

**NOMINATIONS OF: MARY SCHAPIRO,  
CHRISTINA D. ROMER, AUSTAN D. GOOLSBEE,  
CECILIA E. ROUSE, AND DANIEL K. TARULLO**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON**  
**BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**ONE HUNDRED ELEVENTH CONGRESS**  
**FIRST SESSION**

ON

NOMINATIONS OF:

MARY SCHAPIRO, OF NEW YORK, CHAIRMAN-DESIGNATE,  
SECURITIES AND EXCHANGE COMMISSION  
CHRISTINA D. ROMER, OF CALIFORNIA, CHAIRMAN-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS  
AUSTAN D. GOOLSBEE, OF ILLINOIS, MEMBER-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS  
CECILIA E. ROUSE, OF NEW JERSEY, MEMBER-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS  
DANIEL K. TARULLO, OF MARYLAND, MEMBER-DESIGNATE,  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JANUARY 15, 2009

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**THURSDAY, JANUARY 15, 2009**

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

**OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD**

Chairman DODD. The Committee will come to order, if we may. We have got a very busy morning this morning.

Let me first of all welcome all of my colleagues who are here. I want to make a particular warm welcome to Mark Warner, our new colleague who is here this morning, our new Senator from the State of Virginia. Connecticut claims him a little bit, as well, having grown up a bit there, so I have known Mark many, many years and he is going to be a wonderful addition to the U.S. Senate and we are thrilled that you are a Member of this Committee. I gather that Senator Kohl is going to be joining us, and I think Senator Bennet, the new Senator from Colorado, will be joining us, as well, on this Committee.

We appreciate the tremendous work of Bob Casey and Tom Carper, who are going to other committee assignments, but they were wonderful Members of this Committee and I want to publicly thank them for their service over the last 2 years that I have had the privilege of chairing the Committee.

I want to thank Richard Shelby again. We have known each other a long time, have served together for many, many years. It has been a good relationship over these last years. We got a lot done on this Committee and I am looking forward to this Congress. We are obviously going to be a very busy Committee, to put it mildly, with all the issues in front of us. I enjoyed immensely the cooperation that I had from Senator Shelby and the members of the minority side, as well, Bob Corker here on numerous occasions. I drew him into situations he probably had some second thoughts about, but he was a great member and a real complement to the efforts we are making here.

Today, we have a busy agenda—

Senator SHELBY. Mr. Chairman, you weren't going to tell them how many years together we have been here—

Chairman DODD. I wasn't going to tell them that.

Senator SHELBY. No, not together.

Chairman DODD. Many years.

The way I am going to proceed is I am going to make an opening statement regarding our nominees, turn to Senator Shelby for any opening statements he would care to make, and then I am going to turn to my colleagues who are here to introduce our witnesses this morning, and, of course, several of our colleagues are also Members of this Committee. So we will try and move along as quickly as we can here with these nominations.

So this morning, we meet to consider five very distinguished individuals President-elect Obama has designated for nomination to the Securities and Exchange Commission, to the Federal Reserve, and to the President's Council of Economic Advisors, positions critical to restoring confidence in our financial system and stabilizing our underlying economy. I want to thank each of the nominees who are here today for appearing before this Committee and for their willingness to accept the job that you are going to undertake.

Almost every day, we hear more troubling economic news, including the loss of more than a half-a-million jobs in our country in December, that some 9,000 to 10,000 homes are entering foreclosure each and every day in our Nation, or the prospect of another small business facing bankruptcy because of a combination of falling sales and lack of access to adequate credit. And so you arrive as nominees before this Committee at a very, very critical moment in our Nation's history.

On the first panel, we will hear from the Chairman-designate for the U.S. Securities and Exchange Commission. The securities markets consist of trillions of dollars worth of stocks, options, municipal bonds, corporation bonds, mortgage-backed and asset-backed securities, and other securities. Half of American families—half of our families in this country are invested directly or indirectly in the securities markets. They invest for retirement, for college education and tuition. Many small businesses rely on securities markets to raise capital to expand their businesses and to make pay-

roll. And the role these markets play in the world's capital markets obviously is critical, as we all understand.

Given the correlation of the health of securities markets to our Nation's economic stability, the Securities and Exchange Commission is an extremely important institution, to put it mildly. It oversees sales of securities, markets, mutual funds, investment advisors, credit rating agencies, and accounting principles. It coordinates with securities regulators throughout the 50 States, as well.

But perhaps most importantly, it is designed to protect investors. As former Chairman William Douglas said, "The SEC is supposed to be the investor's advocate," to quote him, "responsible for ensuring that a family or a small business investing its hard-earned money can trust that the cops are on the beat and doing their job well."

But as we all know, the securities markets are in turmoil. Mortgage-backed securities markets have cratered and literally billions of dollars have been lost. Major investment banks who contributed mightily to our financial problems have now been forced to either become bank holding companies or fail altogether. The charities and investors who entrusted their money in Bernard Madoff Investment, LLC, lost billions of dollars in a massive Ponzi scheme that went undetected by the examiners of the SEC and FINRA, not for years, but for decades. How did that happen, and who was responsible for that?

In the last 8 months, stocks have plummeted. Since last May, the Dow Jones and NASDAQ averages are down by about 40 percent, damaging the retirement savings and pension funds of millions of Americans, pounding endowments for universities and nonprofits, and endangering critical financing for small businesses and entrepreneurs.

Quite simply, these failures have undermined our economy, and understandably, there has been an erosion of confidence in the regulators. People have questioned the SEC's ability to spot problems or prevent them from occurring in the first place. After years of misleading sales pitches and credit ratings that proved to be wildly optimistic, many have completely lost faith in mortgage-backed securities.

As Columbia University's John Coffee has said, and I quote him, "It is time to find a tough cop for the Wall Street beat, someone who will restore confidence not only in the integrity of the market, but also in its regulators."

There are a host of specific issues the Commission must examine in the coming weeks and months, from accounting and securitization, to credit default swaps, credit rating agencies, short selling, to the Madoff fraud, on which this Committee, by the way, will be scheduling a hearing on January 27. And it is absolutely critical that the Chairman and Commissioners make an extraordinary effort to pursue these issues fairly and independently, free from political considerations and from the industries which formerly employed them. That has always been true, but it is particularly true in these days.

The Committee also considers, or will consider the nomination of one of the Federal Reserve Board Governors, which is among the most important positions that we consider in this Committee. In es-

tablishing the Federal Reserve, the Congress created a system in which the Fed Governor's seat has a fixed 14-year term. Governors at the Fed enjoy the third-longest term given to any appointee in the Federal Government, behind only the lifetime appointments awarded to judges and a 15-year term given to the Comptroller General. As such, a nominee to the Federal Reserve Board Governors requires careful deliberation and thoughtful consideration.

The seven Fed Governors are the only individuals appointed by the President of the United States and confirmed by the U.S. Senate who have a voice in our Nation's monetary policy, entrusted to fulfill the Fed's dual mandate of promoting maximum employment and achieving price stability. They play a very critical role, as we all know, in creating the conditions necessary for our economy to grow and for every American to have the opportunity to share in that prosperity.

While the role of the Fed is critical to setting monetary policy, I would also add it serves as a regulator of the safety and soundness of our largest lending institutions, and very significantly as a regulator and enforcer of the laws passed by the U.S. Congress to protect consumers. These aspects are no less important than the Fed's monetary policy responsibilities.

Chairman Bernanke has, in my opinion, been very forthright and active in identifying that the problems in the housing market are at the root of our economic crisis, and I thank him, quite candidly, for his continued calls for concrete action, such as he did last week in a national given speech.

However, not all of the Federal Reserve Governors have been as helpful. Indeed, when I asked Governor Duke at a hearing in October what the Fed was doing to comply with the law to prevent foreclosures on mortgages that the Fed effectively owns through the Bear Stearns bailout, it took Governor Duke 3 months to respond, and then only half-heartedly. That is unacceptable.

It is my hope that Dan Tarullo will both be more responsive, but also if confirmed, help steer the Fed on a better course so critical during these tough economic times.

On the second panel, we will also have the nominees who will, if confirmed, comprise the President's Council of Economic Advisors. These men and women will be responsible for providing the President and the administration with the facts, economic projections, and recommendations that will guide the administration policy and thinking in the coming days. That job has never been more critical than it is today, given the severe recession that we are battling and the unprecedented crisis that has gripped our Nation's credit and financial markets.

The good news is that help is truly, in my view, on the way. The President-elect has laid out a bold plan to revive our economy by cutting taxes for middle-class Americans and investing in our Nation's infrastructure, which is something that I, along with many of my colleagues on this Committee, have long advocated.

The President-elect has also stated that he will make fundamental changes to the administration of the TARP program and take it in a sharply different direction. That is why I am supporting the release of the second tranche of TARP funds, although I have been extremely disappointed, as most of my colleagues have



been, in the way that the present administration has implemented the TARP program. Given the fragile state of our financial system, halting this program would, in my view, be the height of irresponsibility.

I am sure that we will have an opportunity to discuss these and other issues with the distinguished CEA nominees on our second panel. I and others will introduce them individually at that time, and again, I thank my colleagues who are here to do so.

But this is a critical moment, as we all know, in our Nation's history, and if we are to reestablish confidence in our financial system, then we must do so by looking out for the interests of the American people, their families, small businesses, and others who have been caught by this credit crunch. I know that each of the nominees share these priorities, and if confirmed, I know all of us look forward to working very closely with you to see to it that we achieve the results we all desire.

And now, I would like to turn to my colleague from Alabama, the former Chairman of the Committee, Senator Shelby, for any comments he would care to make.

#### **STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Chairman Dodd.

Ms. Schapiro, as a veteran of the SEC, CFTC, and a self-regulatory organization, you would bring solid experience to the table during a time of economic and regulatory uncertainty, perhaps turmoil. Unfortunately, as the SEC celebrates its 75th year, it finds itself, as Senator Dodd alluded to, under fire for a number of regulatory failures. These failures are not isolated. They cut across the agency's many functions and have had serious consequences, ranging from judicial invalidation of SEC rules to the complete collapse of an entire class of regulated entities.

The Consolidated Supervised Entity Program, which you are familiar with, a program that I had called into question in this Committee, was unceremoniously terminated, as all of the participating firms failed, were merged out of existence, or switched to bank holding company status outside of the SEC's regulatory purview.

Likewise, the SEC's handling of credit rating agencies contributed to the subprime frenzy that is at the root of the current economic crisis. Careless rating practices, which were a byproduct of the SEC's ill-considered approach, have wrought havoc on our financial system. I attempted to address this situation in 2006 here in this Committee with the Credit Rating Agency Reform Act, but the SEC's resulting rule changes came too late.

Most recently, as Senator Dodd mentioned, the Madoff fraud has once again highlighted weaknesses in the SEC's inspections and enforcement functions. Improvements in both programs will be necessary, if not imperative, to ensure that the SEC fulfills its investor protection mandate.

While it is not realistic to think that every fraud will be detected, investors have a right to ask, and I think this Committee has a responsibility to determine, whether the SEC has had its inspection and enforcement priorities wrong. This is an effort that you, as chairperson of the Commission, will have to undertake, as well, should you be confirmed.

The next chairman of the SEC faces a difficult task, as you know, of undertaking considerable reform of the agency at a time of great instability, but this challenge must be met head-on and undertaken immediately. If the SEC does not increase its effectiveness in protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation, the whole economy will continue to suffer.

At the same time, Congress will have to tackle the critical and far more significant issue of how to reform the entire financial regulatory structure. The SEC's place in that reformation is not yet clear. Will the SEC remain in its current form with its current responsibilities? Will it be merged with the CFTC? Alternatively, will the SEC be eliminated and its functions parceled out to other existing or new agencies, as others have suggested? I believe the severity of this current financial crisis demands the consideration of all options.

I hope you agree that the integrity of our financial system is paramount and trumps the interest of any individual, agency, or group. If that is the case, I believe we will have the basis for a productive working relationship as we begin what could be the most significant financial reform effort since 1932.

Our second panel, as Senator Dodd has already mentioned, includes four individuals, one nominee to serve on the Board of Governors of the Federal Reserve System and three nominees slated to serve on the President's Council of Economic Advisors.

Professor Tarullo and his work on banking regulation are well known to this Committee. He has testified here many times, and he has testified before the Committee on the Basel II process that you will all recall. Chairman Dodd and I have long expressed great skepticism regarding Basel II, as did his predecessor, Senator Sarbanes. The events of the past year have confirmed the need for greater scrutiny over bank capital requirements. It is clear that existing capital requirements do not adequately guard against a systemic crisis. It is also clear that Basel II-like standards, which depend on internal models using incomplete assumptions, also fail us. I will be very interested in hearing, Professor Tarullo, your views regarding the future of capital requirements and other regulatory reforms.

I will also welcome the other three nominees who will appear on the second panel. They have been nominated, as I mentioned, to serve on the President's Council of Economic Advisors, Dr. Rouse, Dr. Goolsbee, and Dr. Romer, who if confirmed will serve as chairman. The Council provides, as you well know, the President with economic analysis and advice on the entire range of domestic and international policy issues. Because each nominee here brings specific expertise in the insights to the Council, I will be very interested in the second panel to hear what they recommend and how their views comport with their economic philosophies and writings. Dr. Romer, as a scholar of the Great Depression, your views will be of particular interest at this time.

I thank all the nominees for their willingness to serve and to appear before this Committee this morning and I look forward to a broad range of discussion.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Let me welcome our two Members of this Committee, Senator Reed and Senator Schumer, for purposes of introduction of our nominee. Jack.

#### **STATEMENT OF SENATOR JACK REED**

Senator REED. Well, thank you very much, Mr. Chairman and Senator Shelby. You both have laid out daunting challenges that face the Securities and Exchange Commission and I feel extraordinarily confident that Mary Schapiro will meet those challenges based on her experience, based on her intelligence, based on her integrity.

As you both indicated, she has an extraordinary range of experience, having served on the Securities and Exchange Commission and the Commodities Futures Trading Commission, and recently as the head of FINRA. She brings this experience to the SEC at a time of great challenge, a time in which morale is low, budgets are inadequate, and there has been, I think, a handcuffing of their enforcement activities over the last several years.

I know that Mary Schapiro is committed to restoring investor protection as the hallmark of the SEC. I know she is going to vigorously enforce the laws to protect consumers and investors. And she will bring to this great task, as I said before, insight, integrity, and intelligence. I am just delighted to be able to be here today to commend her to you and ask for her swift confirmation so that she can get on with the task not only of restoring the ability of the SEC, but also this great task of transformation of the regulatory structure, not just domestically, but internationally.

Once again, I can't think of anyone more prepared to do this than Mary Schapiro and I commend her to you with enthusiasm.

Chairman DODD. Thank you very much, Senator.

Senator Schumer.

#### **STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Thank you, Mr. Chairman, Ranking Member Shelby, all the Members of the Committee.

I, too, congratulate Ms. Schapiro on her nomination to serve this country as Chairman of the SEC. When we met last week, I was very impressed by not only your broad and deep knowledge of the securities industry, which I expected, but your clear recognition of the problems that the financial markets in the entire country are presently facing.

We need a much stronger regulator than we have had in the recent past, and I believe by temperament, inclination, and experience, you can become that much-needed stronger regulator. You come here with a long background in securities regulation, with experience leading many of the major institutions that make up our capital market's regulatory system. The trick is for you to turn that experience into a regulatory tool box that you can use to rein in the perilous excesses of the industry while still preserving the entrepreneurial vigor that is the hallmark of a free market.

In other words, you know the world of securities regulation as well as anyone out there, and unfortunately, you will need every drop of this knowledge to succeed in your new position, because we

now face a financial crisis as enormous as we have ever seen in our lifetimes, and the sad truth is that this crisis was caused in good part by the failures of your predecessors at the SEC.

Under the radical laissez-faire ideology of recent regulators, we saw explosive growth in precisely those areas which were unregulated or under-regulated by the SEC. Investment banks were allowed to accumulate enormous amounts of risk. Credit derivatives mushroomed to over \$60 trillion in value. The hedge fund industry saw tremendous growth without any transparency. And the credit rating agencies grew, as well, as firms issued thousands of undeserved AAA ratings that made everyone all too comfortable that these unregulated investments were safe and sound.

Despite all these problems, I believe the SEC has retained a strong fundamental ability to be a sound regulator with the right leadership. Does it need major reforms? Absolutely, and I think in your testimony you show that your priorities are in the right place.

First, the SEC needs a stronger emphasis on finding and preventing fraud by bolstering its inspection and examination process. The only way the SEC is going to find crooks is if it is actively looking for them. The SEC should also follow through on former Chairman Donaldson's initiative to have an Office of Risk Assessment. We need to update the SEC's tools to catch fraud as it is happening by ensuring that it has the resources and expertise it needs. This office would help the SEC triage its cases and focus on those it determines pose the greatest risk.

Second, I would say, in all due parochialism, these preventative efforts should be based out of New York City, as we have talked about. It makes no sense to have inspectors, examiners, and risk assessors headquartered in

Washington, DC, when all the activity they need to be monitoring occurs on Wall Street. At the same time, moving these functions to New York will improve the SEC's ability to hire top professionals with the skills and experience to unearth fraud.

Third, we must have regulatory reform to ensure that there are no more unregulated pockets that might pose systemic risk to our system. In times of crisis, our financial regulators should not be playing whack-a-mole, facing unexpected threats from unregulated areas that pop up every time they have dealt with one crisis. Instead, they must function more like doctors. They must be strong, always watchful, always independent regulators that can snuff out problems before they grow dangerous to the system as a whole.

We must start by bringing unregulated derivatives into the fold. The Fed, SEC, and CFTC have to collaborate further on regulatory oversight of clearinghouses. That is something I applaud, but we have to be vigilant in ensuring strong regulation of these entities and make sure clearinghouses have a presence in the United States, where they will be subject to the full oversight of our agencies. As we speak, the European Commission is debating a policy that would mandate exclusive European clearing of certain derivatives. This kind of protectionist policy has no place in the modern world and I am strongly urging you at all levels to vigorously resist this power grab by the EC.

Finally, we need to improve our regulatory scheme for rating agencies. The main problem with these actors was that they were

inherently conflicted. You can't expect to provide unbiased ratings if people paying the salaries are the ones you are rating. We would never consider allowing students to pay for their grades. Why have we let our banks do essentially the same thing? We need to find a way to promote or even require alternative funding schemes, such as an investor-funded model, which I have been trying to figure out the best way to do that and I hope you will work with the Committee on that issue.

In short, Ms. Schapiro, you face a daunting task ahead of you. Major changes in so many areas are necessary, and you will be the one leading the charge. I believe you have the right experience, the right approach to successfully reform the SEC and restore the reputation of our capital markets as the best and safest in the world.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Schumer, very much for a very good, comprehensive introduction, and we thank you for that.

I am going to now ask my colleagues if they have any opening comments they would like to make. I will ask you, if you have prepared statements, maybe to include them in the record and keep it relatively brief, given the amount of work we have this morning.

Senator Menendez.

#### **STATEMENT OF SENATOR ROBERT MENENDEZ**

Senator MENENDEZ. Thank you, Mr. Chairman. I think this nomination hearing is one of the most important this Committee will hold. We cannot solve the Nation's economic challenges if we do not have the ability to have investor confidence, transparency, and integrity in the marketplace, and that is why this nomination is so critical.

The Securities and Exchange Commission has broken down and it is unclear if it simply needs gas or a whole new engine. Either way, something is seriously wrong. The engine light is flashing and we can't afford to put it off one more day.

So I am looking forward to Ms. Schapiro's testimony. The SEC is in dire need of a strong leader who is not afraid to make drastic changes and tough decisions. Simply moving the paperwork from the in-box to the out-box like we have seen for the last few years is not going to cut it. We need a strong regulator who is willing to go in there and do what is necessary to get this agency back on track.

The SEC should be, and it used to be, about providing protections for our investors and our markets. The mission statement couldn't be more clear, to protect investors, maintain fair, orderly, efficient markets, and facilitate capital formation. But the plaque bearing this motto must have been put in storage because none of these objectives are currently being met.

Madoff may have gotten the most attention recently, but this really is just the tip of the iceberg. Our current economic crisis is in no small part due to the failure of the SEC. A fundamental lack of scrutiny, oversight, and enforcement, fueled by blind ideology, contributed greatly to the conditions under which homeowners, consumers, and investors have been hit hard.

Mr. Chairman, the SEC is supposed to be the cop on the beat, but it seems to have been off duty for the past few years. Without

a tough hand, without real oversight and accountability, this agency, like the TARP funding, cannot meet its objectives.

So, Ms. Schapiro, I want to hear from you that you are willing to take no prisoners and question everything about the way the industry does business and the way the government regulates it. I think that is going to be critical to get us out of the economic challenges we face and I look forward, Mr. Chairman, to hearing Ms. Schapiro's remarks and I ask that the rest of my statement be included in the record.

Chairman DODD. Thank you, Senator. It will be. All members' statements will be included.

Senator Corker.

Senator CORKER. Yes, sir. I am looking forward to the testimony and thank you for having the hearing.

Chairman DODD. Thank you very much.

Senator Tester.

#### **STATEMENT OF SENATOR JON TESTER**

Senator TESTER. Thank you, Mr. Chairman. Thank you, Senator Shelby, for having this.

Mary Schapiro, as has been said already here today, you come into a time where conditions are bleak and a situation where we have had limited regulation at best, a time where it seems like every week there was another titan that was going down and we had a lot of questions and very, very, very few answers to what has transpired.

All I can tell you is what you already know, and that is that we need to reinsert confidence back into the system, into the marketplace. You are going to play a critical role in doing that. I think you have the skills to get that done, but it is going to take a lot of work and it is going to take a lot of good people working with you. I wish you the best and I hope for a quick confirmation.

I would ask that the rest of my statement be put in the record.

Chairman DODD. It will be included.

Senator Enzi.

#### **STATEMENT OF SENATOR MICHAEL B. ENZI**

Senator ENZI. Mr. Chairman, I would ask that my complete statement be put in the record.

I am extremely interested in what happened in the Bernie Madoff case. I know that some mention has already been made of how that is an SEC problem, so I will be interested in how similar situations like that can be prevented in the future, but I would also like to hear how with Ms. Schapiro's experience as a regulator with both NASD and the Financial Industry Regulatory Authority, how they missed that scam when so many on Wall Street seemed to know about it. I am also interested in hearing your opinions about the credit rating agency registration system, because we have been working on a bill to take care of that. I will have some questions with the second panel, as well, but I will reserve it for questions.

Chairman DODD. Thank you. It will be in the record.

