issues that policy makers and regulators are considering as part of the ongoing regulatory reform initiative.

CONCLUSION

Hedge funds, as sophisticated institutional investors, have important market functions, in that they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. MFA and its members acknowledge that smart regulation helps to ensure stable

[18] We believe that there is in excess of $50,000,000,000 in customer assets still being held in Lehman Brothers International (Europe) ("LBIE"), which belongs to pension funds, endowments, hedge funds, and other large U.S. institutions whose beneficiaries are U.S. citizens. There is no timetable for when the assets will be returned. Congressman Gregory Meeks (D-NY) has offered a Concurrent Resolution seeking action to free the assets trapped at LBIE (See H. Con. Res. 184).

and orderly markets, which are necessary for hedge funds to conduct their businesses. We also acknowledge that active, constructive dialogue between policy makers and market participants is an important part of the process to develop smart regulation. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Committee. I would be happy to answer any questions that you may have.

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and Associate Professor of Law, University of Mississippi School of Law

before the

Committee on Financial Services, U.S. House of Representatives

October 6, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to appear before you to discuss the protection of investors. It is an honor and a privilege to appear before the Committee today.

This testimony briefly discusses certain provisions of the October 1 draft of the Investor Protection Act of 2009 (the "Act").

Statutory Fiduciary Duty for Brokers

Section 103 of the Act establishes a federal fiduciary duty for brokers, dealers and investment advisers who provide investment advice about securities to retail investors. It amends the Exchange Act to require the SEC to impose the same "standard of conduct" for brokers who provide investment advice to retail clients that is applicable to an investment adviser under the Advisers Act. It requires a parallel rulemaking under the Advisers Act to establish that the "standard of conduct" for brokers, dealers, and investment advisers as to investment advice provided to retail investors is to "act in the best interest of the customer." The provision defines "retail customer" as an individual or individual's representative who receives "personalized investment advice . . . and uses such advice primarily for personal, family or household purposes."

Section 103 will substantially enhance the protection of investors. Currently, brokers are held to a fiduciary duty with respect to retail investment advice only to the extent that the client can demonstrate a relationship of trust and confidence or the broker is an investment adviser under the Advisers Act. In contrast, Section 103 establishes that the providing of retail investment advice is alone sufficient to create a fiduciary duty for all brokers.

The current fiduciary standard under the Advisers Act, as set forth by the Supreme Court in *Capital Gains*[1] and in numerous federal judicial and administrative precedents, applies only to brokers who are subject to the Advisers Act. Brokers whose investment advice is solely incidental and who receive only commission-based compensation are excluded from the definition of "investment adviser" under and therefore not subject to the Advisers Act. The SEC's overbroad interpretation of the term "solely incidental" has allowed a class of brokers who provide a significant amount of personalized investment advice to avoid regulation under the Advisers Act and thereby the automatic application of the federal fiduciary standard under the Act when they provide investment advice. These brokers are subject to a fiduciary duty only when their advisory arrangements with clients create a relationship of trust and confidence. Section 103 harmonizes the federal fiduciary standard as applied to retail investment advice by establishing that brokers who provide retail investment advice are subject to a fiduciary duty under the Advisers Act, regardless of whether they are otherwise regulated under the Act.

It is unclear, however, whether the same fiduciary standard needs to applied to investment advisers through an amendment to the Advisers Act. Investment advisers already are subject to a fiduciary duty under the Advisers Act with respect to investment advice provided to all clients, whether or not it is retail in nature. There is a risk that creating a statutory fiduciary duty under the Act could be

[1] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

interpreted to narrow the scope of the existing Advisers Act fiduciary duty under *Capital Gains* and other federal court and administrative precedent. By amending Section 102 to leave the Advisers Act unchanged, the Committee could remove any possible doubt that the fiduciary applicable to investment advisers has been narrowed.

If there is a concern that fiduciary standards might be applied differently to brokers and advisers without a parallel amendment to the Advisers Act, then the amendment to the Exchange Act could simply be revised to state that, with respect to retail investment advice, brokers shall be subject to the fiduciary duty that applies to investment advisers under the Advisers Act. This approach would establish that the source of law in applying a fiduciary duty to brokers and advisers regarding retail investment advice was the same for both, without potentially affecting an adviser's fiduciary duty in other, non-retail contexts.

Restrictions on Mandatory Arbitration

Section 201 of the Act amends the Exchange Act and Advisers Act to authorize the SEC to regulate mandatory arbitration clauses in brokerage and advisory agreements. Arbitration can provide a fair and efficient means of resolving disputes that benefits brokers, advisers, and their clients. There are persuasive arguments, however, that mandatory arbitration does not serve this purpose. Many commentators have pointed to: the lack of guidance provided to arbitrators regarding applicable law; the lack of written, public decisions; the process by which panels are selected; the procedural rules governing arbitration and a host of other concerns as showing bias against brokers' customers (virtually all of the commentary has involved broker arbitration, not adviser arbitration).

Regardless of the merits of these criticisms, there can be no question that subjecting arbitration to SEC oversight will enhance the accountability of arbitration systems and increase the likelihood that FINRA and other arbitration sponsors will be

responsive to investors' concerns. The presence of an outside perspective with the authority to require change alone should encourage arbitration reform and improve public confidence in alternative dispute resolution mechanisms.

It should also be noted that the SEC previously has taken the position that a mandatory arbitration clauses in advisory agreements may violate an adviser's fiduciary duty to his client. I am not aware of that position having been expressly reversed, but it is my understanding that advisory agreements commonly include mandatory arbitration agreements (although not necessarily requiring FINRA arbitration as is the case with broker arbitration agreements). This suggests that the advisory community believes that the SEC has informally rescinded that position. In any case, Section 201's amendment of the Advisers Act to authorize the SEC to restrict the use of mandatory arbitration would implicitly overrule the SEC's position because the amendment expressly recognizes the use and implicitly the propriety of adviser arbitration clauses.

Interested Person Definition

Section 412 of the Act would amend the Investment Company Act to include in the definition of an interested person of investment company any person whom the SEC finds would be unlikely to exercise an appropriate degree of independence because of: (1) a material business or professional relationship with the company or any affiliated person of the company, or (2) a close familial relationship with any affiliated person of the company.

These provisions would provide the SEC with the flexibility that it needs to plug significant gaps in the definition of interested persons of investment companies. Noninterested directors of investment companies play an important role in protecting the interests of investors. The current definition of interested person is overbroad and allows conflicted persons to act as independent directors. For example, a former executive of an investment company's investment adviser can

join the board of the company and be considered a noninterested director, as can certain close relatives of current executives of the investment adviser. These persons cannot be expected to exercise impartial oversight of investment company operations or act as strong advocates for investment company shareholders when their interests may conflict with those of the company's adviser. Section 412 would provide the SEC with the authority it needs to ensure that these and other conflicted persons cannot claim to act as independent watchdogs for fund shareholders.

Illiquid Investments

Section 413 would provide the SEC with express authority limit mutual funds' investments in illiquid securities. Mutual funds have not been immune the current liquidity crisis. The illiquidity of short-term debt threatened to cause the per share net asset values of many money market funds ("MMFs") to drop below a dollar when they were unable to sell previously liquid securities at their carrying value. This catastrophe was narrowly averted only by government intervention. Illiquid investments held by other types of funds pose a threat to the integrity of the price at which the fund executes purchasers and redemptions. When market liquidity tightens, shareholders who are late movers in a flood of redemptions can be saddled with a disproportionate share of the fund's losses. While the SEC's longstanding 10% and 15% illiquid investment limits on MMFs and non-MMFs, respectively, have worked reasonably well, any doubt regarding its authority to impose such restrictions should be removed.

Whistleblowers

Section 605 of the Act would amend the whistleblower provision of the Sarbanes-Oxley Act of 2002 to extend coverage to subsidiaries or other affiliates whose financial information is included in the relevant public company's consolidated financial statements. This provision would ensure that the purpose of the whistleblower protections are not frustrated by organizational structures that are

irrelevant to the appropriate application of the provision. The importance of ensuring the integrity of public company reporting is in no way diminished when the information reported is that of a subsidiary or other affiliate.

Similarly, the whistleblower provision should be amended to ensure that employees of a public investment company's investment adviser are also covered. Certain investment advisers have taken the position that the whistleblower provisions do not apply to their employees because the advisers are not public companies, notwithstanding that, with respect to an investment company, the investment adviser is the entity responsible for investment company securities law compliance. An investment company's compliance functions rarely are carried out by the company's employees because investment companies generally have no employees other than persons who are also employees of the adviser. In practice, the only way for the whistleblower provisions to operate in the investment company context would be for them to apply to employees of the company's adviser.[2] Section 605 should also amend the whistleblower provision by inserting after "agent of such company," "or any officer, employee, contractor, subcontractor, or agent of an investment or principal underwriter of a registered investment company,".

[2] *See generally* Letter from Fund Democracy, Consumer Federation of America, Consumer Action and the North American Securities Administrators Association to the SEC (Mar. 28, 2008) *available at* http://www.funddemocracy.com/whistleblower%20letter%20final.pdf.

COALITION OF PRIVATE INVESTMENT COMPANIES

TESTIMONY OF JAMES CHANOS

CHAIRMAN, COALITION OF PRIVATE INVESTMENT COMPANIES

HOUSE OF REPRESENTATIVES FINANCIAL SERVICES COMMITTEE

HEARING ON REGULATING HEDGE FUNDS AND OTHER PRIVATE INVESTMENT POOLS

OCTOBER 6, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee. My name is James Chanos, and I am President of Kynikos Associates LP, a New York private investment management company that I founded in 1985.[1] I am appearing today on behalf of the Coalition of Private Investment Companies ("CPIC"), a group of private investment companies that are diverse in size and in the investment strategies they pursue, with a wide range of clients that include pension funds, asset managers, foundations, other institutional investors, and qualified wealthy individuals.[2]

I want to thank you for this opportunity to testify on the regulation of hedge funds and other private investment pools. Among other subjects, my testimony discusses the "Private Fund Investment Advisers Registration Act of 2009," as proposed by the Administration and included in the Committee's discussion draft. This draft legislation addresses several recommendations that CPIC made in prior Congressional testimony regarding private fund regulation, including requiring that private investment companies register with the Securities and Exchange Commission ("SEC") and be subject to its examination and enforcement authority. It further provides for mandatory reporting to regulators and requires that private investment companies make disclosures to investors, counterparties and creditors, as the SEC may require by rule. CPIC strongly supports those provisions of the draft legislation, with the enhancements discussed in our testimony below.

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[1] Prior to founding Kynikos Associates LP, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science.

[2] CPIC's website, www.hedgefundfacts.org, provides information on how hedge funds serve investors in U.S. and global markets. A primer can be downloaded from that site. CPIC's other website, www.financialdetectives.org, provides information about short selling.

The Administration's proposal and the Committee's draft seek to achieve effective regulation of private investment companies and their managers primarily through amendments to the Investment Advisers Act ("Advisers Act") and broad delegations of rulemaking authority to the SEC. CPIC has proposed in prior Congressional testimony that the Committee consider drafting a special "Private Investment Company" statute. This would have the advantage of being tailored to private investment funds, and would thereby address their unique characteristics and risks, while being less reliant upon a broad grant of rulemaking authority to the SEC.

Whatever approach this Committee decides to undertake, CPIC believes legislation to regulate private investment funds should include the following core requirements to protect investors and address the potential for systemic risks:

- Register private funds with the SEC. Each fund and its investment manager should be subject to SEC inspection, enforcement authority, and record-keeping requirements.
- Apply the registration requirement to all private funds, including venture capital, private equity, and hedge funds, without regard to their asset class or investment strategy.
- Subject private funds to tough, comprehensive custody and audit requirements to protect investors from theft, Ponzi schemes, and fraud.
- Require private funds to provide robust disclosures to investors, counterparties, and lenders, to assure that all of these parties have sufficient information to assess the risks of investing with, or doing business with, private funds.
- Direct private funds to provide basic census data in an online form, available to the public.

- Require private funds to implement anti-money laundering programs, just as broker-dealers, banks, and open-end investment companies must do.
- Mandate that larger private funds adopt risk management plans to both identify and control material risks, and address orderly wind-downs.
- Require larger funds to provide additional reports that enable regulators to assess potential systemic risks posed by large private funds and other large financial institutions.

CPIC believes that these statutory requirements will benefit investors by putting into place a comprehensive regulatory framework that enhances the regulators' ability to monitor and address systemic risks while providing clearer authority to prevent fraud and other illegal actions. We look forward to working with you and your staff as you consider the legislation.

I. Investor Benefits and Risk Mitigation Functions of Private Pools of Capital

Your letter asked that witnesses address how private pools of capital contribute to, or mitigate, systemic risk. Let me begin by briefly addressing the significant benefits of hedge funds and other private investment funds in the U.S. and global markets — benefits that have been widely acknowledged over many years by government and private sector groups, including the President's Working Group on Financial Markets ("PWG"), the Commodity Futures Trading Commission, the SEC, and the Federal Reserve Board, as well as numerous investors who view private funds as essential to their investment programs.[3]

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[3] *See, e.g.*, Remarks of Ben S. Bernanke, who called hedge funds a "positive force in the American financial system." Hearing, Nomination of Ben S. Bernanke to be a Member and Chairman of the Board of Governors of the Federal Reserve System, S. Comm. on Banking, Housing and Urban Affairs, S. HRG. 109–551 (Nov. 15, 2005), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_senate_hearings&docid=f:26610.pdf. Other financial regulators also view hedge funds as a positive force. For example, the United Kingdom's Financial Services Authority (FSA), releasing a March 2006 report on hedge funds, reiterated its view that hedge funds are "a vital segment of the financial services industry. In particular they play a fundamental role in the efficient

As this Committee knows, our markets benefit from the wide diversity of market participants: investment bankers and broker-dealers, commercial banks, savings institutions, mutual funds, commodity futures traders, exchanges and markets of all types, traders of all sizes, and a variety of managed pools of capital, including venture capital funds, private equity funds, commodity pools, and hedge funds.

Private investment funds play significant, diverse roles in financial markets and the U.S. and global economies. They offer investors opportunities to diversify their portfolios and thereby improve risk-adjusted returns and reduce market volatility. Venture capital funds are an important source of funding for start-up companies or turnaround ventures. Private equity funds provide growth capital to established small-sized companies, while still others pursue "buyout" strategies by investing in underperforming companies and providing them with capital and/or expertise to improve results. These funds may focus on providing capital in such particular sectors as energy, real estate, and infrastructure.

Hedge funds invest in or trade a variety of financial instruments worldwide, including stocks, bonds, currencies, futures, options, other derivatives, and physical commodities. Some invest in securities and hold long-term positions, such as some long-short funds and short-only funds.[4] Some are strictly traders. Many serve as important counterparties to other participants in

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reallocation of capital and risk, and remain an important source of liquidity and innovation in today's markets." Press Release, FSA (Mar. 23, 2006) *available at* www.fsa.gov.uk/pages/Library/Communication/PR/2006/026.shtml. *See also* Statement of Joseph A. Dear, Chief Investment Officer, California Public Employees' Retirement System, S. Comm. on Banking, Housing, and Urban Affairs, Regulating Hedge Funds and Other Private Investment Pools (July 15, 2009), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e83f7ca1-6f94-4854-8aa9-ef0ac11b4bb0. In a survey by Preqin Ltd., 56 percent of institutional investors surveyed responded that their primary reason for investing in hedge finds was for "diversification purposes/to decrease volatility." *See Overview of the Global Hedge Fund Institutional Investor Universe: Special Report*, Nov. 2008, *available at* http:/www.preqin.com/docs/reports/Preqin_Hedge_Research_November08.pdf.

[4] Using the components of the Credit Suisse/Tremont Hedge Fund Index as a proxy, 26.2 percent of hedge funds are event driven; 21.9 percent are long/short equity; 17.2 percent are global macro; 15.0 percent are multi-strategy; 8.0

the market who wish to offset risk. Hedge funds who short securities help mitigate the risk of upward price manipulations. Some hedge funds may become "activists" and use a large equity position in a company to encourage management to make changes to increase shareholder value. Hedge funds, as a group, add to the depth, liquidity, and competitiveness of the markets in which they participate. The individuals who run them bring their research and insight to bear on the value of various assets, thereby adding to the price discovery and efficiency of capital markets. Also, they typically commit their personal capital to the funds they manage.

The Chief Investment Officer of the California Public Employees' Retirement System ("CalPERS"), Joseph Dear, calls hedge funds and other alternative investments "indispensable elements" of many public pensions' investment programs.[5] Mr. Dear recently testified that CalPERS invests in private equity and hedge funds to diversify its investment portfolio, manage risk, and add value to the total fund. As he explained, the important benefits of investing in private funds include "effective risk management and investment value creation through allowance for the diversification of our portfolio across a broad array of asset classes."[6]

II. Risks Posed by Private Pools of Capital

For several years, prior to the recent economic downturn, some believed that hedge funds and other private pools of capital would be the source of the next financial crisis. However, as we have all learned painfully, the greatest danger to world economies came not from those entities subject to indirect regulation, such as hedge funds, but from banks, insurance companies,

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percent are emerging markets; 3.9 percent are managed futures, 3.5 percent are fixed income arbitrage, 2.0 percent are equity market neutral; 1.8 percent are convertible arbitrage, and 0.4 percent are dedicated short bias. *Available at* http://www.hedgeindex.com/hedgeindex/en/weights.aspx?ChartType=PieChart&cy=USD&indexname=HEDG.

[5] *See* Statement of Joseph A. Dear, *supra* n. 3.

[6] *Id.*

broker-dealers, and government-sponsored enterprises that operated with charters and licenses granted by state and federal regulators and under direct regulatory supervision, examination, and enforcement. Indeed, Bernard Madoff used his firm, Bernard L. Madoff Investment Securities, LLC — which was registered with the SEC as a broker-dealer and investment adviser and subject to examination and regulation — to perpetrate his Ponzi scheme. The Stanford Group of companies used an SEC-registered broker-dealer and SEC-registered investment adviser to market, among other products, certificates of deposit of an affiliated offshore bank.

Private investment funds are not part of the federal government's "safety net," as are insured depository institutions. No federal guarantees are provided to their investors. Moreover, while some hedge funds are large, they are dwarfed by the sizes of such financial institutions as commercial and investment banks, the government-sponsored enterprises, and others. Despite the rapid growth and size of hedge funds (an estimated 8,900 funds, with an estimated $1.89 trillion in assets as of August 31, 2009), their relative size within the financial sector is small, accounting for about one percent of investments in the world's financial assets — including equities, government and private debt, and deposits.[7] Private investment funds do not participate as intermediaries in payment and settlement systems. Since counterparties to hedge funds and other private investment funds do not rely on a federal safety net or supervision, they typically require higher levels of capital and liquidity and strong collateral from private funds, as compared to their transactions with more heavily regulated financial institutions. Furthermore,

[7] The total number of hedge funds has been estimated at 8,900 as of June 30, 2009. *See* Hedge Fund Research, Inc., *HFR Global Hedge Fund Research Report, Second Quarter 2009,* at 18. *Available for purchase at* http://www.hedgefundresearch.com. Total hedge fund assets have been estimated at $1.89 trillion at the end of August 2009, according to HedgeFund.net. *See HFN Monthly Performance Report: August 2009,* Sept 21,2009, *available at* http://www.hedgefund.net/hfn_public/marketing_index.aspx?template=whatsnew.cfm?story_id=10438. The total value of the world's financial assets—including equities, government and private debt, and deposits—was $196 trillion in 2007. *See* McKinsey Global Institute, *Mapping Global Capital Markets: Fifth Annual Report* (Oct. 2008), *available at* http://www.mckinsey.com/mgi/publications/fifth_annual_report_Executive_Summary.asp.

leverage ratios for hedge funds are very conservative, about two to three on average compared to much higher levels of leverage at many banks.[8] For all these reasons, when a private fund fails, it is not as likely to set off a chain reaction, such as we saw when Lehman Brothers collapsed.

In a rare case, such as that involving the super-leveraged Long Term Capital Management in 1998, it is possible that a private fund could grow to a level of size, leverage, and interconnectedness that it might pose systemic risk. Yet, in our experience, the most prominent risks associated with hedge funds relate to the relationship between funds, their managers, their investors, and discrete counterparties. In a nutshell, these are the risks of unfair dealing with clients, lack of transparency, certain custody issues, potential fraud, and conflicts of interest.

Congress has sought to ensure that hedge funds and other private funds deal appropriately with their investors by imposing conditions on the exemptions from registration under the Securities Act of 1933, the Investment Company Act of 1940 ("Investment Company Act"), and in some cases the Commodity Exchange Act ("CEA"), under which they operate.[9] To meet these exemptions, the laws require hedge funds to limit their offerings to private placements with high-net-worth, sophisticated investors who are able to understand and bear the investment risks. A private fund must either limit its beneficial owners to not more than 100 persons and entities

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[8] *See, e.g.*, the report by Lord Adair Turner, Chairman of the FSA, noting that "[h]edge fund leverage is typically well below that of banks – about two to three on average," compared to levels of 40 or 50 times that at some European banks. The Turner Review, *A Regulatory Response to the Global Banking Crisis*, March 2009, at 72-3 and Exhibit 2.5, *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf. *See also Hedging the Blame*, Wall St. J. Europe, Mar. 20, 2009, *available att* http://online.wsj.com/article/SB123749754096088683.html; *AIMA Statement on the Turner Review*, Mar. 18, 2009, *available at* http://www.aima.org/en/announcements/other-recent-announcements/aima-statement-on-the-turner-review.cfm. In addition, a December 2008 survey of more than 6,000 hedge fund managers by PerTrac Financial Solutions found that 26.9% of managers reported using no leverage, and as many as 42% of hedge funds may be using less than 2:1 leverage. *See* Press Release, *A Broad View of Hedge Fund Performance Reveals Plenty of Strong Performers, Low Leverage and Additional Myth-Busters*, Dec. 4, 2008, *available at* http://www.hedgefundlawblog.com/hedge-fund-performance-performance-better-than-expected.html.

[9] *See Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, at 11-18, 23-25 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf ("Staff Report").

(typically all or most of whom are "accredited investors"), or limit its investors to super-accredited "qualified purchasers," such as individuals with more than $5 million in investments and institutions with more than $25 million in investments. Private funds typically file exemptive notices with the SEC and state securities commissioners under Regulation D of the Securities Act of 1933. Many also file notices with the National Futures Association under the CEA exemptions by which they operate (which impose their own additional restrictions on sophistication and qualifications of investors).

Moreover, the SEC and criminal prosecutors have significant regulatory and enforcement authority to address potential risks posed by private funds — both risks to their clients and other market participants. For example, private investment funds are subject to the same restrictions on their investment and portfolio-trading activities as most other securities investors, including margin rules[10] (which limit the use of leverage to purchase and carry publicly traded securities and options); SEC Regulation SHO[11] (which regulates short-selling); the Williams Act amendments to the Securities Exchange Act of 1934 ("Exchange Act")[12] and related SEC rules (which require public reporting of the acquisition of blocks of securities and regulate other activities in connection with takeovers); and the Financial Industry Regulatory Authority, Inc. ("FINRA") "new issues" Rule 5130 (which governs allocations of IPOs).[13] Private investment funds also must abide by the rules and regulations of the markets in which they seek to buy or sell financial products. Perhaps most important, they are subject to antifraud and anti-

[10] 12 C.F.R. §§ 220, 221.

[11] 117 C.F.R. §§ 242.200-204.

[12] The Williams Act added Exchange Act §§13(d), 13(e), 14(d), 14(e) and 14(f), 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e) and §78n(f) in 1968. Related legislation added Section 13(g), §78m(g), in 1977.

[13] The SEC approved FINRA's proposal to adopt former NASD Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) as FINRA Rule 5130, with only minor changes, on August 25, 2008. *See* Release No. 34-58421, 73 Fed. Reg. 51032 (Aug. 29, 2008).

manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934[14] and Rule 10b-5,[15] and insider trading prohibitions that apply to both the funds' investment and portfolio trading activities and the funds' offers and sales of units to their own investors. Private fund advisers also are subject to the antifraud provisions in Section 206 of the Advisers Act, which applies to registered and unregistered investment advisers.[16]

However, regulators' lack of detailed information about private investment funds — the absence of a registration requirement and the inability of a regulator to subject unregistered private funds to periodic reporting and examination — may handicap the SEC in meeting its investor protection mandate, and may limit financial regulators in addressing potential systemic risks. Therefore, CPIC for many years has advocated that the SEC, at a minimum, should have authority to collect certain "census" data regarding all private investment funds. We have also advocated basic protections for investors in private funds, including disclosure requirements (particularly with respect to valuation of fund assets) and custody requirements, as well as audits by accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB").

III. Private Sector Recommendations for Best Practices

Private sector groups, often working with regulators, have developed best practices for hedge funds, and the industry continues to improve in the areas of risk management and client protection. For example, the Managed Funds Association has initiated and updated a "Sound

[14] 15 U.S.C. § 78j(b).

[15] 17 C.F.R. § 240.10b-5.

[16] 15 U.S.C. § 80b-6.

Practices" guide for hedge funds.[17] Institutional investors have strengthened their "due diligence" processes and have demanded more information and stronger risk management approaches from the funds in which they invest.[18] As a report by the Government Accountability Office ("GAO") in May 2009 noted, "hedge fund advisers have improved disclosure and become more transparent about their operations ...."[19]

Since its formation in 1999, the PWG has shared information regarding private investment funds with regulators and also has launched initiatives with the private sector, including the PWG's appointment in 2007 of an Asset Managers' Committee, on which I served, and an Investors' Committee. Each committee issued reports earlier this year on best practices for private fund managers and investors, respectively.[20]

In my view, one of the most important recommendations of the report of the Asset Managers' Committee ("AMC Best Practices") is that managers should disclose more details — going beyond Generally Accepted Accounting Principles — regarding how their funds derive

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[17] *Sound Practices for Hedge Fund Managers,* Managed Funds Association, 2009 ed., *available at* http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf.

[18] A survey by Constellation Investment Consulting found that hedge fund managers now expect intensive due diligence. The study included over 300 participants consisting of money managers, investors and service providers. Eighty (80) percent of the managers and 75 percent of the service providers stated that they expect due diligence teams to conduct valuation analysis, test trades, review trade tickets, and perform additional risk management procedures. In addition, to ensure additional oversight, 83 percent of the investors are insisting that funds use independent administrators to perform accounting and bookkeeping functions. The study also showed that investors are "shaken, but not deterred" from including hedge fund investment in their portfolios. *See Constellation Investment Consulting Announces that Hedge Fund Managers Welcome Invasive Due Diligence,* Business Wire, Mar. 18, 2009, available at http://www.reuters.com/article/pressRelease/idUS139769+18-Mar-2009+BW20090318.

[19] *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges.* GAO-09-677T, May 7, 2009, at 11, *available at* http://www.gao.gov/new.items/d09677t.pdf.

[20] *See, e.g., Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets,* Jan. 15, 2009, *available at* http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf; *Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets*, Jan. 15, 2009, *available at* http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.

income and losses from Financial Accounting Standard ("FAS") 157 Level 1, 2, and 3 assets.[21] Another recommendation in our report is that a fund's annual financial statements should be audited by an independent public accounting firm that is subject to PCAOB oversight. Still another recommendation would assure that potential investors are provided with specified disclosures relating to the fund and its management before any investment is accepted. This information should include any disciplinary history and pending or concluded litigation or enforcement actions, fees and expense structure, the use of commissions to pay broker-dealers for research ("soft dollars"), the fund's methodology for valuation of assets and liabilities, any side-letters and side-arrangements, conflicts of interest and material financial arrangements with interested parties (including investment managers, custodians, portfolio brokers, and placement agents), and policies as to investment and trade allocations. Our report also recommended specified disclosures to counterparties and creditors to assure that they can fully assess the risks of their relationships with private funds.

Notwithstanding the improvements made by the private sector through these various efforts, those of us who are in the private investment fund industry recognize that a modernized financial regulatory system — one that addresses overall risk to the financial system and that regulates in a consistent manner market participants performing the same functions — should include appropriate regulation of hedge funds and other private pools of capital. Therefore, CPIC believes many of the recommendations put forward by the Asset Managers' Committee should be given legal effect. I would urge this Committee to carefully tailor the legislation to

[21] In brief, under FAS 157, Level 1 assets are those that have independently derived and observable market prices. Level 2 assets have prices that are *derived from* those of Level 1 assets. Level 3 assets are the most difficult to price — prices are derived in part by reference to other sources and rely on management estimates. Disclosure of profits and losses from these categories will allow investors to better assess the diversification and risk profile of a given investment, and to determine the extent to which fund valuations are based on the "best guess" of fund management.

preserve the flexibility of private funds and their capacity for innovation that has long benefited investors and capital markets.

IV. Proposed Legislative Changes

As this Committee is aware, private investment companies and their advisers are not required to register with the SEC if they comply with the conditions of certain exemptions from registration under the Investment Company Act and the Advisers Act.[22] Congress created exemptions under these laws, because it determined that highly restrictive requirements applicable to publicly-offered mutual funds and advisers to retail investors were not appropriate for funds designed primarily for institutions and wealthy investors.

To date, legislative proposals to regulate private investment companies have focused primarily on limiting the exemptions from regulation of private investment companies under the

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[22] Section 3(c)(1) of the Investment Company Act excludes a company from the definition of an "investment company" if it has 100 or fewer beneficial owners of its securities and does not offer its securities to the public. Under the Securities Act of 1933 and SEC rules, an offering is not "public" if it is not made through any general solicitation or advertising to retail investors, but is made only to certain high-net-worth individuals and institutions known as "accredited investors." "Accredited investors" include banks, broker-dealers, and insurance companies. The term also includes natural persons whose individual net worth or joint net worth with a spouse exceeds $1 million, and natural persons whose individual income in each of the past two years exceeds $200,0000, or whose joint income with a spouse in each of the past three years exceeds $300,000, and who reasonably expect to reach the same income level in the current year.

Section 3(c)(7) of the Investment Company Act excludes a company from the definition of an "investment company" if all of its securities are owned by persons who are "qualified purchasers" at the time of acquisition and if the company does not offer its securities to the public. Congress added this section to the Investment Company Act in 1996 after determining that there should be no limit on the number of investors in a private investment fund, provided that all of such investors are "qualified purchasers." In brief, "qualified purchasers" must have even greater financial assets than accredited investors. Generally, individuals that own not less than $5 million in investments and entities that own not less than $25 million in investments are qualified purchasers.

Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser that, during the course of the preceding twelve months has had fewer than fifteen clients and that does not hold itself out as an investment adviser nor act as an investment adviser to any investment company. Advisers to hedge funds and other private investment companies are generally excepted from registration under the Advisers Act by relying upon Section 203(b)(3), because a fund counts as one client.

In some cases, where these companies and their advisers engage in trading commodity futures, they also comply with exemptions from registration under the "commodity pool operator" and "commodity trading advisor" provisions of the CEA. These exemptions generally parallel the exemptions from registration under the securities laws.

Investment Company Act or removing an exemption under the Advisers Act and thus subjecting private investment companies or their advisers to the requirements of one of those Acts.[23] I have testified that simply eliminating the exemptions under the Investment Company Act or the Advisers Act is insufficient to address the potential risks posed by private investment companies, the types of investments they hold, and the contracts into which they enter.[24] Moreover, because the Advisers Act and the Investment Company Act were designed primarily for retail investor protection in individual accounts that invest in publicly traded stocks and bonds, they contain many provisions that would either be irrelevant to oversight of private investment companies or unduly restrictive of their operation.[25]

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[23] For example, H.R. 711 simply strikes the "private adviser" exemption under Section 203(b)(3) of the Advisers Act and makes private funds subject to the Advisers Act in its entirety. A bill introduced in the Senate, S. 344, attempts a more tailored approach by altering the current private fund exemptions under the Investment Company Act to make them conditional exemptions, available only where a fund registers with the SEC and provides specified disclosures. Another Senate bill, S. 1276, strikes the private adviser exemption and includes additional provisions to assure SEC authority to examine both the adviser and its funds, and enhances the ability of the SEC to tailor its rules for different types of advisers.

[24] In my testimony before the SEC's public roundtable on hedge funds in 2003, I recommended that, as a further condition to exemption under the Advisers Act, hedge funds should be subject to specific standards relating to investor qualifications, custody of fund assets, annual audits and quarterly unaudited reports to investors, clear disclosure of financial arrangements with interested parties, clear disclosure of investment allocation policies, and objective and transparent standards for valuation of fund assets that are clearly disclosed, not stale, and subject to audit. Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003) (*available at* http://sec.gov/spotlight/hedgefunds/hedge-chanos.htm).

When I testified before the Senate in 2004, I expanded upon these points and recommended that the SEC require, as a condition to a hedge fund's exemption under the Advisers Act, that hedge funds file basic information with the SEC and certify that they meet the standards outlined above. Testimony before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on Regulation of the Hedge Fund Industry (Jul. 15, 2004) (*available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=79b80b77-9855-47d4-a514-840725ad912c). *See also* Letter from James Chanos to Jonathan Katz, SEC (Sept. 15, 2004) (*available at* http://www.sec.gov/rules/proposed/s73004/s73004-52.pdf). This would have provided the SEC with hedge fund "census" data it has long said it needs; it also would have provided a basis for SEC enforcement action against any fund failing to meet the above standards. Had the SEC adopted this recommendation, the agency would have avoided the legal challenge to the rule it adopted later that year to change its interpretation of the term "client" under the Advisers Act in order to require hedge fund managers to register. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). As this Committee knows, the SEC's hedge fund adviser registration rule was struck down in 2006 (*id.*) and the SEC decided not to appeal.

[25] For example, Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis may work against investors' needs by impinging on a fund's ability to seize rapidly emerging opportunities, particularly in the case of private equity and venture capital funds. Such funds

For that reason, CPIC has proposed in prior testimony that Congress consider drafting a stand-alone "Private Investment Company" statute. This would have the advantage of being tailored to private investment funds, and would thereby address their unique characteristics and risks, while being less reliant upon a broad grant of rulemaking authority to the SEC.

The Administration's proposal and the Committee draft have instead taken the approach of amendments to the Advisers Act. Both proposals remove the private adviser exemption under the Advisers Act and then go several steps further, giving the SEC examination authority over funds advised by a registered adviser and also giving the SEC broad rulemaking authority for record-keeping, reporting, and disclosure. They also enhance the SEC's existing authority to write rules to address different types of advisers. Thus, we believe these proposals offer a way to provide effective oversight and regulation of private fund managers, if they are sufficiently strengthened and tailored, as further discussed below.

Registration of Private Funds

The proposals would generally apply to investment advisers to any "private fund," which would include any investment fund that relies on the exemptions from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act, and that is either organized in or created under the laws of the U.S. or has 10 percent or more of its outstanding securities owned by U.S. persons. The existing mandatory threshold for SEC registration of $30 million in assets under management would continue to apply.[26] The proposals would not require registration of "foreign

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routinely conduct transactions as principal or as a co-investor alongside affiliated funds, and transaction-by-transaction consents from large numbers of private fund investors are, as a practical matter, not possible to collect.

[26] Section 203A of the Advisers Act states that no investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is required to register with the SEC under section 203 of the Advisers Act unless the investment adviser has assets under management of $25 million or more (or such higher amount as the SEC prescribes by rule), or is an adviser to a registered investment company. Under Rule 203A-1 of the Advisers Act, the SEC raised the mandatory threshold for registration to $30

private advisers" — those with no place of business in the U.S. and fewer than 15 clients in the U.S. and less than $25 million in assets under management (or such higher amount prescribed by the SEC) if the foreign adviser does not generally hold itself out in the U.S. as an investment adviser, and is not an investment adviser to a registered investment company or business development company.

The Committee draft (but not the Administration's proposal) would exempt advisers to venture capital funds from SEC registration, although the SEC would be given authority to request information from such advisers concerning the funds. We question whether a category of private funds should be relieved of SEC registration, record-keeping, and inspection solely by virtue of its asset class and operations. Indeed, Ponzi schemes and frauds can be run with any asset class, and the lines between different categories of private funds tend to blur over time. We believe the registration requirement should apply to all private funds, whether they are hedge funds, private equity funds, or venture capital funds. In addition, registration should entail requirements for the filing of basic census data in an online publicly available form.

SEC Examination Authority

The proposals provide that records of the registered adviser's related private funds (those exempted under sections 3(c)(1) and 3(c)(7) of the Investment Company Act) are deemed to be records of the adviser and subject to SEC inspection. Thus, the SEC would have authority under the Advisers Act over all private fund managers (other than foreign advisers and venture capital funds) meeting the specified threshold, and would have broad inspection authority over all

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million of assets under management for advisers in states with an investor adviser statute. SEC registration is optional for certain investment advisers that have between $25 and $30 million of assets under management. The proposed legislation does not change these provisions.

records of related private funds, even though the funds themselves would not be registered. We support this provision.

Record-Keeping and Reporting/Systemic Risk Oversight

The proposals would authorize the SEC by rule to require investment advisers to keep records and submit reports necessary for the assessment of systemic risk by the Federal Reserve (and, under the Administration's proposal, the proposed new Financial Services Oversight Council); authorize the SEC to require investment advisers to maintain those records for a period of time; and authorize the SEC to share information with the Federal Reserve, but otherwise provide that the SEC shall not be required to disclose any of the reports filed. We support these provisions and also believe that any broader systemic risk regulation the Committee develops should include private funds, depending, of course, on their size and level of leverage and interconnectedness.

Special Requirements for Large Funds

We also believe consideration should be given to establishing requirements for a fund (or a family of funds and/or its manager) that controls gross assets in excess of a specified amount that would not apply to smaller private investment companies. For example, larger funds should be required to implement disaster recovery, business continuity, and risk management plans to identify and control material operational, counterparty, liquidity, leverage, and portfolio risks.[27] In addition, such a fund should be required to adopt a detailed plan to address liquidity and to conduct an orderly wind-down that assures parity of treatment of investors in the event of a major liquidity event.

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[27] These requirements are consistent with the AMC Best Practices.

Tailored Rules for Different Types of Advisers

The proposals would further amend existing section 211 of the Advisers Act to enhance the SEC's authority to adopt different sets of rules to address different types of advisers. Under this authority, the SEC could, for example, write a set of rules under the Advisers Act applicable only to advisers to private funds and tailored for those advisers.[28]

Disclosures to Investors, Creditors, and Counterparties

The proposals also would require that advisers make disclosures to investors, counterparties, and creditors, as the SEC may prescribe by rule — but without specification as to what those disclosures should be. Here, we suggest that the Committee may wish to do more than simply delegate this task to the SEC. We recommend providing more direction and more specificity, such as requiring that private funds or their managers provide potential investors with specific disclosures before accepting any investment, and provide existing investors with ongoing disclosures.[29] Among other things, a private fund should be required to disclose in detail its methodologies for valuation of assets and liabilities, the portion of income and losses that it derives from FAS 157 Level 1, 2 and 3 assets,[30] and any and all investor side-letters and side-arrangements. Likewise, private funds should have to disclose the policies of the fund and its investment manager as to investment and trade allocations. They should also disclose conflicts of interest and financial arrangements with interested parties, such as their investment managers, custodians, portfolio brokers, and placement agents. Funds should also be transparent

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[28] For example, the SEC could address current Advisers Act restrictions on transactions with affiliates conducted as principal that require client consent on a transaction-by-transaction basis. *See* n. 25, *supra*.