Senator Warner, welcome.

**STATEMENT OF SENATOR MARK R. WARNER**

Senator WARNER. Thank you, Mr. Chairman. I just want to very briefly say I am really looking forward to working with you and Ranking Member Shelby and all the Members of the Committee. This is my first hearing, so I will keep it brief, other than the fact that in a prior life, I did spend many years from the financial side interacting with the SEC, so I have got a lot of questions and ideas that I will reserve for question time.

But thank you and I am looking forward to working with you. Chairman DODD. Thank you very much.  
Senator Bennett.

**STATEMENT OF SENATOR ROBERT F. BENNETT**

Senator BENNETT. Thank you very much, Mr. Chairman.

I don't have any pearls of wisdom other than to reflect on some of the comments that have been made that sounds like the entire solution to all of our economic problems are now lying on the doorstep of Mary Schapiro. I don't think that is true. I don't think the SEC is solely responsible for our difficulties, nor do I expect her to individually solve them all.

But I enjoyed my visit with her when she came by. I think she is very well qualified for this position and appreciate the prompt calling of a confirmation hearing. I intend to support her nomination.

Chairman DODD. Well, thank you very much, Senator.

Let me just say that if other colleagues arrive to introduce some of the nominees we have forthcoming, I will probably interrupt the hearing in order to accommodate them, but that is not being the case right now, so Ms. Schapiro, what I would like to do is have you stand and I would like you to swear or affirm your presence here this morning. Raise your right hand.

Do you swear or affirm that the testimony that you are about to give is the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. SCHAPIRO. I do.

Chairman DODD. And do you agree to appear and testify before any duly constituted Committee of the U.S. Senate?

Ms. SCHAPIRO. I do.

Chairman DODD. Welcome. It is nice to have you with us. Before we hear your statement, I think I noticed some people behind you who might be members of your family, or some geniuses in the securities area here, maybe both. Do you want to introduce them?

Ms. SCHAPIRO. I would be happy to. Thank you, Senator. My daughter, Molly Cadwell, my daughter, Anna Cadwell, and my husband, Chas Cadwell.

Chairman DODD. Welcome. We are delighted to have you with us here today. Are you missing school today, are you, for this?

[Laughter.]

Senator SHELBY. Oh, yes. They are smiling.

Chairman DODD. So the longer the hearing goes, the less time you have to go to school? Is that how it works?

[Laughter.]

Ms. SCHAPIRO. There is a certain math test that is being avoided today.

Chairman DODD. All right.  
 Senator SHELBY. Postponed, maybe.  
 Ms. SCHAPIRO. Postponed.

Chairman DODD. Well, we are delighted to have you here, and as we have all said here, I don't think any of us expect you to answer all of the issues that face our country, but it is a critical position. I think you know that and our conversations reflect that, so I am anxious to hear your statement and then engage in some conversation about where we are.

**STATEMENT OF MARY SCHAPIRO, OF NEW YORK,  
 CHAIRMAN-DESIGNATE, SECURITIES AND EXCHANGE  
 COMMISSION**

Ms. SCHAPIRO. Thank you very much, Mr. Chairman. Senator Shelby, Chairman Dodd, and Members of the Committee, it is an honor to appear before you today as President-elect Obama's nominee to serve as Chairman of the Securities and Exchange Commission. I also want to thank Senators Schumer and Reed for their very kind introductions, and all the Members of the Committee and your staff, who have been so generous with their time and advice during this confirmation process.

As Senator Schumer mentioned, I grew up in New York, a short train ride from Manhattan but miles away from Wall Street. My father was a printer, my mother a librarian. Like millions of families, my parents worked hard to save enough to buy a home, send their children to college, and have a secure retirement. They taught my siblings and me right from wrong and that we could get ahead by working hard and playing by the rules. And perhaps that why I have spent my career at the SEC, the CFTC, and most recently FINRA committed to building a financial regulatory system that protects investors and supports and strengthens free and fair markets.

We cannot underestimate the situation we are now in. The credit markets have collapsed. Trillions of dollars of wealth have been lost. Our economy is in recession and investor confidence has been badly shaken. Middle-class families who were relying on that nest egg to send a son or a daughter to college or for a secure retirement don't know where to turn. There are many reasons for this crisis and one of them is that our regulatory system has not kept pace with the markets and the needs of investors.

It is precisely during times like these that we need an SEC that is the investors' advocate, that has the staff, the will, and the resources necessary to move with great urgency to bring transparency and accountability to all corners of the marketplace, to vigorously prosecute those who have broken the law and cheated investors, and to modernize our country's regulatory system to match the realities of today's global, interdependent markets.

These urgent responsibilities would fill any agenda, Mr. Chairman, but allow me to highlight a few of my top priorities. First and foremost, if confirmed as Chairman, I will move aggressively to reinvigorate enforcement at the SEC. With investor confidence so shaken, it is imperative that the SEC be given the resources and the support it needs to investigate and go after those who cut corners, cheat investors, and break the law.



As the first SEC Chairman, Joseph Kennedy, told the Nation 75 years ago in explaining this new agency's role, quote, "The Commission will make war without quarter on any who sell securities by fraud or misrepresentation." I look forward to working closely with you and Members of the Committee to ensure the SEC has the capability to fulfill this critical mission as well as to perform all of its other important duties.

Second, I want to reengage the SEC with the people we serve, namely investors. The investor community, from the largest pension fund to the family who has scrimped and saved in their 401(k) or 529 plan, needs to feel they have someone on their side, that they can go to the SEC for advice, to seek redress, or to have their opinions heard.

Third, as I work to deepen the SEC's commitment to investor protection, transparency, accountability, and disclosure, I also want to ensure these commitments are preserved in any regulatory overhaul that may be undertaken. Indeed, as a member of the President's Working Group on the Financial Markets, I hope I can offer its members, the administration, and Congress both the benefits of my years as a regulator as well as the decades of experience the professionals at the SEC have in these areas.

The American people want and expect us to update the regulatory system that has failed them and to prevent the kinds of abuses that have contributed to the economic crisis we now face. I assure you that I will always keep their concerns front and center.

Seventy-five years after the SEC was founded, the Commission finds itself in a situation where, once again, it must play a critical role in reviving our markets, bolstering investor confidence, and rejuvenating our economy. I am under no illusion that this will be an easy job. There is a lot of work to be done quickly and diligently in the months ahead.

But I look forward to this challenge, to helping the millions of investors who rely on strong markets and a strong economy, and to working with the professionals at the SEC and the members of this Congress. To be entrusted with leading the SEC at this moment would be a great honor and I am grateful for your consideration.

Thank you, Mr. Chairman, Senator Shelby, Members of the Committee, and I am very happy to answer your questions.

Chairman DODD. Well, thank you very much, Ms. Schapiro. We appreciate again your willingness to serve.

Let me begin. What I will try and do is I will make it, say, around 10 minutes a round, and I won't be rigid about that since there is not a full complement of the Committee here, but we will try and move along and get as many people involved as possible.

Let me begin with—you and I talked about this in the office the other day, with the Madoff situation, which has been the subject of some discussion. Let me just, as background, and you can correct me if I misstate this, but this is as I understand it. The Madoff firm was a registered broker dealer in 2006. It also registered as an investment advisor. During this period, NASD and later FINRA performed periodic exams, but never found, or apparently according to FINRA's staff, looked at the potential individual investments

that people made with Madoff. They looked at brokerage operations and not the advisory activities—and again, that is the role of FINRA, I understand that—as if they were two separate entities.

However, SIPC has said there was only one firm, the brokerage firm, not a separate investment advisor, and defrauded investors made checks payable to Madoff Firm. All of the advisory staff were brokerage employees, and the SIPC is playing claims based on their finding that the defrauded investors were clients of the SIPC-insured broker.

And I went back and looked, and again, reading the role, FINRA has broad examination authority—and obviously you know all of this but let me just repeat it here—has broad examination authority over its broker dealer members. Under the Securities Exchange Act of 1934 and FINRA’s own rules, Section 8210, which gives FINRA the right “for the purpose of investigation or examination to require a member, a person associated with a member, to provide information orally, in writing, or electronically, or to testify and to inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination,” end of quote.

Madoff Investments was the member and Bernie Madoff was an associated person. How do we respond to that?

Ms. SCHAPIRO. I think, Mr. Chairman, one of the real lessons of this tragedy, is that we have this stovepiped approach to regulation that allows misconduct to take place out of the sight of at least some of the regulators. As you point out, FINRA had jurisdiction over Madoff’s broker dealer activities, but not over its investment advisory activities. The investment advisory activity did not run through the books of the broker dealer, which is what FINRA was examining. And in fact, the SEC required Madoff’s investment advisory activities to be separately registered in an investment advisor in 2006. I would also add that FINRA didn’t have access to any tips, directly—and no tips were shared by the SEC with FINRA.

I think the bigger issue here and one that I have repeatedly expressed concern about, including, frankly, as recently as August with the Chairman of the SEC, is that there is an increasing migration of financial activity out of regulated broker dealers, where there is an SEC, FINRA, other SROs, and State involvement in the regulation, to investment advisors, where there are far fewer resources available for inspection and oversight. The SEC has not shared our view that this is something to be concerned about, this migration of activity out of the more closely overseen broker dealer side of the industry.

Chairman DODD. Well, let me ask you this. If confirmed, and in light of the Madoff experience, are there actions you would pursue, and let me identify several and ask you to comment on them. One, to increase the effectiveness of broker dealer examinations by FINRA and the SEC? I think you suggested the answer to that in your response to my question.

Number two, to improve the use of tips by the SEC staff.

Three, to increase the quality of audit opinions rendered for non-public broker dealers?

And fourth, to ensure for the impartial administration of the Federal securities laws that prominent individuals are subject to the same standards as all other market participants.

Ms. SCHAPIRO. I can answer unequivocally that I would explore and hope to move very aggressively with respect to all of those. I think the effectiveness of the examination programs for broker dealers and investment advisors, and rating agencies, frankly, needs to be carefully examined and significantly bolstered going forward.

With respect to tips and whistleblower complaints, if I am confirmed, within the first couple of weeks, I would like to create an entirely new process within the Commission so that these matters are centralized, they don't reside out in multiple offices but rather come to a central, fairly senior point of contact within the agency where they then can be staffed, examined, pursued, tracked, and reported to the Commission so that we have an understanding of exactly what kind of intelligence is coming into the agency and how it is being followed up on by the staff of the agency.

The quality of audit opinions with respect to non-publicly held broker dealers, particularly those who have custody of customer assets, whether securities or cash, I think needs to be addressed very quickly. We may need a legislative fix to the PCAOB's authority in order to do that. I would absolutely support that.

And finally, with respect to impartiality, my belief is there can be no sacred cows. We have to go with full force and fervor against anyone who violates investors' trust, large or small, regardless of their standing in the investment community.

Chairman DODD. Well, thank you for that. And let me just say, by the way, and we have talked about this, as well, and Senator Shelby and I have discussed this, as I see it, the role of this Committee, we have a lot of work to do. Obviously, we are going to be watching very carefully the TARP program, assuming that we go forward with that, but obviously we want to know how that is working. That will be a major function of the Committee, an ongoing one.

But also the very important track for us is the modernization of the regulatory structures in this country, and this is a huge set of issues with a lot of work to do, but it is a major obligation, I think, of this Committee and this Congress and this administration to do so in light of the events that have occurred. So we are going to be looking to working with you very closely on these issues, because the role of the SEC is critically important in all of that. So I will be very anxious to follow up and would ask you to keep our Committee and staff well informed as to the progress on these matters, if confirmed, that you just mentioned.

The last point I will touch on and then turn to Senator Shelby, because we have a lot of issues to talk about, the credit rating agencies which Senator Enzi has raised and others have, as well, has been a constant issue of concern for us as we look back as to what happened. Senator Schumer's analogy of having students pay for their grades was a pretty good one in trying to describe what was going on. And I have thought a lot about this, as others have, as well, and I am still stymied a bit as to what is the best answer.

I know many say, well, let the purchasers of the information pay for it, but I can identify conflicts where that can occur, as well, just as there would be with those who are selling the information have an obvious conflict.

Just as a throw-out, let me ask you, what is your reaction to something like a FASB approach, or is there a need, even, for credit rating agencies? Have we reached a point where maybe there is a different system we ought to be thinking about to actually rate these securities?

Ms. SCHAPIRO. I think there probably will always be a desire to have some sort of truly independent third-party evaluation about the credit quality or other aspects of particular financial assets, so I guess I wouldn't go so far as to say we don't need credit rating agencies at all. We don't need broken ones. We don't need ones that give us bad information. That is very clear.

I think there are a lot of interesting ideas out there about how to deal with the really serious conflicts of interest that manifest themselves so clearly in the compensation models that currently exist. One I have heard about is the idea of having exchanges as part of their listing fees, collect a small transaction fee for every trade that could then form a pot of money that could be used to pay for the ratings so that they are paid for by an exchange. A similar concept, I think, would be to have a FASB or a PCAOB sort of oversight body that then assessed a fee, compensated the rating agency so that the issuer wasn't directly compensating them, the idea that you suggest.

I think there are a lot of very creative ideas out there. I think they are all worth exploring, because fundamentally, until we deal with the compensation model, we are not going to deal with the conflict of interest and people are not going to have confidence that the ratings are worth relying on, worth the paper they are printed on.

I also think we have to deal with the SEC's oversight of rating agencies. And again, a PCAOB model may be very helpful there. You could almost have resident examiners inside rating agencies really understanding what is happening, following up when ratings fail, pushing out disclosure about the reasons for the failures.

So I think there is fertile ground there for us to explore and I would be very anxious to do that with the Committee.

Chairman DODD. We need to do it soon, in my view.

Ms. SCHAPIRO. I understand.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

I am going to pick up on the rating agencies because I think, Ms. Schapiro, that they are central to any regaining of trust in our securities industry. The problem as I see it today, among other things, but the central problem is lack of trust, not just consumers' lack of trust in the banking system and securities, banks to banks. They don't trust. They don't know what is in those other banks' portfolios. They don't want to borrow any money from each other as they traditionally have done.

We see this morning's headlines where one of our largest banks has got to have a big injection if they are going to go through with a deal they made. So there is something deeply, deeply wrong, as

you know, in our securities and banking system. Trust is central to it.

The rating agencies used to mean something. They used to. Gosh, I have small banks that used to buy securities. Well, they are not buying right now. They are scared. They are solvent, but small.

As long, I believe, as long as we have got the conflicts of interest and rating agencies—and they have told me and they have testified before this Committee that basically their opinion, they are just giving their opinion. I said, really? You are just giving your opinion, but you are paying for it and it has meaning of whether those securities are rated investment grade or whatever they are rated, and they have meaning in the marketplace. Well, we are just giving our opinion. I said, well, what if I gave my opinion? It wouldn't mean anything. And today, their ratings are meaning less and less.

So I think you are going to have a great opportunity and we are going to have a great opportunity to do some right things. I hope that we do the right things. I hope that we are not going to be timid, because if we don't do it, where are we going to be? We have lost our opportunity.

I want to pick up on the regulatory forum. You know, I know that we have got to face reality here. I never thought that I would say this, but I think we have got to visit insurance. Look at AIG. Who regulated AIG? Primarily, the New York Insurance Commission. My gosh, does anybody in this room believe that the New York Insurance Commission knew anything to speak of of the risk they were taking, they had on their books? Why, the answer is obviously no, and so forth.

But you will be playing in those recommendations. We will be in the arena here trying to implement a new, different, and effective regulatory structure. We have to do it right. What, in your opinion, should be the role of the SEC? I mentioned earlier some people say we ought to merge the SEC into what, into this and that. I personally don't have a lot of confidence in the Federal Reserve. I don't have a lot of confidence in a lot of our regulatory agencies today, and I think for good reason. And if you poll the American people, gosh, I don't know where it would be, but it would be low, low, low.

So what is the role you think the SEC should play in the future? And you come out of the CFTC, too. Most of the things, not all, as you know, that are traded on CFTC have to do with financial instruments, securities and so forth, which traditionally have come under the SEC or come under the jurisdiction of this Committee and so forth. Do we have too many regulatory bodies? Are they too stovepiped, as you alluded to earlier? What is the role you think the SEC should play, and where should we go?

Ms. SCHAPIRO. That is a great question. I think I have a couple of principles that guide me in thinking about regulatory reform and there will be lots and lots of suggestions, lots of, I expect, fascinating debate about exactly where do we move the different boxes that currently exist and how do we align them.

But in terms of the principles that I think should guide our discussion, the first is that all systemically important products—credit default swaps, as an example—and all systemically important financial institutions, need to come under the regulatory umbrella so that we eliminate the gaps that exist with large players and prod-

ucts not being part of the regulatory regime. That has clearly been one of the issues that we have seen over the last year in particular.

But I also think we have to think about the roles of the existing agencies, whether or not they continue to exist, and how we preserve those important roles. We have to have and continue to have the kind of focus on systemic risk that the Fed has brought to the debate over the last year, and an institution like the Fed being responsible for protection of the system from a systemic perspective.

From my perspective, though, we don't need to just monitor risk and understand the safety and soundness of our financial system. We must continue to protect investors. So the functions of the SEC must continue to be fulfilled. The protection of investors, the inspection of investment companies, mutual funds, investment advisors, the full and fair disclosure by corporate issuers of relevant information, the exchange regulation and oversight, all of those functions need to continue to exist in, whether it is the SEC as we know it today or the SEC as a larger agency, potentially combined with other agencies, or an entirely new structure that we haven't devised yet. Those functions all matter enormously to the integrity of our capital markets and to the confidence that investors can have when they are allocating their capital. So we have to preserve the functions. We have got to get them better aligned and we have to fill the gaps.

Senator SHELBY. What do you believe should be the role of the SEC in the future in regulating credit default swaps?

Ms. SCHAPIRO. Well, I absolutely believe that credit default swaps need to come under the umbrella of Federal regulation, and we need a centralized clearinghouse for these transactions so that we can have transparency, we can eliminate or minimize counterparty risk, we can assure there is sufficient collateral, margining positions. I think the SEC needs to work very closely with the CFTC and with the Fed and the Treasury to ensure that we don't create another regulatory gap or we have a lack of understanding about which agencies will play which roles with respect to overseeing these clearinghouses.

Senator SHELBY. What do you think the role should be in the future on insurance companies that play in the field, such as AIG and others, but AIG is the big one, that put our whole system at risk?

Ms. SCHAPIRO. Well, I believe, and this is a little bit outside my purview, that we should have Federal oversight of insurance companies and particularly those that create systemic implications, like an AIG, should be under the Federal regulatory umbrella. This is not to suggest there might not also be a role for State insurance regulators—

Senator SHELBY. Sure.

Ms. SCHAPIRO. —but that we have to, at the systemic level, have a better understanding of what is going on in those institutions.

Senator SHELBY. Do you believe that any of the Federal regulatory people had any real inkling of what was going on in the insurance field that helped bring about where we are today?

Ms. SCHAPIRO. I really can't speak to that, having not been in the Federal Government for a long time. I just don't know the answer to that.

Senator SHELBY. You hadn't seen any evidence of that, have you?

Ms. SCHAPIRO. No, I can't say that I have.

Senator, if I could actually go back to your credit rating agency question—

Senator SHELBY. Yes. That is what I was going to do.

Ms. SCHAPIRO. —I think you made a very important point. For the credit rating agencies to suggest that it is just their opinion is a little bit unnerving, to say the least. The requirement for credit ratings is written into a number of Federal rules and requirements, so I think it is more than just one man's opinion, so to speak, when they issue a rating.

I think one of the things we have to explore is ways in which to make the capital regime for financial institutions not so dependent upon changes in credit ratings because they are very vulnerable and it has enormous implications when there is a credit rating change for the capital of the institution. So I think that is something that, working with the other regulators, we really need to explore.

Senator SHELBY. Picking up on something Senator Dodd raised earlier and Senator Schumer, the conflicts of interest and the basic ethics of the credit rating agencies, how are we going to eliminate, or what would you recommend or think about recommending or consider dealing with the conflicts? We have got to deal with the conflicts. If I hire S&P or Moody's to be my consultant and show me how I can do this and that to get an investment-grade rating or even a higher rating, they obviously have a conflict of interest.

Ms. SCHAPIRO. That is right. I think the compensation model, the traditional model that they utilize where the issuer pays for the rating is really at the heart of the conflict problem, and that is why I would be very interested to explore whether there are some quite dramatic things that could be done differently, a FASB or PCAOB type of model for compensation.

Senator SHELBY. It looks like things are for sale in the marketplace.

Ms. SCHAPIRO. Exactly right.

Senator SHELBY. And that undermines the whole integrity of the marketplace, as I understand it.

Ms. SCHAPIRO. That is right, and if you want someone to buy your rating, again, you understand that when you issue your rating in the first instance.

Senator SHELBY. And it is more than a perception.

Ms. SCHAPIRO. I believe that is right.

Chairman SHELBY. Thank you, Senator Dodd.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and Senator Shelby has covered so many important questions that I feel I will sort of be duplicative, but if you would allow me.

With respect to hedge funds, there was an initiative by the Securities and Exchange Commission to have these funds of a certain size register, in particular the ones that have significant influence

in the marketplace. What is your view toward the greater transparency in the hedge funds?

Ms. SCHAPIRO. Well, I would absolutely support proceeding again with registration of hedge funds so that we could have a much better handle on who is out there and what they are doing. We should have better and stronger checks and balances and appropriate disclosure, at an absolute minimum.

Senator REED. And you and your staff will be working on the appropriate items of disclosure so that you could get an adequate picture of their operations?

Ms. SCHAPIRO. Absolutely.

Senator REED. And if this required legislation, you would quickly contact us?

Ms. SCHAPIRO. We will. I guess I would like to express generally my view that the laws are made here, and when the SEC needs help with the laws, I expect that we will be here often seeking that help.

Senator REED. Thank you. Senator Shelby has asked some very insightful questions about credit rating agencies and I will just simply note that this is a concern of everyone here. Your efforts to look at the agencies would be very useful. I know there are several at least preliminary proposals legislatively that are here and so we will be collaborating with you on that effort, also.

In addition, as you indicated to Senator Shelby, the credit default swap issue, I know under the leadership of the New York Fed, the clearinghouse notion was moving. Are there any further comments you would like to make about, other than the need for them, any specifics?

Ms. SCHAPIRO. I have long been an advocate, frankly, since 1994, for a mechanism to bring swaps—credit default swaps didn't actually exist at that time, but other swap transactions into a clearinghouse mechanism so that there would be assurances about the collateral that was supporting the positions and the minimization of counterparty risk. So I am strongly in favor of the efforts that have been undertaken to develop the clearinghouses. I think it is very important that there be strong oversight of those clearinghouses so that we have a level of confidence that they will be there and able to withstand the potential for any defaults that take place.

Senator REED. The Enforcement Division of the SEC has been an area of great concern. Senator Dodd and I contacted GAO. They are finalizing a report. But the general impression, I think, and an accurate one, is that they have been hobbled over the last several years. One aspect of this was a procedure where a penalty would have to be approved essentially by the Commission. I would hope that that procedure could be quickly abandoned and that the Enforcement Division could be given the direction to fairly but aggressively enforce the law.

Ms. SCHAPIRO. I would hope, if I am confirmed, Senator Reed, that one of the first things I will do will be to try to take the handcuffs off the Enforcement Division. The Penalty Pilot Program is an issue, but there are a lot of other procedural hurdles that have really been placed in the way of the Enforcement Division moving aggressively to issue subpoenas and get investigations initiated and I would plan to look at those immediately.



Senator REED. Another area that has been mentioned by Senator Schumer in his opening comments was the Office of Risk Assessment which Chairman Donaldson created, I think very perceptively. In fact, it perhaps could have been very helpful in the run-up to this crisis. What is your view about the Office of Risk Assessment?

Ms. SCHAPIRO. I think it is absolutely essential to reconstitute the Office of Risk Assessment. It has never really been fully staffed and fully equipped with the tools that it needs. When you have hundreds and hundreds of examiners, as the SEC does, that are unconnected to a really robust risk assessment process so you know where to send the examiners in order to have them focusing on the issues of greatest importance, that is a real problem, in my mind. So I would like to build an Office of Risk Assessment and I would like to have Risk Assessment permeate really everything the SEC does. There will never be enough resources to do everything, so we have to be able to focus on those areas of risk where we have investors at most danger.

Senator REED. Much of what you are going to do will have complications and consequences overseas as well as here in the United States, and one of the areas is the IFRS road map. We have repeatedly written to Chairman Cox to try to determine and develop a very deliberate road map. I think there was a rush to judgment on this issue. In fact, I met with the CEO of Honeywell Corporation who says similar concerns about disparate accounting treatment on the international rules that can be used to change income, can be used to treat R&D expenses differently. There is a host of potential, I hesitate to say—I won't. There is a potential arbitrage of the two systems which I think we have to avoid.

Can you give us a notion of how you would like to proceed with this international accounting movement, with the recognition I think we all have that in the global economy, eventually, standards hopefully will converge to high levels.

Ms. SCHAPIRO. Well, I would proceed with great caution so that we don't have a race to the bottom. I think we all can agree that a single set of accounting standards used around the world would be a very beneficial thing, allowing investors to compare companies around the world. That said, I have some concerns about the road map that has been published by the SEC and is out for comment now and I have some concerns about the IFRS standards generally. They are not as detailed as the U.S. standards. There is a lot left to interpretation. Even if adopted, there would still be a lack of consistency, I believe, around the world in how they are implemented and how they are enforced.

The cost to switch from U.S. GAAP to IFRS is going to be extraordinary, and I have seen some estimates that range as high as \$30 million for each U.S. company in order to do that. This is a time when I think we have to think carefully about whether imposing those sorts of costs on U.S. industry really makes sense.

Perhaps, though, my greatest concern is the independence of the International Accounting Standards Board and the ability to have oversight of their process for setting accounting standards and the amount of rigor that exists in that process today.

I will tell you that I will take a big deep breath and look at this entire area again carefully and will not necessarily feel bound by the existing road map that is out for comment.

Senator REED. One area of mutual concern that you have and I have is the independence of the International Accounting Standards Board. Under the Sarbanes-Oxley Act, we thought we created a very clear rule that American public companies couldn't operate under standards promulgated by a non-independent entity. That interpretation was not shared by the previous Commission. I would like very much for you to review that and indicate to us whether your view is—whether we need sufficient additional legislation to clarify that there must be an independent board.

Ms. SCHAPIRO. I will be happy to do that.

Senator REED. I believe that you have been very concerned about proxy access. Can you give us a notion of your priorities with respect to proxy access?

Ms. SCHAPIRO. I would be happy to. You know, the SEC has taken a couple different tacks with respect to proxy access over the last year and I think it is an area that is really calling out for some clarification and some clear direction. Forty of the largest markets outside of the United States allow investors or shareholders of some size and some duration access to the proxy. I think it is time for the United States to step into that club, and again, the devil will be in the details. But I think it is time for us to have a well-crafted, rational approach to the proxy for long-term large shareholders in the U.S. and I am prepared to sit down with my fellow Commissioners quickly and begin that discussion.

Senator REED. I think one of the contributing factors in the current economic crisis, and there are many, is the compensation schemes developed by companies. I know this is something not directly related to the responsibility of the SEC, but I think creatively and collectively, we might want to think about how we monitor those and how we ensure that they don't provide the kind of incentives for risk taking rather than compensation for wise judgments. That is just a general point that I would hope you would consider because I think it is hard to pick out a precise statute or precise even agency that would be charged with that. It is typically up to management, but management ought to be much more sensitive, I think, to these compensation schemes.

Ms. SCHAPIRO. I agree with that.

Senator REED. Just for the record, mutual recognition of Australia, fast, slow, medium?

Ms. SCHAPIRO. Well, I have shared with you and then shared with the SEC over the past year some concerns with the speed with which mutual recognition and amendments to rule 15(a)(6) have proceeded that allows foreign broker dealers access to U.S. investors at virtually a retail level without the protections that exist in the U.S. regulatory regime. So it is another area where I think we need to take a big step back and look at whether we are headed in the right direction. Again, I want to ensure that U.S. investors' protections are maximized going forward, not that they are compromised.

Senator REED. Thank you very much. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator. I thank the Senator for raising the issue of the proxy access issue, as well. I have a strong interest in that, as well, and will be looking forward to further developing your thoughts on that. It has been a subject of some debate and discussion over the last number of months and it is one we are going to come back to on the Committee.

Senator ENZI.

Senator ENZI. Thank you, Mr. Chairman, and I appreciate your questions and, Ms. Schapiro, your answers on the proper role of the SEC in the future, also Senator Shelby's questions about credit default swaps and the derivatives market and everybody's questions about credit rating reform. We have all been involved in that and I will have some additional questions on that, but I will submit them in writing. They are more detailed and I have found that that and accounting questions put people to sleep around here. I appreciate Senator Reed's questions about the converging of the accounting standards, and again, I will have some more detailed questions on those.

As I mentioned in my brief opening remarks, I think one of your strongest assets is your career in the financial regulatory experience. Securities regulation is a complicated subject and the Chairman of the SEC should be well-versed in the language of finance. But I am very concerned about the growing scandal of Madoff and his investment fraud. As the chief executive of the financial industry regulatory authority, how did that expansive fraud scheme slip past the radar and when did your agency first receive notice about that possible fraud and what did you do with the information?

Ms. SCHAPIRO. Senator, I can't really speak to the SEC's handling of this matter. I have not had direct conversations with them. I am anxiously hoping to do that, as well as to receive their Inspector General's report on what went wrong there.

With respect to FINRA's responsibility, as we talked about a little bit earlier, one of the real lessons, I think, from this tragedy is the fact that we have this stovepipe regulatory regime where some misconduct can be hidden from at least some of the regulators some of the time. FINRA focused on the broker dealers' books and records. The investment advisory activity, the Ponzi scheme, didn't run through the books of the broker dealer. They were kept in separate books for the money management business. As a result, FINRA was not aware of the investment advisory fraud. FINRA also had not received any tips, either directly from anybody, nor did the SEC share those tips with FINRA.

I think one of the lessons, in addition to the stovepipe problem of regulation, is that financial regulators, frankly, need to cooperate a whole lot more closely than we have historically. There has sometimes been a little bit of competition. There has sometimes been a little bit of jealousy about who gets to bring a case or who is the first mover. We need to think of the financial markets, policing as a community and our efforts as community policing and cooperate a lot more effectively in sharing whatever intelligence we have between State and Federal and self-regulatory organizations in order to make sure we have the maximum number of eyes looking at an institution or a problem at any given moment.

Senator ENZI. So you are saying that you found out about it about the same time that the rest of us did?

Ms. SCHAPIRO. Yes.

Senator ENZI. OK. I do have to ask an accounting question. In the fall, the Senate Banking Committee heard testimony about mark-to-market accounting and its ineffectiveness in pricing assets in a frozen market. In response, FASB and the SEC issued guidance clarifying how firms should price liquid assets. Do you believe this guidance is sufficient, or should the SEC revisit the mark-to-market accounting method for 2009 and beyond?

Ms. SCHAPIRO. Well, as you know perhaps better than anybody in this room, the integrity of our accounting standards and the quality of our corporate disclosure is absolutely essential. It is the foundation of our marketplace.

I think investors, as I have read what people have said, generally believe that fair value accounting, mark-to-market accounting, has provided transparency to the marketplace and enables better decisionmaking by investors. That said, I think there are circumstances in which hard-to-value assets are written down and have real implications for business as a result.

The SEC has just published its fair value accounting report, just about 2 weeks ago, I think. They make a number of recommendations in that report which I am anxious to study. I have read it. I am anxious to study in detail and see if there are further issues that should be addressed by the SEC with respect to fair value accounting. I know there is a recommendation for further guidance for some alternative approaches, perhaps, with respect to assets where there is no ready market or no readily ascertainable value, whether there can be additional disclosure that would be helpful to people in understanding what the true value of those assets might be. So it is an issue I will get immersed in quickly.

Senator ENZI. Excellent. I will have some more detailed questions on all of those things—

Ms. SCHAPIRO. Thank you.

Senator ENZI. —but I will go ahead and yield the balance of my time.

Chairman DODD. Thank you very much, Senator.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

Ms. Schapiro, I have got two broad-based questions and if you could respond to both, I would appreciate. I share Senator Shelby and Senator Reed's concerns that you have voiced, as well, that some of these new tools that have developed, the credit default swaps, hedge funds, failure to have any regulatory oversight on those new tools. You made mention in your opening comments some of the migration taking place from some folks from the broker dealer coverage to the financial advisor coverage.

How do we get—and with your comments, as well, about the stovepipe regulations. How do we get that broad-based regulatory oversight? And even if we take care of some of these new tools, do you have any thoughts on as the capital market—never underestimate the capital market's ability to create new tools, is there any kind of proactive effort, not that would stymie the flow of capital by any means, but proactive effort to make sure that whatever the

next decade's credit default swaps, we are not then coming back and revisiting years later.

So, first, how do we get everybody underneath that regulatory umbrella, and second, and as we discussed a little bit earlier, even if we get everyone under the regulatory umbrella, it seems that a lot of the crisis that we are currently confronting comes about as the market has tried to price the credit risks of debt and we have seen the market continue to move forward in terms of becoming more and more efficient on pricing that last tranche of two, five or 10 percent of a debt instrument. The question I know we discussed privately was, at some point, is the social utility of pricing that last two to 5 percent worth all of the side bet risks that now the system has taken on, and should you be confirmed, even if we have got these entities within some types of regulatory oversight, is regulation and transparency enough, or in some cases do we actually have to look at bright-line prohibitions on some of these tools?

Ms. SCHAPIRO. A very good question. I think the way we bring all of these products and institutions under the regulatory umbrella is by having an approach that has us look at what is systemically important that needs to be under the purview of a regulator that has the authority and the capability to assess the risks in the system and deal with those through capital, leverage limitations and other sorts of requirements.

And then I think the other way we do it is, at the same time, we look at the business conduct. We look from the perspective of the investor, what is being sold, what is being offered, and how is the investor being protected in that process, so that we stop worrying about who has responsibility for mortgages versus securities versus derivatives versus some other instrument, insurance, for example, and we start to think from the perspective of the investor across a broad panoply of products that may be offered to them that has an investment component or a financial component. How do we protect the investor?

And I think by approaching it from both of those directions, a systemic protection direction and an investor or business conduct protection direction, we can probably cover the universe.

Senator WARNER. Does that mean proactively looking at new products? Would that be your screen in terms of as the market creates new products that we can't envision today, you would look at it from that kind of—

Ms. SCHAPIRO. It has to have that. That has to be a component of it, because we will always fight the last war if we don't look proactively at products as they are being developed, before they are introduced. Do they have systemic implications? What happens in a downturn? What happens if interest rates go through the roof? What does that product have the potential to do to our financial institutions? And at the same time, what do those products have the potential to do, good or ill, for investors who are being sold them?

I think innovation has been a tremendous hallmark of our markets and I think it is important that we preserve that. I think we have seen some products that are innovative mostly in their fee structure—

Senator WARNER. Right.

Ms. SCHAPIRO. —and their ability to generate new fees, rather than being innovative in their ability to help people achieve their goals in investing. And so I think that is, again, something a financial regulator, a business conduct regulator like the SEC in particular can have a focus on.

Senator WARNER. So as you get them within that regulatory umbrella, and I think you have now touched on my second point, regulation and transparency enough or actually looking, as you said, at, in effect, the social utility of some of these products in terms of prohibition or not? I mean, that gets into a touchy area, I know.

Ms. SCHAPIRO. It is a touchy area. We have generally had a system in this country where we go with disclosure and not so much the approval by regulators of particular products, although it is not unheard of. There are certain products that cannot be sold to retail investors. There are certain instruments that have, in fact, been deemed to not be suitable for anyone and therefore not for sale. To expand that approach would be different. I think it is worth exploring.

Senator WARNER. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Mr. Chairman, thanks for having this hearing, Ranking Member. I want to welcome Senator Warner. I think there is nobody that has come to the Senate with greater credentials and I certainly look forward to working with him and welcome him to this Committee.

Ms. Schapiro, I also want to thank you for your tremendous years of public service and commitment to making things better here in our country and I look forward to working with you in the future and just have a few short questions.

We watched—we had hearings here earlier in the year with the SEC and, of course, the Fed and Treasury and others and we watched our investment banking system just kind of dissipate. It evaporated. It is gone. And it appeared that the SEC didn't have the tools, if you will, to really deal with those particular organizations. Of course, they are no more.

But I wondered if, just based on where you sit, if you see is there a need, if you will, for tools right now that the SEC does not have that it should have in the environment that we now live in?

Ms. SCHAPIRO. I expect I could give you a better answer if I am confirmed and get there and spend a little bit of time. But one almost has to conclude that the tools were inadequate to the task. The CSE program was a voluntary program. That was probably one of the flaws in it. But also the capability of the staff to really apply the kind of analytics and the kind of risk assessment approach that one would hope to see, I think those are two areas that probably need significant bolstering.

I think as we move forward, we have to take a completely fresh look at how the SEC conducts examinations of all the entities it regulates, investment banks—there are some smaller ones left, investment advisors, mutual funds, and so forth, to see if we really are understanding the business and how the business is changing.

My sense is that one of the hardest things for regulators is to really understand when the world is changing underneath them

unless it is quite dramatic, because markets evolve, institutions evolve, products evolve. And I think it is going to be very critical to keep the SEC staff much more in tuned with the current events in the marketplace and the evolution of the institutions in order to be effectively finding the risks and helping to control them.

Senator CORKER. Yes. I think a lot of times, our regulators end up sort of figuring out the problem after it occurs and then—

Ms. SCHAPIRO. Catching up.

Senator CORKER. —by virtue of actions that are taken, almost create a self-fulfilling prophesy because their reaction to the issue is at the wrong time. Instead of on the front end, it is on the tail end and actually can make it worse, and I thank you for that input.

In 2007, I guess the SEC did away with something called the uptick rule. A lot of people have said that if that had not occurred, then there wouldn't have been this—I am just repeating, by the way, and asking for your input—a lot of people have said that had that not occurred, then short sellers would not have been able to manipulate the market the way that they did. I wonder if you might give us your thoughts on that.

Ms. SCHAPIRO. Well, I am very happy to do that. And as you know, in addition, this past year, the SEC issued a series of orders related to naked short selling and restrictions on short selling through exemptions, temporary orders, emergency orders, and what that suggests to me is that we actually need to take a step back and reexamine the entire area of short selling, what restrictions may or may not be appropriate, and I think we do need to look at whether the uptick rule ought to be reinstated, and that is one of the things that I would be committed to doing very quickly.

Senator CORKER. Well, thank you. I think even at the CFTC, there was a lot of concern about what speculators were doing at the time, and, of course, now with the world where it is, we are wondering where all these speculators were.

Ms. SCHAPIRO. Right.

Senator CORKER. But in any event, I do hope you will do that and I do hope we will come up with something that market players who really determine the exact pricing because of being on both sides of the equation, I hope you will be able to come up with something that is consistent and people know is going to be there into the future.

Ms. SCHAPIRO. I agree with that. I think markets deal with uncertainty. I mean, that is really what markets are about in some ways, and they deal with volatility. They don't deal so well with not knowing what the rules of the road are, and so we need to provide some certainty about how these issues will be handled on a going forward basis.

Senator CORKER. There has been a lot of comment, I guess, that the SEC is a revolving door. People come in and they learn a few things and then they leave and make a lot of money, and then they come in and vice-versa, not unlike the Senate, I might add. But what comments might you make about restrictions that you think ought to be in place for people who work at the SEC and relation-

ships that they may have in the past or in the future as it relates to companies?

Ms. SCHAPIRO. I think this is an important area, and I understand the banking agencies have done some post-employment restrictions for bank examiners and I am anxious to talk to them about what their experience has been with that.

I would think we have to balance—I worry about the revolving door very much. I hope that we can keep the best people at the SEC for the longest possible time. I worry, on the other hand, about restrictions that will make it impossible for people to come to the Commission in the first place. If I can't leave and go to the industry after 5 years or 10 years, if I am doomed to stay at the SEC for life, maybe I will never go in the first place, and I don't think that would be a good result, either.

I am very anxious to explore some of the possibilities here that allow us to continue to attract people with current understanding of the markets and current experience, keep them as long as we possibly can, but then not create a conflict by their walking out the door and going to a firm and leaving everybody to wonder whether they showed some favor to that firm during their time at the SEC. So it is a very important issue for the integrity of the agency and its credibility. I am not sure yet how to tackle it.

Senator CORKER. Well, I have to tell you, I very much appreciate your balance on that issue. At the end of the day, you want to have the very best and brightest people in your organization that have the ability just due to their experiences to really assess what is happening with companies, and you do want to be able to attract those folks and you do want to be able to bring people in for 2 or 3 years and do a great job for you and leave. At the same time, obviously, you want to make sure that that is beyond reproach. It sounds like you very much have that balance in thought and I thank you for that.

With that, Mr. Chairman, I will stop my questioning and again thank the designee for coming in. I look forward to working with her and you and Mr. Shelby in this upcoming session.

Chairman DODD. Thank you, Senator. On that last point, I am very interested in that subject matter, as well. I think we have all encountered people, particularly in their most productive years of employment that you might very well like to attract to come in and provide some valued service, who are reluctant to do so because of the prohibitions we place on the other side, not without merit, the prohibitions, but striking that balance, we lose a lot of talent, in my view. I don't have a quick answer for that one, either, but I think we really do need to think about it. We talk about it every 4 years in these cycles we go through in terms of who can come into government and it is an issue that does deserve attention, so I appreciate your raising it. I appreciate you bringing the question up, as well.

We have been joined by some additional members. I just will remind my colleagues, we have got some votes at about 12:15, I think. We have got a panel of a nominee for the Federal Reserve Board and three nominees for the Council of Economic Advisors. I don't know how we are quite going to get through all of this, but I want to turn to my colleagues. We are on a 10-minute cycle, but



if there is some way to not use all of that 10 minutes and open it up to questions in written form, we would appreciate the indulgence of my colleagues.

Senator Menendez.

Senator MENENDEZ. Mr. Chairman, since you paid for dinner last night, I will try to accommodate you.

[Laughter.]

Senator MENENDEZ. A lot of my questions have been answered and I have been jumping between different hearings at the same time, but let me get to something that is more overarching. I spoke about it in my opening statement. And let me just say, I think you have tremendous experience. I think you have ability to do this job, unquestionably.

Now, the question is some have said that you are a safe and predictable pick. Some have said that when we look at your record as a regulator, that it shows that infrequently, you have pursued tough action against big Wall Street firms. Some have said, like *The Wall Street Journal* in today's article, that even in a time of very significant market convulsions and Wall Street scandals, FINRA often filed tiny cases against small players and that employment fines against firms have plunged.

So I don't believe all of the—someone categorized my statements before saying that all of the Nation's economic woes lie at this position. That is clearly not the case. But you cannot have investor confidence, you cannot have the opportunity for the markets to regain their integrity, you cannot have all of those things that is one of the major barometers we look at in terms of the necessity to move this economy forward unless we have the Securities and Exchange Commission be the robust cop on the beat, willing to ensure that the industry does business in a fair, honest, transparent way, willing to, as I said earlier, take no prisoners and question every aspect of it. I think to some degree, the marketplace and these industries have gotten ahead of the SEC in terms of the financial instruments that are being used.

So are you really ready and willing—able is not the question—ready and willing to take on what is necessary to restore the incredibly tattered facing confidence that exists in the marketplaces, and how do you respond to the criticisms that have been levied against you that, in fact, while you are a predictable and safe nominee, you will not be the robust nominee that we need?

Ms. SCHAPIRO. Well, Senator, I am absolutely ready to take this on. I am absolutely committed to building a Securities and Exchange Commission that is of the quality, the integrity, and the aggressiveness that the American people deserve for it to be and are entitled for it to be. I think the agency has to have a laser-like focus on fraud and investor protection. I think we have to move aggressively and with a sense of urgency with respect to all of these matters.

I guess I would say to you that I started my career as an enforcement attorney. I absolutely understand what it takes. I understand that you can ignite real passion in enforcement lawyers by giving them the tools and the ability to pursue fraud and do what needs to be done to protect the interests of the public. There is nothing

that is more exciting or more invigorating for people who have chosen to become enforcement lawyers.

I will say that I think *The Wall Street Journal* article today presented a completely unfair picture of my record, in particular with respect to enforcement and enforcement cases. In my 13 years at FINRA, I have presided over nearly 15,000 enforcement cases, including dozens of major cases against very large financial institutions—Morgan Stanley, Citigroup, Merrill Lynch, Lehman Brothers, Ameriprise, CSFB, with multi-million-dollar fines. I have never been afraid to go after people I thought have violated the public trust. That will be not an issue for me at the SEC, as I said earlier.