[29] This requirement is consistent with the AMC Best Practices.

[30] *See* n. 21 *supra*.

with respect to their fees and expense structures, including the use of soft dollars. Investors should receive audited annual financial statements and quarterly unaudited financial statements.

Lenders and counterparties should be provided with information sufficient to assess the risk of doing business with the private fund, including the company's audited annual financial statements, current private placement memorandum, information as to the fund's valuation methodology, the existence of side-letters and side-arrangements and any material conflicts of interest or financial arrangements.

Custody Requirements

We believe the legislation should include provisions to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, and by requiring investment funds to be audited by independent public accounting firms that are overseen by the PCAOB.[31] Custody requirements should be extended to all investments held by covered funds. Fund assets should be held in the custody of a bank, registered securities broker-dealer, or for futures contracts, a futures commission merchant. While the SEC has adopted custody rules for registered advisers pursuant to its antifraud authority under the Advisers Act (and recently proposed amendments to those rules), we believe Congress should provide specific statutory direction to the SEC to adopt enhanced custody requirements for all advisers.[32]

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[31] This requirement is consistent with the AMC Best Practices, and should be designed to close gaps in the protections provided by the Advisers Act custody rule.

[32] We believe the SEC's custody rules under the Advisers Act are insufficient to protect private investment fund assets from theft or prevent other forms of fraud. For example, the rules exclude from custody requirements certain types of instruments that are commonly owned by private investment funds, an exclusion that would deprive investors in those funds of the protection that a custodian provides. These instruments are privately-issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds, as well as shares of mutual funds, which, under current law, can simply be titled in the name of the private investment fund in care of the manager, and the evidence of ownership held in a file drawer at the manager of the private investment fund. The issuers of these assets are permitted to accept instructions from the manager to transfer cash or other assets to the manager. This hole in current Advisers Act custody requirements can allow SEC-registered

Anti-Money Laundering

We also believe private investment companies should be required to implement customer identification and anti-money laundering programs, and file suspicious activity reports and currency transaction reports, just as securities broker-dealers, banks, and open-end investment companies are required to do.[33] Currently, neither registered investment advisers nor registered closed-end investment companies are subject to customer identification or other formal anti-money laundering rules.

We believe the legislation offers this Committee and the Congress an opportunity to set its priorities for private fund regulation, through greater specificity in its delegation of rulemaking authority to the SEC, and through the establishment of specific timetables for proposing and completing the rulemaking in particular areas.[34]

V. Conclusion

Private investment companies have operated remarkably well in the absence of direct government oversight and subject to the due diligence of sophisticated, high-net-worth investors.

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advisers to abscond with money or other assets and falsify documentation of ownership of certain categories of assets, and makes it difficult for auditors, investors and counterparties to verify the financial condition of advisory accounts and private investment funds. Requiring independence between the function of managing a private investment fund and controlling its assets, by requiring that *all assets* be titled in the name of a custodian bank or broker-dealer for the benefit of the private fund and requiring *all cash flows* to move through the independent custodian would be an important control. Similarly, requiring an independent check on the records of ownership of the interests in the private investment fund, as well as imposing standards for the qualification of private investment fund auditors — neither of which currently is required by the Advisers Act — would also greatly reduce opportunities for mischief. Detailed formal requirements on the means by which private investment fund assets enter and exit the custodian's control are needed to assure that the fund's assets really exist and cannot easily be stolen. CPIC has filed a comment letter with the SEC in connection with its pending rulemaking, in which we advocate a further strengthening of the custody rules.

[33] This requirement is consistent with the AMC Best Practices.

[34] In this regard, it is not clear whether the six-month deadline for rulemaking in section 7 of the Committee draft would apply to all rules relating to disclosures (to investors, counterparties, creditors) unless they were also filed in "reports" with the SEC.

CPIC nonetheless supports the call for enhanced oversight, with the SEC as the primary functional regulator. But, simply imposing new regulation without properly tailoring it to address the relevant risks would add to the burdens of hard-working, but already overstretched agency staffs. Moreover, simply requiring registration under the Advisers Act could degrade investor due diligence by causing undue reliance upon SEC regulation under statutes that are insufficiently robust to address the unique characteristics of private funds. We have testified in the past that we believe that the twin goals of improved investor protection and enhanced systemic oversight could be better achieved with a stand-alone statute, tailored for private investment funds. However, we believe the Committee draft can accomplish these goals, if it includes the key provisions and enhancements discussed above.

We appreciate the work this Committee is doing in crafting legislation in this area, and we stand ready to work with you in the days ahead. Thank you for giving CPIC the opportunity to testify on this important subject.

Testimony of Denise Voigt Crawford

Texas Securities Commissioner and

President

North American Securities Administrators Association, Inc.

Before the

House Financial Services Committee

"Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office"

October 6, 2009

Chairman Frank, Ranking Member Bachus, Members of the Committee,

I am Denny Crawford, Texas Securities Commissioner and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I am honored to be here today to discuss legislative changes that are most relevant to the millions of Main Street Americans who are looking to lawmakers and state and federal regulators to help them rebuild and safeguard their financial security. At this critical time in the nation's history, it's imperative that our system of financial services regulation be improved to better protect investors, markets, and the economy as a whole. I commend the Financial Services Committee for its deliberative approach of holding comprehensive hearings to determine how best to improve our financial regulatory system.

In November 2008, NASAA released its *Core Principles for Regulatory Reform in Financial Services* and subsequently recommended a pro-investor legislative agenda for the 111th Congress. We are pleased that many of our proactive policy recommendations to better protect investors and restore confidence in our financial markets are now being debated as part of the broader regulatory reform agenda. Today, I would like to highlight the suggestions that we feel are most vital to sound regulatory reform and strong investor protection.

State Securities Regulatory Overview

The securities administrators in your states are responsible for enforcing state securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, pursuing cases of suspected investment fraud, and providing investor education programs and materials to

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards. We are often called the "local cops on the securities beat," and I believe that is an accurate characterization. While the recent financial crisis was the result of many failures, I am very proud to say that a failure of state securities regulation was not one of them.

Through the years, states have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. We have successfully exposed and addressed the profound conflicts of interest among Wall Street stock analysts by requiring changed behavior. We led all regulators on late trading and market timing in mutual funds. We address on a daily basis abusive sales practices targeting vulnerable senior investors.

State securities regulators continue to lead the effort to ensure that investors receive redemptions for their frozen auction rate securities that were marketed as safe and liquid investments, an effort that already has resulted in the largest return of funds to investors in history. In the last few years, it has been state securities regulators who have been at the forefront of investor protection. Our record demonstrates clearly that we have the will and ability to regulate.

Investor Protection Act Initiatives

The proposals set forth in the Obama Administration's Investor Protection Act ("IPA") and further enhanced in the Committee's October 1 "Discussion Draft" do much to improve investor protection and help restore confidence and integrity to our markets. Included in the Discussion Draft are provisions designed to facilitate communication and the sharing of information between the Securities and Exchange Commission ("SEC") and other regulators. The sharing of information among state and federal regulators is an important element in ensuring that investors are protected. Unfortunately, though, the

sharing of information by the Financial Industry Regulatory Authority ("FINRA") with state and federal regulators has been less than optimal. Claiming that the sharing of information implicates "state actor" questions, FINRA regularly declines to share information with government regulators about examinations and investigations.

Because self-regulatory organizations ("SROs") are private corporations and do not have subpoena power, their members are required to "voluntarily" cooperate with investigators and provide testimony and documents. This has given rise to claims that FINRA, when it cooperates with governmental regulators, is acting as a quasi-governmental actor or "state actor". In turn, FINRA cites the "state actor doctrine" as the reason for non-cooperation with state securities regulators. However, courts have consistently held that the mere sharing of information with state securities regulators who are bringing administrative actions cannot trigger the application of state actor status.[2] Indeed, in one case where a party argued that the NASD[3] is a quasi-governmental agency, the court held to the contrary, stating: "NASD is not a government agency: it is a private, not-for-profit corporation chartered in Delaware."[4]

Barriers to sharing information create regulatory gaps and as we are all too aware, certain industry participants will exploit those gaps to the detriment of all investors.

While there are quite a large number of important matters addressed in both the IPA and the Discussion Draft, today I will focus on three proposals in the IPA that are of utmost importance to individual investors.

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[2] *See*, D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc., 279 F.3d 155, 16 (2d Cir. 2002). *See also*, *Marchiano v. NASD*, 134 F. Supp. 2d 90, 95 (D.D.C. 2001); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000); *OHO DOE, v. Ficken*, Disciplinary Proceeding No. C11040006, October 15, 2007

[3] The NASD was a self-regulatory organization of the securities industry. FINRA was formed by a consolidation of the enforcement arm of the New York Stock Exchange, NYSE Regulation, Inc., and the NASD on July 26, 2007.

[4] *Graman v. Nat'l Ass'n of Secs. Dealers*, 1998 U.S. Dist. LEXIS 11624 (D.D.C. 1998). *See also*, *Desiderio v. NASD*, 191 F.3d 198 (2d Cir. 1999) (holding arbitration provision in brokers employment did not implicate state actor doctrine)

1. Establishment of a Fiduciary Duty for Broker-Dealers Who Provide Investment Advice.

Today, financial services providers – generally stockbrokers and investment advisers – are regulated under two different statutes, though their services are marketed in a way that makes them indistinguishable to investors. The two different regulatory schemes for broker-dealers and investment advisers provide different, uneven levels of protection for customers and clients of the financial intermediaries. Brokers are required to know a client's financial situation well enough to understand a client's financial needs, and to recommend investments that are suitable for the client based on that knowledge. This is referred to as a suitability standard. Investment advisers, on the other hand, are subject to a higher standard – the fiduciary standard. As fiduciaries, investment advisers have long established and well defined duties including: 1) an affirmative duty of care, loyalty, and honesty; 2) an affirmative duty to act in good faith; and, 3) a duty to act in the best interests of their clients.

The migration of stockbrokers into the advisory arena through the marketing of brokers as "trusted advisers" and "financial advisors" over the years has fueled confusion among investors as to the services provided by stockbrokers and investment advisers as well as the level of protection. The SEC, regrettably, has been unwilling to address this problem by, for instance, prohibiting stockbrokers from using titles that infer a relationship that is based on trust and reliance. Fortunately, the Administration's White Paper demonstrates a clear understanding of the different standards and the concomitant harm to investors and proposes the appropriate solution—a true fiduciary duty for broker-dealers that provide investment advice.

The IPA, in section 913, specifically addressed the issue of a fiduciary duty for broker-dealers and that concept is present in the Committee's Discussion Draft in Section 103. The language in Section 103 acknowledges that broker-dealers providing investment advice should be subject to a fiduciary duty. Moreover, it should be the same fiduciary duty applicable under the Investment Advisers Act of 1940 ("IA Act") to

investment advisers.[5] This is such an important issue for investors, however, that Congress should make it clear through explicit language that the SEC must adopt rules no later than one (1) year from passage of the act mandating compliance by broker-dealers with this provision. There should be no equivocation in the language and to the extent that rulemaking is required it should be limited to simply effectuating this requirement.

Further, given that investment advisers are subject to a fiduciary duty, there would seem to be little benefit to inserting this language into the IA Act as suggested in Section 103 of the discussion draft. In fact, taking this step may very well open the door to an argument that the duty as described in the discussion draft is somehow different than the standard adopted by the Supreme Court.[6]

Some industry affiliated groups have also called for the imposition of a fiduciary duty standard.[7] However, upon close examination, their "new federal fiduciary standard" is hardly the pro-investor fiduciary duty that has permeated investment adviser regulation for over four decades. Rather, the industry groups are advocating for the development and imposition of an undefined concept that would potentially supplant longstanding principles of fiduciary law embodied in decades of common law. Despite assertions to the contrary, the fiduciary duty applicable today to investment advisers is a single standard that requires the adviser to put a client's interests ahead of its own at all times by providing advice and recommending investments that the adviser views as being the best for the client. Because they are subject to a fiduciary duty, investment advisers are required to provide up-front disclosures about their qualifications, what services they provide, how they are compensated, possible conflicts of interest, and whether they have any record of disciplinary actions against them.[8]

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[5] 15 U.S.C. §80b-1 *et seq.*

[6] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963)

[7] *See* Securities Industry and Financial Markets Association press release entitled "SIFMA Unveils New Pro-Consumer Reforms" available at http://www.sifma.org/news/news.aspx?id=12442. *See also*, remarks of Rick Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority available at http://www.finra.org/Newsroom/Speeches/Ketchum/P119009.

[8] This information - along with other important disclosure information about the adviser - is contained in a mandatory disclosure document and must be provided by an investment adviser to clients prior to entering into a contract for advisory services.

Brokers are generally not considered to have a fiduciary duty to customers, although this standard may apply in certain limited circumstances. Instead, brokers are required to know a client's financial situation well enough to understand the client's financial needs and to recommend investments that are suitable for the client based on that knowledge. They are not required to provide up-front disclosure of the type provided by investment advisers.

As noted in the Treasury Department's white paper on financial regulatory reform, from the point of the investor, an investment adviser and a stockbroker who provide advice appear in all respects identical. In order to address the issue of investor confusion and to better protect investors, the standard for broker-dealers providing investment advice should be, as proposed by the Treasury Department, "raised" to the fiduciary standard in order to align it with the legal framework applicable to investment advisers.

2. Authority to Restrict Mandatory Pre-dispute Arbitration. Today, virtually every broker-dealer includes in its customer agreements a predispute arbitration provision that forces public investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration run by FINRA. The only chance of recovery for most investors who fall victim to wrongdoing on Wall Street is through a single securities arbitration forum controlled by the securities industry.

NASAA believes the "take-it-or-leave it" clause in brokerage contracts is inherently unfair to investors, and that it's time to end mandatory, industry-run arbitration. We believe that Congress should prohibit the mandatory nature of securities arbitration. Short of an outright Congressional prohibition, Section 201 of the Discussion Draft is a positive step in the right direction, but it should be amended to ***require*** that the SEC prohibit mandatory, predispute arbitration and offer a meaningful choice between binding arbitration and civil litigation. This choice should be solely that of the investor. If arbitration really is fair, inexpensive, and quick, as its adherents claim, then these benefits will prompt investors to choose arbitration. If, on the other hand, arbitration

does not offer these advantages, then this mode of dispute resolution should not be forced upon the investing public.

When arbitration is inadequate to protect the substantive rights of investors, an independent judicial forum must be an option. Arbitration may be desirable and adequate if both parties knowingly and voluntarily agree to waive the constitutional rights provided in court. If an investor decides to waive his or her constitutional rights, this decision should be made at the time the dispute arises, not at the time the account is opened. At this point, both parties may make the determination whether their particular dispute is best decided in a court of law (especially small claims court) with court-supervised discovery, a written opinion, and appellate review of complex legal issues.

Securities arbitration cases are heard by a three-member panel that includes one "non-public" or securities industry member, and two "public" members, who may have worked in the industry. Neither of the public arbitrators is required to be an investor advocate, even though the non-public arbitrator *is* required to be an industry representative, and only FINRA, the industry SRO, selects who is qualified to be in the arbitrator pool. The arbitration process will be both perceptively and fundamentally unfair to investors as long as arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who could have ties to the industry.

In a 2008 study for the Securities Industry Conference on Arbitration (SICA)[9], entitled, "Perceptions of Fairness of Securities Arbitration: An Empirical Study" ("the SICA study"),[10] Professors Jill Gross and Barbara Black surveyed participants in the

[9] The Securities Industry Conference on Arbitration (SICA) was established in 1977 with the support of the SEC to create a Uniform Arbitration Code to harmonize the rules of the various SRO arbitration forums then in existence. Since 1977, SICA has met on a regular basis to discuss SRO arbitration and to review and revise the Uniform Code. Besides three public members, all the SROs also have had voting membership in SICA along with the SIA (Securities Industry Association, now SIFMA), and the SEC has regularly attended quarterly meetings. SICA also drafted and revised the Arbitrator's Manual that was in use at the NASD and NYSE.

[10] Gross, Jill and Black, Barbara, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (February 6, 2008). U of Cincinnati Public Law Research Paper No. 08-01. Available at SSRN: http://ssrn.com/abstract=1090969

arbitration process. According to the SICA study, nearly half (48 percent) of the customers surveyed believed their arbitration panel was biased; 76 percent of the customers found arbitration "very unfair" or "somewhat unfair" as compared to court; 70 percent were dissatisfied with the outcome; more than 60 percent would not choose arbitration in the future; and 49 percent stated that the arbitration process was too expensive.

The SICA study's results are alarming, and they support what state regulators have been hearing from investors in their states – investors believe that the arbitration forum they are forced to participate in is rigged against them.

No further studies are necessary. NASAA believes that the securities arbitration system should be truly voluntary, and the balance in the composition of FINRA arbitration panels should be restored.

3. Aiding and Abetting. One of the purposes of the Securities Act of 1933 and the Investment Advisers Act of 1940 was to establish higher standards of conduct in the securities industry than already existed in common law. Sections 206 and 207 of the Discussion Draft do much to further this purpose by explicitly providing the SEC the authority to prosecute those secondary actors who aid and abet violations of these Acts. However, NASAA believes that the interests of investors would be best served by amending Sections 206(b) and (c) and 207(f) to remove the language, "brought by the Commission." By expressly stating "brought by the Commission", the language may inadvertently be read as an implicit exclusion of private rights of action. Certainly this is what defendants will argue.

In passing the original legislation, Congress implicitly authorized a private right of action and for decades thereafter, courts allowed private suits. The right to bring a private suit for aiding and abetting was restricted by the Supreme Court in *Central Bank*

of Denver[11] and basically eliminated by the Supreme Court in *Stoneridge Investment Partners*. [12] The decisions in these cases interpret the securities laws in a way that protects big business, emboldens secondary actors to engage in manipulative practices, and sets an extremely high bar for defrauded shareholders to seek compensation from wrongdoers. Corporations and secondary actors often seek short-term profits, big bonuses, and large fees, and in too many instances these goals can be achieved by cooking the books or engaging in sham transactions. Given the complexity of corporate activity, secondary actors such as accountants and lawyers now play a critical in the preparation and dissemination of public information. If they are allowed to avoid liability for their actions, there will be no deterrent to prevent them from engaging in fraudulent schemes.

In denying investors the right to bring private aiding and abetting actions, the majority in Stoneridge contends that such actions can be brought by the SEC on behalf of shareholders. In reality, the SEC is not in the position to take on this task. In an April 2009 speech, Chairman Schapiro stated: "Quite frankly, our enforcement and examination resources have been seriously constrained in recent years." (Speech to Council of Institutional Investors, April 6, 2009). In its March 2009 performance audit, the Government Accounting Office ("GAO") found that "Investigative Staffing Has Fallen and Resource Challenges Undermine the Ability to Bring Enforcement Actions."[13] Further, the GAO Report stated, "Enforcement management and investigative attorneys told us that resource challenges hinder the ability to bring cases," and "Investigative attorneys with whom we spoke cited a number of resource challenges that have undercut their efforts, causing significant delays in bringing cases, reducing the number of cases that can be brought, and potentially undermining the quality of cases."[14]

Critics of private securities actions claim that such cases provide little benefit to victims, punish innocent shareholders, and unjustly reward plaintiffs' lawyers. These

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[11] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).
[12] *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008).
[13] GAO, *Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement,* GAO-09-358 (Washington, D.C.: March 31, 2009)
[14] *Id.*

arguments have limited merit. With regard to victim compensation, over the years, private actions resulted in greater recoveries for shareholders than the compensation from regulatory actions. The fact that victims were not able to recover full damages is the result of a number of factors including the corporation's inability to pay and shareholders' desire to settle for less rather than to spend more time in litigation. The contention that paying defrauded victims harms innocent, current shareholders is not applicable in cases involving wrongdoing by secondary actors. Shareholders want accountability and the right to sue for wrongdoing; management and secondary actors are the ones invoking shareholder harm arguments in their attempt to avoid all accountability for their illegal acts. If management is concerned about current shareholders, it might alleviate the cost to shareholders by stripping away the bonuses, high salaries, and stock options awarded to those who participated in the fraud and make those assets available for victim restitution. With regard to plaintiffs' lawyers' fees, it is important to understand that class action settlements, including attorney's fees, are reviewed by the courts. Judges decide whether plaintiffs' attorneys' fees are appropriate.

Allowing investors to file aiding and abetting cases will not open the floodgates of litigation and stifle businesses. Private suits were allowed prior to the *Central Bank* and *Stoneridge* decisions and businesses grew and flourished during those years. It is important to remember that corporate actors who engage in fraud are not merely making bad business decisions - no legitimate business school teaches deceptive acts and practices as part of its curriculum. Deceptive and manipulative transactions that are intended to defraud investors cannot be classified as ordinary business decisions and perpetrators, whether primary or secondary actors, should not be allowed to hide behind corporate law protections.

The dissent in the *Stoneridge* case noted that Congress enacted Section 10(b) of the Securities Exchange Act with the understanding that federal courts respected the principle that every wrong would have a remedy. If aiding and abetting liability is not restored by Congress, innocent victims of investment fraud will be left without a remedy against the entities or persons that assisted in perpetrating the fraud.

Additional Reforms to Better Protect Investors

Increased State Regulation of Investment Advisers. As evidenced by the Inspector General's report on the Madoff affair[15] and the testimony of SEC Chairman Schapiro and other SEC staff before Congress,[16] the bulk of federally covered investment advisers are examined infrequently. To the extent examinations are conducted, the SEC has demonstrated a lack of fundamental understanding as to the business of registrants, even with experienced staff.[17] A clear "oversight gap" has existed for some time and is now emerging into public view. NASAA members are fully prepared and equipped to fill this gap by accepting responsibility for the oversight of investment advisers up to $100 million in assets under management.

NASAA members possess a number of unique qualifications that ensure the permanent closure of the "oversight gap." NASAA members are geographically proximate to the investment adviser population, and this proximity ensures accessibility. Investors may walk into the offices of state securities regulators and be assured that their complaint will be evaluated. Because of this accessibility, state regulators are most often the investor's first point of contact when there is a problem with their adviser. NASAA members have frequent contact with registrants, which in turn, allows for the detection of wrongful conduct in its nascent stage. Further, wrongful conduct is generally prevented in the first instance due to the frequent contact with state examiners. Plus, NASAA members are the only regulators that license investment adviser representatives – the

[15] *See,* Report of the Office of Inspector General, U.S. Securities and Exchange Commission, Review and Analysis of OCIE Examinations of Madoff Investment Securities, LLC, September 29, 2009 at Page 8.
[16] *See,* Testimony of SEC Chairman Mary L. Schapiro before the Subcommittee on Financial Services and General Government, June 2, 2009, Testimony of Andrew J. Donohue, Director, SEC Division of Investment Management before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, July 15, 2009. *See also,* Appendix to Testimony of Chairman Mary L. Schapiro before the United States Senate Committee on Banking, Housing and Urban Affairs, March 26, 2009 (noting 86 percent of SEC registered investment advisers were unexamined in 2008).
[17] Testimony of H. David Kotz, Inspector General, U.S. Securities and Exchange Commission before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 10, 2009. *See also*, Report of the Office of Inspector General, U.S. Securities and Exchange Commission, Review and Analysis of OCIE Examinations of Madoff Investment Securities, LLC, September 29, 2009.

individuals providing investment advisory services. Our members thereby have a view of not only the entities providing investor advisory services, but also the individuals who interact with investors.

Additionally, NASAA members have nearly 50 years of experience conducting examinations and taking enforcement actions against investment advisers. The experience of NASAA members in the application of fiduciary duty sets them apart from SROs whose experience is limited to the suitability standard. Because investment adviser regulation is complex and substantively different from the regulation of broker-dealers, the experience of NASAA members is all the more critical. It is vital that the "oversight gap" be closed as quickly as possible, yet training to the level of basic competence would take years. NASAA members are trained in investment adviser regulation, and are already experts in such oversight. NASAA members are ready to deploy their resources now.

State securities regulators have a long record of investor protection and adviser oversight that is superior to the federal regime and any contemplated SRO model because of the advantages of proximity, experience, and knowledge.

Establishment of a Systemic Risk Council. Because individual behavior is not reliably rational during just those times when systemic safety is in jeopardy, NASAA believes that optimal communication and associated systemic risk mitigation could best be accomplished by establishing an independent "Systemic Risk Council," in which both state and federal financial services regulators would conduct high-level strategy meetings where analyses would be shared and prophylactic risk assessments and recommendations would be made.

Any solution ultimately decided by Congress must provide enhanced communication among state and federal regulatory authorities. A "Systemic Risk Council" would effectively establish a crisis management protocol with clear and regular lines of communication among all regulators.

State and federal governments are the natural providers of systemic safety including the need to insure liquidity, stability and reliability, and a well-functioning financial system. The private sector cannot provide such systemic safety.

Including state regulators on the council is necessary and appropriate. In all financial sectors, state regulators gather and act upon large amounts of information from industry participants and from investors. Consequently, they serve as an early warning system. As a general proposition, state regulators are usually the first to identify risks and related trends that are substantial contributing factors to systemic risk. The complexity of financial markets has exceeded the competency capacity of federal regulators alone. This provides further evidence for the need of a state banking, insurance, and securities regulator on the "Systemic Risk Council."

Conclusion

NASAA appreciates the opportunity to present our views on financial services regulatory reform. State securities regulators believe that enhancing our securities laws and regulations and ensuring they are being vigorously enforced is the key to restoring investor confidence in our markets. NASAA and its members are committed to working with the Committee to ensure that the nation's financial services regulatory regime undergoes the important changes that are necessary to enhance Main Street investor protection, which the states have effectively provided for nearly 100 years.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE FEDERAL INSURANCE OFFICE

October 6, 2009

Statement Made by
Dennis S. Herchel
Assistant Vice President & Counsel
Massachusetts Mutual Life Insurance Company

Mr. Chairman, Ranking Member Bachus and members of the Committee, my name is Dennis Herchel and I am Assistant Vice President and Counsel for Massachusetts Mutual Life Insurance Company. I am here today on behalf of the American Council of Life Insurers (ACLI), the principal trade association for U.S. life insurance companies. The ACLI's 340 member companies account for approximately 93% of the industry's total assets, 94% of the industry's domestic life insurance premiums and 94% of its domestic annuity considerations.

I appreciate the opportunity to appear before you today to share our views on the proposed substitute amendment to H.R. 2609, which would create the Federal Insurance Office (FIO) within the Department of the Treasury. This amendment, based largely on a proposal circulated earlier this summer by the Administration, is a proposal the ACLI strongly supports. In fact, given the breadth of the Administration's proposed response to the financial crisis and the applicability of that response to insurers, we believe it is imperative that the status and role of the FIO within the federal systemic risk regime be strengthened beyond what has been proposed. Doing so will ensure that insurance industry issues are given parity of consideration and importance by the systemic risk regulator to that given to issues affecting other financial industry sectors if broader reform is enacted. Our testimony today will focus both on possible changes to the proposal we believe can achieve that goal, as well as amendments that we think will improve the role of the FIO as originally envisioned.

We support the FIO for many of the same reasons we have supported past proposals to create the Office of Insurance Information, both this year and in 2008. Then as now, we believe the FIO would be enormously beneficial to Congress as it considers issues that are vitally important to our business; would facilitate the handling of international insurance matters; and would provide a means for

effectively involving the insurance industry as national policy decisions are made affecting U.S. financial institutions.

The events of the past 12 months have only served to strengthen the arguments for creating this Office. The financial crisis has all too clearly illustrated the problems associated with the lack of insurance industry expertise at the federal level. As you know, for some time now the ACLI has advocated for the creation of a federal regulatory presence, in the form of an optional federal charter, as the best way to modernize U.S. insurance regulation while also filling the federal government's gap in insurance industry knowledge and expertise. In light of the recent crisis and the various legislative proposals in response, and short of Congressional action creating a federal insurance regulator, we believe it is imperative that Congress act now to establish the FIO.

As proposed, the FIO would effectively serve two roles: it would be the federal government's repository of insurance industry information and expertise and also act as the United States' international representative on insurance issues. It would not have any supervisory or regulatory authority over any insurer doing business in the U.S. In addition to these parameters, which we support and will discuss further below, we believe the FIO should be elevated in status so that it can participate actively and effectively with federal financial industry regulators, including a systemic risk regulator, under any new systemic risk regulatory paradigm that may be implemented. Doing so will ensure that actions and decisions affecting insurers are taken only after any proposed systemic risk regulator has had direct consultation and coordination with the FIO. Given the lack of federal insurance industry expertise today, we believe this role is a critical one for the FIO to fulfill.

The Administration's systemic risk regulation proposal places the Federal Reserve Board (Board) in the position of ultimate systemic risk regulator. As such, the Board would be given broad authority to determine which companies pose "systemic risk", designate them as "Tier 1 Financial Holding Companies", and exercise broad prudential regulatory powers over Tier 1 companies and all of their subsidiaries. This authority would include the power to require increased capitalization or changes in management activities. This power is tempered only slightly, as the Board is required to consult and coordinate with the federal functional regulator of a Tier 1 company or its subsidiary before instituting any supervisory action or enforcement proceeding against it. However, since there is no federal functional insurance regulator, there would be no equivalent consultation or coordination when it comes to Board decisions affecting insurers that are either designated Tier 1 or are subsidiaries of a Tier 1.

Given that the Board is purely a banking regulator and has no insurance regulatory expertise, we believe this result to be highly inappropriate and is potentially damaging to insurers and their customers. The Board would be required to coordinate with other banking regulators, even though it has strong expertise in that area. However, the fact that it would not be required to act similarly when it comes to another major financial industry -- with which it has virtually no regulatory experience -- is an unacceptable contradiction of sound regulatory policy. From our perspective, this glaring oversight reinforces our concerns with the federal government's lack of understanding of the insurance industry (a concern magnified by the fact that the Administration's new Bank Holding Company Act proposal inexplicably fails to include insurance companies altogether in its statutory list of "functionally regulated subsidiaries"). Insurance is a highly regulated industry, where companies who do business in more than one state are supervised by a functional regulator in each of those jurisdictions. Insurance companies are subject to a strict financial solvency regime. Establishing

a systemic risk regulatory system that ignores these facts is an imprudent approach for the federal government to take, and is likely to result in unintended negative consequences for the industry, its customers and the economy.

We believe one solution to this problem is to give the FIO a role equivalent to that of federal functional regulators when it comes to dealing with the Board on all aspects of systemic risk regulation. For example, the Board should be required to coordinate and consult with the FIO whenever a Board supervisory or enforcement action is directed at an insurer in the same way and to the same degree it is required to do so with federal functional regulators of other entities. The FIO should be required to act as intermediary between the Board and an insurer's domestic state regulator regarding any proposed Board action. And the FIO should be given a seat on the proposed Financial Services Oversight Council so that the Council is constantly and contemporaneously made aware of relevant insurance industry issues. These and other changes in the FIO's status as to its relationship to the systemic risk regulator will help address insurer concerns and vastly improve whatever systemic risk regulatory regime is ultimately enacted by Congress.

In addition to these parity issues, we believe the proposal should be amended in a number of ways which, we believe, help strengthen and effectuate the role originally envisioned for the Office. First, we would not want to see the FIO's preemption authority in relation to international agreements employed in a way that leads to a real or potential regulatory "solvency gap." We do believe there may be circumstances under which the FIO can appropriately use preemption to advance sound international insurance policies without giving rise to such a gap, but any enacted language must make clear that such situations are the only circumstances when this power could be used. Also, we would not want to see preemption result in any material, unfair discrimination against any U.S. insurer.

While we do not believe use of preemption should be withheld if it can be used to realize the benefits provided under mutual or unilateral recognition agreements, we support a clear administrative due process prior to any preemption action to ensure that neither of these undesirable outcomes results from such action.

Second, we think it is important to explicitly direct that a portion of the funds appropriated to the FIO be used to secure and retain personnel with an appropriate level of insurance industry experience and expertise. As noted earlier, there is a significant gap in insurance industry knowledge at the federal level today. In order for the FIO to successfully fulfill its charge, it will be absolutely necessary to staff it from day one with personnel who are well versed in the workings of the industry. This becomes even more important given the need to have the FIO act as the federal expert on all things insurance in interactions with any future systemic risk regulator and international solvency matters. Additionally, Congress may want to consider establishing an insurance industry advisory committee that the FIO can look to and work with on important industry issues during the early years of its tenure to ensure it receives input from industry experts.

Third, we think it is important to clarify that the FIO is not to have any general supervisory or regulatory authority over insurance companies. We understand that that is the intent of the proposal, but as currently drafted there is ambiguous language that could cause confusion on this issue at some point in the future. The industry does not support adding an additional regulator on top of the 50+ we already have, and so we believe complete clarity of this intent should be stated within any final bill before it moves forward.

There are a number of additional general adjustments to the proposal that we recommend occur prior to its final enactment. Briefly, these include:

- Clarification that the FIO may represent the U.S. before any and all international organizations, as appropriate;

- Clarification that any information collected by the FIO directly from an insurer will be afforded the same confidentiality protection as information obtained by the FIO from a state or federal regulatory agency; and

- Expansion of the content contained in the FIO's annual report to Congress to include information on the state of the U.S. insurance regulatory system and updates on the FIO's ability to carryout its designated functions under the Act.

Mr. Chairman, we believe the need for establishment of the FIO is now self-evident and, with the addition of the changes we have outlined for you here today, we fully support enactment of the proposed substitute amendment to H.R. 2609. Thank you for giving us the opportunity to present our views, and we look forward to working with you and other members of this Committee as this legislation moves forward.

STATEMENT OF SPENCER M. HOULDIN

ON BEHALF OF THE

INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

October 6, 2009

Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. My name is Spencer Houldin, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA). Thank you for the opportunity to provide our association's perspective on proposals to create a federal office of insurance. I serve as Chairman of the IIABA Government Affairs Committee as well as the Connecticut representative on the IIABA Board of Directors. I am also President of Ericson Insurance, a

Connecticut-based independent agency that offers a broad array of insurance products to consumers and commercial clients across the country.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a broad range of personal and commercial insurance products.

The Economic Crisis and State Insurance Regulation

Over the past year, this Committee has held many important hearings on the economic crisis and on proposals to reform and rebuild our nation's financial regulatory structure. The events of the last twelve months raise many serious questions about the state of financial markets, the manner in which they are regulated, and the appropriate regulatory reforms. Congress has faced and continues to face many challenges and difficult policy questions, and I commend you for your diligent, thorough, and responsible efforts to date. As you continue to identify and assess existing problems and determine what actions this Committee should take, it is important to note that state insurance regulation has performed with distinction throughout the crisis and has greatly outshined its federal counterparts in other financial sectors.

IIABA has long supported state regulation of insurance, and the sensibility of that position has been reinforced and strengthened over the last year. During a tumultuous time, state insurance regulators have admirably and effectively ensured that insurers are solvent, that claims are paid, and that consumers are protected. These state officials have decades of experience, outnumber their banking and securities counterparts, handle countless inquiries and questions

from consumers, and understand the concerns and the often unique issues facing the citizens in their areas. State insurance regulation has a long and stable track record of accomplishment – especially in the areas of solvency regulation and consumer protection – but its benefits and merits have never been more apparent.

State regulation is imperfect and can certainly be improved (including through the use of targeted federal action), but the economic crisis also highlights and reinforces the pitfalls and serious deficiencies associated with creating an optional federal insurance regulatory system. When large financial services entities are permitted to select the regulator of their choice, they will select the path of least resistance and the system that best serves their business interests. That choice may not be – and is often not – what is in the best interest of the consumer, and our nation now has ample evidence of what can arise when regulatory arbitrage of this nature occurs.

Establishing a Federal Insurance Office (FIO)

The Administration and the Treasury Department released their much anticipated regulatory reform blueprint – entitled *Financial Regulatory Reform: A New Foundation* – in June. The comprehensive 88-page white paper appropriately did not call for the dismantling or sweeping overhaul of state insurance regulation, but it did propose the establishment of a non-regulatory insurance information office within the Treasury Department. The creation of such an office has previously been championed by Capital Markets Subcommittee Chairman Paul Kanjorski and others on this Committee, and the Capital Markets Subcommittee passed a well-crafted version of this legislation in 2008.

Although IIABA strongly supports state insurance regulation and would oppose any effort to undermine that system, we recognize the benefits that can be achieved by establishing a

non-regulatory body at the federal level that is able to review industry data, advise federal officials on critical insurance issues, and coordinate efforts on international insurance matters. It is imperative, however, that any statute authorizing the establishment of an insurance information office be designed carefully and with the proper safeguards and not "set the stage" for federal insurance regulation.

IIABA supports H.R. 2609 as introduced in May, but we have significant concerns with several of the revisions unveiled in the discussion draft circulated by the Committee late last week. The version introduced by Chairman Kanjorski just several months ago was a carefully constructed and thoroughly vetted proposal with proven bipartisan support, and it also had near unanimous support from what is often a highly splintered insurance market. Industry voices on all sides of the insurance regulatory reform debate expressed support for the bill upon its introduction, and the National Association of Insurance Commissioners previously voiced its support for that particular version as well. We strongly hope any legislation adopted by this Committee will closely resemble the original iteration.

There are several critical elements of the original version of H.R. 2609 that are – at a minimum – essential to any legislation that creates a federal insurance information office. Specifically, any proposal should make clear that the office does not possess supervisory or regulatory authority over the business of insurance. H.R. 2609 contains several provisions that ensure that neither the insurance office nor the Treasury Department would possess such authority, but these are not part of the new discussion draft. IIABA therefore encourages the Committee to add a provision stating that nothing in the proposal may be construed to establish a general supervisory or regulatory authority of the office or the Treasury Department over the business of insurance. In the alternative, language could be added to prohibit the application of

the preemption provisions in instances where preemption will result in: (1) a need to establish a general supervisory or regulatory authority of FIO or the Treasury Department over any entity involved in the business of insurance or insurance operations in the United States, or (2) a gap or void in the financial or market conduct regulation of any entity involved in the business of insurance or insurance operations in the United States.