I think there are absolutely no sacred cows and I think there are areas where at FINRA we have been particularly leading the regulatory community with respect to the improper sales of variable annuity products to senior investors, improper sales to our military on bases who have been cheated by investment scams, late trading, market timing, IPO abuse, early retirement scams, insider trading, and a wide range of other issues where we have been very, very aggressive.

So I hope that *The Wall Street Journal* piece doesn't color your impression of me because I think that I can be as aggressive an enforcer as anybody has ever been at the head of the SEC. I served under three SEC Chairmen—David Ruder, Richard Breeden, and Arthur Levitt—when I was a Commissioner. I have seen the agency aggressively in court seeking TROs, seeking preliminary injunctions, stopping fraud in its tracks, and that is exactly the kind of enforcement program I want to have.

Senator MENENDEZ. Mr. Chairman, I will submit some questions for the record.

I am going to support your nomination. I am going to hold you to what I expect to see in robust enforcement—

Ms. SCHAPIRO. As you should.

Senator MENENDEZ. —and I will not hesitate when you return to the Committee as the Chairlady to engage in this dialog. I hope it will all be complimentary—

Ms. SCHAPIRO. I hope so, too. Thank you.

Senator MENENDEZ. —and I look forward to that being the case.

Ms. SCHAPIRO. Thank you.

Chairman DODD. Thank you, Senator.

Where did Senator Bennett go? We lost Senator Bennett here.

Senator Akaka.

#### STATEMENT OF SENATOR DANIEL K. AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I am delighted to be here and thank you for this hearing and I am delighted to be here to say aloha to Mary Schapiro and, of course, to your lovely family—

Ms. SCHAPIRO. Thank you.

Senator AKAKA. —Molly and Anna, as well—

Ms. SCHAPIRO. Thank you.

Senator AKAKA. —and to thank you for what you have done already for the people of Hawaii. We share a commitment to empow-

ering our citizens through financial literacy in order to build stronger families, businesses, and communities. Without a sufficient understanding of economics and personal finance, individuals will not be able to manage their finances appropriately, evaluate credit opportunities successfully, invest for long-term financial goals in an increasingly complex marketplace, or be able to cope with difficult financial situations.

Again, I have greatly appreciated your outstanding efforts in Hawaii with FINRA and I must tell you that I have heard back from many people who have been there with you that have appreciated this and have gained from your efforts there. I am looking forward to continuing to work with you to help improve the ability of investors to make better informed financial decisions.

Mr. Chairman, I will just have two questions. Ms. Schapiro, one of my question is what must the SEC do to ensure that investors can make informed investment decisions?

Ms. SCHAPIRO. Well, thank you, Senator. You and I do share a very deep commitment to investor literacy. While it is not within the purview of the SEC, I really believe that it should be a national priority, and perhaps we can talk about that some time.

I think the SEC has an important role here and it reflects on several different levels. The first is, of course, the corporate disclosure, the information that investors receive about the companies that they may choose to invest in or the mutual funds they may choose to buy has got to be accessible to investors. It has got to be complete, honest, accurate, and accessible, understandable, and usable.

I also think that the SEC could work closely with the other Federal financial regulatory agencies on some broad investor literacy initiatives. There is tremendous ability at the SEC to produce plain English content, explanations about how mutual funds work, how does the bond market work, what is a 529 plan, and the SEC ought to be able to develop that information and material and broadly distribute it through its website in conjunction with other agencies, through financial institutions, as well as through the local offices of the SEC. The SEC has offices around the country. Those are people on the ground who could be working with local groups to try to increase investor awareness and investor literacy.

So I think there are many opportunities for the SEC to improve its profile in the investor education space.

Senator AKAKA. Well, I thank you very much. I know the Chairman is looking for time and I will just submit the rest of my questions and say thank you very much, Mary.

Ms. SCHAPIRO. Thank you.

Senator AKAKA. Without question, you have my support. But I thank you so much for what you have done already—

Ms. SCHAPIRO. Thank you.

Senator AKAKA. —not only for Hawaii, but for our country. You have really increased my confidence in SEC and in our country's financial community.

Ms. SCHAPIRO. Thank you.

Senator AKAKA. Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much, Senator. We have these other witnesses to bring up, so we are going to leave the record open for some questions.

One that I intended to ask you, but as I said, I have to move along, were these reports, Ms. Schapiro, of the two lawsuits filed by FINRA members that you are aware of. Do you want to make a quick response? I will submit it as a question, again, but I want to give you an opportunity to respond to that.

Ms. SCHAPIRO. Well, I guess I am happy to respond. I believe that the lawsuits are frivolous. They arise out of the transaction to merge the NASD and the New York Stock Exchange regulatory group. The first lawsuit was dismissed by a Federal judge. The second lawsuit was filed very close in time to my nomination for this position and I believe that there is no merit to the lawsuits.

Chairman DODD. I may follow up with a couple other questions on that.

Ms. SCHAPIRO. That is fine.

Chairman DODD. And also, Elizabeth Warren has recommended something akin to the Consumer Product Safety Commission, a Financial Product Safety Commission idea. It goes to the question that Senator Warner was raising about the anticipation of new products being developed that can circumvent a rule-based system as opposed to a principle-based system, which has some appeal, but probably not a widely held view that that can actually be a more intimidating process than sometimes a rule-based system.

But I sort of like the idea, that idea that Senator Warner raised to be anticipatory about these matters, and again, in another setting here, I would like to pursue that idea with you on how we can do that, because I think that is one of the concerns we have here. We are always fighting, as you say, the last war, the last set of battles, and as we are doing so, there is some very bright 22-year-old who is sitting out there and figured out six ways to get around the rule you just designed with all the best intentions. And so we need to have some better system in place, it seems to me, that more broadly deals with principles, ideas, but gives some sense of confidence to investors that while we are taking care of the problem that occurred yesterday, we are not very well effectively dealing with these—and again, I think the point that Senator Warner made. I think the last thing you want to do is to be stifling the creativity and imagination that has been the hallmark of wealth creation. So it is a difficult balance to strike here, but one that I think deserves our attention.

Ms. SCHAPIRO. I agree.

Chairman DODD. With that, I thank you very much for appearing before us. As has been said by all of my colleagues here, you are extremely well qualified for this job, but I think all of us are anticipating some very aggressive and strong action here to get moving on these matters.

Ms. SCHAPIRO. I appreciate that.

Chairman DODD. We thank you, and I apologize—

Ms. SCHAPIRO. Thank you very much.

Chairman DODD. I apologize to your two children that I didn't filibuster longer—

[Laughter.]

Chairman DODD. —but I want you to know that I am going to—you can go to your teacher and tell them that the Chairman of the Senate Banking Committee said you ought to have the rest of the day off, as well.

[Laughter.]

Ms. SCHAPIRO. Thank you very much.

Chairman DODD. Thank you very much.

Senator SHELBY. And they ought to get extra credit.

Chairman DODD. And extra credit for being here, too, by the way.

[Laughter.]

Chairman DODD. I don't know if my colleagues have arrived. We want to move to our next panel.

[Pause.]

Chairman DODD. I want to ask our—if we can, I appreciate people moving as expeditiously as they can so we can get to our second panel.

[Pause.]

Chairman DODD. I want to welcome all of our second panel, Dr. Rouse, Dr. Romer, Dr. Goolsbee, you are here, as well, and Dan Tarullo, I see coming in. Who are we missing here? We have got everybody. The microphones are live, I would inform my colleagues. These are the kind of moments that get recorded for history.

[Laughter.]

Chairman DODD. Senator Durbin is on his way, but our colleague, Bob Menendez, is here. I am not sure Senator Boxer is going to be able to be here, but I know she wanted to be here. Again, the schedules, with so many of these confirmation hearings going on simultaneously, it is understandable why people would very much like to be a part of it. I am going to make sure the record is open for our colleagues who would normally be doing introductions, that it will be available for them to include their introductions in our comments.

I think I see families arriving here. Again, I am using all the powers of my chair today to provide free passes out of school. That is clearly exceeding the powers of a Chairman, but nonetheless. We give extra credit, too, for appearing. And if you could actually stay the full time, you really get extra credit. That is really the test.

We have others coming in, so let us get people settled.

[Pause.]

Chairman DODD. I know Senator Feinstein wanted to be here, as well, and I am getting messages that maybe one or the other may actually be here, Dr. Romer.

All right, are we getting settled? That is very good.

Senator Menendez, would you like to introduce Dr. Rouse?

**INTRODUCTION OF NOMINEE CECILIA E. ROUSE  
BY SENATOR ROBERT MENENDEZ**

Senator MENENDEZ. Thank you, Mr. Chairman, to you and to all my distinguished colleagues on the Banking Committee. It is my sincere honor to introduce Cecilia Rouse as President-elect Obama's nominee for the Presidential Council of Economic Advisors. I am confident that the Committee will see that she is eminently qualified for this position and will confirm her for this important post.

Dr. Rouse is currently the Theodore A. Wells Professor of Economics and Public Affairs at Princeton University. Her primary research and teaching interests are in labor economics with a particular focus on the economics of education, something I know that my two colleagues who are sitting on the dais at this point, both distinguished members and the Ranking Member of the HELP Committee, are passionate about and leaders in. She has studied the economic benefit of community college attendance, studied the effect of financial aid on college matriculation, and the impact of student loans on post-college occupational choices, all incredibly important issues with a potentially profound impact on our economic choices moving forward.

Dr. Rouse is currently a senior editor of the *Future of Children*, of which she has a few examples here behind us, and an editor of the *Journal of Labor Economics*. Additionally, she is the founding Director of the Princeton University Education Research Section and she is currently the Director of the Industrial Relations Section, as well.

She is not walking into this job without experience in the public sector. In 1998, she served in the White House at the National Economic Council.

I believe Dr. Rouse will bring a unique and important insight to the Council of Economic Advisors that is especially important during these troubling economic times. And while the students of Princeton University will sorely miss their professor, they can take solace in the fact that she will be a 3-hour Amtrak trip away from the great Garden State.

So, Mr. Chairman and distinguished Members of the Committee, I strongly support the confirmation of Cecilia Rouse to be a member of the President's Council of Economic Advisors. I think you will find her to be an exceptional addition to that important body and we look forward to working with her and the other nominees to get our economy back on track and bring much-needed change to this country.

Thank you, Mr. Chairman.

Chairman DODD. Senator, thank you very, very much for those introductory remarks. I had a chance yesterday to talk with Dr. Rouse, as well, and was very impressed with her knowledge, as well.

We have been joined by my colleague from Illinois, Senator Durbin. Dick, we appreciate you making it in to present Dr. Goolsbee to the Committee, who I had a chance, as well, to talk to the other day. But thank you for getting over.

**STATEMENT OF RICHARD DURBIN  
A U.S. SENATOR FROM THE STATE OF ILLINOIS**

Senator DURBIN. Thank you, Mr. Chairman, and Senator Enzi, Senator Warner, Members of the Committee.

President-elect Obama has asked Dr. Austan Goolsbee to become a member of the Council of Economic Advisors. Austan will also direct the new Economic Recovery Advisory Board under Paul Volcker.

Austan graduated from Yale University. He earned a Ph.D. in economics from MIT and was later a Sloan Fellow and Fulbright

Scholar. He is now primarily an economist from the University of Chicago Graduate School of Business. He and the President-elect's other economic advisors will be asked to help the new President make critically important decisions on how to best address perhaps the most challenging economic crisis in 75 years in America. In fact, I know that Austan and many of his colleagues are already working very hard on that.

Austan may teach and conduct research at the University of Chicago, but he is no orthodox Chicago School ivory tower economist. He understands that economics is about more than just abstract definitions and calculations. It is fundamentally about human behavior, why people make the decisions they do, what policies can help people make choices that are in their best interests and the best interests of our economy and our Nation.

He understands many of the modern aspects of our economy, the transformative power of the Internet. He served as a special consultant for Internet policy for the Department of Justice Antitrust Division.

Austan is an admirer, incidentally, of a man that we both admire, Mr. Chairman, my first mentor in politics, Senator Paul Douglas. He happened to bring today Douglas's autobiography which the Chairman of this Committee has told me is one of the best books he has ever read about a Senator's public career. Paul Douglas, of course, may not be remembered by many, but those of us who do reflect on the fact that he was an excellent Senator and an outstanding economist on top of everything else.

Of course, I have to add, when it comes to former Senators from Illinois, Austan's current and future boss is a pretty good fellow, too, who will leave a great legacy himself.

Austan understands the importance of learning from history. I understand he hosted a program on the History Channel at one point. I understand he is also a triathlete, which I am not. Being really good at performing multiple tasks will be helpful to him with the challenges he will face with this economy.

At this moment in history, now more than ever, we need the best and the brightest tackling the economic problems that face our Nation and our world. In the very short term, in a matter of days, Barack Obama will try to create an economic recovery that invests in our country's future, gets the economy growing again, and puts people back to work. Among the investments we must make, Austan has written in particular on the positive economic impact of education, which I think is fundamentally important at all times and even more so at this moment in our history, when the cost of education continues to rise for the middle class across America and their incomes are reduced and jobs are lost.

Perhaps most importantly right now, we need advisors like Austan who understand the economy and can help us aggressively address the root cause of the recession, the foreclosure crisis that continues to devastate neighborhoods in Chicago and across America. Over the long term, the President has to deal with unsustainable deficits, which is a fact of life. Unlike most of the Chicago School economists, Austan believes deficits really do count, and I trust that he will help incoming OMB Director Peter Orszag

and others plot a future course for the Nation's budget that is more sustainable than the current path.

He has been an informal but tremendously valuable advisor to President-elect Barack Obama for many years and I know he will continue in that capacity if given this spot. As a member of the Council of Economic Advisors and as the day-to-day Director of the Economic Recovery Advisory Board, Austan Goolsbee will be filling two key roles at once.

It is an honor to stand here and recommend and introduce a great economist and a proud resident from the great State of Illinois, Dr. Austan Goolsbee.

Chairman DODD. Well, Senator, thank you very, very much. I am impressed that you brought Paul Douglas's autobiography, because Senator Durbin and I have talked about this many times. My father thought he was the brightest man he ever served with in public life, Paul Douglas, and that autobiography ought to be required reading. It is the most wonderful autobiography. It is wonderfully self-deprecating. It has a wonderful view of his life, and a remarkable life he had. When you consider his origins, where he grew up, how he grew up, and the accomplishments he made, volunteering at age, I think, 42 for the Marine Corps as a private in World War II, rising to the rank, I think a field promotion to a colonel, just a remarkable individual. So I am impressed that you are impressed by him, as well.

We have been joined by my colleague from California. Barbara, we thank you very much for being here to introduce Dr. Romer and the floor is yours.

**STATEMENT OF BARBARA BOXER  
A U.S. SENATOR FROM THE STATE OF CALIFORNIA**

Senator BOXER. Well, thank you so much, Mr. Chairman, Ranking Member Shelby, Senator Enzi, and Senator Warner. I am very happy to be here.

This is a tribute to Dr. Romer. It is one of those days that we often have here where you want to be 17 different people. I just left Dr. Rice, questioned her, went down to hear Senator Biden, and I am here for you, Christina Romer, because I am so excited about this opportunity to elect President-elect Obama's nominee for the Chairmanship of the Council of Economic Advisors.

Californians are so proud to have one of the world's great university systems, and today I am proud to introduce one of the finest scholars in that system.

The job of Economic Advisor to the President has never been more important than it is today. I don't have to tell this Committee. You have been in the forefront of trying to work our way out of this, and I want to compliment all of you for the great work you are doing. I know a lot of the times there is not unanimity, but the problems are so hard, it is not that surprising, and I value all of your comments, all of your opinions, both sides of the aisle.

And I want to say particularly to the Chairman, heavy is the head that wears this chairmanship. I just want you to know, aside from everything else, how much I appreciate what you do and Senator Shelby, trying to light a candle in this darkness.



In 2008, we experienced more job losses than any year since World War II, and the past 3 months have seen the biggest jump in the unemployment rate since 1975. Yesterday's retail sales report showed the largest year over year drop ever recorded, and there is overwhelming evidence of serious deflationary pressures on the economy.

We are in the midst of the greatest economic challenge we have seen in a generation and we need to look for leaders who understand this, who understand history, and who understand the way markets work, how markets should work, and I am sitting next to one of those, Dr. Romer, who is uniquely qualified to advise the President in these difficult times.

A former Vice President of the American Economic Association, she is known in the economics community as one of the finest macroeconomic historians in the profession. She brings a combination, as I said, of a broad historical perspective and a deep knowledge of the way the economy works. Her research has examined the entire range of 20th century American economic history, and she has made particularly important contributions to our understanding of the Great Depression, a period that unfortunately seems more relevant today than it has for decades.

Mr. Chairman and Ranking Member Shelby, I am going to tell you a little personal story, tell it to Dr. Romer and everyone who is listening. My dad was a child of the Depression. He and my mom got married just right when the Depression hit. And his attitude about life was so scarred by that experience that he was so frightened to ever buy a home. He was so frightened to move in ways that would have been the right ways to move. So it is all about confidence. And he knew in his heart that his children shouldn't have that attitude, and he always said to both of us, "Go out, save your pennies, buy a home. It is America. You will be fine."

But the experience scarred him, and I think it is important, so important that we don't have a whole generation of young people scarred by this deep recession. And that is why people like Dr. Romer are so important. She is an expert in what happened during the Depression and she understands what we need to do to avoid another depression.

So I look forward to working with this Committee in any way I can. I am an old economics major. That was my passion in college. I worked for a period of time on Wall Street, so economics is very interesting to me. I wish that I was better at giving solutions. But I do know that right now, we need to surround ourselves with people like this who will do everything in their power to lead us in the right direction and I hope you will confirm her speedily. We need her.

Thank you very much.

Chairman DODD. Senator, thank you very, very much. It is very poignant. My father was trying to pay a way through law school and graduated in 1932, and all of us of our generation grew up listening to our parents night after night talk about those days and what it was like, people all across the country. So we thank you immensely for being here. And you are right, we all are 17 different places today with these various things going on.

Senator BOXER. Eighteen for me.

[Laughter.]

Chairman DODD. Well, thank you very much.

Senator Kennedy very much wanted to be here to introduce Dan Tarullo. Dan worked for Senator Kennedy going back a few years ago. Senator Kennedy isn't here today, but I am going to take a minute or so and just present Dan Tarullo to the Committee, as well.

I have known Dan for some time. He is a professor of law at Georgetown University Law Center. He is no stranger to this Committee, by the way, as Senator Shelby has already pointed out in reference to Dan in his opening comments about how many times I think you have appeared before this Committee and various places. He has testified on important issues in the past.

He previously served as the Assistant to the President for International Economic Policy and as the President's personal representative to the G-7/G-8 group of industrialized nations and a principal on both the National Economic Council and the National Security Council during the Clinton administration.

Professor Tarullo graduated Summa Cum Laude from the University of Michigan Law School and, of course, worked in the Senate as the Chief Employment Counsel on what was then the Labor and Human Resources Committee for Senator Ted Kennedy in the 1980s.

So we welcome you to the Committee and congratulate you on your willingness to accept this position to be a Governor on the Fed. It is very, very important and we thank you for doing that.

We thank all of you, in fact, for your willingness to serve, and I am going to ask all of you to stand, if you will, and to swear or affirm. Raise your right hands.

Do you swear or affirm that the testimony you are about to give is the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. ROMER. I do.

Mr. GOOLSBEE. I do.

Ms. ROUSE. I do.

Mr. TARULLO. I do.

Chairman DODD. And do you agree to appear and testify before any duly constituted Committee of the U.S. Senate?

Ms. ROMER. I do.

Mr. GOOLSBEE. I do.

Ms. ROUSE. I do.

Mr. TARULLO. I do.

Chairman DODD. I see some folks here, some children who I presume are not economics majors yet, but why don't we begin with you, Dr. Romer. Any family you would like to introduce? I will ask each of you if you care to present them to the Committee.

Ms. ROMER. Absolutely. I have with me today my father, Clifford Duckworth, a World War II veteran who is here from Massachusetts, my son, Matthew, the youngest of my three children, and my husband, David, also an economist.

Chairman DODD. Good. Well, welcome. Interesting conversations at your house, then.

Dr. Goolsbee.

Mr. GOOLSBEE. With me, I have—I will start with the love of my life, the prettiest girl in Chicago, Robin, my wife. She is holding our 2-year-old, Emmett. I cannot promise that he will still be sitting in that seat through all of this hearing. Next to them is our 5-year-old, Addison—

Ms. ADDISON GOOLSBEE. Hi.

Chairman DODD. Hi.

[Laughter.]

Mr. GOOLSBEE. Linda, my mom, and my dad, Arthur, who is a deacon at the Church of the Heavenly Rest and came from Abilene, Texas, to be at the hearing.

Chairman DODD. Good. We could use you. You might want to stay in town. We can use you here.

Mr. GOOLSBEE. Our 8-year-old, Aden—

Chairman DODD. Hi, Aden.

Mr. GOOLSBEE. —who is being held by our family friend, Sonya.

Chairman DODD. Very good. A good crowd there. Thanks for bringing them along.

Dr. Rouse.

Ms. ROUSE. Well, my family is here today in force. I am very happy to introduce them. I will start with my mother, Lorraine Rouse, and my father, Carl Rouse, my sister, Carolyn, and then we have my husband, Ford Morrison, and our children, Nidal and Safa Morrison, and they are all from New Jersey, and then we have my Uncle George, my Aunt Doris, George Haley, and Phyllis and Bill Taylor—

Chairman DODD. Is there anyone in the room who is not a Rouse or a Morrison?

[Laughter.]

Ms. ROUSE. And also Terrie Rouse, who is actually the CEO of the Capitol Visitors Center.

Chairman DODD. Ah, well, terrific. Great job, by the way, with that. Well, that is terrific. I am glad you have got them here.

Dan, anyone you would like to introduce?

Mr. TARULLO. Yes. Thank you, Senator. I traveled a bit more nimbly here with my mother and my wife, Louisa.

Chairman DODD. Terrific. We are delighted to have both of you here, as well. It is an important day.

And I apologize we are crowded on this schedule. We have already had opening statements, and so we are going to begin in the order, going right down the row, we will begin with you, Dr. Romer, any opening comments you would like to make, and then we will get to some questions.

**STATEMENT OF CHRISTINA D. ROMER, OF CALIFORNIA,  
CHAIRMAN-DESIGNATE, COUNCIL OF ECONOMIC ADVISORS**

Ms. ROMER. Great. Well, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, it is an honor to come before you as President-elect Obama's nominee to Chair the Council of Economic Advisors. Obviously, I would like to thank Senator Boxer for those warm words and Senator Dianne Feinstein, who has submitted a written statement.

Let me tell you just a little about myself. I received my Ph.D. in economics from the Massachusetts Institute of Technology. I have taught economics at Princeton University, and for the last 20 years, as Senator Boxer pointed out, at the University of California at Berkeley. I am a specialist in macroeconomics and economic history. I have studied topics such as the effects of tax changes and monetary policy on the economy, also what caused the Great Depression, and probably much more important, what caused the Great Depression to end.

I have to say, I never dreamed that a knowledge of the 1930s would prove useful in formulating current economic policy, and yet the stresses facing our financial system and the shocks hitting every corner of our economy are the worst since the Great Depression.

My goal, if confirmed, would be to use all that we have learned in the last 75 years to ensure that the tragedy of the 1930s is not repeated. Perhaps even more important, I would hope to create policies that not only allow us to turn the corner on the current downturn, but to put us on a road to a better and more productive future.

Let me just say one word about the organization that I have been nominated to lead and that Austan and Ceci are also nominated to join. The Council of Economic Advisors was created to provide the President and through its reports the Congress the best advice professional economists have to offer. It is an institution with a proud history of providing honest, first-rate economic analysis. If confirmed, I will do my utmost to protect the integrity of the CEA and to make it the center for unbiased scientific analysis of the crucial economic issues facing our country in the years ahead.

Thank you, and I would obviously be delighted to answer your questions.

Chairman DODD. Doctor, thank you very, very much and we appreciate your willingness to serve our country, as well.

Ms. ROMER. Thank you.

Chairman DODD. Dr. Goolsbee.

**STATEMENT OF AUSTAN D. GOOLSBEE, OF ILLINOIS,  
MEMBER-DESIGNATE, COUNCIL OF ECONOMIC ADVISORS**

Mr. GOOLSBEE. Let me just start by saying what a thrill it was to have the senior Senator introduce me. He got his start in politics working for Senator Douglas, who was a great Senator, but was a great economist out of the University of Chicago, and for all the economists in the room, he was the namesake of the Cobb-Douglas production function. So that was a real thrill.

By way of background, I have been at the University of Chicago for 14 years as a researcher. I am an empirical economist, what we call the old style data dogs. We just try to get out and get the data to figure out how the world works or what would be the impact of various policies. I have studied a lot of industries in the United States and how they compare to the rest of the world, innovation and technology, taxes and public policy.

Many years ago, when I was just a freshman in college, I worked for the late great economist James Tobin, who was a Nobel Laureate, and he had served on the Council of Economic Advisors

under John F. Kennedy in 1961. He used to recount that that was the hardest he had ever worked, but that he was very proud that he had been able to serve the country at that time and he believed in his heart—he, himself a child of the Depression—that economics was not just an academic field of study, that it could really affect people’s lives, that you could help prevent or ease events like the Great Depression.

It is my hope that at the CEA, under Christy’s leadership and working with Cecilia Rouse, that we can try to equal the standards that they set back in 1961 in what most people consider the golden age of the CEA by giving hard-nosed, objective analysis of any economic policies that we are asked to. I can’t guarantee that we will meet that gold standard, but I do know we will come to work every day. We will bring the best economic analysis we have. And we are motivated by this great legacy we inherit at the CEA.

I thank Senator Shelby and Chairman Dodd for the opportunity to be here and I also am happy to answer any questions you might have.

Chairman DODD. Well, I thank you for that, as well. Jim Tobin was a good friend of mine. He taught at Yale, of course——

Mr. GOOLSBEE. Yes.

Chairman DODD. ——and when he won the Nobel Prize in Economics, just a wonderful human being, very quiet individual. You have got a good pedigree with Paul Douglas and Jim Tobin, so that is not bad lineage.

Dr. Rouse.

**STATEMENT OF CECILIA E. ROUSE, OF NEW JERSEY,  
MEMBER-DESIGNATE, COUNCIL OF ECONOMIC ADVISORS**

Ms. ROUSE. Mr. Chairman and distinguished Members of the Committee on Banking, Housing, and Urban Affairs, I am very pleased and quite honored to appear before you today as a nominee to be a member of the President’s Council of Economic Advisors.

I am currently a professor of economics and public affairs at Princeton, where I have been on the faculty for the past 16 years. I don’t really like to use that number, but I will.

[Laughter.]

Ms. ROUSE. As a labor economist, I am most committed to understanding the problems, choices, and tradeoffs that individuals face, particularly those that concern the labor market. I am particularly interested in understanding the ways to increase worker productivity, primarily through the acquisition of valuable skills or what we call human capital. As such, I have devoted much of my research to the economics of education at all levels.

As a faculty member of a policy school, I have always been deeply committed to studying real world problems and real world implications rather than abstract theory. I was fortunate to have the opportunity to apply these skills to actual policymaking once before, in 1998, when I spent a year at the National Economic Council, and I would be most honored, should I be confirmed, to have the opportunity to do so again as a member of the Council of Economic Advisors.

I should note that for the past several years, I have taught one of the main introductory micro-economics courses to first-year stu-

dents at the Woodrow Wilson School in the master's program, and I should add that this year's class is particularly inquisitive and challenging. I emphasize to my students the power of economics, both theoretical and applied, in guiding analysis of policy issues. Should I be confirmed, I would bring this dedication and enthusiasm to the President's Council of Economic Advisors.

Thank you very much, and I look forward to answering any questions you may have.

Chairman DODD. Thank you very much, Doctor. I appreciate that.

Dan, good to have you with us. We are more than happy to receive your opening statement.

**STATEMENT OF DANIEL K. TARULLO, OF MARYLAND,  
MEMBER-DESIGNATE, BOARD OF GOVERNORS OF THE  
FEDERAL RESERVE SYSTEM**

Mr. TARULLO. Thank you, Mr. Chairman, Senator Shelby, and other Members of the Committee. As honored as I am by the President-elect's designation of me as his intended nominee to the Board of Governors of the Federal Reserve System, I am also mindful of the enormous responsibility that would come with this position.

As if we needed any reminder, today's headlines underscore the magnitude of the financial and economic problems faced by our Nation. The Federal Reserve has a critical role to play in responding to these challenges. As the Nation's central bank, it must pursue its dual mandate of promoting maximum employment and stable prices in an unusually trying environment. It has in the past year taken a number of unusual and innovative actions intended to ensure liquidity in important credit markets whose functioning has been significantly impaired in the course of this crisis. And very importantly, as a bank regulator, the Board must use its existing authority to provide both effective supervision and robust enforcement. Going forward, it must join with other parts of our government to help revamp the financial regulatory system so as to diminish the likelihood and severity of future financial crisis.

If confirmed by the Senate, I will draw upon both my government and academic backgrounds in addressing each of these responsibilities of the Board. I have the highest respect for the tradition of independence associated with our country's central bank. At the same time, I understand that although so much of the Fed's work is necessarily grounded in technical analysis, the ultimate purpose of this work is to create the conditions under which Americans can make a good life for themselves.

Thank you very much, and I would be pleased to respond to any questions.

Chairman DODD. Well, I thank you, Dan, very, very much for that.

We have a vote that is literally just about to start in 2 minutes, two votes on the floor of the U.S. Senate, and so what I am going to do at this point is declare a recess for about 30 minutes. I think it will take us that long to cast both those votes and get back. I apologize to all of you for this delay, but we had a lot of questions obviously with the nominee for the Securities and Exchange Commission. So we will get back shortly to you and we will complete

the process, hopefully in an hour or two. So thank you very much for waiting.

The Committee will stand in recess.

[Recess.]

Chairman DODD. The Committee will come back to order. I hope you used this time to get to know each other better.

It took a little longer than we anticipated and I apologize to you, in advance, for that.

I am going to ask, and I have notified my friend from Alabama, that we will begin a question period. And obviously, a lot going on. In fact, the debate on the so-called TARP program is going to begin shortly and I will go through some questions for you myself and then Senator Reed has agreed to step in for me as I then go to the floor and try to manage that debate.

I would rather stay here, quite candidly, but the job of the Chair of this Committee with jurisdiction over the matter is to be out on the floor. So I will be doing that.

Let me raise with all of you the TARP issue, in fact. This is the debate and subject of the hour. President Bush has made the request. President-elect Obama has endorsed the request, and said that this is a tool that he needs as the President-elect coming in.

Obviously, I do not need to tell anyone in this room or elsewhere how unpopular all of this is, primarily because people one, believe that this was not a natural disaster, it was an avoidable one. That, in my view, had actions been taken—and I appreciate Senator Shelby has shared his thoughts with me, as well—that we tried 2 years ago to raise the issue, the closure issue, on numerous occasions in this very room, and had very little response to it. And certainly we will take some time in the coming weeks to go back and find some space to go back and review. We already have a couple of hearings on this matter about how we got to this position.

I think both of us agree that while that is important because you are not going to know where to go unless you know where you have been, that we also want to take our time to start talking about what needs to be done to avoid problems like this from occurring again. So I consider that actually a more important function, not to minimize the importance of a review.

But I would like to ask all of you, and I will begin with you, Dr. Romer. I see Ben Bernanke has bluntly warned a few days ago that the Government would probably have to infuse more money into the financial institutions in the months ahead. The issues involved in this, I wonder if you agree with Dr. Bernanke, Chairman Bernanke, about the additional funds needed? And can you help explain to the American public, and I would ask all four of you to do this in different capacities. Obviously Dan, down at the Fed, has a different role than the Council of Economic Advisors.

But I think one of the glaring problems has been here is the failure to explain clearly to the American public what is going on here. Why are we needed? Why is it needed to put capital into these lending institutions? We hear now Bank of America may be requesting new resources. The news this morning is not good, 17,000 people a day losing their jobs, 9,000 homes a day falling into foreclosure.

So the concerns and the evidence out there about an economy in deep trouble, but the public has a hard time understanding why we are where we are and why this approach is needed as part of the solution to get us back on our feet again.

I am not even articulating the question very well. But Dr. Romer, would you begin and I would ask each of you to go down and share your thoughts.

Ms. ROMER. Of course, and I think you are expressing the frustration that certainly I feel and that we know the American people feel about what has happened so far.

I think I feel quite strongly that Chairman Bernanke is correct, that no one has as good a window on the banking system and the financial system as he does. And by all accounts, they are still under incredible stress, and are going to need our help, our resources, to get them through this.

Maybe where I could be the most helpful is trying to explain why the financial system is so important. I think part of the frustration is in helping them there is the sense of we are just helping the Wall Street bankers. And drawing the link between what happens in the financial system and what happens in the rest of the economy, I think, is crucial. It is exactly when lending dries up, people cannot get mortgages, they do not buy houses. They cannot get car loans, they do not buy cars. Firms cannot get loans to meet payroll, they shut down and people are unemployed.

And so it is—any resources that we are putting there are fundamentally really resources we are putting into American businesses, to American consumers. And I think that is the crucial piece.

The fact that if we let the financial system go under, suffer a catastrophic failure, it will not just be catastrophic for Wall Street. It will be catastrophic for everyone of us. So I think that is the key point.

Chairman DODD. Dr. Goolsbee, what are your thoughts on this?

Mr. GOOLSBEE. Mr. Chairman, in broad terms, I agree with what Dr. Romer has just said.

As a guy that focused a lot on American industry in my own research, I will say the prospects of an unprecedented credit crunch and the damage that would do to American industry, and the spillover on millions more people doing their jobs, at this exact moment I think we have got to be very careful with doing things that threaten to make this problem worse.

Now that said, I completely agree with Dr. Romer, and with many members of this Committee who have been, for a long time, been expressing well founded frustration in the lack of transparency in the way this specific TARP has been conducted, that we ought to have, in my view, and we ought to bring our analytical resources to bear. We ought to have some understanding of what it is they are doing, why do we think it will work? What will the money be used for? That it will not be wasted. And that this not just be some grand allowance program that we are handing out money with no upside to the Government, no chance for it coming back. That is not where we want to be.

But on the fundamental matter of is it needed, if you look out at the credit markets, the financial markets, and the job markets,



I think it is needed. I mean, it is a very fragile time in the economy.

Chairman DODD. Dr. Rouse.

Ms. ROUSE. Thank you, Mr. Chairman. I think this is a wonderful question. As someone who just arrived in Washington on Sunday, I have not been part of the inside discussions about the TARP, but I have had the opportunity to look on the outside.

And I myself, as I am teaching my students about microeconomics about insurance, we are saying why do we want to reward failure? As a taxpayer, I am wondering is this really necessary?

But I have to say that the other thing that I teach my students is that well-functioning credit markets are fundamental to a well-functioning economy. Without well-functioning credit markets, consumers cannot make long-term investments in their cars and their houses. Students have difficulty getting student loans to make investments in their human capital going forward.

And so I think a well-functioning credit market is essential. I think this is part of a well-balanced program to try to get the economy up and running. But I do endorse Mr. Bernanke's suggestion that this TARP money is essential.

Chairman DODD. Dan.

Mr. TARULLO. Thank you, Mr. Chairman.

We have all been commenting on the gravity of the economic situation facing the country. I think in these circumstances we need, as a Government and as a country, all of the tools that are potentially at our disposal. We need, obviously, the tools of macroeconomic policy, monetary policy, and the various liquidity facilities that the Fed has created. We need the guarantee authority in the Federal Deposit Insurance Corporation. We need the fiscal measures which the U.S. Congress will be taking up.

But we also need this reserve of resources, which can be deployed to strengthen the capital positions of the American financial system right now, which are under enormous stress. I might add, though, that from the potential perspective of the Federal Reserve, the TARP can serve a complementary purpose as well.

As you probably know, in one of the recent facilities which the Fed created in an effort to inject liquidity into various consumer loans and into small business loans, there is some credit risk. And given the Fed's policies on not assuming credit risk, the Treasury was willing to provide some portion of the TARP as a kind of credit backup, which allows that liquidity facility to be created. And that is obviously critical to getting those markets affecting consumers and small businesses moving again.

Chairman DODD. A lot of our colleagues, in talking about this—and obviously, they are going to start a debate here in a matter of minutes—and asking their views on this, they have been disappointed in how the program has been run over the last number of weeks since it was adopted in the end of September, early October, and are asking questions about a greater specificity on how the program could be run and operated differently.

One of the concern is—well, there are number of them: accountability standards, transparency. Warrants I think are not really a debate. We understand that will be in place. The issue of fore-

closure mitigation, utilizing these resources to try and minimize the cascading problem of home values and people losing their homes.

There are concerns being raised as well about whether or not these funds ought to be used in any way other than within the financial system. We had a debate recently on the automobile issue. And while I think a case could have been made, obviously it was made, and the administration—the outgoing administration—endorsed putting some loans out there for the three major automobile manufacturers.

I wonder if you might comment on these various points: on executive compensation, on accountability standards, transparency, as well as foreclosure mitigation. And again, Dr. Romer, let me begin with you if I can.

Ms. ROMER. I could not agree more that we absolutely, in thinking about going forward, want to have a much clearer sense of what we are trying to accomplish, articulate what the program is going to do, and put a lot more restrictions and teeth on it.

So the things you mentioned about accountability, the American people, the Congress. We ought to know who is getting funds, where it is going.

I think your point about using it certainly for foreclosure mitigation, I know the President-elect is absolutely committed to that and that will be a fundamental part of this program going forward.

On the issue of conditionality, I think one of the ways that I have heard the President-elect describe it is as sensible conditionality. For example, of course it should not just go into executive compensation. Of course, you should put some limitations on what you can do with dividends and mergers and acquisitions. Certainly, they want to have much stronger references on or certainly reporting on what is happening to lending.

And I think all of that—because it is a trust. It is the American people's money that is being—these resources are being invested in financial institutions, as we have all suggested, for a very important purpose, to keep our financial system helping the rest of the economy. But it needs to be done in a responsible way. And I think that is the key going forward.

Chairman DODD. Adam Posen, who is the Deputy Director of the Peterson Institute for International Economics, described the problem with TARP in the following words, and I quote him. He said “The problem is not that we have wasted the money. The problem is that we have put too few conditions on the banks.”

Dr. Goolsbee, how do you react to that?

Mr. GOOLSBEE. I agree that we had problems and that we did not put enough conditions. I guess I do not agree that that is the only problem. It sounded like he was saying that is the only problem. I think in an area of this that I have been somewhat involved in on housing, I think it was a big mistake, and I think most experts now looking at the operation of TARP think it was a mistake not to directly confront the foreclosure crisis directly. Because if you are just trying to deal with the financial system and you are not thinking about the real economy influences, the number one most important of which is the housing market, I am not sure that you can get out of that box.

Now the President-elect was, as you know, very early on saying that. So before the first TARP was voted on, he was saying look, we may have to do things because there is this terrible moment of crisis. But let's not forget, our problems are rooted in the problems of the real economy, on the squeeze on ordinary middle class Americans whose incomes have been stagnant, and the dramatic developments in the housing market that have left a whole bunch of people unable to make the payments on their houses.

That is what the root of this problem—that is where it is to be found. And we are going to have to confront those issues directly.

Chairman DODD. I apologize.

Dr. Rouse, any comments on that at all? Do you want to pick up on that line?

Ms. ROUSE. I guess what I would add to that is the first half of the TARP is relatively new. And I think to really understand and analyze where things went wrong and what the different pieces are that have contributed to its success or to the performance it has to date is something that I would look forward to, should I be confirmed, to really understand as part of the Council of Economic Advisors.

Because I think you are right, it is hard to understand how to go forward without really understanding where we have been.

Chairman DODD. Dan.

Mr. TARULLO. Thank you, Mr. Chairman.

A couple of things here. First, I think with respect to conditions or the structure of the program, everyone needs to keep in mind—and I believe that at this point, because of what you and others have done, people will keep in mind the aim of this very unusual action by the Congress last fall in making these resources available.

The aim is the stabilization of the financial system in this country. The aim is to return our financial system to the circumstances in which growth is again going to be promoted. And keeping that aim in mind, I think, should help shape the program as a whole and the conditions that are deployed along the way.

The second point I would add is that the importance of transparency is, I think, obvious as a matter of democratic accountability and one that I wholeheartedly endorse. But there is another important role that transparency can play, and that is in the signal it provides to the markets as to what the Government policy is and how the Government intends to lead the economy out of its present situation.

When that is made clear through statements by the President and the President's senior officials, then markets get a better sense of where the effort is being made and they are in a position to judge how the results of those efforts are yielding or not yielding the kinds of changes they would like to see.

So I think if it is done well, you get a double benefit—the actual stabilization of the institutions or markets in question and, second, more confidence to economic actors as a whole that there is a plan for moving us forward.

Chairman DODD. I had a constituent of mine, I met with a group of people and talked about this issue, they were knowledgeable about the subject matter. All of them were in the financial services

sector. A lot of things were said that made sense to me a couple of weeks ago.

But one thing that one of them said, there needs to be a framework for this. There seems to have been an absence of a framework that people can understand. And I think that is the point you are making.

Let me just ask you this last point, and then turn to my colleagues. As all of you here have watched all of this from one vantage point or another, in your view would the situation be substantially worse today had we not acted in September?

Mr. TARULLO. Yes, I think it would, Mr. Chairman. With all of the reservations that you and your colleagues on both sides of the Hill have expressed, and the American people have expressed, many of which are very well founded, I do not think we can deny that the situation in the fall was a very grave one indeed.

It is always hard, of course, to prove the counterfactual, what would have happened if. But I, at least, and I think many observers, are convinced that the situation was sufficiently dire at that point that action was called for.

Chairman DODD. Do you want to quickly comment on that, Dr. Rouse?

Ms. ROUSE. I guess I would agree. Ultimately I do not have a crystal ball and I do not know what would have happened had we not had the first—had the TARP not been exercised. But from everything that I have read, everything that I have seen, the downside risk was very high. And that is what worries me going forward, as well.

Mr. GOOLSBEE. I guess I would say almost everybody can agree that there was at least a significant chance of a really fundamental collapse of the credit system at that time. And just the prospect that there was a chance of that, we had to do something to prevent that.

Chairman DODD. Dr. Romer.

Ms. ROMER. I would like to agree very much, and actually, to again put this in the context of going forward. Because I think, coming back to your initial question about Chairman Bernanke, I think it is very important to realize the U.S. financial system is still very weak. And that is precisely why we are having this debate about the second tranche, is exactly—and here, I will use a little bit of my economic history.

When you look at the Great Depression, we had one shock to the financial system. But then what happened is as the economy went down, that further weakened the financial system and we had a sequence of—there were four waves of banking panics.

And that is—certainly, when I arrived shortly after Thanksgiving and started looking at the forecasts and thinking, very much what was so much in my mind was we have been through a huge shock to our financial system. Now, as those effects are feeding into the real economy and we are starting to see the unemployment rate go up, housing prices go down more, that just puts additional stress on the financial system.

So that is why going forward those resources, knowing we have behind us the ability to help our financial institutions is just absolutely crucial.

Chairman DODD. I appreciate you all very much. I have mentioned this to Senator Shelby and Senator Reed. We are going to try, in the midst of everything else, given the time we are in—and I say this particularly to the Council of Economic Advisors, but we do not exclude Fed members—to get together even informally and spend some time talking about some historical consequences and historical examples and how we can better understand what steps we need to be taking.

So I know your primary responsibility is obviously to the President, but you are confirmed by the Congress. And so we feel as though we can have an opportunity to take advantage of your expertise and knowledge as well. And we would like to do that. I do not know how frequently we can, but it is something I would very much like to institute during this very difficult time we are in so that we are well aware of the ideas and thoughts that you bring as a result of your expertise and background.

So I thank you very much. And I apologize for now going up and trying to see what we can do to get this TARP money adopted.

I would like you to keep Senator Shelby here as long as you.

[Laughter.]

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. My dear friend, Senator Shelby.

Senator SHELBY. Thank you.

I want to direct this question primarily to you, Dr. Goolsbee. This question is probably one we need to be thinking about in the future.

It has been reported that credit derivatives peg the probability of a U.S. debt default over the next 10 years compared to 1 percent a year ago. Analysts point to a combination of factors, including the economic downturn, financial sector fragility, concerns over the increase in the size of the Federal Reserve's balance sheet, and the projected size of the budget deficit.

The chances of these risks resulting in a downgrade of U.S. credit rating probably, some would say, is remote. There is, however, some precedent as Japanese debt was downgraded in the 1990s, as you all know, as economists.

Dr. Goolsbee, do you have any concern about these market data, and this is your field, and their implications for our fiscal policy going forward?

Mr. GOOLSBEE. Well, Senator, I did not—

Senator SHELBY. And if not, why not?

Mr. GOOLSBEE. Sorry to cut you off there.