IIABA also believes the information gathering provisions of any proposal should ensure that the insurance information office is not redundantly and inefficiently collecting information available elsewhere, and H.R. 2609 included important protections governing how certain data may be obtained and utilized. In addition, the discussion draft will have the unintended effect of enabling this office to compel main street insurance agents to produce data and information upon demand. We therefore urge the Committee to revise the definition of "insurer" so that it applies, as it should and as intended, only to insurers and reinsurers. At the very least, we believe that this office should be required to establish an exemption to the submission requirements for all covered entities meeting a minimum size threshold, instead of only permitting the office to set up a de minimis exemption as current language sets forth. Explicitly requiring such an exemption would ensure that small agencies and insurers are not unduly burdened by information demands.

Any legislation should also include clear and meaningful administrative and procedural provisions for the handling of any preemption deliberations, but the discussion draft eliminates many of the due process protections and requirements contained in the original version. We therefore urge the Committee to establish additional safeguards that would apply in those instances when the office is considering whether a state law should be preempted, such as:

- Requiring that the U.S. or its representative coordinate with state regulators on international insurance issues and confer with regulators before entering into an

International Insurance Agreement on Prudential Measures in order to identify the potential impact and preemptive effects the agreement might have on existing law;

- Enable affected states and aggrieved parties to appeal a final preemption determination to the Secretary;
- Revise the definition of "International Insurance Agreement on Prudential Measures" to ensure that such agreements adequately protect U.S. consumers; and
- Delete the ambiguous phrase "directly or indirectly" from the preemption standard in §313(f)(1)(A).

The modifications proposed above are important elements of H.R. 2609 and do not adversely affect the overall substance and effect of the legislation. We believe that these changes would ensure that the scope of powers of this office are limited and focused and would eliminate any concern of regulatory mission creep. Our preeminent concern and focus is ensuring that the insurance information office does not operate as a de facto federal insurance regulator or serve simply as a precursor to federal insurance regulation. It has repeatedly been stated, from when this legislation was introduced last year to when the concept was embraced by the Administration earlier this year, that the FIO is not meant as a step towards federal regulation. Our conditional support for this concept is tied directly to these commitments. Therefore, any overt or subtle efforts to make the insurance office look more like a regulatory body or to set it up to become a forerunner to federal regulation – either by providing it with regulatory power or analyzing whether it should eventually be given regulatory authority – would unfortunately force IIABA to vigorously oppose any such proposal.

Conclusion

State insurance regulation has a strong track record of regulating insurers and protecting consumers, and it has been particularly successful over the last year. Nevertheless, most objective observers recognize that the state system suffers from certain inefficiencies. State insurance regulation has been criticized because (1) state officials are unable to enter into international insurance agreements, which hinders their ability to represent the United States in international insurance discussions and (2) there is a lack of institutional insurance knowledge in the nation's capital. The establishment of a non-regulatory insurance information office with limited and delineated responsibilities would effectively address these two challenges. Such targeted legislation would fill the void of insurance expertise that currently exists at the federal level and remedy many of the problems faced by insurance industry participants in the global economy.

Testimony by

Richard G. Ketchum
Chairman and CEO
Financial Industry Regulatory Authority (FINRA)

Before the
Committee on Financial Services

U.S. House of Representatives

October 6, 2009

Chairman Frank, Ranking Member Bachus and Members of the Committee:

I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

I commend you, Mr. Chairman, for holding today's hearing on the critically important topic of reforming our regulatory structure for financial services, with a particular focus on proposals to harmonize the regulation of broker-dealers and investment advisers and addressing the role of arbitration in the securities industry.

As someone who has spent the great majority of my career as a regulator, dedicated to protecting investors and improving market integrity, I am deeply troubled by our system's failures during the last two years. I strongly believe that we must act to pursue comprehensive reforms that will make the financial sector's regulatory architecture more robust, will help prevent a repeat of the kind of volatility we have recently witnessed and—most importantly—will strengthen investor protections.

In the wake of the events of the last two years, all of us involved in regulating the financial markets must take a hard and honest look at our programs and approaches, and search for ways to more effectively uncover misconduct and enhance investor protection. At FINRA, that process is well underway. Already this year, we have enhanced our routine examination programs and procedures for better detecting fraud. We have conducted training programs for examiners aimed at fraud detection. We have also instituted new procedures surrounding review of employer/employee arbitration matters. In March 2009, we established FINRA's Office of the Whistleblower to handle high-risk tips. FINRA has also just announced the establishment of a new Office of Fraud Detection and Market Intelligence. This new unit will provide a heightened review of incoming

allegations of serious frauds, a centralized point of contact internally and externally on fraud issues and consolidate recognized expertise in expedited fraud detection and investigation.

In addition to these efforts, in April 2009, the FINRA Board of Governors established a special committee to conduct a review of FINRA's examination program as it relates to the detection of fraud, specifically Ponzi schemes, including those operated by Bernard Madoff and allegedly perpetrated by R. Allen Stanford. The Special Review Committee, chaired by former U.S. Comptroller General Charles A. Bowsher and assisted by outside counsel, recently concluded its review and presented its findings to the FINRA Board.

Based on the independent review's findings, several key points are apparent. First, FINRA must institute a number of internal reforms to better safeguard investors and the broader financial system. Second, the report calls attention to the many regulatory challenges related to jurisdictional issues and product definitions. Finally, the review points to the urgent need for financial regulatory reform that ensures comprehensive oversight, reduces jurisdictional confusion, streamlines enforcement and improves coordination and communication among all regulators.

In response to the findings and recommendations of the special committee, FINRA is developing plans to implement additional changes to its programs, including: further enhancing fraud-detection measures across all aspects of our examination program; improving our technology systems to better support cross-organizational information sharing to support examinations; working with the SEC and other regulators to increase data sharing related to FINRA-regulated firms; and continuing to seek expanded jurisdiction that would close the regulatory gaps between broker-dealers and investment adviser firms.

The special committee's report provides an important roadmap for FINRA to become a more efficient regulator. I assure you and this Committee that I am fully committed to making the necessary changes to strengthen our programs and raise the level of protection for all investors. We look forward to continuing working closely with this Committee and the SEC as we implement these additional initiatives to make FINRA an even stronger and more efficient regulator.

FINRA

FINRA is the largest non-governmental regulator for securities brokerage firms doing business in the United States. Congress mandated the creation of FINRA's predecessor, NASD, in 1938. Federal law charges FINRA with the responsibility to examine broker-dealers for compliance with and enforce the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board

and FINRA rules. The SEC has oversight responsibility for FINRA and regularly examines FINRA's programs to ensure that we comply with our statutory responsibilities.

FINRA, with a staff of 2,800, provides the first line of oversight for broker-dealers. FINRA registers and educates industry participants, examines broker-dealers and writes rules that those broker-dealers must follow; enforces those rules and the federal securities laws; and informs and educates the investing public. FINRA oversees nearly 4,800 brokerage firms, about 173,000 branch offices and more than 646,000 registered securities representatives.

FINRA augments and deepens the reach of the federal securities laws with detailed and enforceable ethical rules and a host of comprehensive regulatory oversight programs. Significantly, FINRA is funded by regulatory fees – not taxpayer dollars. FINRA's Board of Governors is comprised of a majority of non-industry representatives. The uniquely balanced structure of our Board ensures a paramount focus on investor protection and the opportunity for input from a diverse variety of perspectives.

FINRA's Core Investor Protection Programs

►*Examinations*

FINRA has a comprehensive examination program with dedicated resources of more than 1,000 employees. Routine examinations are conducted on a regular schedule that is established based on a risk-profile model. This risk-profile model is very important: It permits us to focus our resources on the sources of most likely harm to average investors. We apply our risk-profile model to each firm, and our exams are tailored accordingly. In performing its risk assessment, FINRA considers a firm's business activities, methods of operation, types of products offered, compliance profile and financial condition, among other things.

During routine examinations, FINRA examines a firm's books and records to determine if they are current and accurate. Sales practices are analyzed to determine whether the firm has dealt fairly with customers when making recommendations, executing orders and charging commissions or markups and markdowns. Anti-money laundering, business continuity plans, financial integrity and internal control programs are scrutinized.

In addition, FINRA conducts more narrow examinations based on information that we receive, including investor complaints, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. In 2008, FINRA conducted almost 2,500 routine examinations and nearly 6,500 targeted examinations.

►*Enforcement*

FINRA's Enforcement Department is dedicated to vigorous and evenhanded enforcement of the Securities Exchange Act and FINRA and MSRB rules. FINRA brings disciplinary actions against firms and their employees that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry. FINRA frequently requires firms to provide restitution to harmed investors and often imposes other conditions on a firm's business to prevent repeated wrongdoing.

In 2008, FINRA filed over 1,000 enforcement actions. FINRA collected over $28 million in fines and the settlement of its auction-rate securities cases returned in excess of $1 billion to investors. FINRA expelled or suspended 19 firms, barred 363 individuals from the industry and suspended 321 others. Over the past decade, FINRA issued 12,158 decisions in formal disciplinary cases, expelled or suspended 208 firms and barred or suspended 7,496 individuals.

►*Registration, Testing and Continuing Education*

Persons employed by a broker-dealer that engage in a securities business must register with FINRA. As part of the registration process, applicants must disclose their prior employment and disciplinary history, since certain prior conduct may prevent registration. FINRA also develops and administers qualification examinations that securities professionals must pass to demonstrate competence in the areas in which they will work. FINRA further administers a continuing education program that every registered person must satisfy. FINRA administers 28 qualifications exams to over 275,000 people every year, including examinations that support the MSRB, state regulators and National Futures Association programs.

FINRA maintains the Central Registration Depository (CRD), the central licensing and registration system for the U.S. securities industry and its regulators. CRD contains the qualification, employment and disciplinary histories of firms and brokers, making it the world's largest and most sophisticated online registration and reporting system.

FINRA's BrokerCheck system makes publicly available, free of charge, certain information about firms and brokers, including disciplinary histories that can inform an investor's decision as to which firm or broker to use.

FINRA also developed, for the SEC, the Investment Adviser Registration Depository, a utility that allows federal- and state-regulated investment advisers to satisfy mandated licensing requirements. FINRA makes information about investment adviser firms publicly available.

Under contract with the Conference of State Bank Supervisors, FINRA also developed the Nationwide Mortgage Licensing System (NMLS). NMLS is a web-based system that allows state-licensed mortgage lenders, mortgage brokers and loan officers to apply for, amend, update or renew licenses online for participating state agencies using a single set of uniform applications. Twenty-three states are currently participating in the NMLS system. Encouraged by the passage of the Housing and Economic Recovery Act of 2008, 10 additional states plan to participate in the system during 2009; 14 more have indicated plans to participate beginning in 2010.

►*Advertising*

FINRA operates an extensive program to ensure that communications by firms to the public are not misleading. FINRA rules require that advertisements, Web sites, sales brochures and other communications present information in a fair and balanced manner. Some communications—those related to mutual funds, variable products and options, for example—must be filed with FINRA. In 2008, FINRA reviewed more than 99,000 pieces of communication and completed 476 investigations involving 2,378 separate communications.

►*Investor Education*

Investor education is a critical component of investor protection and FINRA is uniquely positioned to provide valuable investor education primers and tools. FINRA sponsors numerous investor forums and outreach programs, and its Web site (www.finra.org) is a rich source of such material, including investor alerts, unbiased primers on investing and interactive financial planning tools.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education. Its mission is to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. The Foundation awards grants to fund educational programs and research aimed at segments of the public who could benefit from additional resources. Since the FINRA Foundation's inception in December 2003, it has approved more than $46 million in financial education and investor protection initiatives through a combination of grants and targeted projects. Many of those initiatives have focused on particularly vulnerable investors, such as seniors and military personnel and their families.

The Need for Harmonizing Regulation of Broker-Dealers and Investment Advisers

In recent years, more retail investors have sought the advice of financial professionals to plan for their retirement, help them through the financial crisis,

prepare for their children's college education and meet their other financial goals. These investors have sought the advice of brokers and investment advisers. At one time, the investment adviser and broker-dealer businesses were distinct and separate but today, while the services offered in each channel differ, the businesses have, in many ways, converged. While broker-dealers and investment advisers have been regulated differently for years, today's reality is—as the Rand Institute said in a study completed for the SEC last year—that "trends in the financial service market since the early 1990s have blurred the boundaries between them." Many customers now hold investment adviser and brokerage accounts with the same firm and rely on the same financial professional who is registered as both a broker-dealer and as an investment adviser representative.

In fact, there are approximately 4,500 firms that are dually registered as broker-dealers and investment advisers or have affiliated broker-dealers and investment advisers. Beyond that, a vast majority of registered investment adviser representatives also offer brokerage services. Approximately 88 percent of all registered advisory representatives are also registered representatives of a broker-dealer. Most of these representatives are employed by a firm that is dually registered.

In reality, this means that firms offer customers a combination of brokerage and advisory services in a product menu, and that many financial professionals offer brokerage and investment advisory services that involve, in many cases, commercially indistinguishable investment services to the same customer, which in turn makes it highly unlikely that that customer can distinguish between those services and the differing obligations and protections that are present in advisory and brokerage channels.

Despite this convergence in services, the federal regulation of investment advisers and broker-dealers remains quite different. The two industries are subject to different standards of conduct and different levels of oversight and enforcement. In light of the rising investor interest in seeking the advice of professionals, one would expect the convergence of the investment advisory and brokerage businesses to continue and even accelerate. This overlap in services has important implications for policy makers and regulators.

Broker-dealers and investment advisers face two standards of conduct and vastly different levels of oversight due to resource constraints at the federal level. The current system allows firms offering similar services to arbitrage oversight by choosing a form of registration that offers the least regulatory burden and minimizes the risk of enforcement should the firm engage in misconduct. This type of fragmented regulatory oversight provides opportunities to those who would cynically game the system to do so at great harm to investors.

The need to harmonize the regulation of broker-dealers and investment advisers to enhance investor protection is clear. FINRA believes that in order to truly harmonize regulation of these providers, two steps are necessary. The first is establishing a consistent fiduciary standard for investment advisers and broker-dealers providing investment advice. The second is harmonizing the oversight and enforcement of that standard and the other rules relevant to each channel to better ensure that participants in that industry actually comply with those obligations.

Consistent Fiduciary Standard

The Administration's white paper on regulatory reform noted that investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective. The Administration has further proposed legislative language that would authorize the SEC to write rules harmonizing the standard of care for the two channels. FINRA stands in agreement with numerous interested parties that the standard of care in both channels should be a fiduciary standard for the provision of advice.

The Administration's proposed legislation would accomplish this objective by giving the SEC broad rulemaking authority to require a fiduciary duty for any broker, dealer or investment adviser who gives individual investment advice about securities. This provision would provide a practical framework that will allow the SEC to fine-tune the application of a fiduciary standard to better protect investors. Commission rulemaking can provide much-needed guidance on what a fiduciary standard requires in specific circumstances, and the duties and obligations that flow from the application of the standard.

Too often regulators must act issue by issue, or violation by violation, rather than addressing problems more broadly and prospectively. A fiduciary standard would establish a benchmark for the regulator and the regulated, to help ensure that brokers and investment advisers have consistent obligations through each step of their financial advice, and that the first question they must ask is not whether a product is acceptable but whether it is in the best interests of the customer.

In FINRA's view, harmonization of the standard of care is an important first step. However, given the number of recently revealed frauds perpetrated by investment advisers bound by the fiduciary standard, it is clear that the existence of the fiduciary standard of care alone is not a guarantee against misconduct. Compliance with that standard must be regularly and vigorously examined and enforced to ensure the protection of investors.

Oversight Examinations and Enforcement

The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms due to lack of resources. As SEC Chairman Schapiro said earlier this year, given the vast number of investment adviser registrants, in some cases, a decade could pass without an examination.

FINRA believes that Congress should authorize the SEC to designate one or more independent regulatory organizations to augment the SEC's efforts in overseeing investment advisers to better protect investors regardless of how their financial professional is registered. Any such independent regulatory organization for investment advisers should structure oversight programs that are tailored to fit the services investment advisers provide and their role in the market. This type of structure has worked well in the broker-dealer channel, with FINRA working alongside, and overseen by, the SEC.

Consider the following:

- There are nearly 5,000 broker-dealer firms registered with the SEC, and between the SEC and FINRA, approximately 55 percent of those firms are examined on an annual basis. By contrast, there are over 11,000 investment adviser firms registered with the SEC, and the agency expects only 9 percent to be examined in fiscal years 2009 and 2010.

- By authorizing an independent regulatory organization for investment advisers, like that which exists for broker-dealers, the SEC could leverage the manpower and resources of a private-sector entity to get more boots on the ground, dramatically increasing the frequency of examinations and resources devoted to enforcement.

- Dedicating more resources to regular and vigorous examination and day-to-day oversight of investment advisers would improve investor protection, just as it has for customers of broker-dealers.

- By authorizing an independent regulatory organization to carry out these functions, the increased manpower and enhanced investor protection would come at no cost to the taxpayer.

In the oversight regime for broker-dealers, FINRA supplements the work of the SEC in terms of front-line regulation and supervision. As outlined in more detail earlier in my testimony, among the functions FINRA provides to that regime are: adopting rules and standards beyond statutory requirements, particularly with regard to professional conduct; conducting examinations to ensure compliance with applicable laws and rules; undertaking enforcement and disciplinary proceedings with respect to regulated firms, including barring firms and

individuals from the industry; administering registration and disciplinary databases to provide critical information to regulators and the public; and implementing continuing education and training programs.

All of these functions provided by FINRA are closely overseen by the SEC, with all rules and fees approved by the SEC. And, as previously mentioned, FINRA's Board is comprised of a majority of non-industry representatives.

Authorizing an independent regulatory organization for investment advisers would bring these significant functions and benefits to the oversight regime for investment advisers and enhance protections for customers who invest through an adviser.

Arbitration

FINRA operates the largest securities arbitration forum in the United States to assist in the resolution of monetary and business disputes involving investors, securities firms and individual brokers.

FINRA's nationwide arbitration and mediation program has 72 hearing locations – at least one in every state. We believe our forum provides efficient resolution of disputes in an impartial forum that is less costly and faster than traditional litigation. FINRA-registered firms pay for most arbitration costs and FINRA waives fees for individuals experiencing financial hardship.

Our arbitration program is subject to rigorous oversight by the SEC, which regularly examines the program and must approve any changes to its rules. Proposed rules are publicly disseminated by FINRA and the SEC and published in the *Federal Register* for public comment.

It is important to note that FINRA can, and does, suspend brokers from doing business if they fail to pay an award or a settlement.

FINRA maintains a roster of 6,300 arbitrators, a group that is separated into two categories – public and non-public. The public arbitrators are from outside the securities industry, while the non-public have – currently or in the past – some affiliation with broker-dealers. FINRA conducts a comprehensive pre-approval background check on all arbitrator applicants and provides training and continuing education. Arbitrators are selected to hear disputes by the parties involved and during this process both sides of the dispute review arbitrators' previous decisions.

Depending on the circumstances of the case, disputes are heard by either a panel of three arbitrators (two public and one non-public), or by a single public arbitrator. Nearly all – 98 percent – of three-arbitrator decisions are unanimous. All awards are made public on FINRA's Web site. The award provides the names

of the parties, the arbitrators, allegations, date and location of hearing and the arbitrators' rulings, which are generally final and binding for the parties. Overall, the average turnaround time for cases is approximately one year.

FINRA rules do not require investors to arbitrate disputes with their brokerage firm; however, we do require the firms to arbitrate if the investor chooses arbitration over litigation. Similarly, the rules do not require firms to include a pre-dispute arbitration section in customer agreement. This is a matter of contract between firms and their customers. To protect investors, however, we do require firms to clearly and conspicuously state the nature and implications of the pre-dispute arbitration agreement.

The Administration has proposed as part of its regulatory reform plan that Congress authorize the SEC to restrict or prohibit mandatory arbitration agreements. FINRA has long maintained that a determination about whether mandatory arbitration agreements should be allowable is a decision best made by Congress and the SEC. Our view is that Congressional or SEC action is necessary in light of Supreme Court precedent that upholds the ability of firms to contract in this way with customers. As such, we do not object to the Administration's proposal.

Recent Rule Changes

FINRA has focused its efforts on running the most efficient and effective program we can. In that regard, we have made several significant changes to our rules recently that I'd like to highlight for the Committee.

First, we raised the dollar threshold for cases that are heard by a single public arbitrator from $50,000 to $100,000, thereby doubling the number of cases decided in this manner – to one-third of all cases. This change alone greatly streamlines the dispute resolution process and cuts costs and time for thousands of investors in hundreds of cases.

Also, at the end of last year, we enacted strict limitations on motions to dismiss arbitration cases. The new rule was put in place after we heard investor concerns about abusive filing of these motions. FINRA received complaints that some firms were filing dispositive motions routinely and repetitively, causing increased costs for retail investors forced to defend against these motions. So we set substantial curbs around the practice, including penalties for motions to dismiss filed in bad faith. From the February effective date of the rule to September 1, 2009, dispositive motions filed in FINRA's forum decreased by 85 percent compared to the same time period last year.

Finally, in response to the collapse of the auction rate securities market, FINRA created a special arbitration procedure for claims of consequential damages

involving auction rate securities filed by customers of firms that entered into regulatory settlements with FINRA, the SEC or state securities regulators. Use of this special procedure is at the investor's sole option and investors also have the option of bringing a case under standard arbitration rules or in any other forum where they may have the right to seek redress.

Non-Public Arbitrator/Public Arbitrator Pilot Program

One year ago today, we launched a two-year Public Arbitrator Pilot Program where a portion of new cases is heard by three public arbitrators, instead of the usual panel of two public and one non-public arbitrator.

We created the pilot program primarily in response to criticism regarding the presence of an arbitrator with securities-industry experience on panels hearing investor claims. Financial markets and products, and the operation of brokerages, can result in disputes with many complexities. While some believe that an individual with relevant experience can serve as a useful guide through complicated disagreements, others believe the presence of a currently or formerly affiliated individual creates a perception of unfairness.

We have deployed pilot programs in the past to gain useful feedback on our operations, and more importantly, to map out a clear path to improvement. We crafted this pilot program to gauge sentiment among all the different constituencies in arbitration. The findings of the pilot program will guide any changes in our policies going forward.

Here is what we are looking at in the pilot program:

- As we test the concept of three-public-arbitrator hearing panels, we are analyzing the percentage of investors who opt into the pilot and the percentage of investors in the pilot program who actually choose an all-public panel. We will also compare the results of pilot and non-pilot cases, including the percentage of cases that settle before award and how quickly they settle, the length of hearings, and the use of expert witnesses. FINRA is also surveying participants for their feedback.

- The pilot program was structured so that even if investors enroll, they still have the choice to select a non-public arbitrator. I should also add that participation in the pilot is purely the choice of the investor. Firms have no control over that choice.

- One notable takeaway at the pilot's midpoint is that half of the investors who are eligible to opt into the public arbitrator pilot are declining to do so, and slightly more than 50 percent of those entering the pilot are choosing to have a non-public arbitrator on their panel.

Yesterday, we announced an expansion of the pilot program. I am pleased to report that, for its second year, the number of eligible cases will increase to over 400 and the program will expand from 11 to 14 FINRA-registered firms.

Law School Clinics, FINRA Foundation Support

In addition to operating the dispute resolution forum, FINRA also works with law schools around the country to provide legal assistance to individuals filing arbitration claims. In May 2009, the FINRA Investor Education Foundation announced an Investor Advocacy Clinic Grant Program to provide start-up funding for investor advocacy clinics at law schools in the United States.

We continuously work to make FINRA's arbitration forum a fair and efficient place for investors to resolve disputes with their brokers. As with our other programs, we will continue to seek ways to enhance our investor service and protection.

SEC Funding

Before I conclude, let me very briefly touch on the issue of self-funding for the SEC. FINRA's view is that that any mechanism that could provide more resources and predictability to the SEC in support of its critical mission should be explored. Especially now, we should evaluate every potential tool available to increase our ability to examine market participants and enforce the laws and rules that apply to them.

Conclusion

It has become painfully clear that the current fragmented regulatory structure is weakened by gaps and inconsistencies that should be remedied.

The individual investor is the most important player in the financial markets, and unfortunately, our system has not sufficiently protected these individuals. We need to earn back the confidence of those investors by closing the gaps in our current system and strengthening oversight.

As I have stated, FINRA believes that one of the most important gaps to close in terms of investor protection is the disparity in oversight between broker-dealers and investment advisers. The addition of a comprehensive and regular oversight program with more frequent exams and strong enforcement would enhance protections provided to all customers of investment advisers.

More broadly, investors deserve a consistent level of protection no matter which financial professionals or products they choose. Creating a system of consistent standards and vigorous oversight for financial professionals—no matter which license they hold—would enhance investor protection and help restore trust in our markets.

FINRA is committed to working closely with other regulators and this Committee as you consider how best to restructure the U.S. financial regulatory system.

Testimony of Douglas Lowenstein

President/CEO, Private Equity Council

House Financial Services Committee

October 6, 2009

Introduction

Mr. Chairman and Members of the Committee, thank you for inviting me back to the Committee to discuss the Private Equity Council's views on financial regulatory reform – specifically legislation recently drafted to require advisers to private investment funds to register with the Securities Exchange Commission (SEC) under the Investment Advisers Act of 1940 (the "IAA").

The Private Equity Council is a two year old trade association representing 12 of the largest private equity firms operating in the United States[1]. Our mission is to educate public policy makers on the positive role private equity ("PE") investments have played in both strengthening hundreds of companies of all sizes and from all sectors of the economy, and in generating above average returns for scores of public and private pension funds and other investors that have allocated a portion of their portfolios to PE funds. While PEC members are among the most visible and well known in PE firms, each with more than $10 billion in assets under management, the Committee should bear in mind that there are more than 2,000 PE firms doing business in the U.S. The overwhelming majority of these are local firms advising very small funds used to make relatively small investments that rarely attract much attention yet help power local, state, and the national economies.

In my testimony to this Committee in July I discussed in some detail the PE investment model, how it works, and how it fits into the financial marketplace. Today, in the interest of brevity, suffice it to say that the goal of all PE investments is to increase the value of the business during the time that it is owned by a PE fund. PE firms accomplish this by adding managerial expertise, making capital and R&D expenditures, expanding into new markets and developing new products, and making strategic acquisitions to create the scale required to compete and become market leaders. Independent research by such distinguished organizations as The World Economic Forum, Ernst & Young, the Boston Consulting Group, and numerous economists and academics document the positive impact PE has on jobs, innovation, and growth.

[1] Apax Partners; Apollo Global Management LLC; Bain Capital Partners; the Blackstone Group; the Carlyle Group; Hellman & Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake Partners; and TPG Capital

Private Equity and Systemic Risk

In laying out its Financial Regulatory Reform program, the Obama Administration articulated three fundamental factors that trigger systemic risk concerns: (i) the impact a firm's failure would have on the financial system and economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system. Private equity presents none of these systemic risk factors and thus should pose little concern for policymakers seeking to develop a new regime to guard against catastrophic, cascading financial shocks. Specifically:

- PE firms have limited or no leverage at the fund level (as distinct from leverage incurred by companies in which funds managed by a PE firm have invested).
- PE funds do not rely on short-term funding. Rather, private equity investors are patient and commit their capital for 10-12 years (or more) with no redemption rights. Therefore, investors cannot withdraw their money on short notice, triggering "asset fire sales" to find cash to make the repayments.
- PE firms are not deeply interconnected with other financial market participants through derivatives positions, counterparty exposures or prime brokerage relationships.
- PE investments are not cross-collateralized, which means that neither investors nor debt holders can force a fund to sell unrelated assets to repay a debt. In a sense, private equity investments are structurally firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.
- PE funds invest in long-term illiquid assets that are typically the equity of operating companies. Private equity funds do not normally invest in short-term instruments such as derivatives, options, swaps or listed equities.
- PE funds are diversified by industry sector, geography, and time horizon, thereby safeguarding against over exposure.
- PE funds are not a source of credit to households, businesses, or governments, nor do they act as a primary source of liquidity for the financial system.
- The borrowings of companies owned by PE funds is still a small portion of the overall credit market, well under five percent of all U.S. credit market obligations outstanding. The total value of all holdings of PE funds is equivalent to just 2.6 percent to 4.3 percent of corporate stocks and 3.1 percent to 5.3 percent of GDP.

In short, when applying the Administration's systemic risk factors to private equity, it is hard to see how any particular PE fund could be considered to present a systemic risk. Indeed, in testimony before this Committee last week, Federal Reserve Board Chairman Ben Bernanke said he "would not think that any hedge fund or private equity fund would become a

systemically-critical firm individually", though he added that it remains important for the systemic risk regulator to monitor the industry as a whole.

The Investment Advisers Act

In the interest of restoring confidence in financial markets generally and the credit markets in particular, we have and continue to support requiring registration of managers of PE, venture capital ("VC"), and hedge funds under the IAA. We do so because the IAA enforces best business practices among financial and fund managers. And our support for registration reflects the view that this law is an important and valuable component of the Nation's investor protection regime.

At the same time, it is important to appreciate that the obligations that come with registration are neither modest nor ministerial. In fact, the IAA imposes very significant obligations and burdens – and cost – for any firm, small, medium, or large.

Specifically, SEC Form ADV requires the disclosure of everything from the most basic information – name and address – to more detailed information about the adviser's business. Being a registered investment adviser requires the firm to establish, maintain and enforce a code of ethics, proxy voting policies and procedures and compliance policies and procedures. Registered advisers are required to keep true, accurate and current books and records including ledgers reflecting asset, liability, reserve, capital income and expense accounts; all written communications; evidence of discretionary authority; written agreements, notices, circulars and advertisements; calculations of performance rates; policies and procedures; possession of client funds; personal securities transactions; client referrals; and various other documents. Registered investment advisers are required to send an account statement, at least quarterly to each of the clients for which it maintains an account. An independent accountant must also verify all of the funds and securities by an actual exam at least once a year. On top of all of this, registered firms are subject to periodic SEC audits. To comply with these and other IAA requirements, firms will typically have to hire at least one and perhaps a dozen or more persons to handle the compliance burden.

All that said, as a necessary ingredient of a new regulatory regime, and notwithstanding the lack of a nexus between PE and systemic risk as outlined above, we are generally supportive of requiring registration of advisers to private pools of capital. Further, we agree that registered advisers should provide information to the SEC regarding the funds they manage that enables the SEC to evaluate a firm's potential to pose systemic risk or otherwise threaten the financial system.

The Private Fund Investment Advisers Registration Act of 2009

As outlined below, we do have several significant concerns with the draft bill. We also have several specific technical issues that we will raise with committee staff following this hearing.

We stand ready to work with you, your colleagues and your staff in the coming days and believe together we can resolve all of these issues.

Section 204(b)(7) of the discussion draft would add to the IAA a requirement that registrants provide reports, records and other documents to investors, prospective investors, counterparties, and creditors, of any private fund advised by the investment adviser if the SEC determines such disclosure is necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

We acknowledge the benefits of requiring PE fund managers to disclose information to the SEC regarding systemic risk. But Section 204(b)(7) and its authorization for the SEC to require registrants to make broad disclosures to third parties is unnecessary and problematic.

To be clear, we acknowledge and support the need to ensure that investors are well-informed. In this regard, The Securities Act of 1933 and The Securities Exchange Act of 1934 already impose a series of requirements obligating PE funds to provide extensive information to investors (subject to stringent antifraud rules). Further, as a matter of common practice, the fund contracts we negotiate with our investors typically require us to provide information that goes far beyond that required by the 1933 and 1934 Acts. Given the highly sophisticated nature of our investors, and our dependence on them for funding our investments, they have both the knowledge and the leverage to obtain the information they need to ensure they are fully protected. Thus, the proposal mandating the provision of reports and other materials to investors and prospective investors is duplicative and unnecessary.

It is even more troubling to contemplate the provision of reports and materials to counterparties, creditors, and others. As a general rule, third parties that privately negotiate with PE funds (whether creditors, counterparties, or investors) are all highly-sophisticated market participants with the leverage to bargain with the fund at the time that the counterparty or creditor relationship is first established to obtain whatever information they believe necessary to evaluate the contract, relationship or credit. For example, a lender can simply refuse to lend to the fund if the lender is not satisfied that it has received sufficient upfront information about the fund and its investments and adequate commitments from the borrower to provide ongoing reporting. And if it does lend, credit agreements typically require periodic reporting of financial information and certain operational reporting, as well as certain management certifications.

Requiring open-ended disclosures to these third parties, as the draft contemplates, is highly problematic because such a requirement is potentially destructive of normal commercial relationships and could expose proprietary information and trade secrets to those with whom we compete.

Many of the parties from which private funds obtain credit or enter into mutually beneficial arrangements are competitors of the PE funds and the provision and use of information

provided to such parties is subject to confidentiality agreements. The maintenance of such confidentiality is critical to the success of the PE funds' businesses. The threat that the SEC would mandate the provision of documents that would otherwise be subject to confidentiality agreements would eviscerate the ability of the funds to obtain such agreements with the consequence of creating a serious competitive disadvantage. For example, this provision could result in the disclosure of a proprietary strategy to a competitor with the result that the competitor adopts the strategy for its own purpose. Or, it could require the disclosure of highly sensitive, material, non-public information about our valuation of a current or prospective investment, information that creates the potential for the counterparty to trade on that information, or pass it along to another client.

We urge that this entire section be struck from the bill.

Section 204(b)(1) appears to require investment advisers who may be unaffiliated with a particular private fund that it advises to make disclosures about that unaffiliated fund. Our concern is that in some contexts, a private fund may use an unaffiliated investment adviser for particular matters, or in addition to an affiliated investment adviser. We suggest that the language be modified to clarify that a private fund's information is only the information of the registered investment adviser and subject to disclosure and reporting only if that private fund is sponsored by the investment adviser or any affiliated person of the investment adviser. This change would ensure that only one adviser is required to provide information about a private fund, and help avoid potential duplication and confusion.

Section 204(b)(3)of the discussion draft provides that the Commission can obtain optional information as it deems necessary and it further authorizes the Commission to set different reporting requirements for different classes of private fund based on the size and type of funds.

In fact, we are very supportive of the concept of calibrated reporting requirements for different types of funds. However, we urge that the language base this calibration not just on the type and size of funds, but on their potential to cause systemic risk.

At the same time, we believe the optional reporting requirement in this subsection is a sweeping and troublesome grant of information gathering authority to the Agency, especially given the enormous detail already required to be filed under the IAA. The section in the draft immediately preceding this provision -- Section 204(b)(2) -- itself authorizes the SEC, in consultation with the Federal Reserve, to collect such information as it deems necessary or appropriate "in the public interest and for the protection of investors or for the assessment of systemic risk." That should be sufficient to carry out the goals of protecting investors and guarding against systemic risk. Thus, we ask that you strike the optional reporting portion of this subsection while retaining and modifying the broader mandate to the SEC that it calibrate all reporting requirements based on the type and size of funds and their potential to cause systemic risk.

Section 6 creates a venture capital exemption. Let me say first that I sympathize with the intent to offer relief to certain funds that may not have the resources or the infrastructure to absorb the administrative costs that accompany registration, and which also are too small to create systemic risk, individually or collectively. However, as currently drafted, the provision may not accomplish its purpose and prove impossible to implement.

PE and venture capital funds (along with other investment firms like real estate and energy funds) have virtually the same business model, skill set and compensation structure. Indeed, many members of the Private Equity Council have funds that invest in early-stage companies, and many venture firms have several billion dollars under management. Given these similarities, I think it will prove nearly impossible to define a "Venture Capital" firm and to distinguish these from most other investment firms.

But as I said, it is reasonable to consider some exemptions from the new registration requirement but I suggest it is simpler, fairer, and fully consistent with the purposes of the Act to base exemptions not on what a fund says its business is, but rather on the activities a fund engages in, the potential for those activities to cause systemic risk, and the fund's size.

Specifically, I would suggest that the most direct and equitable solution is to raise the threshold above which registration is required from $30 million to a level that Congress believes is appropriate. This would ensure that the registration requirement captures the larger firms, regardless of their classifications, that are more likely to pose a systemic risk. This approach has the virtue of treating all small investors similarly, and will still result in many VC funds being exempted. As importantly, it helps ensure that the SEC can focus its scarce resources on overseeing those firms that are most relevant to the public policy concerns underlying this proposal.

Thank you again for the opportunity to express our views on the "Private Fund Investment Advisers Registration Act of 2009." We look forward to working with the Committee to enact sound registration requirements.

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURERS
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
ON
CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, CREATING A NATIONAL INSURANCE OFFICE

October 6, 2009

Statement Made by
Bruce Maisel
Vice President & Managing Counsel
Thrivent Financial for Lutherans on behalf of the American Council of Life Insurers

Mr. Chairman and Committee members: My name is Bruce Maisel, and I am Vice President and Managing Counsel of Thrivent Financial for Lutherans testifying on behalf of the ACLI. I greatly appreciate the opportunity to appear here before you to discuss strengthening investor protection.

The ACLI is the principal trade association for U.S. life insurance companies, and its 340 member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums and 94% of annuity considerations in the United States. ACLI members are organized as public companies, fraternal benefit societies, and mutual companies.

Among those ACLI member companies is Thrivent Financial for Lutherans. Thrivent is a fraternal benefit society, a not for profit membership group for Lutherans with a mission of helping to provide financial security to our members and serving communities. In 2008, Thrivent's members provided over 21 million volunteer service hours and close to $310 million of fraternal assistance to communities nationwide. Federal law requires that fraternals like Thrivent offer our members insurance products regulated like those provided by commercial life insurers, including variable annuities and variable life insurance that are deemed to be securities and are regulated under federal law. As a fraternal group, Thrivent and our predecessor organizations, Lutheran Brotherhood and Aid Association for Lutherans, have been focused for over a century on serving our Lutheran members in a pro-consumer, fair, and transparent way.

I have worked in the financial services industry for 23 years, first as a registered representative and then as legal counsel at law firms and subsequently as in-house counsel at dually-registered investment advisory and brokerage firms.

Most recently, I have led a Working Group at the ACLI focused upon participating in, and contributing to, the dialogue regarding the a establishment of a harmonized standard of conduct for broker- dealers and investment advisers when they provide personalized investment advice about securities to retail investors.

As described in more detail below, while we support the establishment of a fiduciary duty for brokers, dealers and investment advisers, and harmonization of the regulation of brokers, dealers, and investment advisers, we do have some concerns with aspects of the proposed. Section 913 of the Investor Protection Act of 2009 ("Investor Protection Act") and the Discussion Draft on Investor Protection released on October 1, 2009 ("Discussion Draft").

The Working Group is focused on seeking to ensure that the establishment of a such a harmonized standard of conduct that will enhance retail investor protection while, at the same time, permit ACLI member companies to continue to meet investor needs across the broad economic spectrum.