Senator SHELBY. No, you did not cut me off.

Mr. GOOLSBEE. I did not have those statistics, and that is very striking to hear that sixfold increase. It may be a small percentage. But as I indicated before, even a small percentage of something as terrible as that—

Senator SHELBY. Well, we have got unprecedented debt out there, have we not?

Mr. GOOLSBEE. We do have unprecedented debt.

Let me answer your question directly in two ways. The first is at this exact moment, facing the fragility that Dr. Romer has spoken of and that you are familiar with, I do not believe that over the next 2 years we can make major deficit reduction or balancing

the budget a goal. I think that would run the risk of repeating one of the mistakes of Herbert Hoover, that led us into the Depression.

Once we get out of that—

Senator SHELBY. Did he want to raise taxes during—

Mr. GOOLSBEE. His goal was let's try to balance the budget, and as the thing gets worse let's raise taxes and cut spending to balance the budget, in the face—

Senator SHELBY. That certainly did not work.

Mr. GOOLSBEE. And that was a bad idea. That is the motivation behind the recovery package.

The answer to two is once we are out of that, I believe absolutely, we need to pay close attention to fiscal responsibility in the medium and the long run of thinking about health care costs and the things facing the country.

Senator SHELBY. What was basically, within figures—and probably all three of you know this, or should know it—what was our national debt say in 1932 overall? It was not much.

Ms. ROMER. It was very small.

Senator SHELBY. As a matter of fact, I believe that we had paid down a lot of the first World War debt during the 1920, had we not?

Ms. ROMER. We had, absolutely.

Senator SHELBY. So we, as far as a Nation, we were not a Nation of debt then, were we not?

Ms. ROMER. Oh, you are absolutely correct.

Senator SHELBY. As compared to today. Is that fair?

Ms. ROMER. That is fair.

Mr. GOOLSBEE. Yes, that is fair.

Senator SHELBY. So we had more options this way.

Professor Romer, I want to direct this to you because you have worked in this area and you have published in this area. You note that tax increases can have, quoting your words, "Have a large, rapid, and highly statistically significant negative effect on output." Those are your words.

You wrote that quote, and these are your words too, "Tax increases have a large negative effect on investment."

I hope you continue to voice these opinions when giving economic advice to the President. And I agree with you on that basic philosophy. Have you changed any? Do you still believe that? Or have you compromised those principles?

Ms. ROMER. That was the result of an empirical study and I am, at heart, an empirical economist. And I absolutely—

Senator SHELBY. You stand by that?

Ms. ROMER. I absolutely stand by them.

I think there are a couple of things to say. One is I also think that Government spending—

Senator SHELBY. Absolutely.

Ms. ROMER. Changes in Government spending have big effects. Another way to state those same findings is that tax cuts have positive effects on the economy, and that is part of why they are a piece of the recovery package, as we have been discussing.

Senator SHELBY. Dr. Tarullo, the Federal Reserve's balance sheet—and you will be joining the Federal Reserve as a member of the Board of Governors—has grown to over \$2 trillion. As a cen-

tral bank, the Federal Reserve has been providing direct support to various aspects of the credit market. You are very familiar with this.

While these actions, some argue, may be necessary to restore the normal functioning of markets, they also lead a lot of people to believe and be concerned about how the Federal Reserve will be able to smoothly withdraw from all of the markets in which it has intervened. This is real intervention in the market.

Others refer to the Fed, as you have heard, as printing money—and they are obviously printing money—to deal with the crisis and that we will deal with inflationary concerns later.

How difficult do you believe it will be for the Federal Reserve, which you will be part of, to remove itself from these various credit markets? And how will the Federal Reserve know when such action can take place? And do you have any concerns regarding the scope of the Fed's involvement?

Mr. TARULLO. Senator, let me begin by saying that the exit strategy is going to be an exercise in innovation, just as the entry strategy was an exercise in innovation. I think that inevitably means that there are going to be difficult questions of judgment and timing along the way.

With respect to the balance sheet itself, there are, of course, a lot of assets now on the balance sheet of the Fed. The purpose of the Fed, as I understand it, in creating these liquidity facilities has not been directly to increase reserves. But reserves have nonetheless been increased along the way. And as I think the gravamen of your question suggests, that leads at least to the potential for monetary consequences later on.

Under the current circumstances, of course, inflation is not an imminent concern. In fact, I think most economists would suggest that deflation is more of a concern at the moment than inflation.

Senator SHELBY. At the moment.

Mr. TARULLO. At the moment. But as you rightly suggest, there will come a point at which the unwinding, the exit, is critical. And I think that precisely because of the novelty of the situation, there is not going to be an obvious point based on a pre-existing data series which suggests now is the time.

But I think two things will happen. First, because a number of these facilities are themselves dependent upon demand from private markets, as those markets normalize you will probably see a decreased utilization of some of those Fed facilities. And so that will both begin to draw down the size of the balance sheet and to help provide some signal as to when credit markets are normalized.

Second, I believe that the Fed, as a matter of ongoing policy, will need to be vigilant in absorbing all data sources in observing the economy and putting together risks of inflation with getting the economy moving again.

And although I cannot sit here today, as I say, and tell you here is the point at which one has to more actively begin to reverse course, I think it is critical to bear that in mind. And I can assure you that, if confirmed by the Senate, I will be in that mindset.

Senator SHELBY. Professor Romer, you have written that—and these are your words—I quote, “Fiscal policy was a little con-

sequence” in ending the Depression, that almost all of the recovery was due to monetary expansion. Is that correct?

Ms. ROMER. That is.

Senator SHELBY. What is different in today’s economy that would indicate that a massive fiscal stimulus will work now, when it did not work in the 1930s?

Ms. ROMER. Actually, I think that is a wonderful question and I am glad to have a chance to answer it because one of the most famous statements about the Great Depression is not that fiscal policy did not work, but that it was not really tried. And that, I think, is the crucial point. It is not that it would not have worked but sort of as—

Senator SHELBY. We do not know if it would have worked, do we?

Ms. ROMER. —as an empirical question, the size of the fiscal stimulus, we think of Roosevelt as coming in with a big Government spending. In fact, compared to what we are considering today, it was relatively small.

The other thing, just as we have today, we are talking about how States are tending to start to run—they are running up against balanced budget requirements. In the 1930s, as soon as Roosevelt came in, the very interesting thing is that the States said oh thank heavens, the cavalry is here, we can get our budgets back in order. And so actually, on net, very little fiscal stimulus.

So the reason I think there would be a big difference today is we would be doing a lot more. I think the evidence is very strong that it will do good. And so I expect it to be very helpful.

Senator SHELBY. You have a background in monetary policy here.

Ms. ROMER. I do.

Senator SHELBY. What role do you believe that expanding the monetary policy played in creating the housing bubble? Does it not always create problems? And you do not know when to quite? Is that a role of the Fed?

Ms. ROMER. I actually think this is an empirical question for which we do not really have the answer yet. I think that that certainly is a relationship you hear, that low interest rates fed the bubble.

I think, as an empirical matter, it is not at all clear. It is something again, I am sure, the Fed is going to be thinking about this for going forward. It is something I would, in my previous life, think would have been one of—as a university professor—one of the key issues to be thinking about because in thinking about going forward, obviously, we do not want to go through this again.

Senator SHELBY. I want to direct this, I am not going to get Dr. Rouse get by yet, and I have already questioned Dr. Goolsbee. But I want to direct this question to Dr. Goolsbee and Dr. Rouse, if I can.

Many analysts have written that a cut to payroll taxes will result in a more immediate and widespread stimulus by putting more money in people’s pockets, especially if the tax cuts are concentrated in lower to moderate-income brackets. In other words, our working people in the country.

This approach would also, according to them, have the added benefit of avoiding having the Government pick winners in losers



in terms of where any stimulus funds would be spent. It would be up to the people, the market.

Dr. Goolsbee and Dr. Rouse, have you discussed this approach with President-elect Obama? And if not, will you? And has it been included in the stimulus plans that your team has circulated?

You three are going to be advisors to the President on economics.

Mr. GOOLSBEE. Senator, thank you for that question. I believe that the issue you are raising about cutting payroll taxes and giving tax relief to ordinary working Americans can be more than just a benefit to a group that has been squeezed. It can serve as a stimulus.

Not to get too much into what our specific discussions were

Senator SHELBY. Even if it is for a couple of years or so it would help? And how much money are we talking about?

Mr. GOOLSBEE. It is potentially a very substantial amount of money. I would point out that the President-elect's making work pay tax credit is premised on exactly this idea. It is to give up to \$500 per worker of tax relief based on the payroll taxes paid. It is serving very much that function.

Senator SHELBY. Yes, but that has to come later when he claims that credit on his tax return, does it not?

Mr. GOOLSBEE. Well, much of the discussion now is to try to utilize that credit, perhaps change the withholding tables, so that it would serve very much that function.

Senator SHELBY. Doing the same thing in a different way.

Mr. GOOLSBEE. It would be doing the same thing in a different way. And the only reason one is wary about directly changing the payroll tax is obviously that the payroll tax is going into the Social Security Trust Fund. So then one has got to have a different discussion about what is happening to the money that would be going into the Social Security Trust Fund.

Senator SHELBY. Maybe you ought to discuss that with the young people of America. They, I think, consensus-wise they believe that they are not ever going to get any of it. And they are probably right.

Mr. GOOLSBEE. I do not know the answer to that one, but look, I do take your point, Senator. It is an important point that we ought to keep in mind.

Senator SHELBY. Dr. Rouse, do you disagree with Dr. Goolsbee, agree with him?

Ms. ROMER. Have I ever disagreed with Dr. Goolsbee?

Senator SHELBY. Absolutely, I am sure you have.

Ms. ROMER. I have to say, I have not yet had the privilege of directly advising President-elect Obama. But going forward, should I be confirmed, I certainly look forward to doing so. And I certainly believe that, especially in this time where we are trying to jumpstart the economy, a balanced portfolio would include tax cuts, especially for the middle class and for the working class, as well. And I would encourage him to look at that, as well.

Senator SHELBY. Professor Tarullo, bank regulation. As a member of the Board of Governors of the Fed, you will likely consider financial regulatory reform with all of us this Congress. I believe before we examine what changes should be made, that it is important that we first understand—not just the Fed, but the White

House and this Committee—what regulatory mistakes helped produce the current financial crisis. There are probably many.

In your view, what have been the biggest regulatory failures that have played the biggest role in creating the current financial crisis? I do not think we can exclude any of the regulators.

Mr. TARULLO. I would endorse that last statement of yours, Senator. I think that there have been enough shortcomings to go around.

It struck me a few days ago that you and I were sitting in this same room more than 3 years ago talking about financial regulation. And I regret to say that the concerns that I had at the time have been more than justified by subsequent events.

I think that we have got to begin with a recognition that when you have depository or other financial institutions with potential access to liquidity facilities of the Fed, or with Federal deposit insurance, that the capital buffer to be required for those institutions needs to be an adequate buffer. And that premise, which has been central to much financial regulation, I think has not been implemented in such a way as to provide the necessary safety and soundness for our financial system. And I think going forward the first thing we are going to need to do is to determine how we are going to ensure adequate capital, because capital provides a buffer against losses no matter what their source. That is a good reason for it to be a key part of financial regulation.

Second, I think that we have learned that too much financial regulation has focused only on a particular institution, in a kind of silo-like fashion. But as we now know, and as I think some observers were suggesting some years ago, much risk is developed in markets because of the actual or potential interactions among market actors. I think we saw recently, for example, that firms have strategies which entail reliance upon being able to sell assets in a particular moment. And it works just fine up until the moment where everybody wants to sell those same assets.

So we also are going to need devices like central counterparties and more transparency and a greater sense of the interactions among market actors to supplement what I will just say I believe to be the need for more rigorous institution-specific regulation.

Senator SHELBY. You have testified before the Committee before on Basel II and your concerns, and we have had those concerns, too. What is your view on the adequacy of capital levels of U.S. banks? We know it is inadequate. That is what our problem is today.

Mr. TARULLO. Correct.

Senator SHELBY. And for a number of years, the trend was going the other way, as you know. The trend has got to come back to strong banks, strong capitalized banks. And what will be your role as a member of the Board of Governors of the Fed and also as a Central Bank member, and also a bank regulator there?

Mr. TARULLO. Well Senator, first I would hope to contribute to the role of navigating through the current crisis. And obviously that requires a substantial amount of oversight on the financial institutions in question. As you say, at present my strong suspicion is that the capital levels in many institutions are not where we would want them to be. And under present circumstances, they are

going to have substantial difficulty raising capital from the normal sources from which they would otherwise seek to obtain it.

Going forward though—I think you were alluding to this a moment ago—I think collectively, by which I mean the administration, the independent regulators, this Committee, and the rest of the Congress are going to need to reshape a financial regulatory system in a way that is adequate to not just the risks we have seen in the last 18 months. Because as you know, Senator, so often we respond to a crisis by making sure that that crisis does not happen again. Well, that particular crisis not going to happen again.

The key is to put in place systems that both monitor and identify potential new sources of stress, and that have the wherewithal to contain it. And that, I think, is our collective task for—my own personal hope—

Senator SHELBY. Our challenge?

Mr. TARULLO. —2009.

Senator SHELBY. You cannot let the market run ahead of you, can they?

Mr. TARULLO. The market is going to be—

Senator SHELBY. As a regulator that would put risk and stress in it?

Mr. TARULLO. That is right, Senator. The market is always going to be innovating.

Senator SHELBY. Oh yes, and we want it to be innovating.

Mr. TARULLO. And we want it to be innovating, but we need to have at least three things in place. One, the capital buffer to which I alluded.

Senator SHELBY. Absolutely.

Mr. TARULLO. Two, an assurance that the risk management systems of these institutions are sound. And I think another thing we have learned is that risk management within financial institutions fell well short.

And third, as I said a moment ago, the capacity to respond to and contain risks as we see them bubbling up.

Senator SHELBY. Dr. Goolsbee I have one last question, Mr. Chairman, and then a short statement.

Dr. Goolsbee, you have cautioned in the past that any efforts to reregulate the mortgage market should not limit innovation. You just alluded to that and I agree with you.

For instance, you have argued—and these are your words—“The historical evidence suggests that cracking down on new mortgages may hit exactly the wrong people.”

You have also stated, and I quote again your words, “Almost every new form of mortgage lending, from adjustable rate mortgages to home equity lines of credit to no money down mortgages, has tended to expand the pool of people who qualify” in this country.

Dr. Goolsbee, moving forward, what restrictions, if any, do you believe this Committee should place on the types of mortgage products offered? Or should it be our role to place that? It should be on the regulator or what? I know we will do harm. Every time you are doing good you can do some harm, too. What do you believe in this area?

Mr. GOOLSBEE. Senator, thank you for bringing that up. Let me observe one thing about the quotes that you mentioned.

That was from an article. I wrote a column, an economics column, for *The New York Times*, which was not an opinion column. It was my writing about other people's research.

Senator SHELBY. But it was your words though, was it not?

Mr. GOOLSBEE. They were my words, writing about the research of a Republican economist—

Senator SHELBY. You are not repudiating that, are you?

Mr. GOOLSBEE. —Harvey Rosen. I am not repudiating that I wrote it, but it was about the implications of the work of economists that had done research on this 1970 to 2001 period.

Senator SHELBY. I just want to put it in the proper context.

Mr. GOOLSBEE. So that is the proper context, that I was not trying in that to give my own opinion.

Senator SHELBY. OK.

Mr. GOOLSBEE. The thing that changed, and I have talked with Professor Rosen about his study and what the lessons were going forward past that, in the mid-2000s, which are outside the data in the Willen-Rosen paper, they threw all pretense of prudence to the wind. In many cases, there were mortgage brokers, there were people outside the regulatory apparatus that were committing even illegal activities.

Senator SHELBY. What about the—

Mr. GOOLSBEE. I think for this Committee—

Senator SHELBY. What about the investment bankers?

Mr. GOOLSBEE. And the investment bankers are not excluded for that, absolutely right.

Senator SHELBY. And what about Fannie Mae and Freddie Mac?

Mr. GOOLSBEE. Look, they are, as Professor Tarullo and as you indicated, Senator, there is a lot of blame to go around.

What I would say for this Committee, one principle that is worth bearing in mind is that through the 2000s, our disjointed regulatory oversight apparatus allowed for regulatory arbitrage. So if you look at subprime lending, two-thirds of the subprime lending was done by non-banks. So even if the Fed, for example, had put in completely reasonable rules on what our sensible—what would sensible lending origination standards be, that would not have applied in most cases to most of the subprime lending.

I think one thing this Committee might consider, respectfully, would be thinking about this issue of regulatory arbitrage and trying to bring some rationalization of that across sectors.

Senator SHELBY. We have got to make the system work.

One last observation, I thank you for your ability and willingness to serve, all four of you, and your patience here today. We wish you well. I plan to support your nominations.

Mr. GOOLSBEE. I appreciate that.

Senator SHELBY. Do markets work, people say. Yes, I believe they do work. They nearly always work. But you have to have—and you alluded to this. But you have to have trust, integrity, and transparency in the market. And I believe that trust is absent today. And that is our challenge, how do we bring it back together, is it not?

Mr. GOOLSBEE. It is.

Senator SHELBY. Thank you, Mr. Chairman.

Senator REED [presiding]. Thank you very much, Senator Shelby. And thank you all, not only for your very thoughtful responses, but also for your willingness to serve the Nation at a very difficult time.

Dr. Romer, I was listening very carefully to a very interesting discussion about deficits and taxes that you had with Senator Shelby. I recall 8 years ago at this time, when we had a significant surplus in the Federal Government after the Clinton Administration, some of which was the result of difficult tax votes to increase taxes.

And then we had a proposal by the Bush Administration to dramatically lower taxes. The two justifications I heard most frequently were, first of all, they pay for themselves. You just cut taxes and economic activity grows so much. Apparently, over the longer run, that does not seem to work.

Or they, as you have done some studies, they starve the beast. It forces us, the legislature and the administration, frankly, to be much more restrained in spending.

But you did a study with your husband, and I will quote from the abstract, "The results provide no support for the hypothesis that tax cuts restrain Government spending. Indeed, they suggest that cuts may actually increase spending. The results also indicate that the main effect of tax cuts on the budget is to induce subsequent legislative tax increases."

I presume that is accurate, because those are your words?

Ms. ROMER. That is the correct summary of the paper.

Senator REED. And I think one point that could be made, which I think was the thrust of Senator Shelby's comments, that we are in a much weaker position now because of the policies of the last 8 years which have seen deficits pile up upon deficits, some of which is a direct result of tax cuts and spending on the war, failing to pay for that spending. And I can go on and on.

Is that accurate?

Ms. ROMER. Absolutely, and I think a crucial—if you say what is prudent fiscal policy? You run surpluses in good times. That is what gives you the buffer that when you hit a period like this you can run the large deficits that are the appropriate policy when the economy is this sick. So no, I—

Senator REED. Well, certainly before 9/11, which was an event of monumental consequence, the apparent policy of the Bush Administration was to at least cut taxes at a time where it was not quite clear you could maintain the surplus. And that is exactly what happened.

Ms. ROMER. That is correct.

Another thing, since Senator Shelby mentioned my other paper, I think it is important to get on the record that while we find that tax increases taken for sort of exogenous philosophical reasons tend to have negative consequences, we also find if you look at the subset of tax changes explicitly for deficit reduction, kind of getting your fiscal house in order, those actually—the standard errors are big, we are not very sure. But the point estimates certainly say those kind of tax increases can actually be beneficial.

So thinking about the Clinton Administration experience, that sometimes getting your fiscal house in order can improve confidence, can lower long-term interest rates, and can be beneficial.

Senator REED. You seem to be implying that sometimes short-run pain has long-run gain, and short-term gain or tax cuts has long, long-run pain.

Ms. ROMER. That certainly is a—

Senator REED. The other aspect of the tax issue, I think, is it is not so much cutting taxes because that has a certain—in terms of the economy—an overall number. It is who gets the benefits. One of the things, again, I think the discussion that Senator Shelby had was very interesting about well, why don't we cut payroll taxes? It will benefit working Americans. In fact, you could have a cutoff.

I thought a year ago, when the President proposed his tax rebate across the board, that would have been an appropriate way to respond. That was apparently rejected by the Administration.

But the point is, I think, and I think Senator Obama is trying to make this point, that if we can target tax benefits to low and middle-income Americans, those benefits will not only, I think, sort of even the playing field in the struggle, the race of life as Lincoln said, but also provide more stimulus to the economy. Is that accurate?

Ms. ROMER. Yes, and certainly the President-elect has made it very clear that he wants to cut taxes on 95 percent of Americans. That is certainly in the stimulus package. It is a credit for working Americans.

And so yes, we certainly expect that people that are struggling to make month-to-month payments, you give them a tax cut, you lower their withholding, they do go out and spend it. And that would be incredibly beneficial to the economy at this point.

Senator REED. Let me raise a general question I would like to address to all three of the nominees to the Council of Economic Advisors. Let me start with Dr. Goolsbee and then Dr. Rouse, and then come back to you. Give you a breather, Dr. Romer.

One of the issues that we have to respond to is the fact that for the vast majority of Americans over the last decade or more, they have virtually no increase in their income. Now we have seen tremendous increases in income at the upper levels, historically unprecedented increases. But we have seen no growth in the middle class and working Americans, broader than that.

I think the challenge is that we have got to restore that type of growth. I mean, it was there in the late 1990s, for a combination of reasons: Federal Reserve policy, our fiscal policy, the benefits of the huge technological revolution in computerization, and all of these things, and not one cause. But we saw that.

We have to get back there. And the general question is how do we get back there, where we can confidently tell the American people that if you work hard you can expect a growth in your wages and your income—not if you are at the very top but in every income level we hope, but at least lower and middle-income Americans.

And one other comment. The flip side of that, and this is the reality we all understand, is if your income is not going up but your level of life has to be maintained, you go to the credit cards. And

we have become a huge debtor Nation. So the flip side of this, not just in terms of our international obligations, but in terms of households, household debt has accelerated dramatically.

So this is two sides of one coin. How do you increase income so people can consumer from income rather than credit cards? How do you increase income to give them the confidence that this country is going to provide opportunities, as it has in the past? Dr. Goolsbee.

Mr. GOOLSBEE. Senator, I do not think there is a more important question to put to the economy than that for our long run. We obviously have to deal with the immediate crisis.

Senator REED. I agree.

Mr. GOOLSBEE. But once we are through that, I believe that the issues you raise are the No. 1 thing, that it is a fundamentally different America where the median family's income is falling by almost \$2,000 over the course of a boom, as it did in the boom that just ended. That was the first time in recorded American history where that ever happened. And that is fundamentally not the America that any of us grew up in and it is not what we believe the country should be.