Retail investors receive personalized investment advice about securities through numerous distribution channels and various means. Specifically, retail investors work with broker- dealers and investment advisers (and their respective securities licensed representatives) who provide personalized investment advice and offer only those proprietary and non-proprietary securities available for distribution by the particular broker, dealer or investment adviser.

In many cases, such broker-dealers and investment advisers provide advice about proprietary securities exclusively. In other cases, broker-dealers and investment advisers provide personalized advice about non-proprietary products. In still other cases, retail investors receive personalized advice about securities only and the investor may seek to implement that personalized investment advice about securities directly through product manufacturers. The Working Group sought to not advance one distribution channel or method as opposed to another.

We believe that the overriding goal of the establishment of a harmonized standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors must be tailored to reflect and preserve the various types of relationships that exist between a broker-dealer or investment adviser and the retail investor. By doing so, investor choice will also be preserved. We also believe that the harmonized standard and any subsequent rules promulgated by the Securities and Exchange Commission ("SEC") must, as similarly noted above, take in to consideration that broker-dealers and investment advisers (and their respective securities licensed representatives) typically may only provide investment advice about the particular securities that are available through their respective firms.

Given this reality, while we support the establishment of a harmonized standard of conduct, we are concerned by the suggestion that such a standard may only be met when investment advice is given "without regard to the financial or other interest of the broker,dealer, or investment adviser providing the advice..." As discussed in more detail below, such a concept is at odds with the fiduciary duty to which investment advisers are currently subject, and could have the unintended effect of "chilling" the provision of investment advice by broker-dealers and investment advisers, which would run counter to serving the investing public's needs. Such a concept is also at odds with the historical practices regarding securities distribution in which a broker-dealer enters into a contractual arrangement with a securities issuer to offer such securities for sale.

By addressing these and other concerns we note below[1], we believe that the establishment of a harmonized standard of conduct and any subsequent related rulemaking will result in broker-dealers and investment advisers enhancing their ability to: (1) meet the ever increasing retail investor needs across the broad economic spectrum of U.S. retail investors; (2) provide enhanced investor protections to those retail

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[1] We have attached to this Statement a copy of our proposed revisions to Section 913 of the Investor Protection Act, which also includes a brief explanation of the intended purpose of our key proposed revisions.

investors; and (3) be part of a vibrant and growing financial services industry necessary to meet those ever increasing retail investor needs.

Accordingly, my testimony will focus upon the creation of a harmonized standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice about securities to retail investors, and ways intended to ensure the harmonization of the enforcement and interpretation of such a standard of conduct.

The first part of my testimony addresses ACLI member firm registered representatives and investment advisory representatives and the circumstances under which they typically provide personalized investment advice about securities to retail investors. I then analyze the standard of care imposed under the current regulatory framework with respect to the provision of investment advice about securities to retail investors. The second part of my testimony analyzes: (1) recent efforts to harmonize the standard of care applicable to broker-dealers and investment advisers; and (2) ACLI's position regarding the harmonization of the standard of conduct and as reflected in the Investor Protection Act and the Discussion Draft.

Specifically, my testimony will highlight particular factors that we believe need to be addressed by any legislation imposing a harmonized standard of conduct. As I will discuss in detail below, the standard should:

- be targeted to personalized investment advice about securities.
- imposed with respect to dealings with retail investors.
- be one that requires broker-dealers and investment advisers that provide personalized investment advice about securities to retail investors, to act in the "best interests" of the retail investors.
- require broker-dealers and investment advisers, who provide personalized investment advice about securities to retail investors, to make full, balanced, fair, and timely disclosure including material conflicts so that retail investors can make informed investment decisions.
- be consistent with the long-standing relationships between retail investors and broker-dealers and investment advisers, as well as maintaining retail investor choice in the marketplace of financial service providers. We would urge that legislation not be advanced that requires that investment advice be given "without regard to the financial or other interest of the broker,dealer, or investment adviser providing the advice…" Rather, the focus, as noted immediately above, should be upon ensuring full, balanced, fair and timely disclosure about material conflicts of interest and other relevant information. .

Standard of Care Imposed Under the Current Regulatory Structure

Life Insurance Companies and their Representatives. Life insurance companies and their representatives have a direct and significant interest in investment adviser and broker-dealer regulation. In order to meet the varied needs of retail investors across the vast economic spectrum of U.S. investors as well as the demands of a highly competitive

marketplace, life insurance companies offer a wide range of financial products and services. Many of these products and services are subject to the federal securities laws, including broker-dealer regulation promulgated by the SEC and the Financial Industry Regulatory Authority ("FINRA") under the Securities Exchange Act of 1934 (the "1934 Act") and investment adviser regulation promulgated by the SEC under the Investment Advisers Act of 1940 (the "Advisers Act").

A principal element of insurance company product distribution involves eliciting customer needs and matching them with appropriate fixed insurance and annuity products. Similarly, many life insurance agents of affiliated broker-dealers provide essential retail investor needs analysis services in the sale of variable life and variable annuity products. Consistent with this retail investor needs-based approach, many of these broker-dealers offer a variety of other types of securities such as mutual funds, equities, and 529 Plans to meet the retirement, college savings and other investment needs of retail investors. Some life insurance representatives are also associated with registered investment advisers (often dually-registered affiliated broker-dealers and investment advisers) as a result of their functions and services they offer. Life insurance representatives are licensed and trained to offer insurance and annuity products, those other securities and increasingly investment advisory services, all based on the needs of the particular retail investor. In short, life insurers' products, functions, services and regulation fit within the scope of various initiatives that address broker-dealer and investment adviser standards of conduct.

In addition to broker-dealer, investment adviser and other securities regulation, life insurers must also fulfill a comprehensive set of state insurance laws and regulations in every U.S. jurisdiction. As a result, life insurers and their affiliates frequently find themselves subject to the overlapping requirements of the 1934 Act, the Advisers Act, and the insurance and securities regulations of the fifty states. Registered representatives working for broker-dealers affiliated with life insurance companies are not only a significant part of the broker-dealer industry, but in fact a majority of the industry. We believe that over 50% of FINRA's universe of approximately 675,000 registered representative work for broker-dealers affiliated with life insurance companies.

The Current Standard of Care Imposed upon Broker-Dealers and Investment Advisers. Today, broker-dealers and investment advisers are subject to different standards with respect to the duty of care that they owe to retail investors (and other investors) to whom they provide investment advice about securities.

The Advisers Act does not specifically set forth fiduciary requirements. The SEC recognized that an investment adviser managing assets for a fee owes a fiduciary duty to her clients as early as 1948 in the *Arleen Hughes* release, when the SEC stated that an investment adviser owes a client the duty "to act in the best interests of her clients and to make such recommendations as will best serve such interest." [2]The SEC also recognized

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[2] In re Arleen W. Hughes, Exchange Act Release No, 4048, 27 S.E.C. 629, 1948 WL 29537 (Feb. 18, 1948).

that while a fiduciary should endeavor to avoid conflicts of interests, a fiduciary is able to mitigate conflicts of interest by making disclosure of the conflict and obtaining the client's "informed consent to such dealings." The SEC stated that "disclosures constitute a safeguard which the law imposes to prevent the possibility of abuse which is inherent in a situation presenting conflicts between a fiduciary's self interest and his loyalty to his principal." *Id.*

In the *SEC v. Capital Gains Research Bureau*[3] the Supreme Court ruled that investment advisers owe a fiduciary duty to investors. The Court noted that the Advisers Act reflects a congressional recognition of the "delicate fiduciary nature" of an investment advisory relationship and a congressional intent to eliminate or expose "all conflicts of interest which might incline an investment adviser— consciously or unconsciously— to render advice which was not disinterested." The *Capital Gains* Court held that this implicit common law fiduciary duty arises from Section 206, the Adviser Act's anti-fraud provision. It is important to note that the Court recognized that the Advisers Act did not go so far as to eliminate conflicts of interest , even though some had advocated for doing just that. Instead, the Court acknowledged that the SEC in *Capital Gains* sought only disclosure. To meet her fiduciary duty, the Court held that an investment adviser is required "to make full and frank disclosure of his practice of trading on the effect of his recommendation."

In contrast to investment advisers, broker-dealer registered representatives are not generally bound by any rule or other guidance that imposes a fiduciary obligation upon them. We note that in certain limited instances broker-dealers have, based on specific facts and circumstances, been deemed by court decisions as having a fiduciary duty to particular customers. However, in contrast to investment advisers, broker-dealer registered representatives are subject to a full panoply of rules and duties—including the duty to recommend to investors suitable securities.[4] These rules and duties are imposed by FINRA, the broker-dealer self-regulatory organization ("SRO").

Treatment of Broker-Dealers Under the Advisers Act. The question arises as to whether a broker-dealer should be subject to the Advisers Act fiduciary duty when it provides investment advice about securities to retail investors. .

By the very nature of their activity, virtually all broker-dealers and their registered representatives come within the broad sweep of the Advisers Act basic definition of an investment adviser: They are in the business of advising others for compensation as to the advisability of investing in securities. However, in recognition of the comprehensive regulation to which broker-dealers are subject, Adviser Act Section 202(a)(11)(C) provides an exclusion for "any broker or dealer whose performance of such [advisory]

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[3] 375 U.S. 180 (1963).

[4] While the Advisers Act does not expressly impose suitability requirement on investment advisers, such a requirement has been enforced by the SEC as implicit in the antifraud provisions of section 206. See e.g., In re Bing Sung, Investment Advisers Act Release No. 1814 (Aug. 12, 1999).

services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."

To rely on the broker-dealer exclusion, two tests must be satisfied: (1) the advice must be "solely incidental" to the firm's brokerage activities; and (2) the broker-dealer may not receive "special compensation" for the investment advice.

The past ten years have seen significant developments and challenges with respect to applying the broker-dealer exclusion to investment advice about securities provided by broker-dealers to retail investors. As investment advisers and broker-dealers began to offer increasingly similar and in certain instances virtually the same, services to retail investors, it became more difficult to establish a differentiation of broker-dealer versus investment adviser activities and functions. The SEC has previously tried to demarcate broker-dealer activity from investment adviser activity in an attempt to modernize the broker-dealer exclusion under the Advisers Act, but these efforts have not borne fruit and certain of them (e.g., viewing the provision of "financial planning" as a differentiation) have since been abandoned.

The RAND Report. In connection with its attempts to, among other things, better understand the practical ramifications to the U.S. retail investing public and the industry of the broker-dealer exclusion in the Adviser Act, the SEC engaged a third-party corporation to study the broker-dealer and investment advisory industries.[5] The study, which is typically referred to as the "RAND Report" examined how broker-dealers and investment advisers market and provide products and services to investors, and how investors understand the differences between investment advisers and broker-dealers. The chief purpose of the RAND Report was to provide the SEC with a description of the current state of the investment advisory and brokerage industries for its evaluation of the legal and regulatory framework applying to these industries.

The RAND Report was released in January 2008. In determining its findings, RAND gathered information using a variety of sources: a survey of both experienced and inexperienced investors; focus groups; interviews with interested parties and financial services firms; review of relevant literature; a review of samples of documentation used by investment advisers and broker-dealers; and a review of various regulatory filings.[6]

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[5] RAND Corporation Study on Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, available at www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[6] Notably, the RAND Report concluded, among other things that investors, as a whole, do not understand the key distinctions between broker-dealers and investment advisers, and relationships among service providers. Also, investors, although having a general sense about the differences in services provided, are not clear about the varying legal duties of and standards imposed on broker-dealers and investment advisers. However, the Study concluded that despite the confusion that exists among investors, investors polled were generally satisfied with their own financial service providers, and in particular with the personal attention that they receive.

Harmonizing the Broker-Dealer and Investment Advisor Standard of Conduct

Calls for Harmonization. In 2009, efforts to demarcate broker-dealer activity from investment adviser activity gave way to calls from regulators and others to harmonize the regulatory structures applying to broker-dealers and investment advisers when providing personalized investment advice to retail investors. These calls were fueled in large degree by the Madoff scandal. Many have claimed that the scandal went undetected, at least in part, by a regulatory regime that calls for regulators to narrowly focus on either broker-dealer or investment adviser activity, as opposed to taking a more comprehensive approach.

Harmonization efforts have generally focused upon the establishment of a fiduciary duty for broker-dealers and advisers when providing personalized advice to retail investors. With respect to a harmonized standard of conduct, SEC Chairman Schapiro has stated that she believes that "all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients."[7] Previously, SEC Commissioner Elisse Walter stated that she believes that every financial professional should be subject to a uniform standard of conduct.[8] At that time, Commissioner Walter suggested that in developing a uniform standard of conduct, regulators should not dwell on the label to be placed on the standard. Commissioner Walter also noted that it is important that any standard be accompanied by business practice rules that provide practical guidelines regarding the standard's parameters. Commissioner Walter explained that what a particular fiduciary duty requires would depend on the functional role being performed by the financial professional. Specifically, she stated that "...what a fiduciary duty requires depends on the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account."

Similarly, state securities regulators have urged the application of a fiduciary standard for broker-dealers providing investment advisory services. [9]

The Investor Protection Act of 2009 On June 17, 2009, President Obama announced that his Administration was "proposing a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression." [10] In turn, the U.S. Department of Treasury ("Treasury") released a White Paper which stated two general goals with respect to the regulation and oversight of

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[7] Speech by Chairman Mary Schapiro at the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009)

[8] Speech by Commissioner Elisse Walter at the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 15, 2009)

[9] NASAA Statement on *Obama Financial Regulatory Reform Proposals* (June 17, 2009).

[10] U.S. Treasury Department's White Paper, *Financial Regulatory Reform: A New Foundation* (the "Treasury Proposal").

broker-dealers and investment advisers: establishing a "fiduciary duty" for broker-dealers; and harmonizing the regulation of broker-dealers and investment advisers.

This was followed on July 10, 2009, with the Obama Administration, through the Treasury, submitting the above referenced proposed legislation to Congress the Investor Protection Act. For the most part, the provisions of the Investor Protection Act were outlined in Treasury's White Paper.

The Investor Protection Act would add a new Section 15(k) to the 1934 Act to articulate its view of the "fiduciary duty" owed by broker-dealers. Under proposed Section 15(k), the SEC may promulgate rules to provide that the standard of conduct for a broker-dealer "providing investment advice about securities to retail customers or clients" shall be "to act solely in the interest of the customer or client without regard to the financial or other interest of the" broker-dealer providing the advice. The Investor Protection Act provides similar language for such a duty to be imposed on investment advisers under the Advisers Act.

ACLI Position on a Harmonized Standard of Conduct; the applicable Sections of Investor Protection Act and the Discussion Draft. In the wake of the Madoff and other similar scandals, the ACLI appreciates the interest of the Administration, Congress and regulators in considering how the standards of conduct applicable to broker-dealers and investment advisors can be enhanced to improve investor protection.

As similarly noted above, we support the general concept of harmonizing standards of conduct so long as the resulting standard(s) accurately and appropriately reflect the nature of the services being rendered and the nature of retail investor relationships as well as preserving investor choice. We also support the general concept of rationalizing inconsistent broker-dealer and investment adviser rules, where appropriate.

Other factors that are relevant to the development of an appropriate harmonized standard of conduct include:

- Providing opportunity for the retail investor to make informed choice
- Assuring transparency regarding offered products and services
- Disclosing material conflicts of interest and other relevant information

With this background, as noted above, we believe that certain revisions to the Investor Protection Act, and as applicable, to the Discussion Draft are necessary to achieve a workable standard of conduct under which broker-dealers and investment advisers can continue to meet the ever increasing retail investor needs across the vast economic spectrum of U.S. investors.

Personalized Investment Advice. First, we believe it should be clear that any fiduciary duty should apply to "personalized" investment advice. "Personalized investment advice" is investment advice about securities that is provided to a retail investor based on the personal financial information provided by such retail investor, including the retail

investor's financial needs, investment objectives, risk tolerance and financial circumstances. [11] When brokers, dealers or investment advisers provide such impersonal investment advice about securities to retail investors, we believe there is no policy or other reason to shift or modify existing regulatory requirements. Examples of impersonal investment advice include a broker-dealer merely executing an order for a customer, references to securities at seminars to a broad audience of attendees and the distribution of marketing materials that reference certain securities.

Retail Investors. It should be clear that the harmonized standard is imposed with respect to dealings with retail investors. Use of the term retail investor (rather than retail "customer" or retail "client"), which is used throughout the Investor Protection Act, better reflects the status of the retail consumer that is the recipient of personalized investment advice about securities. It also helps to ensure consistency with other sections of the Investor Protection Act.

Best Interest of the Retail Investor. The standard that is advanced should be one that requires brokers, dealers or investment advisers that provide personalized investment advice about securities to retail investors, to act in the "best interests" of the retail investors. Such a standard of conduct is consistent with the apparent intent of the proposed legislation. Specifically, the standard of conduct is intended to enhance the standard of conduct currently generally required with respect to the provision of personalized investment advice about securities.

Full, Balanced, Fair and Timely Disclosure. It is important to note that a hallmark of the harmonized standard should be the requirement that brokers, dealers and investment advisers, who provide personalized investment advice about securities to retail investors, make full, balanced, fair and timely disclosure, including of material conflicts of interests and related information so that retail investors can make informed investment decisions. This standard of conduct is generally consistent with the duty that historically has been imposed on investment advisers pursuant to the Advisers Act. As such, the standard has been used by the SEC as the basis for imposing substantive obligations and prohibitions on investment adviser conduct and also to require investment advisers to disclose important information to clients, including information about material conflicts, often prior to the time an investment decision is made.

The SEC has consistently recognized that investment advisers mitigate conflicts of interest through disclosure so that clients can choose for themselves whether an investment adviser can meet their needs notwithstanding the existence of conflicts. The Advisers Act has never required that an adviser "act without regard to" their financial interests, as the SEC has recognized that disclosure is required regardless of whether the investment adviser's "sense of duty prevails over the motives of self-interest." Whether advice being given is influenced by self-interest is in many cases ultimately unknowable. Investment advisers, instead, have historically been and currently are required to make

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[11] We note that the term "impersonal investment advice is defined under Advisers Act Rule 203A-3(a)(3)(ii) as "investment advisory services provided by means of written or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts."

disclosures of material conflicts of interests so that investors, including retail investors can decide for themselves whether a conflict of interest is so great as to prevent an investment adviser from offering objective advice. Essentially, those retail investors – with those essential disclosures typically made to the retail investor at or before entering in to the relationship with the investment adviser – are able to make informed investment choices. We believe that timely and robust disclosure should be the hallmark of a harmonized standard and that the standard should be extended to broker-dealers providing personalized investment advice to retail investors.[12]

ACLI Reaction to the Discussion Draft. We are pleased that the Discussion Draft has: (1) indicated that the harmonized standard should apply to retail investors receiving "personalized investment advice"; and (2) has recognized that the receipt by broker-dealers of commission-based compensation would not, in and of itself be a violation of the standard.

We also support the Discussion Draft's establishment of a "best interest" standard which, as discussed earlier, is consistent with the overall intent of this legislation and with longstanding Supreme Court and SEC views on an investment adviser's fiduciary duty.

As noted above, however, we strongly oppose the tying of acting in the best interest to the notion of acting "without regard to the financial or other interest of the broker,dealer, or investment adviser providing the advice…" As noted above, such a requirement is contrary with the fiduciary duty to which investment advisers are currently subject, and could have the unintended effect of "chilling" the provision of investment advice by broker-dealer, and investment adviser, which would run counter to serving the investing public. Such a requirement would also be at odds with basic notions of securities distribution, in which a broker-dealer enters into a contract with an issuer for that broker-dealer to act on behalf of such issuer. Also, as similarly noted above, it is, in many cases, ultimately unknowable whether investment advice is influenced by any self-interest.

It is also critical that any legislation recognize a broker-dealer's obligations to a securities issuer as expressed under a selling agreement under which the broker-dealer has a contractual and legal obligation to engage in selling efforts as an agent of for example, an insurance company, and gets paid by such issuer.

We are also concerned that the requirement of acting "without regard to" the financial interest of the broker-dealer or investment adviser be construed so broadly that it effectively requires no compensation be paid, or steps having to be taken to ensure that absolutely no disparity in compensation exists between similar, or even different, financial products.

As noted above, these issues are best left to effective, robust and timely disclosure, as has been the historical practice under the Advisers Act.

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[12] We note that many broker-dealers have already adopted similar, although not explicitly or otherwise required by law, disclosure approaches.

Once again, I appreciate be given the opportunity to appear before you today. The ACLI applauds the efforts of the Committee and we are committed to working towards strengthening investor protections. We believe that with the above noted modifications to the Investor Protection Act and the Discussion Draft, a harmonized standard of conduct and related rulemaking can result in broker-dealers and investment advisers enhancing their ability to: (1) meet the ever increasing retail investor needs across the broad economic spectrum of U.S. retail investors; (2) provide enhanced investor protections to those retail investors; and (3) be part of a vibrant and growing financial services industry necessary to meet those ever increasing retail investor needs.

Section 913. ESTABLISHMENT OF A FIDUCIARY DUTY FOR BROKERS, DEALERS, AND INVESTMENT ADVISERS, AND HARMONIZATION OF THE REGULATION OF BROKERS, DEALERS, AND INVESTMENT ADVISERS.

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(a) AMENDMENT TO SECURITIES EXCHANGE ACT OF 1934.---Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended by adding at the end the following new subsections:

(k) STANDARDS OF CONDUCT.---Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing personalized investment advice about securities to retail investors, shall be to act in the best interest of the retail investor and to disclose to the retail investor, at or prior to the time such personalized investment advice about securities is provided, any material conflict between the interests of the broker, dealer, or investment adviser and the best interests of the retail investor related to the provision of such personalized investment advice. Any rules promulgated hereunder shall: (i) be tailored to reflect the various types of relationships that exist between a broker, dealer, or investment adviser and a retail investor in light of the nature of the personalized investment advice being provided and any related material conflicts of interest; and (ii) be designed to provide disclosure to allow the retail investor to make an informed decision with respect to the personalized investment advice being provided.

Deleted: customers or clients (and such other customers or clients as the Commission may by rule provide)

Deleted: solely

Deleted: customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.

Purpose: Regarding the use of the term "personalized" investment advice," when brokers, dealers or investment advisers provide personalized investment advice about securities to retail investors they should be held to the same standard of conduct. "Personalized investment advice" is investment advice about securities that is provided to a retail investor based on the personal financial information provided by such retail investor, including the retail investor's financial

needs, investment objectives, risk tolerance and financial circumstances. We note that the term "impersonal investment advice is defined under Investment Advisers Act of 1940 ("Advisers Act") Rule 203A-3(a)(3)(ii) as "investment advisory services provided by means of written or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts." Accordingly, when brokers, dealers or investment advisers provide such impersonal investment advice about securities to retail investors, we believe there is no policy or other reason to shift or modify existing regulatory requirements. Examples of impersonal investment advice include a broker-dealer merely executing an order for a customer, references to securities at seminars to a broad audience of attendees and the distribution of marketing materials that reference certain securities. In each example, the broker-dealer would be providing impersonal investment advice about securities that does not purport to meet the objectives or needs of a specific investor(s).

Purpose: Regarding the use of the term retail "investors," that term is used throughout the Investor Protection Act of 2009 (the "Act") as well as in the title of the Act itself. Use of the term retail investor (rather than retail "customer" or retail "client") in this section better reflects the status of the retail consumer that is the recipient of personalized investment advice about securities. It also helps seek to ensure consistency with other sections of the Act.

Purpose: Regarding the inclusion of the phrase "best interest of the retail investor and to disclose to the retail investor…," for brokers, dealers or investment advisers that provide personalized investment advice about securities to retail investors, such a standard of conduct is consistent with the apparent intent of the proposed legislation. Specifically, the standard of conduct is intended to enhance the standard of conduct currently generally required with respect to the provision of investment advice about securities. It is important to note that a hallmark of the standard would be the requirement that brokers, dealers and investment advisers, who provide personalized investment advice about securities to retail investors, make full, balanced and fair disclosure including material conflicts so that retail investors can make informed investment decisions. This standard of conduct is generally consistent with the duty that historically has been imposed on investment advisers pursuant to the Advisers Act. As such, the standard has been used by the SEC as the basis for imposing substantive obligations and prohibitions on investment adviser conduct and also to require investment advisers to disclose important information to clients, including information about material conflicts, often prior to the time an investment decision is made.

Purpose: Regarding the SEC rulemaking process, language is intended to ensure that any SEC rulemaking to implement this section take into account that retail investors receive personalized investment advice about securities through numerous distribution channels and various means. In some cases, retail investors receive personalized investment advice through distribution channels that provide advice about a variety of proprietary and/or non-proprietary securities. In other cases, retail investors receive personalized advice about securities only and the investor may seek to implement that personalized investment advice about securities directly through product manufacturers. Any SEC rulemaking should not look to advance one distribution channel or method as opposed to

another. Rather, the overriding goal is to serve retail investors by imposing a harmonized standard across distribution channels or methods, tailoring the standard to the extent necessary to reflect the various types of relationships that exist between a broker-dealer or investment adviser and a retail investor. SEC rulemaking should also take in to consideration that brokers, dealers and investment advisers (and their respective securities licensed representatives) typically may only provide investment advice and offer those securities available for distribution by the particular broker, dealer or investment adviser.

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"(1) OTHER MATTERS.-The Commission shall-

"(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers; and

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"(2) examine and, where appropriate, promulgate rules, including the establishment of duties regarding sales practices, conflicts of interest, and compensation practices for brokers, dealers, and investment advisers for the purpose of promoting the best interests of, and fair dealing with, retail investors. In doing so, the Commission shall tailor any such rules and duties to reflect the various types of relationships that exist between a broker, dealer or investment adviser and a retail investor in light of the nature of the personalized investment advice being provided and any related material conflict of interest."

Deleted: prohibiting

Deleted: schemes for financial intermediaries (including

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Purpose: Regarding the proposed requirement that the Commission examine and, where appropriate, promulgate rules, including the establishment of duties regarding sales practices, conflicts of interest and compensation, the language is intended to: (i) mirror the language included in an analogous section of the Consumer Financial Protection Agency Act of 2009

(specifically, Section 137(a)(2)(3)); (ii) reflect the proposed standard of conduct that all brokers, dealers, and investment advisers, in providing personalized investment advice about securities to retail investors, act in the best interest of the retail investor and to disclose to the retail investor, at or prior to the time such personalized investment advice about securities is provided, any material conflict between the interests of the broker, dealer, or investment adviser and the best interests of the retail investor related to the provision of such personalized investment advice; and (iii) require that any such promulgated rules or duties be tailored to reflect the various types of relationships that exist between a broker, dealer, or investment adviser and a retail investor in light of the nature of the personalized investment advice being provided and any related material conflicts of interest. Please also see the fourth "Purpose" paragraph that follows Section 913 (a)(k) above (that starts with the phrase "Regarding the SEC rulemaking process…") for additional information regarding, among other things, the various ways that brokers, dealers and investment advisers provide personalized investment advice about securities to retail investors.

(b) AMENDMENT TO INVESTMENT ADVISERS ACT OF 1940.-Section 211 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-11) is amended by adding at the end the following new subsections:

(f) STANDARDS OF CONDUCT.—Notwithstanding any other provision of this Act or the Securities Exchange Act of 1934, the Securities and Exchange Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing personalized investment advice about securities to retail investors, shall be to act in the best interest of the retail investor and to disclose to the retail investor, at or prior to the time such personalized investment advice about securities is provided, any material conflict between the interests of the broker,

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dealer, or investment adviser and the best interests of the retail investor related to the provision of such personalized investment advice. Any rules promulgated hereunder shall: (i) be tailored to reflect the various types of relationships that exist between a broker, dealer, or investment adviser and a retail investor in light of the nature of the personalized investment advice being provided and any related material conflicts of interest; and (ii) be designed to provide disclosure to allow the retail investor to make an informed decision with respect to the personalized investment advice being provided.

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"(g) OTHER MA TTERS.-The Commission shall-

"(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including consultation with other financial regulators on best practices for consumer disclosures, as appropriate; and

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"(2) examine and, where appropriate, promulgate rules including the establishment of duties regarding sales practices, conflicts of interest, and compensation practices for brokers, dealers, and investment advisers for the purposes of promoting the best interests of, and fair dealing with, retail investors. In doing so, the Commission shall tailor any such rules and duties to reflect the various types of relationships that exist between a broker, dealer or investment adviser and a retail investor in light of the nature of the personalized investment advice being provided and any related material conflict of interest."

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U.S. House of Representatives Committee on Financial Services
October 6, 2009
Hearing on
"Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office"

Testimony of:
Terry McGuire
Co-Founder and General Partner, Polaris Venture Partners,
Waltham, MA
and
Chairman of the National Venture Capital Association

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Terry McGuire and I am a co-founder and a general partner of Polaris Venture Partners, a venture capital firm based in Waltham, Massachusetts with additional offices in Seattle, Washington. We founded Polaris in 1996 with a mission to identify and invest in exceptional entrepreneurs and operating companies with innovative ideas and the promise to become market leaders. Since its inception Polaris has invested in more than one hundred companies in the areas of information technology, life sciences, digital media, and consumer and business services. Today we are actively nurturing more than 90 companies. Our entire organization employs 53 people of which 20 are venture investors. Even at this modest size, we are considered one of the larger venture firms in the industry.

At Polaris we build companies by actively partnering with each entrepreneur and management team to help propel their ideas into market leading businesses. We do this by providing a small amount of capital and a large amount of operating expertise and strategic counsel over a long period of time. While providing capital is the first order of business, it is the least time consuming of all our activities. We also recruit and attract employees at all levels. We identify and structure strategic partnerships. We raise additional equity to help the company make it to the next milestone. And, we're available 24/7 to support great teams, solve problems, identify opportunities, and detect "land mines." We also take a long-term view of our partnerships, knowing that building a successful company from the ground up takes time. We provide access to Polaris' expertise and network at all stages of a company's development and across all strategic areas of the business. And while we bring our own unique expertise and culture to the table, my

firm operates under the same long-term principles that all venture capital firms do in the United States. The venture industry has been doing business this way for more than 50 years.

In addition to my responsibilities as a venture investor, I am also Chairman of the Board of Directors of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of more than 400 venture capital firms in the United States which comprise more than 90 percent of the venture industry's capital under management.

It is my privilege to be here today to share with you, on behalf of the industry, the role of venture capital investment in the financial system, particularly as it relates to systemic risk. While it is our steadfast position that the venture capital industry poses no systemic risk to the world financial markets or to retail investors, we understand the need to identify and address the causes that led to the recent financial crisis. Further, we recognize the importance of eliminating regulatory gaps so that our country is never "surprised" by massive financial failures again.

Last week Capital Markets Subcommittee Chairman Paul Kanjorski released a discussion draft focusing on risk related to private pools of capital. We would like to express our sincere appreciation for the work of the Subcommittee and the full Committee under the leadership of Chairman Frank in drafting legislation that recognizes that venture capital firms do not pose systemic risk as well as understanding the burden that Advisers Act registration would place on our industry. The direction given to the SEC to "identify and define the term venture capital fund and provide an adviser to such fund an exemption from the registration requirements" offers welcomed assurances that we will be able to continue to build companies and create jobs without major encumbrances to that process. We are extremely encouraged by the understanding this Committee has demonstrated for the differences between entrepreneurial and systemic risk and we look forward to working with Congress, the Administration and the SEC to implement the recommendations put forth in the draft legislation.

The venture capital industry is committed to being part of the solution. To that end, today I will provide assurances and support to this Committee's draft legislation as to 1) why the venture capital industry does not create systemic risk, 2) why the government must continue to embrace entrepreneurial risk, 3) how sweeping venture capital into the originally introduced regulatory proposals would have been harmful to our industry and economic growth, and most importantly

4) how we might work within the framework of your legislative draft to achieve transparency and oversight without burdening our asset class.

Venture Capital Investment Overview

The contained structure of a venture capital fund, the long term nature of our investments, and the straightforward cash for equity model make our asset class unique. Venture capital funds typically are organized as private limited partnerships. Generally, 95 to 99 percent of capital for the venture fund is provided by accredited institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals who seek the high risk/high reward exposure afforded by venture capital. Venture capital funds are not sold directly to retail investors like mutual funds. The only means in which a retail buyer can have access to a venture fund is through a pension fund where venture capital might comprise a very small percentage of a fully diversified investment portfolio.

Our investors, referred to as the limited partners (LPs), commit to our fund a fixed amount for a fixed term of at least 10 years, sometimes extending to 12 or more years. During that time, the venture capitalists that make investment decisions on behalf of the fund form the general partnership (the GP), and we supply the rest of the capital for the fund from our own personal assets. Importantly, the capital supplied to a venture capital fund consists entirely of equity commitments provided as cash from investors in installments on an as-needed basis. Venture capital funds do not use debt to make investments in excess of the partner's capital commitments or "lever up" the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government. In fact, most limited partnership agreements, ours included, prohibit us from any type of long term borrowing.

All committed capital remains in the LP's control, until the venture capitalist has identified a company or idea in which to invest. These "capital calls" for investments happen in cycles over the full life of the fund on an "as needed" basis. Our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. Often these companies are formed from ideas and entrepreneurs that come out of university and government laboratories – or even someone's garage. Typically, the venture industry has focused on high technology areas such as

information technology, life sciences, and more recently, clean technology. As an example, one of our recent investments at Polaris is Pulmatrix based in Lexington, Massachusetts which is further developing novel technologies out of the labs at MIT and Harvard to treat, prevent and control the spread of highly contagious respiratory diseases such as H1N1.

Once we have identified a promising opportunity, we vet the management team and conduct due diligence research on the company, the market, the financial projections and other areas. For those companies that clear this investigation, we make an investment in exchange for equity ownership in the business. Importantly, investments into start-up companies are structured as cash in return for an equity share of the company's stock. Leverage is not part of the equation because start-ups do not typically have the ability to sustain debt interest payments and often do not have collateral that lenders desire. In fact most of our companies are not profitable and require our equity to fund their losses through their initial growth period. We also generally take a seat on the company's board of directors. We expect to hold a typical venture capital investment for 5 - 10 years, often longer and rarely much less. During that time, we continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones.

Our ultimate goal is what we refer to as an exit – which is when the company is strong enough to either go public on a stock market exchange or become acquired by a strategic buyer at a price that ideally exceeds our investment. The liquidity from these "exits" is distributed back to the limited partners. At that juncture, the venture capitalist "exits" the investment, essentially making way for new public investors (when the company issues an IPO) or a new corporate owner (when there is an acquisition).

Our industry is no stranger to technological and entrepreneurial risk. In fact, our business model – and our success – is built on embracing this type of risk. At least one third of our companies ultimately fail, and those that succeed usually take 5-10 years to do so. Our industry is one of the only asset classes with the long-term patience to withstand the high rates of failure among start-up businesses. This high tolerance for risk, however, is limited entirely to the operational success or failure of the start-ups in which we are owners. This is not financial engineering; this is straightforward equity investment and partnering with management to build a company

This risk is very different from the systemic risk that is the basis for the recent SEC registration proposals. Because there is typically no leverage component between the VC fund and its outside investors or between the VC fund and the companies in which we invest, venture capital investment risk is contained and measured. Those portfolio companies that succeed do so in significant ways, counterbalancing the losses elsewhere in the portfolio, while losses do not compound beyond the amount of capital committed by each partner. The venture industry has operated under this risk-reward model for the last 50 years.

The Economic Contribution of Venture Capital

The venture capital industry has contributed disproportionately to US economic growth and historically has differentiated the US economy from all others across the globe. Since the 1970's, the venture capital community has served as a builder of companies, a creator of jobs, and a catalyst for innovation in the United States. According to a 2009 study conducted by econometrics firm IHS Global Insight, companies that were started with venture capital since 1970 accounted in 2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, FedEx, Microsoft, Google, Medtronic and Apple. At Polaris, we have seen many of our companies go public including Akamai, which pioneered Internet content delivery in the late 1990's and today employs more than 1600 people and delivers 15-20 percent of all web traffic.

Our asset class has been recognized for building entire industries including the biotechnology, semiconductor, online retailing and software sectors. Within the last year, the venture industry has also committed itself to funding companies in the clean technology arena which includes renewable energy, power management, recycling, water purification, and conservation. Personally, as an investor in the life sciences arena, I am extremely proud of the work that I do each day, even knowing that not all my companies will succeed. Because the ones that do – the ones that have succeeded, have created jobs, generated revenues, and literally saved lives. Innovation and technology are critical to our economic future and the venture capital industry is committed to playing an important role in continuing our leadership in this arena.

Venture Capital and Lack of Systemic Risk

Since the financial crisis occurred, proposals before Congress rightly sought to protect investors from systemic risk. This Committee, through its legislative draft, has taken the lead in demonstrating an understanding that the venture capital industry's activities are not interwoven with U.S. financial markets and should not be regulated in the same manner as other asset classes that may indeed create such risk. Below is an analysis of the areas of systemic risk identified by the Treasury Department along with an explanation as to why venture investing does not contribute to this threat.

Venture capital firms are not interdependent with the world financial system. We do not actively trade in the public markets. Most venture capital funds restrict: (i) investments in publicly traded securities; (ii) investor redemptions prior to the end of the fund's term (which, in most cases, is ten to twelve years); and (iii) short selling or other high risk trading strategies. Moreover, our firm stakeholders are contained to a defined set of limited partners and their interests in the funds are not publicly traded. LPs make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund, generally 10 or more years. This long-term commitment is critical to ensure that funds are available not just for the initial investment into a start-up, but also for the follow-on rounds of investment which provide the company continued resources to grow. LPs agree to this lack of liquidity because the venture industry has historically achieved higher returns than the public markets.

Venture capital funds are not directly available to retail investors. The Advisers Act and the Investment Company Act apply primarily to the retail mutual fund sector and are both designed primarily for retail investor protection in individual accounts that invest in publicly-traded stocks and bonds. Unlike mutual funds or hedge funds, individual investors do not have direct access to venture capital funds. The one exception to this rule are high net worth individuals who comprise less than 10 percent of our institutional investor base and must be accredited to gain access to our funds. And while pension funds are often institutional investors in venture funds, their exposure is extremely small as these institutional investors are limited, in some cases by law, to the amount of money that is dedicated to venture activity. A pension fund, for example, typically will only invest 5-15% of its investable assets in what are called alternative assets – the broad category of

hedge fund, private equity, real estate and venture capital investments. The percentage or component of that allocation that is then committed to venture investing is quite small.

The venture capital industry is small in size. While certain pooled investment funds may present a systemic risk due in part to their size, the same cannot be said about venture capital funds, as the collective venture industry equates to a fraction of other alternative asset classes. In 2008, U.S. venture capital funds held approximately $197.3 billion in aggregate assets. This figure is expected to decrease in 2009. As a comparison, in testimony delivered earlier this year in the Senate, Mark Tresnowski, Managing Director and General Counsel of Madison Dearborn Partners speaking on behalf of the Private Equity Council, noted that the private equity industry has more than $450 billion in committed capital waiting to be invested. In the first quarter of 2009, the U.S. hedge fund industry held approximately $1.33 trillion in assets[1]. In 2008, venture capitalists invested just $28 billion into start-up companies which equates to less than 0.2 percent of US GDP. The average size of a venture capital fund in 2008 was $144 million dollars, an average fund level which we expect to continue to decline over the next several years.

Venture capital firms do not use long term leverage, rely on short term funding, or create third party or counterparty risk. Again, from previous testimony submitted by the buy-out industry, the typical capital structure of the companies acquired by a buyout fund is approximately 60% debt and 40% equity. In contrast, borrowing at the venture capital fund level, if done at all, typically is only used for short term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well. Start-ups generally cannot take on debt even if they wanted to do so – they simply don't have the collateral to acquire debt and many don't have any revenue from which to make debt payments. Additionally, venture capital firms themselves do not generally rely on short-term funding. In fact, quite the opposite is true. Our firms gradually call down equity capital commitments from investors over a period of approximately ten years on a "just-in-time basis", with initial investments in a company typically made within the first three to five years.

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[1] *See* Senate Banking SubCommittee Testimony of Jim Chanos from the Coalition of Private Investment Companies," *Regulating Hedge Funds and Other Private Investment Pools"*, July 15, 2009

All risk is contained within the venture ecosystem of limited partners, venture capital funds and portfolio companies. This ecosystem differs significantly from others where leverage and or securitization or derivatives are used. A venture capital fund in distress would generally only have consequences limited to the investors' returns, the fund sponsor's inability to raise a subsequent fund, and the fund's portfolio companies potentially losing access to additional equity capital. With its relatively small allocation to venture, the totality of the capital at risk is known and transparent, bounded by the level of capital initially committed.

For example, a million dollar mortgage can create a multiple of asset flows – perhaps $ 100 million – because of derivatives and bets regarding interest rates for that mortgage pool. In our world, a million dollar investment is just that – a million dollars. There is no multiplier effect because there are no side bets or other unmonitored securities based on our transaction. When one of our companies fails the jobs may go away and our million dollars is gone but the losses end there. Even when certain industries broadly collapsed in the past – such as the optical equipment or telecom industries – the failure and losses remained contained to that industry and those investments. Although entrepreneurs and their companies were impacted, the impact remained a very isolated, non systemic exposure. Without the layer of securities or use of derivatives that were at the heart of the many problematic transactions that catalyzed the recent financial crisis, the financial pain of failure remains self contained. No outside parties are betting on the success or failure of the venture industry and therefore they can not be impacted.

Lastly, it should be noted that during the recent financial crisis, the venture capital industry, though not immune to the recession, outperformed all major indices. According to Cambridge Associates, the one year return for pooled venture capital ending March 31 2009 was -17.5 percent, compared to -32.9% for the NASADQ, -35.9% for the DJIA, and -38.1% for the S&P 500. Anecdotally, at Polaris, our collective portfolio had consistent revenue growth during the financial crisis. Thus, while the venture industry was impacted tangentially by the recession, our companies exhibited a stronger buoyancy than the overall market. This phenomenon is not inconsistent with historical performance of our asset class.

Additional SEC Registration Requirements Would Hamper Venture Activity

We appreciate the implicit acknowledgement by this Committee that SEC registration is not just filling out a form and submitting it annually. The Investment Advisors Act of 1940 requires the creation of a substantial infrastructure which will easily cost small venture firms hundreds of thousands of dollars each year. The additional regulatory requirements will prevent us from focusing our time and financial resources on helping to start and grow new companies, does not provide the government with meaningful insight into systemic risk assessment and will divert government resources.

A venture capital firm employs a small administrative staff to handle firm operations. Often an investing partner will take on the role of Chief Administrative Officer and in that capacity will manage a Chief Financial Officer. The CFO is fully engaged in the financial operations of the firm, including portfolio company reporting, and all investor relations activities. At Polaris, our CFO John Gannon is, in our opinion, one of the most qualified financial professionals working in the venture capital industry today. He previously was a manager with PricewaterhouseCoopers and the CFO of publicly traded company. As General Partner, John also sits on 5 portfolio company boards, offering his financial expertise to grow these fledgling businesses. In addition to John, we have a finance staff of four. Yet even with these highly qualified individuals, we are still stretched thin and would need to add additional resources to meet SEC Advisers Act registration requirements. And, please remember that Polaris is viewed as one of the larger venture firms in the United States.

In addition to filing information regarding the identification of the firm, its partners and assets under management, the Advisers Act establishes a number of substantive requirements that would change the operation of a venture fund and the relationship between the venture fund and its limited partners. Many of these requirements, which are summarized below, would demand significant resources and overhead which sophisticated investors have not requested and venture funds currently do not have in place.

SEC Examinations -- The SEC can and does conduct periodic examinations of registered investment advisers. The SEC inspection staff looks closely at, among other things, the firm's internal controls, compliance policies and procedures, annual review documentation and books and records. SEC examinations may last anywhere from a few days to a few months. The intent

of these inspections is to evaluate the firm's compliance with various policies and procedures imposed on registered advisers. We do not believe that requiring periodic inspections of venture capital firms would provide meaningful insight for the government's assessment of systemic risk; however, we do believe it would further divert the SEC's resources from inspection of firms that do present systemic risk. Moreover, the costs and administrative burdens associated with preparing for an examination can be substantial.

Performance Fees. The Advisers Act prohibits contracts that provide for compensation based on a percentage of the capital gains or capital appreciation in a client's account, subject to certain exceptions, including a provision that permits a performance fee to be charged to certain "qualified clients" of the adviser that have a minimum net worth or a minimum amount of assets under management with the adviser. This limitation was designed to preclude advisers from subjecting client funds and securities to unnecessary speculation in order to increase fees to the adviser. However, venture firms are intentionally structured to make investments in companies that may fail and requiring venture firms to register could unintentionally prohibit carried interest payments for certain investors, thereby denying them access to a high-growth alternative asset class. In particular, it would require significant restructuring issues for existing funds formed in reliance on existing exemptions. More fundamentally this restriction alters the long-standing practice of LPs providing increased incentives for the GP to demonstrate long-term commitment to company growth. Doing so could change the dynamics of the industry unnecessarily.

Compliance Programs and Appointment of Chief Compliance Officer: The Advisers Act would require venture firms to implement written policies and procedures designed to prevent violations of the federal securities laws, to review the policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (a "CCO") to be responsible for administering the policies and procedures. The CCO selected by the venture firm must be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. The SEC has indicated that it expects that written policies and procedures would address, at a minimum (i) portfolio management processes; (ii) trading practices; (iii) proprietary trading of the adviser and personal trading by the adviser's supervised persons; (iv) accuracy of disclosures made to clients, investors and regulators; (v) safeguarding of client assets; (vi) accurate creation and maintenance of required books and records; (vii) advertising and marketing practices; (viii) processes to value client holdings and assess fees based

on those valuations; (ix) safeguards for the privacy protection of client records and information; (x) disaster recovery and business continuity plans; (xi) insider trading safeguards; and (xii) anti-money laundering efforts.

Codes of Ethics: The Advisers Act would require venture firms to adopt a code of ethics (a Code) which must set forth, among other things, (i) standards of conduct expected of personnel; (ii) a system of pre-clearance for investments in initial public offerings and private placements (iii) a requirement that all violations of the Code be promptly reported to the CCO or his or her designee; and (iv) a requirement that certain advisory personnel periodically report their personal securities transactions and holdings in securities. As venture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions, the latter requirement is of limited relevance to venture capital funds, yet would still apply.

Reports in relation to securities holdings must be submitted to CCO on an annual basis; reports in relation to securities transactions must be submitted on a quarterly basis. The adviser must provide each supervised person with a copy of its Code and must obtain each supervised person's written acknowledgement of receipt of the Code, as well as any amendments.

Form ADV and Periodic Filing: The Advisers Act would require a venture firm to file Form ADV Part I with the SEC in order to become registered under the Advisers Act. In addition, all registered venture firms would need to furnish each limited partner or prospective limited partner with a written disclosure statement that provides information concerning the venture firm, its operations, and its principals. This would need to be done on at least an annual basis.

Custody: The Advisers Act would require a venture firm that has custody of limited partner funds or securities to maintain such funds or securities with a qualified custodian. If a venture firm has custody of the limited partner funds or securities, then the firm must send quarterly account statements directly to each limited partner, member or other beneficial owner. However, the venture fund need not send these quarterly account statements if such entity is subject to audit at least annually and distributes audited financial statements to all limited partners. In the alternative, a venture firm possessing custody may also have an independent public accountant verify the assets held by the firm at least once a year. This auditing procedure must be conducted on a surprise, rather than a scheduled, basis.

Recordkeeping: The Advisers Act sets forth the books and records investment advisers must maintain. The CCO and at least one member of the professional staff of a venture firm would have to be fully familiar with this rule, which lists approximately 20 categories of records to be maintained, and with all operating procedures for complying with the recordkeeping rule. Generally, a registered investment adviser's books and records must be kept for a total period of five years (and longer in some cases).

All of these compliance elements promise to be costly from both a financial and human resources perspective. They also promise to change the way venture capital firms operate, adding significant administrative burden in exchange for information that is neither relevant nor useful for measuring and managing systemic risk. The costs will impact all venture firms in a negative fashion but will hit smaller firms the hardest as they typically do not have the financial or human capital today to comply with these requirements. These smaller firms are often located in regions of our country without a large venture presence like Georgia, Idaho, Michigan, Wisconsin, Ohio and Florida. Whereas in other industries, larger firms might view regulation as a competitive opportunity to weed out smaller players, the venture industry depends on the viability of firms of all size for a thriving ecosystem. We applaud this Committee for recognizing the human and financial costs for all our firms and assert that the direction provided in the legislative draft has gone a long way towards assuring the ongoing viability of these important company builders.

Meeting the Need for Transparency: A Proposal

The venture capital industry has always recognized the need for transparency into our activities and, in fact, we have provided information to the SEC for decades. I would like to take a moment to review our current disclosure activities, and then offer a proposal for consideration by the SEC for an enhanced process that seeks to address the concerns of policy makers.

As limited partnership interests are securities, venture capital fund offerings must either be registered with the SEC or meet an exemption from registration proscribed by the Securities Act of 1933 (the Securities Act). Venture capital funds typically rely on the latter and invoke Rule 506 "safe harbor" of Regulation D, as an exemption from public registration. To comply with the Rule 506 safe harbor, most venture capital funds file a "Form D" disclosure document with the Securities and Exchange Commission (SEC) during or shortly after their offering has

commenced. The Form D requires disclosure of significant information about the private offering.

An initial Form D must be filed with the SEC no later than fifteen calendar days after the "date of first sale" of securities in the venture capital fund's offering. Any information contained in a Form D filing is publicly available. As part of the current Form D filing requirements, venture capital funds are required to disclose many aspects of their business that can assist the government in assessing whether or not the venture capital fund imposes any systemic risk to the financial system.

Form D currently requires venture capital funds to disclose information about the fund, including (i) the fund's name, (ii) principal place of business, (iii) year and jurisdiction of organization, and (iv) the form of legal entity. Form D also requires venture capital funds to disclose material information regarding the size and terms of the offering. This information includes (i) the date of first sale of the fund's securities, (ii) the intended duration of the fund's private offering, (iii) the minimum investment amount accepted from a third party investor, and (iv) the total number of accredited and non-accredited investors to which the fund has sold securities (a Form D amendment is required if the total number of non-accredited investors increases to more than 35). This information also discloses the relevant Securities Act and Investment Company Act of 1940 exemptions that the fund relies upon in privately offering its securities.

A venture capital fund must also disclose the total dollar amount of securities the fund is offering. In contrast to hedge funds and some other types of pooled investment funds, a venture capital fund offering is generally neither continuous nor for an indefinite amount of interests. The stated offering amount is also often disclosed in the venture capital fund's offering memorandum or in the limited partnership agreement among the limited partners and general partner of the fund.

While we believe the Form D filing to be sufficient to determine the lack of systemic risk from venture capital firms, we also understand the concern expressed by the Administration that the financial system overhaul must protect against what has been called "regulatory arbitrage"—where industries seek to exploit regulatory gaps. Therefore, we put forth that the information we provide with slight modifications could easily be sufficient to meet these additional needs *without* burdening our firms with additional regulations that do not further the understanding of systemic risk. Our proposal is as follows:

Currently on Form D, question 4 asks the type of fund being raised, with options listed as "venture capital," "private equity fund," "hedge fund," or "other." If the "venture capital" box is selected, we could then file, on an annual basis with the SEC, a supplemental form – call it D-2 – that answers the administration's questions on the elements of systemic risk: the use of leverage, assets under management, trading positions and counterparty obligations. For pure venture capitalists, this form would be simple to complete as we do not use leverage, don't have counterparty obligations, and only have trading positions if we are fortunate enough to have a company that has just successfully completed an IPO and we have not yet been released from the post-IPO lock-up to sell that stock.

The D-2 solution is a preferable option because it does not require the SEC to derive and test a complex definition of venture capital investing. Rather it allows firms to first define themselves, but then be confirmed as "safe from systemic risk" by responding to questions that reveal the nature of the investing activity rather than relying on nomenclature alone. Firms engaging in systemically risky activities will quickly be identified by the SEC. Regulators would also enjoy the efficiency of the form, following up only with those firms which indicate they are engaged in activities that contribute to systemic risk. This process would accomplish the Administration's stated goals of providing transparency and eliminating regulatory gaps without unnecessarily burdening the venture firms or the SEC, as full blown SEC registration would do.

The Committee's support of exempting venture capital from regulatory proposals is backed by precedent. In 2001, then President Bush signed into law the USA Patriot Act, broad legislation intended to combat terrorism and money laundering activity. The legislation imposed anti-money laundering ("AML") compliance obligations on "financial institutions," including broker-dealers, commodity trading advisors, commodity pool operators and investment companies. While the term "investment companies" was not specifically defined, most legal opinions concluded that the term was intended to encompass both registered investment companies (e.g., mutual funds) and private investment funds (e.g., U.S. and offshore unregistered hedge funds, funds-of-funds, commodity pools, private equity funds and venture capital funds).

In addition to complying with existing AML requirements such as reporting currency transactions and complying with the economic sanctions imposed by the U.S. through the Office of Foreign Assets Control ("OFAC"), the new statute imposed significant new obligations, including

designating a compliance officer, establishing ongoing training programs and arranging independent audits to ensure compliance.

However, as the regulatory process unfolded, the Treasury Department ultimately recognized that venture activity did not meet the criteria for money laundering risk. The Treasury concluded that funds which do not permit investors to redeem investments within two years of their purchase would not be required to comply with the USA Patriot Act's AML compliance program obligations. In this instance the regulations were tailored to meet the need for information and transparency while not affecting activity ultimately unrelated. We hope that the Senate and the Administration will follow this precedence and the recommendations of this Committee and work together with our industry to ensure a similar outcome in the current regulatory overhaul.

Commitment to Effective Implementation

Along with our expressed appreciation for this Committee's thoughtfulness with regards to the treatment of venture capital in this legislation, we would like to convey a commitment to implementation. As we know from past experience, time can create uncertainty and completing the legislative and regulatory process on financial services will not be simple. We are ready to assist policy makers in expediting the process so that a regulatory policy can be effectively and efficiently implemented for venture capital funds, all in the best interest of investors, entrepreneurs and regulators.

Summary

We applaud this Committee's recognition that venture capital did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors. Requiring venture capital firms to comply with the Advisers Act would have unfairly burdened our industry with significant processes and costs redirecting our limited resources from finding and building new businesses to administrative tasks. We are hopeful that the Committee's intent to protect entrepreneurial growth and innovation is shared by the full House, the Senate, and the SEC as the legislative process moves forward.

The venture capital industry supports the government's request for greater transparency into what we do and how we do it so that policy makers can achieve the necessary comfort level that no gaps exist in our regulatory ecosystem. We believe that an enhanced reporting mechanism such as the form D-2 process we've described will provide the necessary assurances ongoing without burdening our small asset class.

The venture capital industry has benefited from many public policies that support entrepreneurs and create a positive environment for company growth. We have also struggled at times with the unintended consequences of the casting of a wide net which was not meant for us. We are grateful that this Committee has chosen the former with regards to this legislation.

At a time when economic recovery is paramount, we must all focus on the task at hand. Embracing entrepreneurial risk has created tremendous economic growth for our country. We stand ready to work with you so that you can gain the transparency you require without hurting our industry and the start-up companies with whom we work so closely. I thank you for your consideration today and I am happy to answer any questions.

TESTIMONY OF JOHN TAFT
HEAD OF U.S. WEALTH MANAGEMENT
RBC WEALTH MANAGEMENT
CHAIRMAN
PRIVATE CLIENT GROUP STEERING COMMITTEE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:
CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE

OCTOBER 6, 2009

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee: My name is John Taft. I am Head of U.S. Wealth Management, RBC Wealth Management, and Chairman of the Private Client Group Steering Committee of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for the opportunity to testify at this important hearing. I will present SIFMA's views on the discussion draft of the Investor Protection Act of 2009 ("Investor Protection Discussion Draft"),[2] particularly

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C. and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org.

[2] Discussion draft released by Congressman Kanjorski on October 1, 2009, available at http://www.house.gov/apps/list/press/financialsvcs_dem/investor_protection_act_draft.pdf.

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with respect to Section 103 (establishment of a fiduciary duty for brokers, dealers and investment advisers) and Section 201 (predispute arbitration agreements in the securities industry).

SIFMA and its members support the Committee's efforts to reform our financial regulatory system in order to create a new foundation for investor confidence and stability in our financial markets. We are also committed to being a constructive participant in the process as Congress considers important changes in our financial regulatory system.

We have the ability – and the responsibility – to both enhance investor protection and improve the efficiency and effectiveness of regulatory oversight. This guiding principal underpins the testimony we present today on fiduciary duty and securities arbitration. It also distinguishes SIFMA's views in terms of our support for strong and consistent safeguards that both protect individual investors, and preserve their choice of the widest range of products, services and advice offered by their financial services providers – which is part of putting clients first.

A. Fiduciary Duty for Brokers, Dealers, and Investment Advisers

On July 17, 2009, SIFMA testified before this Committee in support of a harmonized fiduciary standard for broker-dealers and investment advisers, established and applied at the federal level.[3] Under our proposed formulation, when broker-dealers

[3] Testimony of Randolph C. Snook before the U.S. House of Representatives Committee on Financial Services in the July 17, 2009 hearing on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" ("Snook Testimony"), available at http://www.sifma.org/legislative/testimony/pdf/Snook-testimony-7-17-09.pdf.

and investment advisers engage in the identical service of providing *personalized investment advice* about securities to individual investors, they should be held to a uniform, federal fiduciary standard of care. We further testified that the federal fiduciary standard should be applied exclusively, and should supersede existing state common law-based fiduciary standards. We also agreed with the U.S. Treasury's proposal to delegate to the SEC broad authority to create the rules that would govern the federal fiduciary standard.

Today, we will expand upon these and other important points from our earlier testimony.

1. Personalized Investment Advice

One of our primary concerns with the proposed legislation is ensuring that it clearly and appropriately defines the circumstances under which a federal fiduciary duty would apply. As we testified in July 2009, we believe the term *personalized investment advice* is perfectly suited for this purpose.[4]

This term was coined nearly 25 years ago in a U.S. Supreme Court case that sought to define the business of investment advisers.[5] Since that time, the term has been

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[4] As illuminated by Supreme Court caselaw and the federal securities regulations, the term *personalized investment advice* means investment advice services which purport to meet the objectives or needs of specific individuals or accounts.

[5] *Lowe v. Securities and Exchange Commission*, 472 U.S. 181, 204 (1985) (legislative history of Investment Advisers Act of 1940 "plainly demonstrates that Congress was primarily interested in regulating the business of rendering *personalized investment advice* (emphasis added)").

further clarified under various federal securities regulations.[6] In recent months, SEC Chairman Mary Schapiro invoked the term to define the circumstances under which a fiduciary duty should apply to both brokers and investment advisers alike – when they are performing the same important service of providing personalized investment advice to individual investors.[7]

SIFMA agrees with the SEC Chairman that the term *personalized investment advice* appropriately identifies the common business activity that both broker-dealers and investment advisers provide to individual investors, and that should be subject to a federal standard of care. Although broker-dealers and investment advisers provide some of the same services to individual investors,[8] they are disparately regulated, contributing to investor confusion.[9] This area of overlap, thus, is at the crux of this particular harmonizing legislation and addressing it should deliver the most meaningful benefit to

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[6] *See, e.g.*, Investment Advisers Act Rules 203A-3(a)(3), 204-3(g)(1), and 206(4)-3(d)(3).

[7] Speech by SEC Chairman Mary L. Schapiro, Address before the New York Financial Writers' Association Annual Awards Dinner, New York, NY (June 19, 2009), available at http://sec.gov/news/speech/2009/spch061809mls-2.htm.

[8] Section 103 uses the term "retail customers," as opposed to "individual investors," but defines the term to mean an individual who receives from a broker, dealer or investment adviser personalized investment advice which is to be used primarily for personal, family, or household purposes, and also the legal representative of such an individual. We believe this lends valuable clarity and focus to the legislation. The federal fiduciary standard that SIFMA supports should apply to individual investors only based on our view that institutional clients are better able to – and in practice do in fact – appreciate and appropriately define the terms of their relationships with investment advisory service providers.

[9] Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, December 31, 2007, available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

individual investors.[10] Thus, when broker-dealers and investment advisers engage in the identical service of providing *personalized investment advice* about securities to individual investors, SIFMA agrees they should be held to the same standard of care.

We appreciate that the Investor Protection Discussion Draft embraces the term *personalized investment advice* by incorporating it into the definition of *retail customer*. It does not, however, use the same term to specify when the fiduciary standard applies. Rather than invoke the concept of personalized investment advice to define the customers who are protected by this new standard, we believe it should be used to define the type of advice to which the standard will apply. Specifically, the proposed legislation should clarify that *personalized investment advice – about securities*[11] – triggers the fiduciary standard, and should direct the SEC to explicitly incorporate this harmonized standard into its rules under the federal securities laws.

2. Authentic Fiduciary Standard

Some have suggested that SIFMA's proposed fiduciary standard is somehow inferior to the genuine article – something less than what some refer to as the

[10] SIFMA also supports much further reaching harmonization and rationalization of the financial regulatory system in a wide variety of contexts. *See, e.g.,* Snook Testimony, available at http://www.sifma.org/legislative/testimony/pdf/Snook-testimony-7-17-09.pdf.

[11] The language in the Treasury's version of the Investor Protection Act wisely limited application of the fiduciary duty to advice *about securities*. Treasury's approach is consistent with the federal securities laws which broadly prohibit fraudulent activity "in connection with the offer, purchase, or sale of securities." It also avoids unnecessary and unintended over-breadth, and potentially abusive application, of the standard.

"authentic"[12] or bona fide or true fiduciary standard. Nothing could be further from the truth.

SIFMA's vision of a harmonized fiduciary standard is even stronger, and more pro-investor, than any other alternative we have heard advanced. As we previously testified, the central imperative of a fiduciary is putting investors' interests first. A fiduciary should also act with good professional judgment, and avoid conflicts of interest, if possible, or otherwise effectively manage conflicts through clear disclosure and, as appropriate, investor consent.[13] These decidedly pro-investor, core principles lie at the heart of what it truly means to be a fiduciary. This is the formulation of fiduciary that SIFMA endorses – and that individual investors deserve.[14]

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[12] *See, e.g., New trade group wants 'authentic fiduciary standard,'* Sara Hansard, InvestmentNews (June 29, 2009) (reporting on a self-interested media campaign by a group of eleven fee-only advisers and consultants).

[13] Conflicts are inherent to the business of investment advisers and broker-dealers. As one SEC official has observed: "When you are *paid* to act as an intermediary, like a broker, or as another's fiduciary, like an investment adviser, the groundwork for conflict between investment professional and customer is laid. The historical success of the financial services industry has been in properly managing these conflicts, either by eliminating them when possible, or disclosing them. In the long run, treating customers fairly has proven to be good business." Remarks of Stephen M. Cutler, Director, SEC, Division of Enforcement, (Sept. 9, 2003), available at www.sec.gov/news/speech/spch090903smc.htm. We agree that the proposed legislation should encourage the SEC to review conflicts of interests facing investment advisers and broker-dealers alike and the adequacy of their measures to manage them, including through disclosure and investor consent as appropriate.

[14] We note that broker-dealers are already subject to and operate under many core fiduciary principles, including the following which are memorialized under current FINRA rules: just and equitable principles of trade; suitability of recommendations; best execution of transactions; fair and balanced disclosure to investors; supervision; and training.

3. *Federal Fiduciary Standard*

Our recommendation is based on traditional and well-recognized aspects of fiduciary law, and is also highly distinguishable from what others are proposing. SIFMA calls for the creation of a federal fiduciary standard that is *exclusive* and that supersedes and improves upon the current state common law-based fiduciary standards applicable to investment advisers for the benefit of *individual investors.*[15] SIFMA does not propose to modify the current state common law-based standards applicable to the delivery of investment advice to the institutional clients of investment advisers.[16]

The current state common law-based fiduciary standards are inadequate to serve as a harmonized standard for individual investors. Under state common law, which is court-made and often varies from court to court and jurisdiction to jurisdiction, the nature of a person's fiduciary duty depends on the relationship between the parties and the particular circumstances.[17] So, when you ask the seemingly simple question, "How do you define fiduciary?," the answer is, "It depends."

Courts across the country have reached decidedly different outcomes in determining whether a fiduciary duty exists, and if so, whether a financial services

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[15] Currently, neither the Securities Exchange Act of 1934, which governs broker-dealers, nor the Investment Advisers Act of 1940, which governs advisers, expressly imposes a fiduciary standard. With respect to investment advisers, however, a 1963 Supreme Court case declared advisers to be fiduciaries by virtue of state common law. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). Although the broker-dealer regulatory scheme has no corollary to the *Capital Gains* decision, it clearly reflects fiduciary principles, as described immediately above.

[16] See discussion in footnote 9.

[17] Restatement (Third) Agency § 8.07 comment b.

professional satisfied that duty towards his or her individual client.[18] Not surprisingly, as a result, fiduciary law has developed haphazardly and often inconsistently among the 50 states.[19] Consequently, investor protection can actually grow or diminish as an individual investor moves from state to state.

In sum, the existing state common law-based standards for individual investors are imprecise and indeterminate, and have been developed unevenly over time. Thus, individual investors would benefit from the clarity, consistency, and uniformity of a national standard.

The Investor Protection Discussion Draft is silent as to the prospective interaction or interplay between the proposed harmonized fiduciary standard and common law-based fiduciary standards. Given this issue's potentially profound implications for both

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[18] Among the dozens of cases that address this issue, there are few unifying principles or rules of thumb than can be drawn from them. *Compare Farmland Indus. v. Frazier-Parrott Commodities, Inc.*, 871 F.2d 1402, 1411 (8th Cir. 1989) (In Missouri, fiduciary duties may arise out of a financial professional-customer relationship); *with Lefkowitz v. Smith Barney, Harris Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986) (stating that "a simple [financial professional]-customer relationship does not constitute a fiduciary relationship in Massachusetts."); *and with Brown v. California Pension Administrators & Consultants, Inc.*, 52 Cal. Rptr. 2d 788, 796-97 (Cal. App. 1996) (stating that where a financial professional provided investment advice to his customer, the relationship was one of principal-agent, and therefore, fiduciary duties applied). *See Robinson v. Merrill Lynch*, 337 F. Supp. 107, 111 (N.D. Ala. 1971) ("The [fiduciary] relationship of agent and principal only existed between [broker and customer] when an order to buy or sell was placed, and terminated when the transaction was complete"), and *Baker v. Wheat First Securities*, 643 F. Supp. 1420 (S.D. W.Va. 1986) (stockbroker does owe a fiduciary duty to his client, but the scope of the broker's duties owed depends on a detailed consideration of other factors). *See also Int'l Order of Foresters v. Donaldson, Lufkin & Jenrette*, 157 F.3d 933, 940-41 (2d. Cir. 1998); *Davis v. Merrill Lynch*, 906 F.2d 1206 (8th Cir. 1990); *Romano v. Merrill Lynch, et al*, 834 F.2d 523, 530 (5th Cir. 1987); *Leib v. Merrill Lynch*, 461 F.Supp. 951, 953 (E.D. Mich. 1978); and *Paine, Webber*, 718 P.2d 508, 517-518 (Colo. 1986).

[19] As a result of the inconsistent, seemingly haphazard approach among the states, some commentators have suggested that fiduciary duties for broker-dealers should be developed primarily through rulemaking. *See The Madoff "Opportunity": Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice* (T. Lemke & S. Stone), 13 Wall Street Lawyer 6, n. 38 (June 2009).

investor protection and investor choice, however, we strongly recommend that Congress provide the clarity and consistency that only an exclusive fiduciary standard that is uniformly and even-handedly applied at the federal level can deliver.

We recognize and support the important role that States play in protecting individual investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions to the extent consistent with the federal fiduciary standard. We also recommend that the SEC confer with state regulators on how the SEC should define this federal fiduciary standard.

The federal fiduciary standard would best harmonize the regulatory regime for broker-dealers and investment advisers by avoiding other fiduciary regimes. It should also retain sufficient flexibility to adapt to: the wide range and variety of investment products and services that individual investors may choose; the personalized investment advice that individual investors may elect to receive and follow, or not, in the exercise of their own discretion; and their choice as to how they pay for their advice, whether on a commission-basis,[20] or fee-basis, or otherwise.

We agree that the SEC is best positioned to ensure that a federal fiduciary standard is clear, well-defined, and equally applied, so that all individual investors receive the same protections when receiving the same kinds of personalized investment

[20] The Investor Protection Discussion Draft explicitly states that a broker-dealer's receipt of commission-based compensation would not violate the fiduciary duty. SIFMA agrees, but suggests that the proposed legislation should contemplate and allow for other forms of compensation as well.

advice about securities. But we are concerned about two aspects of the draft legislation that we think threaten to hinder attainment of its objectives.

First, we are concerned that the proposed legislation omits the concept of disclosure from its framing of the federal fiduciary duty – and thereby paints an adviser's obligations as absolute, without any ability to address conflicts through disclosure and client consent. This approach threatens to unhinge the disclosure-based approach that has been read into the Act ever since the Supreme Court decided *Capital Gains* and that has been the foundation of the SEC's framework of regulation under that statute. In essence, the Supreme Court ruled that an investment adviser's fiduciary duty was to act in the client's best interest or to disclose any material conflicts of interests that could impede the adviser in so doing. We expect that this proposed change will be of concern to both investment advisers and broker-dealers alike, and would be a setback to investors if it leads to them receiving less information from their financial professionals.

Second, we are concerned that the Investor Protection Discussion Draft fails to provide the SEC with adequate leeway to accomplish the important purpose of the legislation. The Investor Protection Discussion Draft appears to unnecessarily constrain the SEC by entirely subjugating broker-dealer regulation under the Securities Exchange Act of 1934 to investment adviser regulation under the Investment Advisers Act of 1940.

The SEC, however, should retain sufficient flexibility to craft broker-dealer regulations – consistent with a uniform federal fiduciary standard – without being limited or constrained by investment adviser rules and in a manner that makes sense within its framework for regulating broker-dealers under the Securities Exchange Act of 1934. In

certain respects, such flexibility would be necessary in recognition of the numerous, diverse, and investor-beneficial products and services offered by broker-dealers that differ from, and are more numerous than, those offered by today's investment advisers. Such flexibility would also necessarily protect investors by appropriately respecting and preserving investor choice – an often neglected, but necessary, component of putting individual investors' interests first.

B. Pre-Dispute Arbitration Clauses

The U.S. Treasury White Paper released in June 2009 proposed giving the SEC authority to prohibit pre-dispute arbitration agreements in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors.[21] Similarly, the proposed Consumer Financial Protection Agency[22] would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.[23]

Although the Treasury White Paper states that the SEC is required to study the use of predispute arbitration clauses to determine whether they harm investors,[24] the

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[21] U.S. Treasury White Paper, *A New Foundation: Rebuilding Financial Supervision and Regulation* at p.72 (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[22] Consumer Financial Protection Agency Act (CFPAA) of 2009, H.R. 3126, available at http://www.opencongress.org/bill/111-h3126/text.

[23] See Section 127 of the CFPAA discussion draft released on September 25, 2009.

[24] U.S. Treasury White Paper at p.72.

Investor Protection Discussion Draft omits this important requirement. We strongly support its restoration. We support continuous study of the fairness and efficiency of the securities arbitration system.

We recognize that Congress is taking a fresh and broad look at arbitration practices generally. An SEC study could help inform Congress's consideration of these issues with respect to securities arbitration in particular. In this context, it would be inappropriate and unfair to investors and securities firms alike to allow the SEC to ban predispute arbitration agreements by fiat without the benefit of study.

For nearly four decades, the SEC has upheld and enforced securities rules that require securities firms to arbitrate at the election of the investor.[25] Securities firms have gained the same right in return by entering into predispute arbitration agreements with their new customers. Such contracts ensure that both sides are treated fairly and effectuate the public policy in favor of predispute arbitration agreements that has been recognized by both Congress and the U.S. Supreme Court.[26] The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency.

Accordingly, the SEC should be required to study arbitration clauses and submit to Congress a report on the findings of any such studies, including any legislative

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[25] *See* § 12200 of the Financial Industry Regulatory Authority (FINRA) Code of Arbitration Procedure ("Code of Arbitration Procedure") and Rule 600A(a)(ii) New York Stock Exchange Arbitration Rules (directing that members of the securities industry must arbitrate upon demand of the customer). FINRA's rules have required member firms to arbitrate at the investor's demand since March 1972. *See* FINRA Manual (July 1, 1974) (noting that former Code of Arbitration Procedure ¶ 3702, § 2(a)(2) took effect on March 9, 1972).

[26] *See* Federal Arbitration Act, 9 U.S.C. Section 1 *et seq.*, available at http://www.law.cornell.edu/uscode/html/uscode09/usc_sup_01_9_10_1.html; *Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220, 225-226 (1987).

recommendations that the SEC finds are in the public interest and for the protection of investors. Frankly, we do not believe that any such study would ever lead to the conclusion that predispute arbitration agreements do not benefit investors.

We base this assertion in part on our own study of arbitration concluded in October 2007.[27] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them to pursue claims that they could not afford to litigate or that would be dismissed in court.

Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system. In fact, prohibiting such clauses would be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater

[27] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of the proposed legislation. We urge Congress to consider these factors in its deliberation over the securities arbitration proposal. We also urge further study of predispute arbitration clauses in the securities industry to determine whether there is any basis whatsoever for concern that these clauses may harm investors.

Conclusion

Thank you, Chairman Frank, Ranking Member Bachus, and members of the Committee, for allowing me to present SIFMA's views. Again, we support your efforts to improve upon our financial regulatory system. SIFMA and its members remain committed to being a constructive participant in the process, and we stand ready to assist the Committee on this historically important initiative.

Statement of

David G. Tittsworth
Executive Director and Executive Vice President
Investment Adviser Association

Hearing on Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

House Committee on Financial Services

October 6, 2009

Executive Summary

The IAA strongly supports the Administration's recommendation in its white paper to require "broker-dealers who provide investment advice about securities to investors to have the same fiduciary obligations as registered investment advisers." Investment advisers are fiduciaries to all of their clients under the Investment Advisers Act of 1940. As fiduciaries, advisers must at all times act in the best interests of their clients, placing their clients' interests above their own. Advisers have an "affirmative duty of utmost good faith, and full and fair disclosure of all material facts as well an affirmative obligation to employ reasonable care to avoid misleading its clients." We strongly believe that all persons who are performing investment advisory activities should be subject to the same standard of care.

We are concerned, however that the Administration's proposed legislative language in Section 913 of the Investor Protection Act would open the door to weaken the current fiduciary duty standard for advisers and would not effectuate the recommendation made in the white paper. The proposed text would amend the Advisers Act to grant broad rulemaking authority to the SEC to promulgate different standards of

care than the fiduciary standard that already applies to all investment advisers with respect to all of their clients under the Advisers Act.

We are particularly concerned that the proposal could impose a fiduciary duty only with respect to retail clients and would water down or eliminate the fiduciary obligations that advisers owe all of their clients – whether individual or institutional (*e.g.* pension plans, endowments, mutual funds, or trusts). It would be a mistake to alter or narrow the fiduciary standard. One of the greatest strengths of a fiduciary standard is precisely its breadth – the standard has allowed the regulation of advisers to remain dynamic and relevant in changing business and market conditions.

In addition, the IAA continues to strongly support the SEC as the direct regulator for investment advisers. The SEC must be adequately funded to carry out its important missions of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. Congress and the SEC should take steps to bolster the SEC's resources:

- There must be full funding for the SEC's regulatory, inspection, and enforcement efforts. We believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding, including self-funding mechanisms and user fees.

- The SEC should increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the threshold would reduce the number of SEC-registered advisers and permit the SEC to focus on the appropriate universe of advisers on a risk-adjusted basis in its examination program.

- The SEC should improve its inspection program for investment advisers. There are a number of steps the SEC can take to better leverage its resources, including use of better technology, enhanced training, and additional data.

We would be pleased to work with the Committee and the SEC to explore ways to ensure that investment advisers are subject to appropriate and timely examinations.

- The idea of establishing a self-regulatory organization (SRO) for investment advisers has been raised and rejected a number of times over the years. We continue to oppose the creation of an SRO for the advisory profession. The drawbacks to an SRO – including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs and bureaucracy – continue to outweigh any alleged benefits.

Introduction

The Investment Adviser Association (IAA)[1] greatly appreciates the opportunity to appear before the Committee today to address the Treasury Department's proposed legislation, the Investor Protection Act of 2009, and issues related to SEC resources.

We commend the Committee for convening this hearing. Both as entities subject to regulation and as investors in the securities markets on behalf of their clients, the IAA's investment adviser members bring important perspectives to the regulatory reform discussion. We expressed our general views on regulatory reform at a hearing of the Senate Banking Committee earlier this year. Among other issues, we expressed our support for Congressional action to address true gaps in the current regulatory structure, notably the regulation of hedge fund managers and derivatives, including credit default swaps. We applaud your work in addressing these and other problems that were directly

[1] The Investment Adviser Association (IAA) is a not-for-profit trade association that exclusively represents the interests of federally registered investment advisory firms. Founded in 1937, the IAA's membership consists of more than 450 investment advisory firms that collectively manage in excess of $8 trillion for a wide variety of clients, including individuals, trusts, endowments, foundations, corporations, pension funds, mutual funds, state and local governments, and hedge funds. For more information, please see www.investmentadviser.org.

related to the financial crisis that began last year.[2] The IAA stands ready to assist the Committee in undertaking the critical tasks of renewing investor confidence and addressing failures of and weaknesses in the current regulatory framework.