In the short run, I think tax relief to working Americans and the middle class is a direct form of help. In the medium and long run—and I am sure Professor Rouse is going to have more input on that—investing in the skills of our own workforce, investing in the industries of the future, and investing in our own Nation's capabilities, be they the infrastructure and the things that lay the groundwork for future growth, there has to be an element of all of those things to restore his rising tide that lifts all boats.

Senator REED. Dr. Rouse.

Ms. ROUSE. Thank you very much. I do agree that one of the ways that we want to really try to shore up the middle class is to— one, we really need to understand what are the forces that have been at work that have led to the stagnation in income. But one of them that we can see immediately is the increased globalization and the fact that our workers are competing against workers all over the world.

And I think that really points to the very importance of our education system, our training system. We need to really look hard at it to understand the ways in which it can be adapted and made more nimble so that it also can train our workers to be competing in this new economy.

I would also say that I think another big component is dealing with health care, which is a big budget item for many families and puts many of them at risk for bankruptcy and makes them economically fragile.

Senator REED. Dr. Romer.

Ms. ROMER. I mainly want to say—I think my two colleagues have spoken very eloquently.

The one thing I would add as a little bit of a statement of what is so fabulous about the American recovery and reinvestment plan that is out there is that it is very much aimed at being something that gets us through the hard times now, but is doing exactly these investments. It has a lot of money for infrastructure that will make our industries more profitable and should make wages go up. It has

money for education and 21st century classrooms, which is just going to be crucial for going forward.

So I think one of the things that is so important is if we have to spend all of this money to get the economy going again, let's make sure we get the crucial long-run dividends like rising incomes for those people who have stagnated for the last 8 years.

Senator REED. I have one question, and I am not ignoring you. I have got some Federal Reserve questions. Just take a rest in place, I guess.

I have one more question. We have talked about targeting tax benefits to those who need it. We have talked about getting the resources, the direct spending, to places that need it. This has geographic consequences. My State of Rhode Island has the second highest unemployment rate in the Nation, just behind Michigan. It is suffering grievously.

I would hope that in the advice you are giving to the President about not just this round of assistance but going forward, that there would be a special attention to those parts of the country that are really under extreme duress and have limited resources to be able to cope with this problem. And I just—

Ms. ROMER. No, I mean, absolutely. One of the roles that I took on when I started trying to help the transition was exactly to monitor situations and notice which States are suffering more than others, what industries are suffering more than others. And that has played a big role in kind of thinking about what we want in parts of this package.

And so as you know, for a State that is important in manufacturing, one of the things that is good about the stimulus package is that it is going to create a lot of jobs in manufacturing. It is going to create a lot of jobs in construction.

And then I think the other thing to point out is things like State fiscal relief. That is going to be, I think, something very important for helping so many of the States that are genuinely suffering.

Senator REED. Dr. Goolsbee, any comments?

Mr. GOOLSBEE. Look, I agree with that. And Senator, your admonishment, let's pay attention to where people are really hurting, we have got to remember that. I mean, there are wide swaths of the country where they are already in the thing that we are warning everybody about. We do not need to warn them. They have already been living it for several months or, in some cases, even up to a year.

Rhode Island is similar to Illinois in that way. My own home State has been really hard hit by this downturn. And I hope we keep that foremost in our mind when we are designing these policies.

Senator REED. Thank you.

Dr. Rouse, any comments?

Ms. ROUSE. Not really. I think that is absolutely—I think we not only have to pay attention to the average, but we have to look at the distributional consequences and the distributional suffering, geographically, by demographic characteristics, *et cetera*. But I think that is all very important.

Senator REED. Thank you very much.



Now, Mr. Tarullo, I thought Senator Shelby made some excellent comments about the need for introspection by every Federal regulator, every State regulator also, and not just as an intellectual exercise but to have going forward a clear sense of what went wrong and how we are going to fix it.

As I mentioned to you in my discussions, at a hearing months ago I raised this issue with Governor Kohn of the Federal Reserve. I would hope that when you go to the Federal Reserve, that you would quickly ensure that this appropriate self-analysis is going forward.

And then at some point it is going to have to be public. I think the best way to do that is to have the Federal Reserve come up here with their version of lessons learned and corrective action. Your thoughts on that?

Mr. TARULLO. Senator, as you know, from my earlier response to Senator Shelby and from our conversation, I absolutely agree with the need to begin with an understanding of what went wrong. Not, as I say, because we think that an additional or a new crisis is going to unfold in the same way. It never does. But because I have been concerned that the regulatory shortcomings that allowed the circumstances that have existed over the last few years to develop might similarly allow future risky circumstances to develop.

So I could not agree more. My only concern—and this is not directed toward you. My only concern is to make sure that this is done not just at the Fed but throughout the Government, not in the spirit of trying to assign or avoid blame, but in an effort to figure out what it is that needs to be done going forward. Because, as I know you agree, that is the shared task which is critical.

Senator REED. I absolutely concur. That is why my sense is that it would be better for the Federal Reserve to come to make this presentation on their term rather than try to coax it out of them or somebody else. I think that would be very helpful.

And it is not about assigning blame. It is about avoiding problems in the future and ensuring that we have taken the right steps going forward. That is, at least, my view.

You are an expert on Federal regulation, banking regulation, and to a degree the Federal Reserve from your academic position. Recently, there has been a change in a policy toward ownership of bank holding—participation in the ownership of bank holding companies by private equity companies. GMAC has been given bank holding company status. Their private equity owner had to adopt a minority position, but still a significant position.

Do you have any concerns given the kind of wide ranging and generally undisclosed nature of the activity of the private equity companies? They may not own more than 25 percent, but with a 10 or 15 or significant percentage interest, could have influence on the company. Do you think the Federal Reserve, from your perspective now as an academic expert, has the ability to monitor those activities? Is this something that introduces another degree of perhaps problems?

Mr. TARULLO. Senator, my—the inference I have drawn here is that with sources of capital for financial institutions obviously not what they used to be, that there has been renewed interest on the types of issues that have been talked about for some years now—

the conditions under which minority investments could be made in financial institutions without triggering all of the regulatory consequences that have normally attended such an acquisition. That is obviously an important consideration not just today but going forward.

Having said that, I think the monitoring and regulatory question you raised is the salient one. That is, if there is an expectation that a certain kind of investment will be made in what in investment terms we refer to as a passive fashion, then the terms of that regulation need to be carefully monitored and enforced. And I do think that if and when people get to the point of proposing things which would fundamentally alter the separation between banking and commerce, that that is a judgment for the Congress to make ultimately. That was a judgment the Congress chose to—they chose to maintain that separation in 1999. And if there are to be changes which significantly affect the current statutory regime, those appropriately go through the Congress.

So while there is obviously room to modify and to allow capital infusions from a variety of sources, the monitoring issue to ensure that the investments are conducted only in the terms that have been suggested needs to be carried through. And all regulators need to be attendant to Congressional intent as embodied in our existing statutes.

Senator REED. Thank you.

One just final thought, and again you have described the situation, I think, the present situation which is there was, for the longest time, a reluctance to get into this issue of sovereign wealth fund investments, private equity investments and bank holding companies because the standards were pretty strict. Once you went over—it was a 25 percent ownership or—I mean, I think—

Mr. TARULLO. That would be definite control, but well under that could be control.

Senator REED. Control. There was pretty tough standards about who was controlling the company. I think the presumption was, for these entities in particular, that anything more than a modest investment and a very passive investment was controlling and they stayed out of it.

Now we are desperate for capital and desperate people do desperate things. I think this is something that when you go on to the Board, you have to ensure—and your colleagues—that there is a kind of policing of these arrangements, as you suggested. And also, it is not so much just the commerce and banking combination. It is information which a significant shareholder might have which could be very relevant to the marketplace. I think that has to be—the Fed has to be interested also. And influences that can be brought to bear not to make decisions—and this is in the context of sovereign wealth funds—to make decisions that otherwise might not have been made.

And some of that it is so complicated, some of it might be the management anticipating a bad reaction from their shareholder so avoiding action because of that.

I do not envy your task, but I think this is something serious. And long before it raises to such a bright level issue that Congress

is going to have to step in, you and your colleagues will have to face it, is my sense.

Mr. TARULLO. Understood.

Senator REED. I think that on behalf of Senator Dodd I can thank you all profusely for your responses and, as I said initially, for your commitment to public service.

Thank you very much and the hearing is adjourned.

[Whereupon, at 2:20 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

**PREPARED STATEMENT OF SENATOR TIM JOHNSON**

Thank you, Chairman Dodd for holding the hearing for today's nominees. All of us here today are very concerned about the current state of the economy, especially as our Nation continues to confront a crisis in the capital markets. This crisis has had negative consequences for American families, workers, businesses and investors. Today's nominees will all play an important role in our Nation's economic recovery, and I congratulate you all on your nominations.

While this Committee has a lot on its plate this year, I do believe that the confirmations of a new Chairman of the SEC, a new member of the Federal Reserve Board of Governors and three members of the President's Council of Economic Advisors may among some of the most important actions we take.

The next Chairman of the SEC faces the daunting task of restoring confidence, integrity and fairness to our securities markets, as well as enforcing securities laws and protecting investors. Achieving these goals may mean serious reform at the SEC. I look forward to hearing Ms. Shapiro's vision for this critical position.

The effects of the current crisis have been felt far beyond Wall Street and the SEC, and we will be looking to all of you for advice.

**PREPARED STATEMENT OF SENATOR JON TESTER**

Chairman Dodd, Ranking Member Shelby, thank you for convening today's hearing. And I want to thank the witnesses for appearing here today and for their agreement to serve their country.

Ms. Schapiro, you are seeking one of the most important positions in the Federal Government at a time of economic uncertainty. Very simply—you have a tremendously difficult but important job to do as it is my opinion that the most recent financial regulators have not been steadfast in their duties.

Over the course of the past few months, it seemed that a different titan in the financial sector was facing imminent collapse each week. This Committee was being asked to support a bailout and the regulators were left with questions and few answers. That has to change and this Committee is going to need your help.

We need to work with the SEC and the other financial regulators to put in place common sense regulations—regulations that protect the consumer first. As we start tackling legislative initiatives to revamp the patchwork of regulations, your guidance will be critical.

At the same time, you will need to increase the level performance of the enforcement division at the Commission.

Last October, former Chairman of the SEC, Arthur Levitt told the Senate Banking Committee in written testimony,

Enforcement is so important not because the SEC can catch every cheat and prevent every abuse. It's important because it holds people accountable and serves as a powerful deterrent to bad behavior—and is the most powerful tool a regulator has to keep a market functioning. Indeed, the signals the SEC can send to investors are critical. By bringing a tough enforcement action, making a well-timed public statement, or taking action on a critical need, the SEC builds the investors' confidence that someone is looking out for them which, in turn, builds market trust. Yet at critical moments and on critical issues, the SEC has been reactive at best or has shown no real willingness to stand up for investors.

Thousands of Montanans have told me over these past few months that we need to find the criminals who brought us into this situation and send them to their 8x10 cells. They demand accountability to make sure no crime goes unpunished when American taxpayers are picking up the tabs for their crimes. I agree with them, and I want the SEC to make sure those investigations are a priority.

I look forward to your testimony. Thank you.

**PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI**

In the past several months, Americans have seen unprecedented developments in the financial and housing markets. Beginning with the rise in home foreclosures and delinquencies that caused a panic in our mortgage industry, by September 2008, the Federal Government had seized Freddie Mac and Fannie Mae. The five largest investment banks, previously the primary entities regulated by the SEC, were either being sold, restructured, or going bankrupt. Our economy started falling faster, and the credit markets became completely frozen.

Our Federal response so far has been to throw money at the problem and hope it goes away. However, some of my colleagues and I realize that it takes more than blind spending to get our economy back on track. We need to take an honest assessment of our current financial regulatory system and address the fundamental problems that have caused this meltdown. Efficient and responsive market regulation is the best answer to a crisis of confidence. Common-sense reforms combined with pro-growth economic policies will get our economy humming again. However, it is going to take a lot of work to get there.

Before we talk about a sweeping financial modernization, I must note that, for many Americans, this global financial crisis has exacted a very real and very personal price. Many workers have seen a lifetime of retirement earnings shrink down to nothing. Others have lost their home, their most stable financial asset in past years, due to rising unemployment and a frozen credit market. For those Americans without a job, they face dismal employment prospects as companies cut their workforces to stay in the black.

These Americans expected a market that was transparent, accountable, and fair to the average retail investor. They have been failed by investment fraudsters, deceptive credit ratings, misleading lenders, and, most importantly, by the regulators who are tasked with preventing such behavior. The SEC is not solely responsible for policing the entire financial market, but as the agency charged with investor protection, we must be able to look to the SEC to prevent outright fraud and manipulation of American investors. The SEC has been front and center in the debate about our financial crisis, and that is why this nomination hearing is so important. We stand on the brink of a financial sea-change. Our organic system of financial regulation has been built-up over a century, responding to individual crises with targeted changes to regulation. However, the institutionalization of this patchwork quilt of regulation has made our system slow to respond and confusing to navigate. We must create a system that is proactive, not reactive. Regulators should have the surety to act swiftly and prevent fraud and manipulation in our markets. Participants should not have to operate in a regulatory "grey areas" or worry that market innovation will be stifled by cumbersome regulation.

The SEC is on the front lines of this movement, and Ms. Schapiro, if confirmed, will be charged with implementing these reforms. This is no easy challenge. There are several issues the SEC must confront in order to be the regulator our markets need in the 21st century.

First, a primary role of the SEC is investor protection. Last month, the confidence of American investors was badly shaken with the revelation that Bernie Madoff, former Chairman of the NASDAQ stock exchange, was running a \$50 billion investment fraud scheme. According to a statement from Chairman Cox last month, this scam is at least a decade old, owing its success to "multiple failures" at the SEC and elsewhere to catch this crook. More amazingly, news reports are stating that many investors on Wall Street knew about this scheme and may have invested with him *because* he was cheating the system to gain illicit returns. This is outrageous.

As President-elect Obama's designee for chairman of the SEC, I am curious to hear your reaction to this scandal and how, as chairman, you plan to ensure it will never happen again. I am also curious to hear about your experience as a regulator both with the NASD and with the Financial Industry Regulatory Authority. Why did FINRA, under your management, miss this investment scam when so many on Wall Street seemed to know about it?

I am also interested in hearing your opinions about the credit rating agency registration system at the SEC, and if you believe the conflicts of interest inherent in credit rating agencies can be properly managed.

Ms. Schapiro, I would like to hear your opinions about several initiatives already underway at the SEC. These include mark-to-market accounting, credit derivative swaps, and the convergence of U.S. and international account standards. I look forward to your testimony and the question and answer period.

I also look forward to the testimony of our second panel of witnesses, especially Mr. Tarullo. There is no doubt that the role of the Federal Reserve as a financial regulator will be addressed in the coming months, and I am interested in understanding Mr. Tarullo's perspective on the future of the FED as the agency in charge of U.S. monetary policy and interest rates, as well as a regulator of banks and other financial institutions.

Chairman Dodd and Ranking Member Shelby have made clear that regulatory modernization will be a priority in the 111th Congress and I look forward to joining them in this important debate. Thank you.

**PREPARED STATEMENT OF MARY SCHAPIRO**

CHAIRMAN-DESIGNATE,  
SECURITIES AND EXCHANGE COMMISSION

JANUARY 15, 2009

Mr. Chairman, Senator Shelby, and Members of the Committee—it is an honor to appear before you today as President-elect Obama’s nominee to serve as Chairman of the Securities and Exchange Commission.

I also want to thank Senator Reed for his very kind introduction, and all the members of the Committee and your staff who have been so generous with their time and advice during this confirmation process.

As Senator Reed mentioned, I grew up in New York a short train ride from Manhattan, but miles away from Wall Street. My father was a printer; my mother a librarian.

Like millions of families, my parents worked hard to save enough to buy a home, send their children to college, and have a secure retirement. They taught my siblings and me right from wrong—and that we could get ahead by working hard and playing by the rules.

Perhaps that’s why I’ve spent my career—at the SEC, CFTC, and most recently at FINRA—committed to building a financial regulatory system that protects investors and supports and strengthens free and fair markets.

We cannot underestimate the situation we are now in: the capital markets have collapsed; trillions of dollars of wealth have been lost; our economy is in recession; and investor confidence has been badly shaken. Middle-class families who were relying on that nest egg to pay to send a son or daughter to college or for a secure retirement now, don’t know where to turn.

There are many reasons for this crisis—and one of them is that our regulatory system has not kept pace with the markets and the needs of investors.

It is precisely during times like these that we need an SEC that is the investor’s advocate—that has the staff, the will and the resources necessary to move with great urgency to bring transparency and accountability to all corners of the marketplace, to vigorously prosecute those who have broken the law and cheated investors, and to modernize our country’s regulatory system to match the realities of today’s global, interdependent markets.

These urgent responsibilities would fill any agenda, but, Mr. Chairman, allow me to highlight a few of my top priorities.

First and foremost, if confirmed as Chairman, I will move aggressively to reinvigorate enforcement at the SEC. With investor confidence shaken, it is imperative that the SEC be given the resources and the support it needs to investigate and go after those who cut corners, cheat investors, and break the law. As the first SEC Chairman, Joseph Kennedy, told the Nation 75 years ago in explaining the agency’s role, “The Commission will make war without quarter on any who sell securities by fraud or misrepresentation.”<sup>1</sup>

I look forward to working closely with you, Mr. Chairman, and the members of the Committee to ensure the SEC has the capability, to fulfill this critical mission—as well as to perform all of its other important duties.

Second, I want to re-engage the SEC with the people we serve, namely, investors. The investor community—from the largest pension fund to the family who has scrimped and saved in their 401(k) or 529 plan—needs to feel that they have someone on their side, that they can go to the SEC for advice, to seek redress, or to have their opinions heard.

Third, as I work to deepen the SEC’s commitment to investor protection, transparency, accountability, and disclosure, I also want to ensure these commitments are preserved in any regulatory overhaul that may be undertaken.

Indeed, as a member of the President’s Working Group on the Financial Markets, I hope I can offer its members, the Administration, and Congress both the benefits of my years as a regulator as well as the decades of experience the professionals at the SEC have in these areas.

The American people want and expect us to update the regulatory system that has failed them—and to prevent the kinds of abuses that have contributed to the economic crisis we now face. I assure you that I will always keep their concerns front and center.

Seventy-five years after the SEC was founded, the Commission finds itself in a situation where, once again, it must play a critical role in reviving our markets, bolstering investor confidence, and rejuvenating our economy.

<sup>1</sup>Remarks to the National Press Club, 25 July 1934.

I am under no illusion that this will be an easy job. There is a lot of work to be done—quickly and diligently—in the months ahead. But I look forward to this challenge, to helping the millions of investors who rely on strong markets and a strong economy, and to working with the professionals at the SEC and the Members of this Committee.

To be entrusted with leading the SEC at this moment, would be a great honor, and I am grateful for your consideration.

Mr. Chairman, before closing I want to thank my husband, Chas, and our daughters Molly and Anna, for their support and understanding. They are here with me today.

Thank you, Mr. Chairman, and I am happy to answer any questions.

### PREPARED STATEMENT OF CHRISTINA D. ROMER

CHAIRMAN-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS

JANUARY 15, 2009

Chairman Dodd, Ranking Member Shelby, and members of the Committee, it is an honor to come before you as President-elect Obama's nominee for Chair of the Council of Economic Advisers.

I want to thank Senators Feinstein and Boxer of California for their warm introductions. I am truly honored to have both of my home state Senators with us today and appreciate their kind words.

Before I begin, I would like to introduce three people who are with me today: my husband of 25 years, David Romer, who is also an economist, my father, Clifford Duckworth, from Massachusetts, and my 12-year-old son, Matthew. My two other children, Katie and Paul, are away at school and are not able to join us today.

Let me take a moment to tell you a little about myself. I was born in Illinois and lived in Connecticut, Ohio, Alabama, and New Jersey as I was growing up. I attended the College of William and Mary in Virginia and received my Ph.D. in economics from the Massachusetts Institute of Technology. I was an assistant professor at Princeton University for 3 years before moving to the University of California, Berkeley. I have been a professor at Berkeley for almost exactly twenty years, and have had the honor of teaching introductory economics to thousands of Berkeley freshmen.

As we are all far too aware, economic conditions in the United States, and indeed in much of the world, are weak and deteriorating rapidly. The unemployment rate announced last Friday was 7.2 percent, more than 2 percentage points above its level at the start of this recession. Job loss has now topped two and a half million and shows no evidence of stopping. And, our financial institutions remain in a precarious position and crucial credit flows have not been restored, despite unprecedented actions by the Congress, the Treasury, and the Federal Reserve.

As you may know, my area of expertise is the history and effects of monetary and fiscal policy. I have also done extensive work on the causes of the Great Depression of the 1930s and the sources of recovery from that national crisis. I never expected my knowledge of the 1930s to be useful in a modern policy setting. And, certainly, as bad as current conditions are, they remain far better than what our parents and grandparents experienced 75 years ago. But, the U.S. economy over the past year has suffered the worst macroeconomic shock since the 1930s, and the risks to the economy are by far the greatest they have ever been in my lifetime. The possibility that continued economic decline will further weaken the financial sector and lead to a devastating rise in joblessness is a risk that demands immediate and unprecedented action.

It is for this reason that, if confirmed, I am dedicated to working with President-elect Obama and Congress to forge an economic recovery plan to help stabilize the U.S. economy. Making crucial investments in infrastructure, education, healthcare, and energy, will not only help us through the current crisis, but also put us on a path to a much better future—a future in which we deal with our long-run energy needs, equip our children to compete in the world economy, and ensure that middle-class families once again realize the full promise of the American dream.

The vision of hope that the President-elect has given the American people is one that I share. The resilience of the American people and the fundamental strength of the market system are the most important reasons for optimism. But I also believe that well designed, aggressive government policies will make a crucial difference. Indeed, much of my academic research has shown exactly this: government policies to increase aggregate demand do indeed increase output and reduce unem-

ployment in the short and medium run. And, while I have not personally done research on the effects of government spending, I firmly believe that the evidence shows that timely government investment will be very beneficial.

Of course, getting through the current crisis and putting us on the road to better long-run growth will not be the end of the economic agenda. Much more work will need to be done in a wide range of areas, from health care to energy to financial market reform. And, all of this work will have to take place in the context of medium- and long-run budget projections in which government revenues and expenditures are painfully out of balance. Dealing with all of these issues will be difficult and will require extensive analysis and hard choices. But, I can think of no greater honor than to be a part of such an important endeavor, and I can think of no President whose leadership and judgment I would trust more than the President-elect.