The Administration's White Paper and Proposed Legislation on Investor Protection

In June, the Administration released its white paper for financial services regulatory reform.[3] The document includes a discussion of initiatives "to empower the SEC to increase fairness for investors."[4] Citing the confusion of retail investors about the differences between investment advisers and broker-dealers, the Administration's white paper contains the following recommendations:

> *New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:*
>
> - *requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;*
> - *providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and*
> - *prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.*[5]

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[2] For additional views on financial services regulatory reform, *see Enhancing Investor Protection and the Regulation of Securities Market Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs* 111th Cong. (March 26, 2009) (statement of David G. Tittsworth, Executive Dir. and Executive Vice President, Investment Adviser Association).

[3] U.S. Dept. of the Treasury, *A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), available here.

[4] *Id.* at 71.

[5] *Id.* at 72.

In July, the Treasury Department released proposed legislation, entitled the "Investor Protection Act of 2009," to implement these recommendations and other issues set forth in the white paper. Section 913 contains parallel amendments to the Securities Exchange Act of 1934 (the primary law governing broker-dealers) and the Investment Advisers Act of 1940 (the primary law governing investment advisers) that would authorize the SEC to conduct various rulemakings under both statutes relating to standards of conduct, disclosures, sales practices, conflicts of interest, and compensation schemes.[6]

The IAA strongly supports the Administration's recommendation to require broker-dealers who provide investment advice to have the same fiduciary obligations as investment advisers. The Advisers Act fiduciary duty is the appropriate standard for protecting investors who rely on investment advice provided by investment advisers and other financial services providers. As noted below, the fiduciary duty under the Advisers Act is well-established and has been applied consistently over the years by courts and the SEC. It requires those who provide investment advice to put the interests of their clients ahead of their own interests. The Advisers Act fiduciary duty has worked well to protect investors and should not be revised, re-interpreted, watered down, or eliminated.

The IAA has long supported the view that persons providing the same services should be subject to the same laws and standards.[7] Accordingly, we have for many years argued in favor of subjecting brokers and others who provide investment advice about securities to the same laws and standards that apply to investment advisers. This is a

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[6] We note that Rep. Kanjorski released a 114-page discussion draft of the Investor Protection Act of 2009 late last week which, in certain respects, includes significant differences from the Treasury's proposal. Although it includes some improvements, Section 103 of the draft is substantially similar to Section 913 of the Treasury Department's draft legislation and continues to implicate many of the concerns addressed in our testimony regarding Section 913.

[7] *See, e.g., Letter from David G. Tittsworth, Executive Dir., Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission*, (Jan. 12, 2000) (on file with SEC) in re *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 34-42099, Investment Advisers Act Release No. 1845, 64 Fed. Reg. 61226 (proposed Nov. 4, 1999) (The IAA "agrees with the Commission that a functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act.") available here.

commonsense and reasonable approach. Unfortunately, as broker-dealers have migrated toward the investment advisory model, they have not been subject to the same standards.

To understand the issues underlying the Administration's current proposal, an examination of the legal and regulatory framework governing investment advisers, the migration of broker-dealers toward the investment advisory model, and developments related to the broker-dealer exclusion under the Advisers Act is required.

Background

The Investment Adviser Profession and Applicable Regulatory Framework

The investment advisory profession is robust and dynamic. Investment advisers serve a wide variety of clients, including individuals, trusts, endowments, foundations, corporations, government and private pension funds, mutual funds, hedge funds, and other types of pooled investment vehicles. In general, investment advisers are required to register with the SEC if they manage more than $25 million in assets. As of April 2009, there were 11,257 investment advisers registered with the SEC.[8] These advisers collectively reported assets under management of $34 trillion.

Contrary to public perception, the overwhelming majority of investment advisory firms are small businesses. As of April 2009, more than 8,000 investment advisers (71 percent of all SEC-registered investment advisers) reported managing between $25 million and $1 billion in assets. More than 10,000 advisers (90 percent) reported 50 or fewer employees. A few large investment advisory firms manage a disproportionate share of total assets: fewer than 500 advisory firms (about 4 percent of all SEC-registered investment advisers) reported managing more than $10 billion in assets, yet collectively accounted for more than 80 percent of all assets ($27.9 trillion).

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[8] *See* Investment Adviser Association and National Regulatory Services, *Evolution/Revolution 2009: A Profile of the Investment Advisory Profession,* (Oct. 2, 2009), available at the IAA web site, www.investmentadviser.org, under "Publications/News" and "Reports & Brochures."

While investment advisers employ a broad range of business strategies, the core activity of most investment advisers is providing investment advice on a discretionary basis to clients, that is, they are granted authority by their clients to make investment decisions for their clients' portfolios on an ongoing basis.[9] In addition to providing investment advisory services for individual or institutional clients, some investment advisers engage in other related activities, such as financial planning services, assisting in selection and monitoring of other advisers, serving as subadvisers to funds offered by other advisers, or providing wealth management services.

The legal and regulatory regime for the advisory profession must be flexible in order to address the enormous diversity among advisers. Consistent with this concept, the Advisers Act provides a largely principles-based statutory framework governing the conduct of those who provide investment advice. The Advisers Act sets forth a broad definition of "investment adviser": an investment adviser is a person who, for compensation, is in the business of rendering advice regarding securities. There are a number of exclusions from the definition, including the broker-dealer exclusion discussed below.[10]

The basic statutory framework of the Advisers Act is relatively simple and straightforward. Certain investment advisers are required to register with the SEC and are subject to regulations issued and enforced by the Commission.[11] The statute makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client

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[9] *Id.* at 5. Of the $34 trillion assets under management reported by advisers in 2009, only $3.1 trillion were reported as non-discretionary. 89% of all investment advisers reported having discretionary authority over client accounts. *Id.* At 24. 75% reported providing portfolio management for individuals or small businesses. *Id.* at 21. 63% reported that they provide portfolio management for businesses or institutional clients, other than mutual funds. *Id.*

[10] *See* Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (2008). Other exclusions cover, under certain circumstances, banks, attorneys, accountants, publishers, and those who provide only incidental investment advice.

[11] *See* Investment Advisers Act of 1940 §§ 203, 209; 15 U.S.C. §§ 80b-3, 80b-9 (2008).

or prospective client," to engage in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and to engage in principal trades without receiving the consent of the client.[12] The law authorizes the Commission to promulgate rules and regulations that define and prescribe ways to prevent any act, practice, or course of business by an adviser that is "fraudulent, deceptive, or manipulative."[13] As discussed below, fundamental to the Advisers Act is the principle that an investment adviser is a fiduciary that must act in the best interests of its clients at all times. As former SEC Chairman Arthur Levitt has stated:

> *[T]he Act broadly prohibits fraud and holds advisers to rigorous fiduciary standards when dealing with clients. Investment advisers have two choices under the Act. They must rid themselves of all conflicts of interest with their clients – conflicts that might influence them to act in their own best interest rather than in the best interest of their clients. Or, they must fully disclose any conflicts to clients and prospective clients.*[14]

In addition to this overarching principles-based regulatory framework and the ongoing duties that flow from it, investment advisers are subject to specific rules and disclosure requirements. All SEC-registered investment advisers are required to submit a registration form and investor disclosure document (Form ADV) and update it at least

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[12] Investment Advisers Act of 1940 § 206(1)-(3), 15 U.S.C. § 80b-6(1)-(3) (2008).

[13] Investment Advisers Act of 1940 § 206(4), 15 U.S.C. § 80b-6(4) (2008). The Commission also is given authority to exempt persons or transactions from the Advisers Act or regulations thereunder, "to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." Investment Advisers Act of 1940 § 206A, 15 U.S.C. § 80b-6a (2008).

[14] Arthur Levitt, Chairman, Sec. and Exch. Comm'n, *Amendments to Form ADV: Opening Statement*, (April 5, 2000); *see also SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 190-192 (1963) ("[t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested").

annually and promptly for material changes.[15] Form ADV, Part 1 disclosures are publicly available and reveal extensive information regarding each investment adviser.[16]

Under SEC rules and pronouncements, investment advisers are subject to a variety of requirements relating to insider trading, proxy voting, books and records, custody, privacy, best execution, business continuity, advertising, and referral arrangements.[17] Investment advisers must adopt written codes of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.[18] Advisers must also adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review the policies and procedures at least annually to determine their adequacy and effectiveness of their implementation, and designate a chief compliance officer responsible for administering the policies and procedures.[19] Further, investment advisers are subject to inspections and oversight by the SEC.

The Broker-Dealer Exclusion and the Migration of Broker-Dealers to the Investment Advisory Model

The Advisers Act includes an exclusion from the definition of investment adviser for "any broker or dealer whose performance of such services is solely incidental to the

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[15] Advisers are required to disclose detailed information about their firms and executives, including: the educational and business background of each person who determines general investment advice to clients; the adviser's basic fee schedule (including how fees are charged and whether such fees are negotiable); types of investments and methods of securities analysis used; how the adviser reviews client accounts; the adviser's other business activities; material financial arrangements the adviser has with a wide variety of entities; certain referral arrangements; and numerous other disclosures that describe activities that may pose potential conflicts of interest with the adviser's clients, including specific disclosures relating to trading and brokerage practices.

[16] *See Investment Adviser Public Disclosure Web Site:* www.adviserinfo.sec.gov. The IAA has been urging the SEC to issue final rules amending Form ADV, Part 2 to provide greater clarity and enhanced disclosure to investors.

[17] *See, e.g.,* Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. §§ 275.204-1, 275.204-2, 275.206(4)-1, 275.206(4)-2, 275.206(4)-3, 275.206(4)-6, 275.206(4)-7 (2008), Regulation S-P, 17 C.F.R. § 248.1 et. seq.

[18] 17 C.F.R. § 275.204A-1 (2008).

[19] 17 C.F.R. § 275.206(4)-7 (2008).

conduct of his business as a broker or dealer and who receives no special compensation therefor." The term "special compensation" is intended to cover non-commission-based compensation.

When brokers charged only commissions, the broker-dealer exclusion provided a consistent, bright-line test separating the activities of brokers from investment advisers. However, over the past two decades, broker-dealers began charging asset-based fees, rendering application of the exclusion increasingly uncertain.

The migration of broker-dealers toward the investment advisory model, and the resulting investor confusion, has been well-documented. For example, the 2008 RAND report, a report commissioned by the SEC, compared how the different regulatory systems that apply to broker-dealers and investment advisers affect investors, and found that "...over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that (at least under the regulatory regime) have historically been the province of investment advisers."[20] Based on interviews conducted with investors, the report also found investor confusion resulting from broker-dealers providing similar activities as investment advisers:

> *Participants mentioned that the line between investment adviser and broker-dealers has become further blurred, as much of the recent marketing by broker-dealers focuses on the ongoing relationship between the broker and the investor and as brokers have adopted such titles as "financial advisor" and "financial manager."*[21]

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[20] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, *RAND Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* 14 (Jan. 3, 2008) [hereinafter *RAND Report*].

[21] *Id.* at 19; *see also, Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 16-17 (July 17, 2009) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute) (noting that "over the last decade, brokers have significantly shifted their business model to include providing investment advice and charging fees based on assets under management, rather than commissions for each transaction. This model previously had been used solely by investment advisers").

This confusion has resulted in a mismatch between client expectations and reality: investors now expect that brokers are acting in the investors' best interests when there is no obligation to do so.[22] Thus, these activities have raised significant issues under the broker-dealer exclusion. The exclusion was the subject of a protracted rulemaking commenced by the SEC in 1999, which sought to deal with the migration of broker-dealers toward the traditional investment advisory model. Under the proposed rule, a broker-dealer providing investment advice to a customer would be excluded from the definition of adviser, regardless of the type of compensation received, as long as three conditions were met: (i) the advice provided was non-discretionary; (ii) the advice was solely incidental to brokerage services provided; and (iii) the broker-dealer disclosed to its customers that the account was a brokerage account. The SEC's rule adopting changes to the exclusion in 2005 was subsequently vacated after a legal challenge.[23]

The application and interpretation of the broker-dealer exclusion continues to be problematic. As noted below, one simple solution to this problem would be to remove the exclusion for broker-dealers in the Advisers Act. The Treasury Department, however, has opted to address the issue through a different approach.

The Investor Protection Act of 2009 – Fiduciary Duty

The Administration's proposed Investor Protection Act, Section 913, titled "Establishment of a Fiduciary Duty for Brokers, Dealers, and Investment Advisers, and Harmonization of the Regulation of Brokers, Dealers, and Investment Advisers," would amend both the Investment Advisers Act and the Securities Exchange Act to permit the SEC to promulgate rules to provide "in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may

[22] *RAND Report, supra* note 20, at 31-32.

[23] *Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." Although the title explicitly uses the term "fiduciary duty," the statutory language does not.

The IAA strongly supports extending an investment adviser's fiduciary duty to brokers who provide investment advice. Virtually every regulator, consumer, and industry group that has commented on this issue agrees.[24] The Administration's white paper on financial services reform includes the stated goal of "requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers (underlining added)" and *raising* the standard for brokers "to the fiduciary standards to align the legal framework with advisers." The IAA has consistently advocated that all persons who perform investment advisory activities should be subject to the same standard of care. We strongly believe that investors deserve the protections afforded by the fiduciary standard under the Advisers Act.

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[24] *See, e.g., Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. On Fin. Servs.,* 111th Cong. 16 (July 17, 2009) (statement of Paul Schott Stevens, President and CEO, Investment Company Institute) ("the standard that governs the provision of investment advice must be one that explicitly incorporates the fiduciary duty that governs investment advisers' dealings with their clients."); *Enhancing Investor Protection and the Regulation of Securities Markets – Part II, Hearing Before the S. Comm. On Banking, Housing and Urban Affairs,* 111th Cong. 12 (March 26, 2009) (statement of Fred J. Joseph, Colorado Securities, Comm'r and President North American Securities Administrators Association, Inc.) ("NASAA urges Congress to apply the fiduciary duty standard of care to all financial professionals who give investment advice regarding securities—broker-dealers and investment advisers alike."); Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n, *Speech Before the Financial Services Roundtable — 2009 Fall Conference* (Sept. 24, 2009) ("I also support the administration's efforts to apply a fiduciary standard of conduct to financial service professionals that provide investment advice about securities, regardless of whether those professionals carry the label "broker-dealer" or "investment adviser."); *Enhancing Investor Protection and the Regulation of Securities Markets – Part II, Hearing before S. Comm. On Banking, Housing and Urban Affairs,* 111th Cong. (March 26, 2009) (statement of Barbara Roper, Consumer Federation of America) ("all those who offer investment advice should be required to put their clients' interests ahead of their own … that fiduciary duty should govern the entire relationship"); *Letter from IAA, Consumer Federation of America, Fund Democracy, NASAA, Financial Planning Association, National Association of Personal Financial Advisers, and CFP Board of Standards to the Honorable Barney Frank and the Honorable Spencer Bachus, House Committee on Fin. Servs., U.S. House of Representatives* (July 14. 2009) available here.

Fiduciary Duty under the Advisers Act is Well-Established and Consistently Applied

Fiduciary duty under the Advisers Act is a cornerstone upon which the regulation of investment advisers is built. In a seminal decision by the U.S. Supreme Court in 1963, the Court held that the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers.[25] The Court found embodied in the Advisers Act an adviser's affirmative duty of utmost good faith and full and fair disclosure of all material facts to its clients as well as an affirmative obligation to employ reasonable care to avoid misleading its clients.[26] Under this federal fiduciary standard,[27] investment advisers must, among other things, act in the best interest of their clients and place the interests of their clients before their own. This well-established standard has been consistently interpreted and applied by the SEC and the courts to require investment advisers to serve their clients with the highest duty of loyalty and duty of care.[28]

As a fiduciary, "an investment adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions."[29] Among the specific obligations that flow from an adviser's fiduciary duty are: (1) the duty to have an adequate, reasonable basis for its investment advice; (2) the duty to seek best execution for clients' securities transactions where the adviser directs such transactions; (3) the duty to render advice that is suitable

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[25] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

[26] *Id.* These duties of a fiduciary were applied by the SEC and the courts long before the Supreme Court in the *Capital Gains* case found them to be embodied in the anti-fraud provisions of the Advisers Act. *See, e.g., In the Matter of Arleen W. Hughes,* Exchange Act Release No. 4048 (Feb. 18, 1948).

[27] *See Transamerica Mortgage Advisors Inc. v. Lewis*, 444 U.S. 11 (1979) ("Section 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers"); *Laird v. Integrated Resources, Inc.* (5th Cir. 1990) (in a 10b-5 action against an investment adviser, the court looked to the federal fiduciary standard and stated that its "holding encompasses a developed federal standard"). *See also Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No.2910, 74 Fed. Reg. 39840 (proposed Aug. 3, 2009) ("The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers").

[28] *See, e.g., Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2059, 68 Fed. Reg. 6586 (Sept. 20, 2002) ("An adviser's fiduciary duty includes the duty of care and the duty of loyalty to clients").

[29] Lemke & Lins, *Regulation of Investment Advisers,* 169 (2009).

to clients' needs, objectives, and financial circumstances; and (4) the duty to make full and fair disclosure to clients of all material facts, particularly regarding potential conflicts of interest.[30]

For more than 45 years, state and federal courts as well as the SEC have consistently required investment advisers to satisfy this fiduciary standard.[31] The standard by which investment advisers are judged – to act in the best interests of the client – is unquestionably clear and should be maintained for the benefit of investors.

Application of the Advisers Act Fiduciary Duty is Broad and Flexible

The fiduciary standard is based on common law principles arising from the relationship of trust between the adviser and the client. The application, however, of the fiduciary standard is based on particular facts and circumstances. Some outside the advisory profession who are unwilling to take on this duty on behalf of their clients have criticized this aspect of fiduciary duty as being ill-defined and amorphous and have

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[30] *See Applicability of Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Investment Advisers Act Release No. 1092, 46 Fed. Reg. 41771 (Oct. 16, 1987) (discussing fiduciary duties); *Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients*, Investment Advisers Act Release No. 1406, note 3 (Mar. 16, 1994) (noting duty of full disclosure of conflicts of interest, duty of loyalty, duty of best execution, and duty of care and citing various sources).

[31] *See Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1979); Laird v. Integrated Resources, Inc.* (5th Cir. 1990) (in a 10b-5 action against an investment adviser, the court looked to the federal fiduciary standard and stated that its "holding encompasses a developed federal standard"); *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d (E.D. Va. 2003) (section 206 "establishes fiduciary duties for investment advisers). *See also In re Sterling Capital Planners, Inc.*, Investment Advisers Act Release No. 2797, (October 8, 2008) (breach of fiduciary duty through transfer of funds without client consent, failure to disclose significant conflicts of interest); *In re Invesco Funds Group, Inc.*, Investment Advisers Act Release No. 2311 (Oct. 8, 2004) (breach of fiduciary duty through market timing, failure to act at all times in the best interests of the client and provide full and fair disclosure of all material facts); *In re David A. King*, Investment Advisers Act Release No. 1391 (Nov. 9, 1993); *In re George Sein Lin*, Investment Advisers Act Release No. 1174 (June 19, 1989); *In re Westmark Financial Services Corp.*, Investment Advisers Act Release No. 1117 (May 16, 1988). Broker-dealers, on the other hand may be subject to inconsistent standards because they are not considered fiduciaries by operation of law. Rather, courts have looked to the nature of the relationship between the client and the broker-dealer to determine whether a broker-dealer is a fiduciary in a particular case. Any concerns about the consistency of judicial analysis of broker-customer relationships would be remedied by applying the Advisers Act fiduciary duty to broker-dealers providing investment advice by operation of law.

argued that more precision is necessary. We disagree. The overarching protection afforded investors under the fiduciary standard is essential. Because the duty is a principle-based standard and investment advisers must place the interests of their clients before their own in every circumstance, obligations of investment advisers cannot be circumscribed by a rule book no matter how voluminous. The Advisers Act and the rules adopted under the Act are only the starting point for investment advisers to ensure that they act in the best interest of their clients and place clients' interests above their own. These fiduciary obligations must guide every action taken by an investment adviser.

The criticism that all of these obligations have not been or cannot be reduced to a checklist misses a core strength of the fiduciary standard. As the IAA and other organizations expressed in a letter to the SEC's recently established Investor Advisory Committee:

> *We believe that it would be no more appropriate to insist on a precise definition of fiduciary duty than it would be to insist on a precise definition of the duty not to commit fraud. . . . Attempting to provide specific definition of all aspects of fiduciary duty, or to enumerate precisely how it applies and what it entails, would have the perverse consequence of diluting protections for investors.*[32]

It would be contrary to the interests of investor protection to attempt to define precisely all elements of the Advisers Act fiduciary duty. Doing so would diminish the protections of the fiduciary standard.[33] Moreover, the breadth and flexibility of the fiduciary duty of investment advisers have allowed the regulation of investment advisers

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[32] *See Letter from Kevin R. Keller, CEO, CFP Board, Marvin W. Tuttle Jr., Executive Director and CEO, Financial Planning Association, David G. Tittsworth, Executive Director, Investment Adviser Association, and Ellen Turf, CEO, National Association of Personal Financial Advisors to Richard Hisey and Hye-Won Choi, Co-Chairs of Investor Advisory Committee* (Aug. 6, 2009), available on the IAA web site under "Publications/News" and "Comments & Statements."

[33] *See* Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 Sec. Reg. & Law Rep. 776 (April 27, 2009) ("Given the equitable nature of fiduciary law, it is not tenable to set forth a fiduciary's responsibilities in a detailed manner or to specify a convention to govern their activity. Nor would it be in the public interest to do so. And it certainly would not be consistent with the way fiduciary law has evolved and been interpreted for hundreds of years").

to remain dynamic and relevant in changing business and market conditions. SEC Commissioner Luis A. Aguilar echoed this sentiment when he stated:

> *[Fiduciary duty] is a fundamental investor protection...The fiduciary standard is a dynamic, living principle that provides investors with true protection....A fiduciary standard has real teeth because it is an affirmative obligation of loyalty and care that continues through the life of the relationship between the adviser and client, and it controls all aspects of their relationship. It is not a check-the-box standard that only periodically applies.*[34]

Section 913 of the Proposed Investor Protection Act Should Be Revised to Extend the Advisers Act Fiduciary Standard to Broker-Dealers Providing Investment Advice

The fiduciary standard established under the Advisers Act continues to provide a strong level of protection for all investment advisory clients. The proposed legislation should, as intended, extend the same protection to clients of broker-dealers receiving investment advice. We are concerned, however, that the specific text of the current legislation may open the door to watering down or weakening the current fiduciary standard.

If the proposed legislation is intended to fulfill the Administration's regulatory reform goal – *i.e.,* "requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers" – it should explicitly incorporate the Advisers Act fiduciary standard. Instead, the proposed legislation authorizes the SEC to adopt standards of conduct that are "in substance...to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." By using the term "in substance," the proposed legislation could allow for rules that may be less protective than the current Advisers Act fiduciary standard.

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[34] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009).

In addressing issues relating to Section 913, it is important to remember the context in which these issues have arisen. Brokers have been migrating toward the investment advisory business, not the other way around. However, some brokers would prefer to avoid being governed by the Advisers Act fiduciary duty due to concerns about certain requirements applicable to advisers. Given the migration of brokers to the advisory business, we believe it would be inappropriate to water down or weaken the strong investor protection standards and provisions embodied by the Advisers Act to accommodate certain broker practices.

In addition, we are concerned that Section 913 proposes to authorize the SEC to adopt rules under the Advisers Act for "retail customers or clients (and such other customers or clients as the Commission may by rule provide)." This provision of the proposed legislation could lead to different standards for different advisory clients. The current Advisers Act fiduciary duty applies equally to all advisory clients, whether individual or institutional (*e.g.* pension plans, endowments, mutual funds, or trusts). The IAA strongly believes that all investment advisory clients deserve the protections afforded by the Advisers Act fiduciary duty. We oppose efforts to impose a different standard of care under the Advisers Act for investment advisers providing services to different types of clients.

Instead, we recommend that Section 913 be revised to provide unambiguously for the extension of the Advisers Act fiduciary duty to brokers that provide investment advice and to ensure that the fiduciary duty that already exists under the Advisers Act is preserved. These goals and the Administration's stated intent could be achieved without amendments to the Advisers Act. Thus, Section 913 should be amended to apply the Advisers Act fiduciary duty to brokers under the Exchange Act and to delete references to the SEC's establishing fiduciary standards under the Advisers Act. Another simple approach that has been suggested to extend the fiduciary duty under the Advisers Act to broker-dealers providing investment advice is to remove the exclusion for broker-dealers in the Advisers Act. Under this approach, broker-dealers who meet the definition of

"investment adviser" (*i.e.*, who provide investment advice) would be subject to the provisions of the Advisers Act, including the fiduciary standard.

We intend this recommendation to apply only to broker-dealers who are providing investment advice as defined under the Advisers Act. Although the debate relating to the fiduciary standard has focused on broker-dealer activities relating to investment advice to individuals, broker-dealers are engaged in other activities, including execution of securities transactions, underwriting, investment banking, advising issuers regarding the structure of securities offerings, market-making, or other lines of business that do not involve advice about securities investments to clients. Our recommendation would not subject broker-dealers to a fiduciary duty in those other lines of business or activities.

A "New Federal Standard" Would be Detrimental to Investors

The broker-dealer industry, through SIFMA, its trade association, has proposed that a "new federal standard" should be established for broker-dealers and investment advisers that would supersede the existing fiduciary standard.[35] We strongly oppose any suggestion to replace the Advisers Act standard for the following reasons:

- Advisers are already subject to a federal fiduciary standard, as discussed above. Beyond perpetuating misunderstandings of the existing fiduciary duty, SIFMA has failed to describe how the "new federal standard" would improve upon the Advisers Act fiduciary duty.
- SIFMA argues that the "new federal standard" would "provide firms with appropriate relief from the SEC's current prohibitions against principal trading." Section 206(3) of the Advisers Act includes restrictions on principal trades (*i.e.*, buying and selling from one's own account). It is clear that one of the primary reasons that broker-dealers (who typically buy and sell from and to their own

[35] *See Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. (July 17, 2009) (statement of Randall Snook, Executive Vice President, SIFMA).

accounts) resist coverage under the Advisers Act is to avoid the principal trading restrictions. But the fact remains that principal trades involve significant potential conflicts of interest involving self-dealing. If there are situations in which exemptions from the prohibition on principal transactions are appropriate, the SEC already has the authority to provide such exemptions.

- SIFMA argues that a new standard is necessary so that financial services firms can continue to provide investor choice of investment products. Frankly, we are not aware of any meaningful investor choices that are prevented or impeded under the existing fiduciary standard – or why imposing a "new federal standard" would allow for greater investor choice. To the extent that "investor choice" refers to availability of proprietary products, we note that the fiduciary duty under the Advisers Act does not prohibit particular products, but rather provides a high standard for fully disclosing and resolving potential conflicts in the best interest of the client.
- SIFMA has professed concern regarding judicial protection of investors under an adviser's fiduciary duty. That concern is unfounded. As discussed above, "the SEC has been bringing cases on behalf of investors for the last 70 years prosecuting fiduciaries for breaching their duties and for failing to mitigate or disclose conflicts to their clients."[36] In addition, advisers are subject to breach of fiduciary duty claims by clients under common law. Fiduciary duty has been a powerful and flexible remedy that has worked well.

The Investor Protection Act of 2009 – Other Provisions

Other "Harmonizing" Changes in the Investor Protection Act

In addition to suggesting legislative changes related to the fiduciary duty standard, Section 913 of the proposal contains parallel amendments to the Exchange Act and the Advisers Act that would authorize the SEC: (1) to provide for "simple and clear disclosure to investors" and (2) to examine, and where appropriate, adopt rules

[36] *See supra* note 341.

prohibiting certain sales practices, conflicts of interest, and compensation schemes for financial intermediaries.

As discussed above, investment advisers already are subject to extensive disclosure obligations, both with respect to required regulations (*e.g.,* Form ADV) and the overarching fiduciary obligations that apply under the Advisers Act. Further, the SEC already has broad statutory authority under the Advisers Act to prohibit fraudulent, deceptive, and manipulative acts or practices.[37]

While we believe the SEC already has the ability to act in these areas under its broad anti-fraud authority, we understand that it may be beneficial to promulgate rules that are not anti-fraud rules. We are concerned, however, that Section 913 could be used to shift away from the current principles-based regime under the Advisers Act to a more inflexible conduct regime. Further, the proposal's requirement that the SEC consult with other financial regulators on best practices under the Advisers Act but not under the Exchange Act does not make sense. We would be pleased to work with the Committee to better understand the issue that the proposed legislation seeks to address and to consider whether additional statutory amendments to the Advisers Act are necessary.

Mandatory Arbitration

The Administration's regulatory reform proposal would give the SEC authority to prohibit or impose conditions on agreements that require customers of broker-dealers or clients of investment advisers to arbitrate future disputes arising under the federal securities laws or the rules of an SRO if it finds that such action is in the public interest and for the protection of investors.[38] The Administration notes that "although arbitration may be a reasonable option for many consumers to accept after a dispute arises,

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[37] *See* Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2008

[38] We submit that the legislation's proposed language to amend the Advisers Act regarding arbitration be revised to eliminate reference to "rules of a self-regulatory organization." As discussed below, advisers are not subject to the jurisdiction of an SRO, nor should they be.

mandating a particular venue and up-front method of adjudicating disputes – eliminating access to courts – may unjustifiably undermine investor interests."[39]

The IAA supports the Administration's proposal. While we fully appreciate the goals and efficiencies of alternative dispute resolution, we believe that investors should be provided with choice in their selection of a dispute resolution forum. In particular, mandating that investors participate in an industry-run arbitration system creates the perception of unfairness, regardless of the actual results of such a system. In addition, arbitration may not present the best venue for certain types of claims. If the SEC exercises the authority it will be given to prohibit or limit mandatory arbitration, we suggest the SEC develop investor education materials that would assist customers or clients in determining whether to participate in alternative dispute resolution on a voluntary basis. We would be pleased to assist in such efforts.

SEC Enforcement Tools

The Administration's proposed legislation would provide the SEC with a number of expanded enforcement tools. First, the SEC would be able to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant monetary sanctions. The SEC currently may compensate sources in insider trading cases and would be able to extend that ability to other types of actions. We support this provision. Encouraging insiders and others with substantial evidence of securities violations voluntarily to provide that evidence to the SEC would enhance the SEC's ability to pursue wrongdoers.

Second, the proposal would expand the SEC's authority to impose collateral bars on individuals who violate the securities laws. Currently, a person the SEC has barred from being an investment adviser could still act as a broker-dealer. The SEC should be given authority to bar individuals who commit serious misconduct from all segments of

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[39] *See Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward Legislation for Strengthening Investor Protection Delivered to Capitol Hill* (July 10, 2009) available here.

the regulated securities industry in one proceeding. We agree with SEC Chairman Mary Schapiro that this proposal "would enable the SEC to more effectively protect investors and the markets while more efficiently using SEC resources."[40]

Finally, the Administration's proposal addresses inconsistencies in the SEC's ability to bring cases against those who aid and abet securities fraud. Currently, the SEC has authority to bring actions for aiding and abetting violations of the Exchange Act and the Advisers Act in civil enforcement actions. The proposal would extend such authority to actions under the Securities Act of 1933 and the Investment Company Act of 1940. In addition, the proposal would clarify that the Advisers Act permits imposition of penalties on aiders and abettors. We support consistent standards governing aider and abettor liability.[41]

Investor Advisory Committee

Earlier this summer, the SEC established a new Investor Advisory Committee to provide investors with a greater voice in the Commission's work. The committee's charter permits it to address broad goals of enhancing investor protection, including: advising the SEC on matters of concern to investors in the securities markets; providing the SEC with investors' perspectives on current, non-enforcement, regulatory issues; and serving as a source of information about, and recommendations for, regulatory programs from an investor perspective. The Committee is comprised of 15 individuals selected by the SEC chairman representing a broad spectrum of investors.

Section 911 of the Administration's proposed legislation would make this Committee permanent. We strongly support giving investors a more robust, continuing presence in the dialogue on the SEC's investor protection agenda. Insights from the

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[40] *See Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 9 (July 22, 2009) (statement of Mary Schapiro, Chairman, Sec. and Exch. Comm'n). *See also* U.S. Treasury Department Title IX Section by Section Analysis at Section 925, available here.

[41] While we support the concept of this proposal, we may have comments on the specific language.

Committee will assist the SEC in considering the effects of new products and services, trading venues and practices, and various disclosure regimes.

Consumer Testing

Section 912 would amend the Advisers Act (as well as the other securities laws) to authorize the SEC to "gather information, communicate with investors or other members of the public . . . as it in its discretion determines is in the public interest or for the protection of investors." These amendments would appear to provide the SEC with the explicit authority to obtain information from investors, such as clients of investment advisers. We fully appreciate that the SEC may need information directly from the public or investors to carry out its mandate, including the protection of investors. We are concerned, however, that the information obtained from clients may include personal or financial information that should be protected from further dissemination.

Therefore, we ask that the provisions be amended to require that all information provided to the SEC under this section be confidential, not subject to civil discovery or other legal process, and exempt from disclosure under the Freedom of Information Act or otherwise.

The SEC's Resources

While not the subject of Administration proposals, the adequacy of the SEC's resources to appropriately oversee and examine investment advisers is a legitimate and compelling concern that deserves serious consideration and action by policy makers. We support a strong and effective SEC as the direct regulator of investment advisers. However, the SEC does not have sufficient resources to appropriately conduct examinations of the more than 11,000 advisers under its jurisdiction. We recommend a number of measures to address the SEC's resources and to ensure a robust and appropriate oversight program of the investment advisory profession.

Give the SEC Appropriate Resources to Fulfill Its Mission

First, as long-supported by the IAA, there must be full funding for the SEC's regulatory and enforcement efforts. While we applaud the Administration's recommended budget increase for the SEC, more resources are still needed. In addition to the appropriations process, we believe Congress should examine alternatives to allow the agency to achieve longer-term and more stable funding.

Authorizing self-funding for the SEC would be optimal. In August, SEC Chairman Schapiro discussed her views on the subject, stating that "Self-funding has been discussed over the years but I think it may now well be the moment. Some stability in funding would be an enormous benefit because it would help with long-term planning in such areas as technology and staffing."[42]

The IAA issued a statement in support of Chairman Schapiro's comments, stating that "[t]he IAA is in strong agreement with Chairman Schapiro that the SEC would be better able to fulfill its investor protection mission if it was able to operate as a self-funded agency like other financial regulators."[43] SEC Commissioner Aguilar also has spoken in favor of a self-funding mechanism for the SEC, stating that self-funding "would greatly enhance the SEC's ability to advance its mission."[44] As he noted earlier this year:

Being self-funded is not a novel idea. In addition to the Federal Deposit

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[42] *Financial Times* (Aug. 5, 2009).

[43] As Sen. Schumer has noted, "the SEC raises millions more dollars every year in registration and transaction fees (not including enforcement penalties or settlements) than it is allocated through the appropriations process, but its budget is limited to the amount approved by Congress. In 2007, though the SEC brought in $1.54 billion in fees, it secured just $881.6 million in funding." Press Release, Sen. Schumer (Sept. 3, 2009). At a minimum, a self-funding mechanism would permit the SEC to retain the funds it currently collects.

[44] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *Speech at North American Securities Administrators Association's Winter Enforcement Conference: Empowering the Markets Watchdog to Effect Real Results*, (Jan. 10, 2009).

Insurance Corporation, other regulators that are independently funded include the Office of Thrift Supervision, Office of the Comptroller of the Currency, and the Federal Reserve, to name a few. There is no logical reason to treat the SEC differently, and many reasons to similarly empower the Commission. Congress should consider providing the SEC with the ability to budget and self-fund its operations. In this challenging environment, the SEC should be able to set long-term budgets, be able to react to changing markets and new products and services, and be able to adjust its staffing as appropriate.

While self-funding is the optimal means to address the SEC's resource constraints, there are a number of other options, including user fees. We would be pleased to work with the Committee to further develop these measures to ensure that the SEC is fully funded.

The SEC Should Increase the $25 Million Dividing Line Separating SEC-Registered and State-Registered Investment Advisers

Second, we recommend that the SEC increase the $25 million threshold that separates federally registered and state-registered advisers. An increase in the $25 million level would reduce the number of SEC-registered advisers and allow the SEC to focus on larger investment advisory firms. Smaller investment advisers, which typically have a strong local presence, would be subject to regulation and oversight by the state securities regulators.

The $25 million level was established by Congress in 1996 under the Investment Advisers Supervision Coordination Act.[45] The Coordination Act allocated responsibility for investment advisers between the SEC and the states, with the SEC regulating larger advisers and the states regulating smaller advisers. [46] This allocation of regulatory

[45] *See Title III, National Securities Markets Improvement Act of 1996,* Pub. L. 104-290.

[46] The $25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the Commission "may also use its exemptive

responsibility between the SEC and the states has worked well to enhance investor protection, provide for more efficient use of limited regulatory resources, and reduce burdensome, inconsistent, and unnecessary regulatory costs.

The Coordination Act explicitly contemplated that the threshold would be regularly re-evaluated and adjusted. Although the SEC has authority to do so, in the 13 years since enactment of the law, the SEC has never, to our knowledge, initiated any formal review or proceeding to determine whether the threshold should be increased. In considering such action, the SEC obviously needs to coordinate closely with the North American Securities Administrators Association (NASAA).

In a recent speech, Denise Crawford, NASAA president, indicated support for increasing the level to $100 million:

> *[T]he current dividing line between federal and state regulation of investment advisory firms is $25 million of assets under management. The SEC might increase this to $100 million of assets under management. Given the difficulty the SEC has in examining such a large number of investment advisory firms, I think this is a good idea. NASAA has endorsed such a change and will work closely with the SEC to make this happen.*[47]

Raising the level to $100 million from $25 million would shift approximately 4,200 investment advisers from SEC regulation to various state regulators. The resulting number of SEC-registered investment advisers (about 7,000) would be consistent with the number of advisers after the Coordination Act was initially implemented.

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authority under the bill to raise the $25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act." S. Rpt. 104-293, p. 5 (June 26, 1996).

[47] Denise Voigt Crawford, Texas Sec. Comm'r, *Speech to Annual Meeting, North American Securities Administrators Association* (Sept. 15, 2009). The full text of the speech is available on NASAA's web site: www.nasaa.org.

The IAA Supports Greater Effectiveness of the SEC's Inspection Program

Third, the SEC should improve its inspection program for investment advisers. The SEC's examination and oversight of investment advisers, broker-dealers, and investment companies is a critical part of the SEC's mission. The stated purpose of examinations is "to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the Commission is continually made aware of developments and areas of potential risk in the securities industry."[48]

SEC Chairman Schapiro already has taken many meaningful steps to enhance the current oversight program. In her recent testimony before this Committee, Chairman Schapiro cited the following initiatives:

- Providing more staff training on fraud detection;
- Hiring staff with expertise in securities trading, portfolio management, valuation, derivatives, risk management, and other important areas;
- Conducting exams more focused on firms with higher risk profiles and practices;
- Providing examiners with more tools and methodologies to detect fraud, including improved pre-exam work protocols;
- Leveraging the work performed by a firm's independent auditor;
- Improving systems for surveillance and risk-based targeting; and
- Improving the handling of tips and complaints.[49]

We have written to Chairman Schapiro to applaud these initiatives, which represent positive steps to strengthen the Commission's examination program.[50] We

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[48] *See* home page of SEC Office of Compliance Inspections and Examinations, at http://www.sec.gov/about/offices/ocie.shtml (July 20, 2009).

[49] *See SEC Oversight: Current State and Agenda, Hearing Before the H. Sub. Comm. on Capital Markets, Insurance and Government Sponsored Enterprises Hearing*, 111th Cong. (July 14, 2009) (statement by Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n).

have expressed our willingness to work with the Commission toward the shared goal of enhancing the effectiveness of investment adviser exams.

The IAA Supports the SEC's Mission to Oversee Investment Advisers and Opposes a Self-Regulatory Organization for Investment Advisers

The idea of establishing a self-regulatory organization (SRO) for investment advisers is not new; it has been raised and rejected a number of times over the years. An SRO for investment advisers is not currently under consideration by Congress and, notably, the SRO issue was not addressed in the Administration's financial regulatory reform white paper or draft legislation.[51] Nevertheless, the issue has been raised again recently, in part as a way to address the SEC's resource constraints.[52]

The IAA strongly supports robust and appropriate oversight and regulation of the investment advisory profession by a fully-funded SEC. We believe the SEC has the necessary expertise and experience to be the primary regulator of the investment advisory profession. Given the great diversity among advisory firms – including firms with a wide range of business models, strategies, and clients – this expertise and experience is critical in regulating and overseeing the profession.

Since its inception, the SEC has been an effective regulator with a strong enforcement arm in the areas of disclosure and fiduciary duty, the bedrock principles underlying investment adviser regulation. In the face of recent difficulties, the SEC has taken prompt and comprehensive action to revitalize its enforcement efforts and enhance

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[50] *Letter from David G. Tittsworth, Investment Adviser Association to The Hon. Mary L. Schapiro, Chairman, Securities and Exchange Commission* (July 29, 2009).

[51] U.S. Dept. of the Treasury, *A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), available here.

[52] *See*, e.g., *Assessing the Madoff Ponzi Scheme and Regulatory Failures, Hearing Before the H. Sub. Comm. On Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. 5 (Feb. 4, 2009) (statement of Stephen I. Luparello, Interim CEO, FINRA). *See also Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking, Housing & Urban Affairs* 111th Cong. (August 17, 2009) (statement of Daniel Sibears, Executive Vice President, Member Regulations Programs, FINRA).

its investigative capabilities.[53] While the current system of regulation and oversight of investment advisers can and should be improved, adding a new layer of bureaucracy and cost on the profession through an SRO will not significantly enhance investor protection. As noted by Commissioner Aguilar, an SRO is "an illusory way of dealing with the problem of resources. The issue is really one of hiring, training, and overseeing an adequate program to examine advisers."[54] Further, as Commissioner Aguilar has indicated, the SEC is "the only entity with experience overseeing investment advisers, an industry governed by the Advisers Act, which is based on a principles-based regime. By contrast, broker-dealer SROs primarily regulate through the use of very detailed, specific sets of rules and are not well versed in the oversight of principles-based regulation."[55]

Further, the effectiveness of the SRO model has not been demonstrated. When SROs have pursued major cases or sought fundamental changes, they typically have been following investigations by others (*e.g.* state attorney generals, media reports, prosecutors). Indeed, recently some have called for the MSRB to be merged into the SEC due to its ineffectiveness.[56] Similarly, SROs have been discredited internationally.[57] For example, in the late 1990's, the U.K. government transferred SRO

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[53] *See Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance, Hearing before S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (Sept. 10, 2009) (statement of Robert Khuzami, Director, Division of Enforcement, Sec. and Exch. Comm'n, and John Walsh Acting Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm'n)

[54] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, *SEC's Oversight of the Adviser Industry Bolsters Investor Protection* (May 7, 2009), available here.

[55] *Id.*

[56] *See* Andrew Ackerman, *MSRB Won't Amend Rule G-37,* Bond Buyer, April 7, 2009 (noting that in testimony before the Senate Banking Committee, former SEC chairman Arthur Levitt said "that self regulation through the MSRB does not work and that it should be folded into the SEC."); *see also Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance, Hearing Before the H. Comm. On Fin. Servs.,* 111th Cong. (May 21, 2009) (statement of Keith D. Curry, Past Pres., Nat'l Ass'n of Indep. Pub. Fin. Advisors); *Enhancing Investor Protection and the Regulation of Securities Markets; Hearing Before the S. Comm. On Banking, Housing & Urban Affairs,* 111th Cong. 7 (March 10, 2009) (statement of Thomas Doe, founder and CEO of Municipal Market Advisors) ("End the MSRB as an SRO").

[57] "Whereas [SROs] are rather significant in the United States, they do not play any role in the United Kingdom and are hardly of any importance in Germany. In the EU, priority is given to the statutory approach to regulation." *See Securities Market Regulation: International Approaches*, Deutsche

regulatory powers to the FSA due to the complexities and inefficiencies of the U.K. SRO system.[58]

We therefore continue to oppose the creation of an SRO for the advisory profession. Ultimately, the drawbacks to an SRO continue to outweigh any alleged benefits. These drawbacks include inherent conflicts of interest based on industry funding and influence, questions regarding transparency, accountability and oversight, due process issues in disciplinary proceedings, and added cost and bureaucracy. In addition, as noted by Tulane Law Professor Onnig Dombalagian, who testified at a Senate Banking Committee hearing in August, "[t]he conflicts of interest between the brokerage industry and the investment advisory industry… are too great for FINRA to exercise a meaningful role in the oversight of investment advisers."[59]

While self-regulation may appeal to those who wish to shift taxpayer-funded regulation costs to industry, we also note that appropriate government oversight is required in any SRO structure and thus requires expanded dedication of government resources. Most investment advisory firms are small businesses with limited resources. The costs of any SRO are borne by the regulated entities and will obviously impact all investment advisers, including thousands of small advisory firms. Ultimately, those costs may be passed on to investors. If pricing resistance is such that the costs cannot be passed on, they will have a significant impact on job retention and creation in these small

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Bundesbank Monthly Report. (January 2006), available here. As a further example, Australia does not have SROs under the true definition, although exchange organizations have limited self-regulatory powers. *See* Prof. Berna Collier, Comm'r, ASIC, *Ensuring Capacity, Integrity and Accountability of the Regulator* (2005) available here.

[58] Even the chairman of the Securities and Investments Board, the most important of the SROs, "acknowledged that self-regulation had failed in the U.K. and seemed unable to restore investor confidence." *See Enhancing Investor Protection and the Regulation of Securities Markets, Hearing Before the S. Comm. on Banking, Housing & Urban Affairs,* 111th Cong. 35-36 (March 10, 2009) (statement of Prof. John C. Coffee, Jr., Columbia Univ. Law School).

[59] *Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform, Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* 111th Cong. (August 17, 2009) (statement of Prof. Onnig H. Dombalagian, Tulane University) available here. The concerns we have raised about SROs generally are particularly relevant with respect to FINRA. FINRA has been pursuing a role in supervising investment advisers for some time. We have serious concerns about FINRA's governance structure, cost structure, areas of expertise, and track record.

businesses - in which human resources account for the vast portion of cost structure. It would be more cost effective to use the industry's funds that would be spent on an SRO to bolster the SEC's oversight efforts, for example through a self-funding structure as discussed above. Moreover, a single, governmental regulator - operating without confusion of overlapping regulation, regulators and "stovepipes" - is also directly accountable to Congress and the public.

Further, the reasons that persuaded Congress to authorize the creation of an SRO for broker-dealers in 1939 – including the high level of interconnectivity between broker-dealers as well as highly technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions – simply do not exist in the investment advisory profession.

Finally, the diversity of the investment adviser industry makes a rules-based SRO model unworkable. There is not sufficient commonality among the various types of adviser business models – traditional asset management firms, financial planners, wealth managers, advisers that are part of global financial institutions, small advisers with a limited number of high net worth clients, asset allocators, hedge fund managers, mutual fund managers, pension consultants, and others – to achieve fair and flexible self-regulation. Command-and-control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues do not lend themselves to this widely divergent community of advisers. As Professor Dombalagian stated, "there would be little benefit to using the financial resources and operational expertise of industry members to develop and enforce industry standards" due to the "considerable variety in the conduct of their business, the handling of customer funds and securities, and the risks their activities pose to clients."[60]

Therefore, continued oversight of the advisory profession by the SEC under the current structure of the Advisers Act – and its reliance on disclosure and broad anti-fraud

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[60] *Id.*

authority rather than specific and rigid regulatory requirements – is both appropriate and effective.[61]

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The IAA appreciates the opportunity to discuss our views on regulatory reform and specific issues that have been raised with respect to the Advisers Act. Our testimony does not include detailed comments regarding Capital Markets Subcommittee Chairman Kanjorski's recently circulated discussion draft of the Investor Protection Act. We are currently analyzing the draft and would be pleased to provide comments as soon as possible. We look forward to working with the Committee in the coming weeks and months in efforts that are designed to enhance and improve the effective and appropriate regulation of the financial services industry, to restore the vitality of the U.S. economy, and to renew investor confidence in our markets.

October 6, 2009

[61] Given its clear preference for broker-dealer rules, we believe it would be inappropriate and counterproductive to establish FINRA as the SRO for investment advisers. Any regulator for investment advisers should, at a minimum, acknowledge and reflect the practices, culture, regulation, and oversight of the advisory profession. In light of its explicit statements favoring the broker-dealer regulatory model, FINRA clearly cannot serve in this capacity. Establishing FINRA as the SRO for investment advisers would eviscerate the "self" in self-regulation. Instead, it would lead to an extension of the broker-dealer regulatory model to the advisory profession.

Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Financial Services
United States House of Representatives

Regarding:
"Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office"

Tuesday, October 6, 2009

Therese M. Vaughan, Ph.D.
Chief Executive Officer
National Association of Insurance Commissioners

Testimony of Therese M. Vaughan, Ph.D.
Chief Executive Officer
National Association of Insurance Commissioners

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for inviting me to testify today on the issue of creating a national insurance office.

My name is Therese Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). As I testified before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises last March, prior to joining the NAIC I was a Professor of Insurance and Actuarial Science at Drake University, where I focused on the management and regulation of financial institutions. I also served as the Iowa Insurance Commissioner from 1994 to 2004, and as NAIC President in 2002. I am pleased to be here today to offer the NAIC's perspectives on establishing a national insurance office.

NAIC Continues to Support Insurance Regulatory Reform

In past NAIC testimony before this Committee, we have offered the state regulatory system as the rational starting point in any effort to modernize insurance regulation. We have focused on options for reform in areas where uniformity of process and harmonization of standards are appropriate to ensure a stronger and more effective insurance regulatory scheme. We have stated our recognition that certain fundamental improvements to state-based regulation may require federal assistance, state empowerment or selective federal partnership. And we have rejected so-called "reforms" that are merely a veiled attempt at undermining state authority and substituting self-regulation or no regulation for effective oversight.

We continue to hold those views, and I hope to be able to expound on them today in the context of establishing a national insurance office.

Ensuring Equal Standing on the World Stage

Mr. Chairman, we sincerely appreciate the efforts of you and your staff, as well as those of Capital Markets Subcommittee Chairman Kanjorski and his staff, in taking serious consideration of NAIC's concerns in drafting bills introduced by Chairman Kanjorski in both the current

Congress and the previous one to create an Office of Insurance Information (OII) at the federal level. You have worked with us to address concerns raised by our members and worked to incorporate the appropriate legislative language into the OII. That language was carefully crafted to achieve specific improvements to insurance regulation, without unnecessarily preempting state laws and regulations. Consequently, a broad cross-section of the insurance sector supports the OII and we have been pleased to offer our endorsement of that approach.

The draft Federal Insurance Office (FIO) Act, based on the Administration's proposed legislation to create an Office of National Insurance (ONI), embraces the two primary goals of Chairman Kanjorski's original legislation: (1) increasing insurance knowledge and expertise at the federal level, and (2) enhancing international competitiveness for U.S. insurance companies. However, it goes further than the OII bills in terms of its use of federal preemption, and provides a greatly reduced role for state insurance regulators. Therefore, we have submitted legislative language to help bring the Administration's proposal more closely in line with Chairman Kanjorski's original Office of Insurance Information bills.

Increasing Insurance Knowledge at the Federal Level

Mr. Chairman, Ranking Member Bachus, we fully support the concept of increasing knowledge of insurance at the federal level – indeed, a core mission of the NAIC's Washington office, and its Center for Insurance Policy and Research, is to educate and inform federal policymakers and regulators. While insurance regulatory information and expertise has always been available directly from the states and collectively through the NAIC to those in Washington, a formal federal interface is necessary. Access to information and data related to insurance is critical at the federal level, particularly as Congress evaluates appropriate oversight of the financial system as a whole. The state regulatory system, which has operated effectively for over 150 years, is an experienced, willing and able partner for a new federal insurance information center.

The vast majority of insurance data and information that would be collected and disseminated by a federal insurance office, and the capacity to continue and expand its collection and dissemination, already exists at the state level and with the NAIC. States collect a tremendous amount of information from insurers, and states require much of that information to be reported uniformly to the NAIC to aggregate a national picture of the insurance market. The NAIC maintains a large compendium of financial and subject matter information on all facets of

insurance. The NAIC's comprehensive collection of insurance financial information is the largest in the world. The collection and interpretation of that information, and its continual development and refinement over the years, has been of immense benefit to state regulators and insurance consumers.

The following examples demonstrate the wealth of information and analyis currently available through the NAIC:

- The NAIC's Financial Data Repository (FDR) captures every data element of the extensive and detailed statutory annual and quarterly financial statements, including close to 200,000 data elements per annual filing, in a structured format for over 4,800 insurers.

- The comprehensive nature of the data captured in FDR also allows for extensive analysis in response to unexpected developments. Immediately after the tragic events of 9/11, the NAIC provided analysis reports to identify all insurers that would be impacted, including exposures to life, health and property insurance claims. More recently, the NAIC has provided analysis of insurers' investment exposure to subprime-related issues, allowing states to target insurers of concern long before the standard analytical tools would be able to identify them.

- States can now see the exact amount of municipal securities, by individual insurer and in the aggregate, exposed to credit quality rating downgrades due to the recent bond insurance crisis. This information has allowed the states, through the NAIC, to take proactive measures to allow these securities to be considered in the issuer's credit quality rating, and allowed ratings to be assigned to issuers with no previous rating.

- The NAIC is performing analysis of industry-wide exposures in different asset types and classes, including mortgage backed securities, and drilling down to a company-by-company level to better assess the industry's exposure to the capital markets.

- The NAIC's State Producer Licensing Database, which houses licensing and demographic information on over four million insurance agents and brokers in the United States, allows consumers to verify that they are dealing with an agent or broker that is

We point out the extent of the information available through the states and the NAIC to raise a concern with the ONI/FIO proposal and the Committee's discussion draft. To the extent that the states have the relevant information, either individually or collectively through the NAIC, the national insurance office should not seek to duplicate the time, expense, or resources necessary to obtain that information. This principle was included in the OII legislation, but the critical role of the NAIC has been deleted from the current proposal. While nothing in the proposal precludes the national insurance office from being able to collect information from the NAIC, information sharing between state and federal counterparts too often has been a one way street where information may be taken from the states through the NAIC without reciprocation. Any national insurance office should be empowered specifically to engage with both the states and the NAIC, which as illustrated above, has increasingly become an integral component of the national system of state regulation. Likewise, to the extent that a national insurance office collects information beyond what the states have, the office should be able to share that information with the states, including in a coordinated way through the NAIC.

Congress is appropriately debating how best to ensure consolidated supervision of complex financial institutions, but any solution ultimately will require regulators at the state and federal level and from different functional areas to work collaboratively. State insurance regulators have too often been excluded from federal efforts and discussions to regulate the financial markets, thereby ignoring one of the principal pillars of the financial system. If a national insurance office is created at the federal level, it must leverage and engage state regulators, and bring their resources and expertise into the federal purview.

Competition Remains Critical

It is well recognized that financial markets and institutions have become more globalized. This fact is true of insurance as well as banking and securities. As markets and institutions have become more globalized, regulators and policymakers must continue their efforts to develop a regulatory system that reflects this change.

A key goal of legislation to create a national insurance office should be to maximize the

competitiveness of U.S. insurers when insurance regulatory policy is discussed internationally. The states lack the Constitutional authority to bind the nation, so empowering the national insurance office in this area is an appropriate goal. However, any binding discussion at the international level should respect and reinforce the states' authority to regulate insurer solvency and protect insurance consumers, and therefore should be limited to agreements of regulatory equivalence or mutual recognition. These types of agreements serve to "level the playing field" for U.S. and non-U.S. insurers, without preempting states' ability to prescribe the specific "rules of the game" for solvency and consumer protection. The current ONI/FIO discussion draft definition of an "international insurance agreement on prudential measures" is overly broad, and could unnecessarily preempt state solvency regulation. As such, we have offered language to limit such preemption to regulatory equivalence, which is consistent with the OII proposal.

Preservation of State Solvency Regulation

The financial turmoil of the past year has generated a newfound respect for strong capital and solvency regulations. These concepts have been embedded in state regulation of insurance, and are a critical reason why insurers have weathered the financial downturn relatively better than other types of financial institutions. Our solvency system is national in scope: all fifty states are now accredited by the NAIC, utilizing the same risk-based capital and baseline solvency standards. This system undoubtedly has been stress-tested by the dramatic losses in the capital markets – insurers, after all, are among the largest institutional investors – but it also has been vindicated by its stability and the continued safety and soundness of insurance policies and products. With that in mind, we strongly believe state solvency regulation should not be subject to preemption by the ONI/FIO, and we have offered legislative language to make that explicit.

Similarly, if preemption stemming from an international agreement could jeopardize the safety and soundness of the insurance markets or ultimately harm U.S. consumers, that preemption should be stayed or prevented. This protection was embedded in the OII legislation, but is notably absent from the current ONI/FIO discussion draft. The NAIC recommends adding a stay provision, along with a requirement that the national insurance office adhere to the Administrative Procedures Act, into any final proposal.

Finally, our support for any national insurance office is predicated on the notion that the office be a tool to connect the state regulatory system with the federal regulatory system, and not be an

instrument to displace or diminish state insurance regulation. The OII legislation made clear that the office would not create a supervisory role over insurance at the federal level, and we urge inclusion of identical language into any final legislation.

Conclusion

Mr. Chairman, we fully support the goal of creating a national insurance office to serve as a resource for the federal government and a conduit for the states, but we will continue to strongly oppose any efforts to use such an office as a precursor to establishing a federal insurance regulator.

The Office of Insurance Information bills in this Congress and the previous one struck the proper balance between federal preemption and retention of the current successful state insurance regulatory system, and the comments we offer today attempt to restore that balance to any final proposal considered by this Committee. We look forward to working with you on this effort, and on the many other critical issues before this Committee.

Thank you for the opportunity to testify, and I would be happy to answer your questions.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON "CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION, ENHANCING OVERSIGHT OF PRIVATE POOLS OF CAPITAL, AND CREATING A NATIONAL INSURANCE OFFICE"

October 6, 2009

Testimony of
Stef Zielezienski, Senior Vice-President and General Counsel,
American Insurance Association

Thank you, Chairman Frank, Ranking Member Bachus, and members of the Committee. My name is Stef Zielezienski. I am Senior Vice-President and General Counsel of the American Insurance Association (AIA), a national trade association whose property-casualty insurance company members write business in every U.S. jurisdiction and throughout the world. I appreciate the opportunity to be here today to discuss a topic of great importance to AIA and its members – the establishment of a federal insurance office within the Treasury Department, as contemplated in the "Federal Insurance Office Act of 2009" H.R. 2609 Discussion Draft offered by Representative Kanjorski (Discussion Draft).

As this Committee is aware, AIA has long advocated a national regulatory alternative to the state-by-state framework of supervision that exists today. While the Discussion Draft does not create a national functional insurance regulator, the Federal Insurance Office, if structured correctly, would represent a substantial contribution toward broadening and deepening our nation's understanding of the critical role of insurance in our financial system. The Office would also substantially improve the representation of the United States in international insurance-related negotiations. As such, AIA supports the Discussion Draft as a strong and important step forward along our shared journey to bring the U.S. insurance regulatory system into the 21st century.

I will focus my remarks today on two major themes that capture these principles, and offer some suggested amendments to the Discussion Draft that would enable those principles to be fully realized.

Federal Insurance Expertise

Because property-casualty insurance now represents a significant part of our national economy and supports the resiliency of U.S. homeowners, businesses, local governments and others, it is clearly time for the federal government to develop its own insurance expertise. Insurance contributes 2.4% to the annual GDP, with property-casualty insurance accounting for more than $535 billion in capital, purchasing close to $370 billion in state and municipal bonds, paying almost $250 billion annually in claims and, importantly, directly or indirectly employing 1.5 million hard-working Americans. The Treasury white paper recognized that "[i]nsurance plays a vital role in the smooth and efficient functioning of our economy" and is a "major component of the financial system." (U.S. Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation", p. 39 (June 16, 2009) (White Paper)).

In many ways, it is the engine that propels commerce and innovation, protecting individuals and businesses against adverse events leading to loss, and enabling them to meet financial demands in the face of adversity. And the unique focus of property-

casualty insurers on reducing societal risk has saved hundreds of thousands of lives, prevented millions of injuries, and avoided hundreds of billions of dollars in economic losses.

For these reasons alone, given its role as a key segment of our national economy, the federal government must create and empower an office that understands how the insurance industry works (including how it handles risk, utilizes capital, and meets the needs of its customers), understands the issues that confront it, and assesses whether it is regulated appropriately. The proposed Federal Insurance Office will be a significant advance in carrying out these functions. In recognition of the importance of insurance to our national economy and the duties outlined in the Discussion Draft, we believe the Federal Insurance Office should be led by an Assistant Secretary of the Treasury who would be appointed by the President and confirmed by the Senate, like the heads of other federal offices that are responsible for the several financial services sectors. By having this position filled by a presidential appointee, the head of the Federal Insurance Office will be recognized domestically as well as internationally as serving an important role as a senior government official with insurance sector responsibilities, bringing more influence to the position.

The Discussion Draft also makes a significant investment in developing such expertise by granting the Office the authority to "monitor all aspects of the insurance industry...."

(Discussion Draft, § 313(c)(1)(A)). Implicit in this function, as detailed in the Discussion Draft, the Office has authority to gather information from insurers and a wide variety of government and industry sources. In exercising this authority, the Discussion Draft recognizes the current state regulatory system by requiring the Office to make every effort to leverage information insurers already provide to government sources, in order to prevent duplicative or burdensome requests. With respect to information collection from those sources, this principle is already reflected in the "advance coordination" language of the Discussion Draft (§ 313(e)(4)); yet there is no similar provision that applies to data gathered from non-governmental sources. The Discussion Draft should be amended to add parallel language covering such sources.

With respect to maintaining confidentiality protection or privileges that attach to non-public information gathered by the Office, the "confidentiality" section of the Discussion Draft does a good job of preserving those protections, as well as protecting information submitted as part of a regulatory agency report. (Discussion Draft, § 313(e)(5)). However, the Discussion Draft should also provide protection for commercially sensitive information or trade secrets that are provided to the office, whether that information comes from a governmental or non-governmental source. As a result, we recommend amending the Draft to confirm that such information is considered subject to the confidential information and trade secret exemption from public disclosure under the Freedom of Information Act, 5 U.S.C. § 552(b)(4).

In its role as federal insurance expert, the Discussion Draft also envisions that the Office will (a) identify "issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system," (Discussion Draft, § 313(c)(1)(A)) and (b) make recommendations to the Federal Reserve as to whether any insurer (including affiliates of such insurer) should be designated as a "Tier 1 Financial Holding Company" for purposes of additional supervisory and regulatory scrutiny. (Discussion Draft, § 313(c)(1)(B)).

We agree that this is an important function for the Federal Insurance Office. With respect to property-casualty insurance, the Office should start with the premise that this sector has successfully weathered the current crisis and remains strong overall today. It remains strong for a number of reasons, including the fact that property-casualty insurance operations are generally low-leveraged businesses, with lower asset-to-capital ratios than other financial institutions, more conservative investment portfolios, and more predictable cash outflows that are tied to insurance claims rather than "on-demand" access to assets.

Given this result, the Office should serve as a resource not only to Congress, but to the federal banking agencies and to the Administration to facilitate understanding of the regulatory model that applies to insurance companies and to ensure that the insurance industry and its customers are not adversely affected by the application of inappropriate regulatory standards. This is a concern with respect to some of the legislative

recommendations that are part of the Treasury proposal, particularly where those recommendations apply bank regulatory models to insurance companies.

This is not to say that the current system of insurance regulation is perfect or that insurance companies should not be part of a systemic risk monitoring regime. To the contrary, as the Treasury white paper notes, the state-by-state system of insurance regulation is "highly fragmented, inconsistent, and inefficient." (White Paper at p. 40). Equally important, and despite good intentions, the states are inherently limited in their ability to resolve issues that cross state and national borders. But, until Congress decides to establish a national functional insurance regulatory alternative – a resulting structure that AIA would welcome – the expertise promised through the Federal Insurance Office is essential to prevent the unintended consequences to the insurance marketplace that may flow from indiscriminately applying bank-centric regulation to insurers, particularly because insurers are already subject to strict cradle-to-grave regulation and supervision.

In addition to the authority included in the Discussion Draft, we would urge the Office to target its surveillance activities to identify un- or lightly-regulated products or activities (which do not include traditional property-casualty insurance products) that could present systemic risk to other institutions or sectors of the financial system and U.S. economy. After all, it was these types of activities and regulatory gaps that led to the need for a federal rescue of AIG. By directing its attention to identifying and analyzing

such activity, this approach would allow the Office to monitor the insurance sector in a way that is not distracted by company size, but measures companies and the industry through the prism of risk aggregation and counterparty exposure generated by non-traditional products or activities, and identifies any regulatory gaps that have the potential to create systemic risk.

We recognize that the current state-based insurance regulatory system is not well-suited to bridge information or regulatory gaps that may arise where a financial conglomerate that includes traditional insurance subsidiaries engages in non-traditional financial activities. Such non-traditional activities exceed the jurisdiction of state insurance regulators and may span multiple federal regulatory regimes. The resulting information and regulatory gaps are often cited in connection with the AIG meltdown. In addition to other elements of the Administration's proposal, the Federal Insurance Office represents a tangible step toward identifying and closing those gaps.

Regarding the Office's relationship to any federal systemic risk council that may be established, we strongly urge this Committee to provide a seat for the head of the Federal Insurance Office on the council – as recommended earlier, the Assistant Secretary of the Treasury for Insurance. While traditional property-casualty insurance activities do not present substantial systemwide risk, any council should not operate without access to insurance expertise. Insurance is too important a sector in our nation's economy to be left out. Providing the head of the Office with a recognized seat

at the table would afford the council a federal stakeholder offering a national and international perspective on insurance issues that is not available to either the National Association of Insurance Commissioners (NAIC) or any individual state insurance commissioner or group of commissioners. In turn, providing the Office with a position on the council would advance that Office's charge to explore more fully the interplay between insurance and the other financial services sectors and enhance its monitoring function. In addition, serving on the council would engage the Assistant Secretary in discussions of developing and emerging issues so that any potential impact on insurance could be minimized or avoided altogether.

International Authority on Insurance Matters

Significantly, the Discussion Draft vests the Federal Insurance Office with the authority "[t]o coordinate Federal efforts and establish Federal policy on prudential aspects of international insurance matters...." (Discussion Draft, § 313(c)(1)(D). That authority includes the ability to represent the United States in the International Association of Insurance Supervisors (IAIS) and complements separate power in the Discussion Draft for the Treasury Secretary to negotiate international insurance agreements relating to prudential measures. (See Discussion Draft, §314(b)).

These are important and necessary functions, given that the U.S. Constitution vests the federal government – not the states or the NAIC – with exclusive power to conduct

foreign affairs. Both the Discussion Draft and the Treasury white paper document ongoing frustrations with the inability of the United States to negotiate authoritatively with foreign counterparts on pressing insurance issues. The Discussion Draft notes that "[t]here is increasing tension in the current regulatory systems as the result of an absence of clear and settled means for governments to enter into agreements on prudential measures with respect to the business of insurance or reinsurance." (Discussion Draft, § 314(a)). The white paper reinforces the point, stating that "the lack of a federal entity with responsibility and expertise for insurance has hampered our nation's effectiveness in engaging internationally with other nations on issues related to insurance." (White Paper at pp. 39-40).

The Discussion Draft ensures that state insurance regulation will come into alignment with at least prudential matters established in international agreements. While the term "prudential" is not defined in the Discussion Draft, in this context, it appears reasonable to equate the term with "financial regulation" by looking at (1) the use of the term in other aspects of the Treasury reform package, (2) the goal of addressing systemic risk in the United States and globally, and (3) the Draft's purpose to break the logjam caused by the lack of U.S. negotiating authority.

First, Title II of the Treasury proposal contemplates additional financial regulation for those institutions the failure of which would present a threat to the U.S. economy or to financial stability. In doing so, this title requires the systemic risk regulator to prescribe

"prudential standards" for such entities that include factors such as risk-based capital requirements, leverage limits, liquidity requirements, and risk management requirements. (See "Title II – Consolidated Supervision and Regulation of Large, Interconnected Financial Firms," § 204). All of these "prudential" factors are components of financial regulation.

Second, one primary purpose of establishing the Federal Insurance Office is to identify and mitigate risk that threatens the stability of our financial system. As we have painfully learned in the current crisis, such risk does not stop at our borders, but can have a domino effect for institutions and economies around the globe. Viewed in this context, it is clear that the Office's international authority over prudential insurance measures must involve a comparative ability to engage with foreign nations on financial regulatory issues that may address the risk of financial or economic instability on an international scale.

Third, to reinforce this point, Treasury's white paper discusses the importance of the Office's international role, using Solvency II, the recently adopted European Union insurance solvency framework, as its primary example of a global insurance issue that requires the U.S. to be represented with a single authoritative national voice. Solvency II is intended to make European companies more globally competitive by creating an efficient and uniform standard for all E.U. Member States and encouraging, while

carefully overseeing, new developments in risk management intended to spur competition and innovation.

Solvency II is now moving forward. Simultaneously, other major insurance markets, such as Switzerland and Bermuda, have instituted, or are in the process of instituting, very similar systems. In sharp contrast, the current U.S. insurance regulatory system remains fragmented among 57 state and territory level jurisdictions, and their regulators have forcefully objected to adopting Solvency II's innovative, pro-competitive aspects.

As Treasury noted in its white paper, an important part of Solvency II involves a third country "equivalency" determination: "In addition, the European Union has recently passed legislation that will require a foreign insurance company operating in its member states to be subject to supervision in the company's home country comparable to the supervision required in the EU." (White Paper at p. 40).

High level European spokespersons have repeatedly stated that the equivalence determination will not be made state-by-state, but rather will be made at the national level. At this time, it is hard to see how the current U.S. insurance regulatory system could pass this test. And, considering that Europe is one of the three largest insurance markets in the world, a failure by the U.S. regulatory system to be deemed equivalent, could negatively impact the global competitiveness of U.S. insurers and the jobs that

activity generates in the United States. At minimum, the United States should be fully empowered to sit at the negotiating table and engage with their foreign counterparts while Solvency II discussions evolve.

Solvency II's equivalency test highlights the disparity between financial regulatory regimes that will determine whether U.S. insurers doing business in Europe will be treated equally with insurers domiciled in other countries or will be disadvantaged abroad. It is but one example of the urgent need to empower the Federal Insurance Office and Treasury to engage on so-called prudential insurance regulatory matters to protect U.S. economic interests and to preserve the global competitiveness of the U.S. insurance industry.

Indeed, linking the authority of the Secretary and the Office with the critical insurance policy issues being discussed at the international stage, we believe that the Discussion Draft compels a conclusion that the Office has the ability to pre-empt state insurance measures that are inconsistent with international agreements concluded on behalf of the United States to the extent those agreements involve financial supervision.

Because the United States must speak with one voice on insurance regulation and policy at the international level, we strongly urge this Committee to expand the Office's representative capacity beyond the IAIS. The IAIS is not the only international organization that deserves an authoritative U.S. presence in this regard. Broad financial

services regulatory reform discussions are taking place in a number of international forums, and the United States must be part of those discussions, with a clear mandate and the most credible representation on international insurance matters.

Let me close by thanking the Committee again for circulating Representative Kanjorski's Discussion Draft and for engaging in an open dialogue on the substantial merits of a robust Federal Insurance Office. Establishing such an office – properly empowered – represents a necessary first step in ensuring that the essential role of insurance is recognized at the national level, and that the federal government retains the ability to preserve a viable private insurance market and maintain U.S. competitiveness in a changing global economy.

WRITTEN STATEMENT OF THE
FINANCIAL SERVICES INSTITUTE
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
HEARING ON:
"CAPITAL MARKETS REGULATORY REFORM: STRENGTHENING INVESTOR PROTECTION"
OCTOBER 6, 2009

Introduction

In the U.S., approximately 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the independent broker-dealer (IBD) channel.[1] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. Independent financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, and small businesses with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "Main Street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest.

Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[2] Independent financial advisors get to know their clients personally and provide them investment solutions in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

The IBD community has been an important and active part of the lives of American investors for

[1] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[2] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

more than 30 years, providing comprehensive financial planning services and unbiased investment advice. IBD firms share a number of similar business characteristics. They generally engage in the sale of packaged products, such as mutual funds and variable insurance products; utilize the services of a clearing firm to maintain actual custody of client funds and execute securities transactions; they take a comprehensive financial planning approach to their clients' financial goals and objectives; and provide investment advisory services through affiliated registered investment adviser firms. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

The Financial Services Institute (FSI)[3] is the advocacy organization for IBDs and independent financial advisors. Our vision is that all individuals have access to competent and affordable financial advice, products and services delivered by a growing network of independent financial advisors affiliated with independent financial services firms. Our mission is to create a healthier regulatory environment for independent broker-dealers, and their affiliated independent financial advisors, through aggressive and effective advocacy, education, and public awareness.

Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Financial Crisis and Regulatory Reform Proposals

The failure of large financial institutions in the U.S. due to excessive exposure to high-risk securities related to, among other things, subprime loans and credit default swaps has rapidly evolved into a global economic crisis resulting in bank failures, sharp reductions in the value of equities and commodities worldwide, and widespread economic uncertainty. The revelation of the massive Ponzi schemes operated by Bernard Madoff and Allen Stanford further shook the financial markets and investor confidence. On June 17, 2009, the Obama Administration released its plan for a sweeping overhaul of the financial services industry's regulatory structure in the form of a white paper entitled "Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation" (White Paper).[4] The White Paper offers

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[3] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 113 Broker-Dealer member firms that have more than 152,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 10,000 Financial Advisor members.

[4] Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation (White Paper), at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

sweeping reforms to address the "most severe financial crisis since the Great Depression."[5] The White Paper's reform proposal is intended to address five key objectives:

- Promote robust supervision and regulation of financial services firms;
- Establish comprehensive supervision of financial markets;
- Protect consumers and investors from financial abuse;
- Provide the government with the tools it needs to manage financial crises; and
- Raise international regulatory standards and improve international cooperation.

On October 1, 2009, Rep. Paul E. Kanjorski, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, released discussion drafts of his Investor Protection Act (IPA).[6] The bill is designed to achieve the goals of the Administration's White Paper. Among other things, the bill would: (1) direct the Securities and Exchange Commission (SEC) to establish a standard of conduct for broker-dealers consistent with that applicable to investment advisers under the Investment Advisers Act of 1940, and (2) increase funding for the SEC by doubling the authorized congressional funds over a five-year period and by allowing the SEC to "collect from investment advisers … fees designed to help recover the cost of inspections and examinations of registered investment advisers conducted by the Commission."[7]

FSI's Guiding Principles for Regulatory Restructuring

The current market turmoil provides Congress with a unique opportunity to reform the financial services regulatory structure. The large financial conglomerates will have significant input in this process. However, for any reform effort to be judged a success, Congress must design the regulatory framework from the perspective and for the benefit of middle-class investors. In pursuit of this goal, we believe all legislative and regulatory options should be evaluated by asking the question, "How will this proposal impact middle-class investors?" This question will be best answered by improving the transparency, effectiveness, and efficiency of the existing regulatory structure.

While the White Paper and IPA address weaknesses of the current regulatory structure, we believe they fall short of the transparent, effective, and efficient financial services regulation needed by middle-class investors. These shortcomings are most pronounced in the proposed new standard of care and in the resources that are dedicated to the supervision of investment advisers. We describe our concerns below:

- Transparency
    - Standard of Care – The White Paper and IPA would each apply a version of the fiduciary duty to broker-dealers and investment advisers. With its many

[5] White Paper, at 2.
[6] *See generally*, Investor Protection Act of 2009, available at http://www.house.gov/apps/list/press/financialsvcs_dem/investor_protection_act_draft.pdf.
[7] Investor Protection Act of 2009, page 61.

definitions and permutations created in case law, the term "fiduciary" lacks transparency and fails to provide investors with clarity concerning the duty owed to them by their financial advisor and IBDs.

  - Supervision of Investment Advisers – The White Paper fails to allocate additional resources to supervision of investment advisers. The IPA attempts to address this concern, but unwisely subjects the regulatory resources to the political process. A regulatory system that promises a heightened standard of care, but fails to dedicate adequate resources to enforce these requirements will provide investors a false sense of security.

- Effectiveness
  - Standard of Care – The existing retail supervisory structure can be made more effective by eliminating redundant, contradictory, and inefficient requirements including the separate and distinct standards of care owed by broker-dealers and investment advisers to their clients. Both the White Paper and the IPA address this problem by adopting a form of the fiduciary standard. Unfortunately, the fiduciary standard will prove unworkable and ineffective in many broker-dealer client relationships, particularly those involving middle-class investors who bring relatively small dollar amounts to the table, who need professional support and guidance to achieve their investment objectives.
  - Supervision of Investment Advisers – The White Paper's proposal fails to dedicate resources to vigorous examination and enforcement. While the IPA attempts to address this issue, its approach depends heavily on congressional appropriations for those resources. We believe a self-funded regulator focused solely on investment adviser supervision, examination, and enforcement will develop the much-needed expertise to perform the function effectively.
- Efficiency
  - Standard of Care – The White Paper and IPA's proposal to adopt the fiduciary standard of care will create significant inefficiencies that will restrict investor access to advice and service by increasing costs and other barriers to entry. We believe regulation should support universal investor access to financial advice, products, and services by creating an efficient structure that reducing costs and other barriers to entry.
  - Supervision of Investment Advisers – A competitive marketplace encourages efficiency. Unfortunately, the White Paper's approach would allow investment advisers to continue to complete on an unlevel playing field. The IPA would address this concern by dedicating increased resources to the supervision, examination and enforcement of investment adviser regulations. However, its approach would limit industry input that is essential to ensure effective oversight by keeping regulators ahead of the curve on business developments and assisting them in minimizing the unintended consequences of regulation.

We believe there is a better way to protect investors that involves a transparent universal duty of care supported by effective and efficient regulatory supervision and enforcement.

Universal Standard of Care

While the White Paper correctly points out that "investors are often confused about the differences between investment advisers and broker-dealers," it suggests that this problem can be corrected by adopting a version of the arcane and opaque fiduciary duty as the standard of care for those dispensing investment advice. The IPA makes a similar mistake by adopting the fiduciary duty standard of the Investment Adviser Act of 1940. The term fiduciary duty is subject to a variety of different legal definitions in a range of applications. These varying definitions make it difficult even for attorneys to define the standard owed to investors. As a result, we believe it is unfair to adopt this as the standard of care owed to clients by financial advisors. Imposing the fiduciary standard on all financial advisors will have the unfortunate consequence of eliminating cost effective compensation arrangements that allow small investors to receive professional support in their investment decision making. The result will be a confused public who will find that financial services are priced beyond the reach of small investors.

FSI supports the development of a single universal standard of care applicable to all financial advisors who provide investment advice to clients. Development of a single standard of care will promote and enhance investor protection while reducing inefficiencies inherent in the current regulatory system. The universal standard of care should be designed to ensure transparent business relationships, effective client disclosures, and efficient low-cost investment solutions and operations.

As a result, we urge Congress to instruct the SEC to develop a fully transparent "universal standard of investor care" based upon the following three principles:

1. A financial advisor shall place the interests of their client before their own;
2. A financial advisor shall avoid material conflicts of interest when possible, and obtain informed client consent to act when such conflicts cannot be reasonably avoided;
3. A financial advisor shall provide advice and service with skill, care and diligence based upon information known about their client's investment objectives, risk tolerance, financial situation and needs.

We believe the creation of a new universal standard of investor care based upon these principles will greatly enhance investor protection over the status quo with greater transparency, effectiveness and efficiency.

Supervision and Oversight of Investment Advisers

True regulatory reform will come from rationalizing and harmonizing the oversight of broker-dealers and investment advisers so that the serious regulatory gaps that exist today are closed. The SEC projects that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010. By contrast, the SEC and industry-funded regulators examine more than half of the approximately 4,900 registered broker-dealer firms each year. The Administration's plan would leave in place an unbalanced and

inefficient allocation of regulatory resources. As a result, it would do nothing to close this existing regulatory gap or promote an efficient and effective regulatory examination and enforcement program for registered investment advisers. In fact, many of the financial advisors involved in recent high-profile fraud cases were subject to a fiduciary standard and SEC examination, yet were able to operate their frauds for years due to the lack of regular and vigorous oversight of their activities.

However, the White Paper misses this important point and leaves in place an unbalanced and inefficient marketplace for financial products and services that allows investment advisers to drop their affiliation with a broker-dealer in a form of "regulatory arbitrage" to escape the more rigorous scrutiny to which broker-dealer activity is subject and, instead, work under the umbrella of a registered investment adviser. We believe it is clear that adding a higher standard of care to broker-dealers without serious improvement in the regulatory supervision, examination, and enforcement efforts for investment advisers will not close the most significant existing regulatory gap. As a result, we believe that a heightened standard of care must be supported by effective regulatory supervision of registered investment advisers.

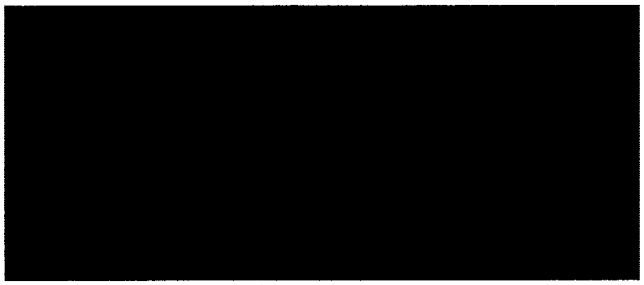
The IPA attempts to address this concern by doubling congressional funding for the SEC and by seeking increased funds for the SEC for its examinations of investment advisers by collecting "fees designed to help recover the cost of inspections and examinations … conducted by the Commission." We applaud the IPA's attempt to increase the regulatory resources dedicated to investment adviser supervision, examination, and enforcement. However, we believe the regulatory system will remain ineffective if the resources dedicated to vigorous examination and enforcement are dependent upon congressional appropriations. In addition, we believe a regulator solely focused on investment adviser supervision, examination, and enforcement efforts will develop the much-needed expertise to perform the function well.

FSI urges Congress to create an industry-informed, industry-funded regulatory authority dedicated to effective supervision, timely examination, and vigorous enforcement. Emphasizing examination and supervision of registered investment advisers will protect investors by contributing to the transparency, effectiveness, and efficiency of the financial services regulatory structure. Therefore, it must be part of any serious regulatory reform effort.

Conclusion

FSI stands ready to participate in a constructive dialogue with policymakers on the most effective means of improving investor protection while encouraging universal access to financial products, services, and advice. We urge Members of Congress to pursue proposals that will create a financial services regulatory system that adopts a transparent universal standard of investor care and supports it through the creation of an industry-informed, self-funded regulatory authority for registered investment advisers. We believe these reforms will truly benefit middle-class investors by promoting a transparent, effective, and efficient financial services regulatory structure.

Statement of



in connection with a hearing of

The United States House of Representatives

Committee on Financial Services

Regarding

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

October 6, 2009

The National Association of Insurance and Financial Advisors (NAIFA) appreciates the opportunity to share with you, the members of the House Financial Services Committee, our views in connection with your hearing on capital markets regulatory reform. Our comments are focused specifically on imposing a fiduciary duty on broker-dealer registered representatives and the creation of a national insurance information office. As discussed more fully below, we have strong reservations about creating a new fiduciary duty standard and urge you to take steps to ensure that statutory and regulatory changes do not have the effect of restricting the ability of investors to get the advice and service they need to competently engage in the marketplace. We do, however, fully support the creation of a Federal Insurance Office, which we would serve as a source of information expertise and information for the federal government and on the international level.

Founded in 1890 as the National Association of Life Underwriters, NAIFA comprises more than 700 state and local associations representing the interests of approximately 200,000 agents and their associates nationwide. NAIFA members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. The Association's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. NAIFA's website can be accessed at www.naifa.org.

1. Fiduciary Duty and Harmonization of Standards for Investment Advisers and Broker-Dealers

The Administration's proposal, and Chairman Kanjorski's draft legislation, to impose a fiduciary standard of care on broker-dealers and harmonize the standards applicable to investment advisers and broker-dealers is of grave concern to NAIFA members. That said, we fully understand – and share – the goals of the Administration and the Chairman with respect to lessening the consumer confusion that exists with respect to the role of investment advisers and broker-dealers. Indeed, one of the findings of the SEC-commissioned Rand report issued last year was that consumers do not clearly understand the differences between investment advisers and broker-dealers. It is important to note, however, that the Rand report also found that

investors are generally happy with their advisers and the services they provide. The latter point is critical to keep in mind as proposals for a uniform standard of care are considered so that the goal of harmonization does not damage the current, generally successful, nature of existing client-adviser relationships.

This issue is important to us because nearly three-quarters of NAIFA's members are registered representatives of broker-dealer firms, and many NAIFA members are registered investment adviser representatives. Thus, any statutory or regulatory changes that are put in place will have a significant impact on our membership and on the relationships NAIFA members have with their clients. We are therefore deeply concerned about the application of a yet to be defined fiduciary standard across the board to all persons providing financial advice. The term "fiduciary standard" is subject to a variety of different legal definitions and may impose different obligations under different sets of circumstances. This makes it very difficult to determine with certainty the standard owed by an adviser to a client, particularly given the differing levels of engagement between advisers and clients. With that in mind, we ask that Congress consider the following important factors as it contemplates establishing a harmonized standard for broker-dealers and investment advisers:

First, the standard must preserve the ability of financial professionals to sell products made available by the company or companies with which they are affiliated and/or with which they have a binding contractual relationship. A financial adviser that is affiliated with a broker-dealer or insurer is limited as to the product offerings that the adviser can make available to clients.

Second, the standard must recognize the ability for financial professionals to be fairly compensated, without restriction on the manner or type of compensation arrangements, including, but not limited to commissions or fees. Compliance with a standard of care should not be determined by the manner or type of compensation received by the financial adviser.

Third, the standard must preserve the ability of middle and lower income investors to have access to competent and professional advice. The key here is preserving competitive, cost-effective compensation arrangements that allow these investors to access the advice, financial

products, and services of financial professionals. The danger is that by imposing a fiduciary standard of care – without establishing some parameters or guidelines to that duty such as protecting the commission structure – small and middle-level investors will be priced out of the marketplace.

Anecdotally, investors often start with very small investment amounts of only a few dollars per month. Advisory fee-only accounts generally require assets under management of $150,000 or more. Therefore, investors with smaller portfolios may not be able to afford, or may be unwilling to pay for, the fees that advisers need to charge for fee only/percentage of assets under management types of accounts. Therefore, in a fee-only environment, small and medium-sized investors would not receive the level of service, access to financial products, and advice that they are currently able to receive in an environment that allows for commission compensation. As a result, these investors will be less likely to achieve life's major goals and objectives for personal and family financial security.

Finally, the standard must call for clear and easy to understand disclosure about the respective roles of advisers, the nature of their contractual relationships, and the different products, advice, and services available. In our members' experience, simple disclosure engages clients in a constructive dialogue about their financial goals and objectives and what they can expect from their financial professional. To that extent, we are encouraged by the provisions of Chairman Kanjorski's discussion draft that call for such disclosure.

Although we are very concerned about the call for a single – one size fits all – fiduciary standard, we look forward to a continued dialogue with the Chairman and the members of the committee to ensure that any standard Congress puts forth will protect consumers and be practically workable for the financial professionals that serve them – in an effort to preserve existing business models and the various types of compensation arrangements.

2. The Federal Insurance Office

NAIFA members have debated long and hard regarding the proper federal role in insurance regulation. NAIFA members are long-time supporters of state regulation and remain

steadfastly committed to this tradition. Having said that, NAIFA recognizes the shortcomings of the current regulatory structure. Unnecessary distinctions among the states and inconsistencies within the states on issues such as licensing, product approval, and consumer protection, thwart competition, reduce predictability and add unnecessary expenses to the cost of doing business, all of which ultimately harm consumers. We have – and continue to – work with the states to make improvements. We recognize that reform is critical to protect consumers and to ensure a strong and healthy insurance marketplace, and we believe that fixing the problems with the insurance regulatory system ultimately will enable the insurance industry to provide better and greater choices for consumers, without sacrificing consumer protection.

Despite the solid efforts made by the states to improve the current regulatory system, it has become increasingly clear that the state system can be improved. NAIFA believes it is imperative that the problems and inefficiencies in the state regulatory system be corrected quickly, and supports continued efforts on the part of the states and the involvement of Congress in the reform process. To that end, in 2002, NAIFA adopted an official policy position, amended in 2004, which supports congressional action to improve and augment the regulation of insurance, and provided such action meets NAIFA's specific guidelines aimed at maintaining fairness to agents and protection for the consumers they serve. Our policy highlights our support for the NAIC's regulatory modernization efforts and identifies certain federal proposals, such as the Federal Insurance Office, NARAB II, and an optional federal charter, that could if properly crafted, improve the regulation of our industry.

While our regulatory reform policy continues our century-long support for state regulation of insurance and confirms our commitment to improve the state-based system, we believe the status quo of insurance regulation is detrimental to consumers and NAIFA members. Thus, our policy acknowledges that all regulatory reform options are on the table and that NAIFA is willing to consider a breadth of alternatives, both federal and state, in our desire to fix the problems confronting us. Simply put, NAIFA favors reform, improvement and progress over the status quo.

In order to achieve that goal, NAIFA is open to considering federal efforts to improve the insurance regulatory system, while continuing to work through the NAIC and at the state level to achieve the necessary regulatory improvements. We saw action when the Treasury Department's blueprint for financial regulatory reform released earlier this year, included a provision calling for the creation of an Office of National Insurance within the Treasury Department to serve as a federal source of expertise on insurance matters. NAIFA was an early supporter of Rep. Kanjorski's Office of Insurance Information legislation, because we believe creating a federal insurance office – as detailed in Chairman Kanjorski's updated legislation H.R. 2609, the Federal Insurance Office Act – is an important step in advancing insurance expertise and understanding at the federal level, and in bringing some degree of uniform treatment in terms of international insurance regulatory and trade matters.

The need for this legislation is clear to NAIFA members based on our own experience. Last year, NAIFA leaders undertook an exhaustive study of the various proposals to reform the regulation of insurance. During that review, it became clear that there is a fundamental lack of understanding at the federal level regarding issues that impact professional agents and the industry on a national and international scale. Currently there are 14 federal agencies that have a role in regulating insurance, and yet there is no central body of expertise at the federal level to provide advice and council to the Administration and Congress on policy matters affecting the insurance industry. As provided for in Rep. Kanjorski's legislation, the Federal Insurance Office (FIO) would ably fill that role, while at the same time not impinging on state regulatory prerogatives.

Thank you for your consideration of NAIFA's views.

* * *

Statement for the Record

of the

National Association of Mutual Insurance Companies

to the

House Financial Services Committee

hearing on

Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office

October 6, 2009

The National Association of Mutual Insurance Companies ("NAMIC") is pleased to offer comments to the Financial Services Committee on the creation of a national insurance office.

Founded in 1895, NAMIC is the largest, most diverse national trade association in the United States. NAMIC represents the interests of its property/casualty insurance company members and their policyholders. NAMIC's membership includes farm mutual insurance companies, single-state and regional writers, and national insurers operating across North America. The more than 1,400 NAMIC members underwrite 41 percent of the automobile and homeowners insurance market and 31 percent of the business insurance market in the United States.

The recent financial crisis has called attention to our nation's system of financial services regulation. Insurers recognize the need for greater coordination among financial services regulators and enhanced cooperation and coordination among the various global financial services regulatory bodies. NAMIC supports a reformed system of state-based insurance regulation and believes that any federal role in the regulation of insurance should be limited in scope without regulatory authority. NAMIC believes that an office of insurance information could be properly constructed to meet these objectives.

NAMIC was pleased to support H.R. 2609, the Insurance Information Act, as introduced earlier this year by Subcommittee Chairman Paul Kanjorski. The legislation as originally introduced struck an appropriate balance between providing an effective means of international coordination, protecting the confidentiality of company information, and recognizing the primacy of state regulation. However, NAMIC has serious concerns with the recent discussion draft of the "Federal Insurance Office Act of 2009."

Federal Insurance Office

The draft legislation would create a new Federal Insurance Office with broad authority over international prudential matters, including the authority to preempt state insurance laws that are deemed inconsistent with international supervisory agreements; the power to compel information and data submission from insurers and their affiliates; and a perceived mandate to recommend that specific insurance companies be subject to federal oversight as systemically significant "Tier 1 Financial Holding Companies."

In essence, the discussion draft represents a significant change in the concept, embodied in the original H.R. 2609, of a federal office with narrowly tailored authority to gather information about the insurance industry and ensure that non-U.S. domiciled insurers are not subject to discriminatory treatment under state insurance laws. Instead, H.R. 2609 has become a near replica of the Treasury Department's proposed "Office of National Insurance Act of 2009." Indeed, the discussion draft differs from the Treasury proposal in only two respects: it eschews the Treasury proposal's grant of

formal subpoena power to the Office of National Insurance, and it changes the name of the Office of National Insurance to the Federal Insurance Office.

Specifically the Federal Insurance Office would be granted the authority to (i) monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system; (ii) recommend insurers, including affiliates, as entities subject to regulation as a Tier 1 financial holding company; (iii) assist in administrating the Terrorism Risk Insurance Program; (iv) coordinate Federal efforts and establish Federal policy on prudential aspects of international insurance matters, including representing the United States as appropriate in the International Association of Insurance Supervisors and assisting the Secretary in negotiating International Insurance Agreements on Prudential Measures; (v) determine whether State insurance measures are preempted by International Insurance Agreements on Prudential Measures; (vi) consult with the States regarding insurance matters of national importance and prudential insurance matters of international importance; and (vii) perform such other related duties and authorities as may be assigned to it by the Secretary. The Federal Insurance Office is further directed to advise the Secretary on major domestic and prudential international insurance policy issues.

The Federal Insurance Office would also be given authority to issue orders, regulations, policies and procedures to implement the Act.

The authority granted to the Federal Insurance Office goes well beyond the parameters outlined in the original Office of Insurance Information. The change of name from the Office of Insurance Information to the Federal Insurance Office is illustrative of the new direction taken in the legislation. As described in the discussion draft, the Federal Insurance Office more closely resembles a *quasi*-regulator than an information resource. The broad authority to monitor all aspects of the insurance industry would grant the Federal Insurance Office unprecedented and unnecessary authority to enter into virtually every aspect of the functioning of insurance markets, the operation of specific insurance companies and the regulation of insurance. Such authority would ultimately lead to costly and highly intrusive investigations.

Unlike prior legislation, the proposal also lacks any explicit limitation on the authority of the Federal Insurance Office to act in a regulatory capacity. NAMIC believes the inclusion of express language providing that nothing in the Act would be "construed to establish a general supervisory or regulatory authority of the Office or the Department of the Treasury over the business of insurance" is necessary. A clear prohibition on supervisory or regulatory authority is essential to avoid a dual regulatory scenario.

Systemic Risk

The Federal Insurance Office Act would direct the Office to identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system and to recommend insurers, including affiliates, as entities subject to regulation as a Tier 1 financial holding company.

The suggestion that insurers could be designated as Tier 1 financial holding companies refers to the Administration's proposal for "Consolidated Supervision and Regulation of Large, Interconnected Financial Firms." The Administration proposes that Congress establish criteria for identification of any financial institution as a large and interconnected Tier 1 firm. Such firms are generally presumed to be institutions that pose a threat to the economy's financial stability based on their size, leverage, and interconnectedness to the financial system. Designated firms would be subject to consolidated supervision and regulation at the federal level, regardless of whether they own insured depository institutions. The Federal Reserve would assume supervisory authority over these financial institutions and would be permitted to prescribe, examine, and enforce more stringent prudential standards even against functionally regulated entities.

Unlike banks and certain other types of financial institutions, property/casualty insurers have little or no capacity for propagating systemic risk because of the nature of the products that property/casualty insurers provide, their capital structures, and underwriting practices. In addition, most of the obligations of property/casualty insurers are protected by the insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, reduces the systemic impact of any failing property/casualty insurer by providing most customers or claimants assurance that the insurer's obligations will be satisfied on a timely basis.

NAMIC supports regulatory efforts to identify, monitor, and address systemic risk. However, systemic risk oversight and regulation should complement existing regulatory resources. Assessment of the risk posed by an insurer, or holding company, should be made in consultation and coordination with the relevant functional state regulator. The Federal Insurance Office's focus on regulatory gaps and individual company evaluation presupposes that insurers pose a systemic risk and virtually guarantees that the Federal Insurance Office will be duty bound to recommend insurers for Tier 1 designation. As numerous experts have pointed out, designating certain firms as systemically significant and subjecting them to the authority of a federal systemic risk regulator could do enormous harm to financial markets by undermining market discipline and distorting market competition. NAMIC urges the Committee to remove from the discussion draft any suggestion that insurers are, or could be, systemically significant institutions, or that they should be subject to federal systemic risk regulation.

Information Gathering

The Federal Insurance Office as drafted would be empowered to receive and collect data and information on and from the insurance industry and insurers; enter into information-sharing agreements; analyze and disseminate data and information; and issue reports regarding all lines of insurance except health insurance. The Office could require any insurer, or affiliate, to provide information directly to the Office. Prior to requesting information from insurers or affiliates the Office would be directed to coordinate with the relevant state insurance regulator to determine if the information is available, or may be obtained in a timely manner, from the state regulator or other federal or state regulatory agency.

Data calls and document productions are costly and time-consuming endeavors for insurers and raise issues related to the confidentiality and security of the information. Insurers regularly submit information to state regulators on all aspects of their operations. NAMIC has long supported and encouraged harmonization and coordination of the information requests among the states. Imposition of an additional reporting layer is counter to the goal of simplification and coordination. NAMIC recognizes the need for information at the federal level, but believes that collection of information can be achieved working through data-gathering systems already in place.

Although the Office is directed to coordinate with state regulators prior to collecting data or information, the Office is permitted to request information directly from insurers. The authority to demand data and document productions more closely resembles the authority of a regulatory agency than an information and research institution. NAMIC is pleased that the discussion draft eliminates the controversial provision granting the Office subpoena authority to enforce its information requests. However, NAMIC urges the Committee to further amend the proposed legislation to require the Office to certify that the information may not be obtained from state regulators, the NAIC or other sources, such as authorized statistical reporting agents, prior to going to directly to companies.

Confidentiality and Privilege

NAMIC is also concerned about protecting the confidentiality and privilege of information collected and maintained by the Federal Insurance Office. Under the proposal, submission of non-publicly available data and information to the Office would not constitute a waiver of, or otherwise affect, any privilege arising under Federal or State law (including the rules of any Federal or State Court) to which the data or information is otherwise subject. In addition, federal or state laws and requirements pursuant to written agreements regarding the privacy and confidentiality would continue to be applicable to data after it is received by the Office. Information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for the use of a State insurance regulator or other Federal or State regulatory agency responsible for the insurer or affiliate's regulation or supervision would be exempted from Freedom of Information ("FOIA") requests.

NAMIC appreciates the assurances received from the Committee and the Department of the Treasury that company specific information will be accorded the highest privacy and confidentiality protections. However, NAMIC believes that additional statutory protections are essential to ensure the integrity and security of sensitive, confidential and proprietary information. NAMIC recommends the inclusion of additional language providing that "any non-publicly available data and information received or collected by the Office shall be considered to be subject to 5 U.S.C. 552(b)(4)." The inclusion of this language would ensure that non-publicly available information obtained would be treated as trade secrets and commercial or financial information obtained from a person are privileged or confidential and properly excluded from FOIA requests.

NAMIC further recommends the addition of language precluding the Federal Insurance Office from "disclosing to any party any personally identifiable information received or collected, except to the Board of Governors of the Federal Reserve in connection with the exercise of its authority under subsection (c)(1)(B)." The Federal Insurance Office is directed to make periodic reports to Congress including any information requested by Congress or that the Director deems appropriate. Disclosure of personally identifiable information could have adverse consequences and violate the confidentiality and privilege of information and should be expressly prohibited.

The unlimited grant of information collection authority combined with the mandate to monitor all aspects of the insurance industry transforms the Office from a policy and information resource to an oversight entity. NAMIC urges the Committee to return to the original concept of a non-regulatory office at Treasury as a source of information in order to avoid the dual regulatory environment inherent in the current construct.

International Insurance Agreements on Prudential Measures

The discussion draft suggests that there is a lack of consistency between international regulatory authorities that impairs the ability of domestic and foreign-based companies to participate fully in each others' markets. NAMIC believes increased coordination and cooperation among international regulatory authorities is desirable, but disputes the notion that the current system imposes an inappropriate or undue impediment to participation in U.S. markets by non-U.S. insurers. Movement of capital which is intended for risk or insurance generally flows freely at the present. Coordination of reporting or presentation standards to permit review and evaluation help to foster greater regulatory transparency and encourage competition. Present cooperation between the European Union and U.S. provide a sound basis for further collaborative efforts.

As a part of these efforts, U.S. insurance regulators – through the NAIC – participate in the International Association of Insurance Supervisors ("IAIS"). The IAIS develops international standards for insurance supervision, provides training to its members, and fosters cooperation between insurance regulators, as well as forging dialogue between insurance regulators and regulators in other financial and international sectors. Regulators and staff participate in the work of the IAIS on a variety of issues including international solvency supervision, accounting standards, reinsurance regulation and other issues of regulation of the business of insurance.

Under the discussion draft, the Federal Insurance Office would be empowered to coordinate Federal efforts and establish Federal policy on prudential aspects of international insurance matters, including representing the United States as appropriate in the International Association of Insurance Supervisors and assisting the Secretary in negotiating International Insurance Agreements on Prudential Measures. The authority of the Secretary of the Treasury would also be expanded to negotiate and enter into such agreements on behalf of the United States.

The term "prudential measures" is undefined in the discussion draft, but has generally been used to refer to laws, regulations, or administrative practices undertaken for the protection of users of financial services and the stability and integrity of the financial system. Left undefined the authority of the Office could be interpreted to extend to accounting procedures, solvency and investment requirements, licensing requirements, and reinsurance collateral requirements. Such prudential matters go to the very heart of insurance and cannot be severed from the regulation of the underlying terms of the insurance contract, including rates, forms, and underwriting requirements. Transferring authority over prudential matters to the federal government would effectively separate key insurance regulation functions and could undermine the integrity of the system. The grant of such broad authority could easily render Treasury a *de facto* insurance regulator.

NAMIC supports enhanced cooperation and coordination among the various global financial services regulatory bodies. However, such cooperation and coordination should not come at the cost of abrogation of regulatory authority to foreign jurisdictions or quasi-governmental bodies. Likewise, authority to enter into agreements and bind U.S. insurers and insurance regulators should not be abrogated solely to the discretion of the Secretary of the Treasury. International agreements affecting insurance must be negotiated in full coordination with state regulators and Congress must not abandon its oversight function and should exercise full consultative authority.

Preemption of State Insurance Measures

The Federal Insurance Office Act of 2009 would preempt State insurance measures to the extent that the Director of the Office determines that the measure (i) directly or indirectly treats a non-United States insurer domiciled in a foreign jurisdiction that is subject to an International Insurance Agreement on Prudential Measures less favorably than it treats a United States insurer; and (ii) is inconsistent with an International Insurance Agreement on Prudential Measures.

Prior to making a determination, the Director would be required to publish notice of the potential inconsistency – including a description of any state insurance measure and the international agreement at issue – in the Federal Register, provide interested parties the opportunity to submit comment, and consider any comments received. Upon determination of any inconsistency the Director shall notify the state and provide reasonable time before the determination becomes effective. If at the expiration of the time period the inconsistency still exists the Director would publish notice of preemption in the Federal Register with the effective date and notify the state. States would be precluded from enforcing any measure that has been preempted.

The preemption provisions fail to include provisions to address situations in which maintenance of state law or regulation is necessary to protect policyholders and claimants, ensure the soundness of any insurer, or maintain the stability of the insurance market or U.S. financial system. Although a state insurance provision may be inconsistent with an International Insurance Agreement on Prudential Measures, it may nevertheless be in the best interest of the citizens and policyholders of a state or be

necessary for the health and stability of an insurance market or the U.S. financial system. Failure to permit exemptions in exigent circumstances could undermine a well-functioning insurance market.

Likewise the discussion draft fails to include provisions for right to redress in the event of preemption. States on behalf of their citizens, affected insurers, and other stakeholders should be afforded the right to seek the judicial redress they enjoy with other federal regulations. Preemption decisions and enforcement actions must be subject to the rule of law and interested parties provided the due process administrative procedure rights and judicial review.

Conclusion

NAMIC member companies understand that federal policymakers must have better information about the insurance industry, and confidence in the financial health of property/casualty insurers. To that end, NAMIC has supported the creation of a federal Office of Insurance Information. The current proposals, however, go far beyond information analysis and international coordination. As currently drafted, the Federal Insurance Office Act would grant the federal government broad authority to establish regulatory standards through international agreements and place the Office in a supervisory role over insurers and the insurance regulatory system.

NAMIC looks forward to working with the Committee to craft legislation that will facilitate international coordination and improve information sharing without instituting a duplicative and costly regulatory apparatus or dismantling the state regulatory system.

National Association of Mutual Insurance Companies
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October 6, 2009

Chairman Barney Frank
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Congressman Spencer Bachus
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank and Ranking Member Bachus:

The purpose of this letter is to communicate the views of the National Association of Small Business Investment Companies (NASBIC) regarding the impact that the current draft of the Private Fund Investment Advisers Registration Act will have on small businesses.

NASBIC understands that a functioning and honest financial market is critical to small businesses and the national economy. Clearly there are areas of financial regulation that need reform and added transparency. However, we encourage Congress to avoid adding any duplicative regulatory requirements, particularly as they as they relate to the Small Business Investment Companies (SBICs). The existing regulation of SBICs should be recognized and a waiver should be granted for SBICs in the bill.

Small Business Investment Companies (SBICs) are small, highly regulated private equity funds, licensed by the Small Business Administration (SBA), that invest exclusively in domestic small businesses. There are only 316 SBICs licensees with almost all being smaller than $150 million and having an average size of just under $50 million. Most SBICs are small operations having fewer than 10 employees.

SBICs have been regulated for over 50 years by SBA via the Small Business Investment Act of 1958. As part of the SBIC license, the federal government regulates and reviews who can be a fund manager, who can invest in SBICs, what the acceptable risk profile is for the fund, what is the minimum investment diversity of the fund, etc. SBICs are regularly examined by regulators for financial reporting and for a broad range of regulatory compliance. The federal government has and uses its existing authority to take strong action in the event of regulatory non-compliance, financial impairment, or malfeasance including: the ability to replace fund management teams, force receiverships and even compel liquidations. Clearly, SBICs are already fully regulated.

The current proposals to restructure the financial regulatory system are intended to prevent and manage systemic risk, as well as to provide regulatory sunshine to private equity. Transparency and stability are worthy goals that promote healthy markets. However, despite the importance of the SBICs to small businesses and job creation, SBICs pose absolutely no systemic risk. Further, SBA already has access to all of the fund information needed for regulatory transparency. For Small Business Investment Companies, the initial version of the bill presents a risk of duplicative

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regulation and increased costs. NASBIC's members strongly encourage this Committee to modify the bill to ensure that SBICs are not double regulated.

New, broader regulation is supported by large hedge funds and large funds engaged in passive investments for whom the compliance costs would be nominal. The current proposals may be adding consumer protections by regulating these large funds. However, many of the smaller funds that are directly investing in active small businesses will have higher proportional compliance costs and marginal, if any, new consumer protections. Nowhere in the spectrum of seed funds through the lower middle market is there a source of systemic risk. Creating new costs or restrictions in the small business investment continuum (from seed through the lower middle market) would not add value to the public, but would hamper small business job creation, stifle innovation (both financial and of the small businesses invested in), and reduce domestic investment. A small nuisance to a large multinational hedge fund may be an impenetrable wall to an SBIC or to other small business funds. Despite the support of the large hedge and other mega funds, Congress should be careful not to create new barriers to entry for funds directly investing in the small business space.

We encourage this Committee be mindful of the Small Business Investment Companies as financial regulatory reform makes its way through the process. We would welcome the chance to work with the Committee to make improvements to the reform bills.

Sincerely,

Brett T. Palmer
President

Cc
Rep. Paul E. Kanjorski
Rep. Maxine Waters
Rep. Carolyn B. Maloney
Rep. Luis V. Gutierrez
Rep. Nydia M. Velázquez
Rep. Melvin L. Watt
Rep. Gary L. Ackerman
Rep. Brad Sherman
Rep. Gregory W. Meeks
Rep. Dennis Moore
Rep. Michael E. Capuano
Rep. Rubén Hinojosa
Rep. William Lacy Clay
Rep. Carolyn McCarthy
Rep. Joe Baca
Rep. Stephen F. Lynch

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Cc continued

Rep. Brad Miller
Rep. Al Green
Rep. Emanuel Cleaver
Rep. Melissa L. Bean
Rep. Gwen Moore
Rep. Paul W. Hodes
Rep. Keith Ellison
Rep. Ron Klein
Rep. Charles Wilson
Rep. Ed Perlmutter
Rep. Joe Donnelly
Rep. Bill Foster
Rep. Andre Carson
Rep. Jackie Speier
Rep. Travis Childers
Rep. Walt Minnick
Rep. John Adler
Rep. Mary Jo Kilroy
Rep. Steve Driehaus
Rep. Suzanne Kosmas
Rep. Alan Grayson
Rep. Jim Himes
Rep. Gary Peters
Rep. Dan Maffei
Rep. Spencer Bachus
Rep. Michael N. Castle
Rep. Peter King
Rep. David Scott
Rep. Edward R. Royce
Rep. Frank D. Lucas
Rep. Ron Paul
Rep. Donald A. Manzullo
Rep. Walter B. Jones
Rep. Judy Biggert
Rep. Gary G. Miller
Rep. Shelley Moore Capito
Rep. Jeb Hensarling
Rep. Scott Garrett
Rep. J. Gresham Barrett
Rep. Jim Gerlach
Rep. Randy Neugebauer
Rep. Tom Price
Rep. Patrick T. McHenry
Rep. John Campbell
Rep. Adam Putnam
Rep. Michele Bachmann
Rep. Kenny Marchant
Rep. Thaddeus McCotter
Rep. Kevin McCarthy
Rep. Bill Posey
Rep. Lynn Jenkins
Rep. Christopher Lee
Rep. Erik Paulsen
Rep. Leonard Lance

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Answers from Mr. James S. Chanos to
Questions from Congressman McHenry at the October 6, 2009 hearing:

Q. Do you believe the prospective or current investors should have an easy way to confirm that a particular accounting firm had in fact audited a fund's statement?

A. Prospective and current investors in private investment funds (registered or not) should be able to request and receive a copy of the results of an audit to gain confirmation that the audit took place. A posting or listing of a recorded auditor/firm by the SEC or the applicable regulator shouldn't be necessary. The investor, who receives a copy of the audited financial statement from the private fund manager, should be able to send that statement directly to the audit firm and ask that they verify that they did, in fact, perform the audit evidenced by their opinion. If the auditor cannot confirm that fact, the investor should not invest.

Q. Would you support a solution to this problem where investors would be able to request audited financial statements directly from the auditor, rather than from the fund manager?

A. This step shouldn't be necessary. If a potential or current investor is unable to obtain appropriate financial information about a fund, including an annual audit, the investor should not consider investing with the fund or should withdraw their investment as soon as practicable/possible. The investor, who receives a copy of the audited financial statement from the private fund manager, should be able to send that statement directly to the audit firm and ask that they verify that they did, in fact, perform the audit evidenced by their opinion. If the auditor cannot confirm that fact, the investor should not invest. Auditors should be willing to confirm that the audited statements were, in fact, produced by them – but, for liability reasons and other reasons such as release of proprietary data, may not be willing to answer questions beyond confirmation of the audited statements.

INVESTMENT ADVISER
ASSOCIATION

November 12, 2009

The Honorable Emanuel Cleaver
U.S. House of Representatives
1027 Longworth House Office Building
Washington, DC 20515

Re: Supplemental Response to Question Posed by Rep. Cleaver at October 6, 2009 Financial Services Committee Hearing on Capital Markets Regulatory Reform

Dear Representative Cleaver:

This letter is intended as a supplemental response to the question regarding financial planning that you posed to me at the October 6 hearing of the Financial Services Committee entitled, "Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office."

Specifically, you asked about the regulatory requirements for a person to hold themselves out to the public as a financial planner. Although my brief answer, indicating that there are no financial planning-specific regulatory requirements, was accurate, I believe it would be useful to provide a more detailed response.

Financial planning typically involves a range of advisory and, frequently, other services across a range of disciplines. These include advice with respect to selecting and managing investments, income tax, insurance coverage, saving for college and retirement, and estate planning. However, the financial planning profession is not regulated as a discrete group. Instead, financial planners are subject to a range of federal and state regulation depending on the nature of the services they provide and the capacity in which they act.

With respect to federal regulation, the activities of financial planners are most likely to be governed by the Investment Advisers Act of 1940. The definition of "investment adviser" set out in section 202(a)(11) of the Advisers Act includes anyone who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.

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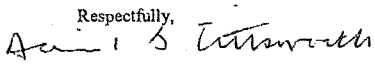
Therefore, subject to a *de minimis* assets under management threshold and absent any available exclusion (*e.g.* working for a bank or broker-dealer, or acting solely on an incidental basis as an attorney or accountant), a financial planner offering a comprehensive range of services is subject to regulation under the Advisers Act and oversight by the SEC. The Advisers Act imposes registration and disclosure requirements, broad anti-fraud provisions, and an overarching fiduciary duty to all advisory clients. Pursuant to its broad authority under the Advisers Act, the SEC has issued comprehensive regulations governing the conduct and activities of investment advisers. In addition, the SEC is authorized to conduct inspections and examinations of all investment advisers.

Financial planners providing investment advice who do not fall under the Advisers Act are instead generally regulated by state securities departments. If they sell securities, they must be registered or licensed representatives of brokers. If they provide advice with respect to insurance products, they would also be subject to regulation by state insurance departments. State regulation of investment advisers generally mirrors the characteristics of SEC regulation, including disclosure and record keeping requirements, and anti-fraud provisions. Some financial planners may be subject to both federal and state regulation, depending on the nature of the services they provide, or if they are affiliated with a federally registered investment adviser.

Most states also impose examination requirements on individual investment advisers, including those affiliated with a SEC-registered investment adviser who meet the definition of "investment adviser representative." Such individuals would be required to pass the NASAA Modified Series 65 Exam, or possess professional certifications as either a CFA (Chartered Financial Analyst) or CFP (Certified Financial Planner).

I hope this supplemental response clarifies the issue about which you inquired at the October 6 hearing. Should you have additional questions, or seek information about other matters relating to the regulation of investment advisers, please do not hesitate to contact me.

Respectfully,



David G. Tittsworth
Executive Director

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