In closing, let me say just a word about the organization I have been nominated to lead. The Council of Economic Advisers was created to provide the President, and through its reports, the Congress, with the best advice professional economists have to offer. It is an institution with a proud history of providing honest, first-rate economic analysis. This is a tradition I would intend to continue and strengthen. As someone who has spent my entire professional life as a scholar and teacher, I am a firm believer in the power of knowledge and research. I would do my utmost to protect the integrity of the CEA, and make it a center for unbiased, scientific analysis of the crucial economic issues facing our country in the years ahead.

Thank you. I would be happy to answer any questions you might have.

#### PREPARED STATEMENT OF AUSTAN D. GOOLSBEE

MEMBER-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS

JANUARY 15, 2009

Let me start by thanking my senior Senator for his kind introduction. And what a thrill and how appropriate that Senator Durbin himself got his start in politics working for the late Senator Paul Douglas—a legendary figure in Illinois politics but also originally a famous economics professor from the University of Chicago (for those economists here today, none other than the namesake of the Cobb-Douglas production function).

Chairman Dodd, Senator Shelby, Members of the Committee, thank you for your time and the chance to be here today.

Before I begin, I would like to introduce you to my family. My wife Robin—the love of my life and, as you can see for yourself, prettiest girl in Chicago—is here with our three kids. Our daughter Aden is 8, our son Addison is 5, and our son Emmett is 2. Emmett is a lot more interested in trucks than he is in economics so he may not sit still in that seat for too much longer. Next to them there is my mom, Linda, and my dad, Arthur, who came up for this hearing all the way from Abilene, Texas. My Dad recently got ordained as a Deacon at the Church of the Heavenly Rest in Abilene and I especially appreciate his being able to take time out from his new duties to be here.

By way of background, I was born in Waco, Texas, and spent most of my childhood in Whittier, California. I went to school at Yale and then M.I.T. before becoming a professor in 1995 at the Business School at the University of Chicago (recently named the Booth School of Business). I am currently the Robert P. Gwinn Professor of Economics and the co-director of the Initiative on Global Markets.

As a researcher, I am an empirical economist—one of the old-style data dogs. My research has covered public policy and taxation, the Internet, telecom and innovation, capital investment, and the study of industries in America and the world like manufacturing, airlines, media, computers, and others.

Now given the expertise of the Members of this Committee and the situation Professor Romer just described, I don't think that anyone here needs further convincing that we arrive at a time of great moment in the Nation's history and one as intimidating as any since the Depression.

But at a moment like this I cannot help but remember my old friend and mentor, the late Nobel laureate and former CEA member James Tobin. When I was a freshman I took the last class of Jim Tobin's career and he took me under his wing as a research assistant. He had grown up in the Great Depression and always believed that economics was more than just an interesting field of study, that it could make the world a better place. In 1961, President Kennedy asked him to join the Council of Economic Advisers. He used to say that he never worked harder in his life than



those years at the CEA. He was proud to have served the country and given sound economic advice.

I think it's appropriate to remember Tobin these days because he spent his life teaching his students that economics could be used to fight catastrophes just like this. And as I sit before you now—almost a half-century later—as the nominee for Tobin's old seat at the CEA, it is my sincere hope that we will live up to the standard the CEA set back then in what most view as its Golden Age. If we are confirmed, Mr. Chairman, I can assure you that we will come to the job every day ready to work hard, to bring the best economic thinking we have, and to be motivated by the great CEA legacy that has come before us.

I thank you for the opportunity to be here and will be happy to answer any questions you might have.

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**PREPARED STATEMENT OF CECILIA E. ROUSE**

MEMBER-DESIGNATE,  
COUNCIL OF ECONOMIC ADVISORS

JANUARY 15, 2009

Mr. Chairman and distinguished Members of the Committee on Banking, Housing, and Urban Affairs: I am pleased and honored to appear before you today as a nominee to be a Member of the President's Council of Economic Advisors.

Before I begin, I'd like to introduce my family who is here today in force. First is my husband and partner in life, Ford Morrison, along with our two girls Nidal (who is 7) and Safa (who is 5). There is also our contingent from the great State of New Jersey, my parents, Carl and Lorraine Rouse, and my sister and niece, Carolyn Rouse and Skylar Schiltz-Rouse. Next to them are my cousin, Terrie Rouse who is also the CEO for Visitor Services for the Capitol Visitor Center, and my Aunts and Uncles Doris and George Haley, and Phyllis and Bill Taylor. And while she really wanted to be here, my mother-in-law, Toni Morrison, is unable to attend.

I am currently a Professor of Economics and Public Affairs at Princeton University where I have been on the faculty for the past 16 years. As a labor economist I am most committed to understanding the problems, choices, and tradeoffs that individuals face, particularly those that concern the labor market. I am particularly interested in understanding ways to increase worker productivity, primarily through the acquisition of valuable skills or human capital. As such, I have devoted much of my research to the economics of education at all levels.

As a faculty member of a public policy school, I have always been deeply committed to studying real-world problems with real-world implications, rather than abstract theory. I was fortunate to have the opportunity to apply my skills to actual policymaking once before in 1998 when I spent a year at the National Economic Council and I would be most honored to have the opportunity to do so again should I be confirmed as a member of the Council of Economic Advisors.

Indeed, these are extraordinary times. As Professor Romer has already described, the macroeconomic shock is the worst that it has been in a generation and by all expectations the unprecedented job loss will continue in the short term. Importantly, we are seeing that some sectors are suffering more than others forcing many unemployed workers to search for jobs that require a different set of skills than those they currently possess. As such, I believe that investments in education and training are critical to any strategy to help jumpstart our economy and should I be confirmed I look forward to working with the other members of the Administration and this Committee to provide the economic insights and analysis you need to craft wise and effective policy.

As a concluding note, I would like to add that for the past several years I have taught one of the main introductory micro-economics courses to first-year students in the Woodrow Wilson School's master's program. (This year's class was particularly inquisitive and challenging!) I emphasize to the students the power of economics—both theoretical and applied—in guiding analysis of policy issues. Should I be confirmed, I would bring this dedication and enthusiasm to the President's Council of Economic Advisors.

Thank you. I would be happy to answer any questions you or other Members of the Committee might have.

**PREPARED STATEMENT OF DANIEL K. TARULLO**  
MEMBER-DESIGNATE,  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
JANUARY 15, 2009

Thank you, Mr. Chairman, Senator Shelby, and other Members of the Committee. I am honored by President-elect Obama's designation of me as his intended nominee for the Board of Governors of the Federal Reserve System. I am also mindful of the enormous responsibility that would come with this position.

We are all aware that our country faces greater financial and economic challenges than at any time since the Depression. The Federal Reserve has a critical role to play in responding to these challenges. As the Nation's central bank, it must pursue its dual mandate of promoting maximum employment and stable prices in an unusually trying macroeconomic environment.

As a bank regulator, the Board must use its existing authority to provide both effective supervision and robust enforcement. Going forward, it must join with other parts of our government to help revamp the financial regulatory system. In particular, we need sensible changes that will contain potential sources of systemic risk in 21st century financial markets, and thus diminish the likelihood and severity of future financial crises.

Over the last decade, I have devoted considerable time to thinking and writing about banking regulation and international financial regulation, including the management of international financial crises. In the last few years, I have focused on capital regulation. This work has reinforced my views on the importance of adequate capital buffers for ensuring the safety and soundness of financial institutions. This study of capital has, I believe, provided a good foundation for participation in the Board's regulatory functions and, more generally, in the process for reforming financial regulation.

Prior to returning to an academic position, I was directly involved, as Assistant to the President for International Economic Policy, in responding to the international financial crisis of the late 1990s. Each financial dislocation has its own unique features, of course, and the severity of current problems far outstrips the impact on the United States of that earlier episode. Thus experience with one crisis cannot provide the answers for dealing with the present situation. Still, such experience does help prepare one to consider options and make decisions in times of great uncertainty and stress.

If confirmed by the Senate, I will draw upon both my government and academic backgrounds in serving on the Board of Governors. I have the highest respect for the tradition of independence associated with our country's central bank. At the same time, I understand that, although so much of the Fed's work is necessarily grounded in complex economic analyses and highly technical rules, the ultimate purpose of this work is to create the conditions under which Americans can make good lives for themselves.

Let me close by thanking the Committee for expeditiously scheduling this hearing. I hope to work with each of you in the months and years ahead. I would be pleased to answer any questions you may have for me.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD  
FROM MARY SCHAPIRO**

**Q.1.** Investment Advisers: Investment advisers serve an important role in the helping Americans improve the management their finances. I have been contacted by investment advisers from Connecticut who have expressed concerns that you would join the Commission with the intent to require investment advisers to register with a self-regulatory organization, based on statements made during your tenure at FINRA. One of their letters to me stated:

[W]e have very serious concerns with her stated support for extending FINRA's reach to become the self-regulatory organization for investment advisers. Investment advisers are already subject to strict oversight and examination by the SEC and any additional layer of bureaucracy would be redundant, inefficient and confusing to the investing public. FINRA would be an especially poor fit to regulate investment advisers because it is geared to police the brokerage industry which, as you know, is not held to the same fiduciary duty under law as are investment advisers.

If confirmed, would you approach this issue and other issues affecting investment advisers with an open mind, independent of past employment affiliations? Prior to taking any action in this area, would you invite and consider the views of interested parties?

**A.1.** I will approach this and all issues with an open mind and consult broadly on actions that the Commission might take.

**Q.2.** Financial Professionals: Investor advocates have expressed concerns that some registered representatives are marketing themselves as advisers without being subject to the same standards as investment advisers, who have a fiduciary duty to place the customer's interests first.

Do you feel that there should be increased regulatory attention to requiring registered representatives to more accurately inform their clients of the nature of the duties owed to the clients and distinguish themselves from those professionals who owe their clients a fiduciary duty?

**A.2.** Whether or not a registered representative owes a client a fiduciary duty depends upon the activities that the representative has undertaken to perform on the client's behalf. SEC rules and regulation should ensure that all investment professionals, whether broker-dealers or investment advisers, accurately inform their clients of all relevant matters, including the scope of their responsibilities, fees, and conflicts of interest.

In addition, I believe that we need to have more uniform regulation across product lines and industries to help ensure that consumers receive the same basic regulatory safeguards and protections no matter which investment product or service they purchase. Regulation of the U.S. financial industry is fragmented and inefficient. If a firm offers a security, an insurance product and a futures contract, it will be subject to disparate regulatory standards for each product imposed by different agencies. If the firm underwrites mortgages, it may be subject to little substantive regulation.

Both the SEC and Treasury have noted the rapid and continued convergence of the services provided by broker-dealers and investment advisers and the resulting regulatory confusion due to an outdated statutory regime. Most securities professionals are either "broker-dealers" or "investment advisers" under the federal securi-

ties laws. Both offer financial advice for compensation and serve as intermediaries between investors and the securities markets. However, broker-dealers are regulated under the Securities Exchange Act of 1934 and FINRA rules. Investment advisers are regulated under the Investment Advisers Act of 1940 (Advisers Act), and are not governed by any SRO.

**Q.3.** Transparency of SEC Decision-Making: I am pleased to hear your intent to reconsider the proxy access issue. I want to raise an issue about the Commission's decision-making process that arose in 1990 when its interpretation that the shareholder proposal rules allowed proxy access proposals was changed. From 1976 to 1990, the Commission had a policy of, essentially, allowing shareholder proxy access proposals. Then, staff in the Division of Corporation Finance reversed this significant policy and denied proxy access in a no-action letter decided for reasons that, as the Second Circuit Court of Appeals said in the *AFSCME v. AIG* case, "the SEC has not provided, nor has the Division ever provided." This led to new rulemaking (through which the Commission received many thousands of public comments).

If confirmed, would you have the Commission use transparent decision-making processes on issues of such significance?

**A.3.** Yes.

**Q.4.** Shareholder Proposal Rule: If confirmed, would you preserve and protect shareholders' rights to raise important issues through the shareholder proposal process consistent with the letter and spirit of Rule 14a-8?

**A.4.** Yes.

**Q.5.** NRSRO Data Disclosure: If confirmed, would you consider the potential benefits to investors and to the integrity of the markets if Nationally Recognized Statistical Ratings Organizations were required to make available to the public more of the data they have obtained from issuers in the course of formulating a credit rating on securitizations, such as bond structure, types of assets (*e.g.*, size of and geographic locations of loans), debt service coverage, loan to value statistics and services?

**A.5.** As we look at the entire area of NRSRO regulation, we will consider this option.

**Q.6.** Cooperation with State Securities Regulators: State securities regulators perform important work in protecting investors and have made key contributions to national enforcement and education efforts over the years. If confirmed, would you fully cooperate with and support the work of State securities regulators?

**A.6.** Yes.

**Q.7.** Broker Voting: The Commission has before it a rule proposal submitted by the New York Stock Exchange that would prevent brokers from voting in elections for corporate directors without receiving instructions from the beneficial owner of the shares.

New York Stock Exchange Rule 452 allows brokers to vote on certain "routine" proxy proposals if the beneficial owner has not provided voting instructions at least 10 days before a scheduled meeting. The uncontested election of directors is among the pro-

posals the NYSE has considered to be routine. Some investors have long argued that director elections are not routine. The Council of Institutional Investors has noted that some observers have said that broker votes are virtually always cast for management, and believes that the rule taints the integrity of proxy voting by effectively stuffing the ballot box for management.

In April 2005, the NYSE created a Proxy Working Group to review the exchange's regulation of proxy voting. In October 2006, the NYSE submitted for SEC approval a plan to redefine director elections as "non-routine," in effect eliminating uninstructed broker votes from director elections. The SEC staff responded to the proposal with comments. Subsequently, the NYSE board resubmitted the original proposal with an amendment to exclude board elections at investment companies (mutual funds).

If confirmed, would you seek for the Commission act on the issue of broker voting within a reasonable period of time?

**A.7.** Yes.

**Q.8.** Review of Disclosures by Public Companies involved with Securitizations: If confirmed, would you ask the Commission staff to carefully review disclosures in periodic filings of public companies that were extensively involved with securitizations, such as investment banks, during the past few years for compliance with Federal securities laws and to take any appropriate enforcement actions?

**A.8.** Yes.

**Q.9.** Public Company Disclosures: In light of the recent credit crisis and its damage to the values of investments, are there any additional public disclosures that you would recommend the Commission require public companies in the securities or banking industries, particularly those involved with securitizations, to make for the protection of investors?

**A.9.** This is an issue that we review carefully. It is essential that investors have a full assessment of the risks of the companies they own or seek to own.

**Q.10.** Accounting Restatements: The SEC has received the recommendations of the Advisory Committee on Improvements to Financial Reporting (CIFiR). A tremendous amount of work went into this analysis and some recommendations have been uniformly praised. However, others have drawn criticism for excessively limiting the circumstances under which errors in financial reports have to be restated—by making it easier to deem quantitatively large errors to be immaterial and by encouraging greater deference toward judgments by public companies and their auditors. Some retail and institutional investors are concerned that these would undermine reliability and comparability of financial disclosures, and undo improvements to accounting made in the wake of the Enron and WorldCom scandals. They argue that continued efforts should be made to reduce the number of errors, rather than reducing the number of errors that have to be restated.

If confirmed, would you seek to protect investors and preserve and enhance the integrity of the financial reports of public companies by advocating improvements in the quality of accounting, so

that the number of errors would be reduced, and by requiring appropriate accounting restatements?

**A.10.** Yes.

**Q.11.** GAAP and IFRS Accounting: Will you proceed cautiously and carefully on any proposal to allow U.S. firms to file financial reports using International Financial Reporting Standards instead of Generally Accepted Accounting Principles, particularly while significant differences exist between the two standards and in the governance, independence and funding of the standard setters?

**A.11.** Yes.

**Q.12.** Mutual Recognition: Will you proceed cautiously and carefully on proposals relating to mutual recognition, and perform extensive analysis of the comparability of regulations, resources devoted to regulation, agency independence, rule of law, commitment to investor protection and other key factors to assure the adequate protection of U.S. investors, prior to taking any action?

**A.12.** Yes.

**Q.13.** Credit Default Swaps: Broadly speaking, how would you propose that the Commission address recent problems which have occurred in the over-the-counter derivatives markets? Do you support the Commission's recently adopted rule "Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps"?

**A.13.** I think it makes sense to answer these questions in reverse order. I do support the temporary exemptions for credit default swaps. First, there is an overriding compelling need to reduce the counter party risk that attaches to any bilateral contract and is not transferred to a clearing agency for settlement. The temporary exemption does not exempt application of the federal anti-fraud rules, applies only to credit default swaps not otherwise exempt from SEC purview, applies to contracts entered into by sophisticated customers as defined in the rule and allows clearing platforms to be established without registration at this time with the Commission. Given the compelling risk of further possible systemic damage without reducing these contracts to the guarantee of performance that a clearing platform offers, I believe the temporary order is warranted. The temporary rule itself asks a series of questions that will allow the Commission to determine the future of the temporary rule and how it may better perfect its purposes.

I would direct that the Commission address recent problems in the over-the-counter derivative markets from transparency and market structure viewpoints. With estimates of \$70 billion or more in notional credit default swap contracts we have to understand who is holding these positions. Clearly many of these contracts represent a leverage risk position rather than insurance for many participants. In the listed options markets we have position and exercise limits because of the perverse market effects that transpire in their absence. We can't determine the extent of such concerns in the over-the-counter derivatives market if we don't know the holdings of various participants.

**Q.14.** NASD Merger With NYSE: *The New York Times* in an article entitled "SEC Choice is Sued Over a Merger of Regulators,"

published on January 12, 2009, reported that two lawsuits by FINRA members claim that, as Chairman and CEO of the NASD, you made misleading statements to NASD members in order to obtain support to complete a merger of the New York Stock Exchange Regulation and the NASD. The alleged misstatements reportedly were to the effect that the I.R.S. in a ruling limited the NASD from paying each member more than \$35,000.

Were the representations that you made accurate and consistent with applicable law?

**A.14.** The NASD, as is FINRA, was a Delaware non-stock corporation exempt from federal taxation under Section 501(c)(6) of the Internal Revenue Code. As such, (and under its own corporate charter) the corporation's assets cannot inure to the benefit of its members. The faulty premise of the lawsuits is the belief that the assets were the property of the members. We were working to obtain a ruling from the IRS that would allow the proposed distribution but there was not any guaranty that such a payment would be allowed. The statements made were accurate representations in the judgment of the Board and management as to the payment that could be made under applicable law.

**Q.15.** FINRA Regulatory Authority: FINRA and its predecessor, the NASD, have had broad authority to examine and investigate members and their associated persons, and perform periodic exams, pursuant to their corporate rules and bylaws as well as the Federal securities laws. Bernard L. Madoff Investment Securities LLC was founded in 1960 and the firm was registered as a broker-dealer with FINRA and its predecessor, the NASD. In 2006, this firm additionally registered as an investment advisor (there was not a separate corporation). The press reports that Madoff operated a fraudulent "Ponzi scheme" for decades from the premises of the brokerage firm, using discretionary accounts which were charged trading commissions but not advisory fees.

You indicated that "FINRA had jurisdiction over Madoff's broker-dealer activities but not over its investment advisory activities." Please identify the FINRA and NASD rules and bylaws or securities laws that, as has been indicated to the Committee, have prevented FINRA and NASD from examining for fraudulent activity such as Madoff's during the extensive period this fraud reportedly was taking place.

Also, please describe how FINRA and NASD distinguished between "broker-dealer activities" and "advisory activities" when determining what they could look at in an examination of Bernard L. Madoff Securities LLC or associated persons.

**A.15.** Section 15A of the Securities Exchange Act of 1934 establishes the statutory jurisdiction of FINRA. That section authorizes FINRA to "enforce compliance by its members and persons associated with its members, with the provisions of [the Securities Exchange Act], the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board" and FINRA rules. Under our fractured system, broker-dealers are regulated under the Securities Exchange Act and investment advisers are regulated under the Investment Advisers Act of 1940. Section 15A does not authorize FINRA to enforce compliance with the Investment Advisers

Act—even when a broker-dealer also conducts investment adviser activities. Authority to enforce the Investment Advisers Act is granted solely to the SEC and to the states.

Madoff Securities represented, and the books and records it provided to examiners showed that, but for a *de minimis* number of employees, it had no customer accounts. In its regulatory filings and examinations, the Madoff BD has consistently represented itself as a wholesale market-making firm that also conducted proprietary trading and that had counterparty relationships with other BDs, which sent order flow to the Madoff BD for execution. The Madoff BD has consistently reported that 90 percent of its revenue comes from proprietary trading and 10 percent comes from market making. There was no evidence in the Madoff firm's BD books of the BD executing trades for the IA business or of any customer account statements being issued by the BD.

**Q.16.** FINRA Enforcement Statistics: *The Wall Street Journal* published a front-page article on January 15, 2009, that describes FINRA enforcement metrics over recent years. It stated, for example, that: "Finra levied fines against financial firms totaling \$40 million in 2008, according to a *Wall Street Journal* analysis. That was the third straight annual decline in fines levied by Finra or one of its predecessor agencies, the NASD. The total was 73 percent below the \$148.5 million in fines collected in 2005, the year before Ms. Schapiro took the helm of the NASD." ["Obama's Pick to Head SEC Has Record of Being a Regulator with a Light Touch," *The Wall Street Journal*, January 15, 2009.]

Please describe the major reasons for changes in the amount of fines levied by FINRA in the years since 2005.

**A.16.** Fine levels for 2007–08 are in fact lower than the 2004–06 time frame, but are higher than the prior time period. The 2004–06 numbers were driven by a small number of high fine settlements involving the mutual fund and research analyst scandals. It is important to note that I have been responsible for the Enforcement program at NASD/FINRA since 1996, including the 2004–06 time frame that saw record high fines.

**Q.17.** Cooperation with NTEU: If confirmed, would you work cooperatively with the National Treasury Employees Union?

**A.17.** Yes.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY  
FROM MARY SCHAPIRO**

**Q.1.** In connection with the Madoff matter, FINRA has maintained that it was unable to look into the activities in question. Two May 2001 news articles discussed concerns about Madoff's money management activities and the links between those activities and its broker-dealer activities. See, Erin E. Arvedlund, "Don't Ask, Don't Tell: Bernie Madoff Is So Secretive, He Even Asks His Investors To Keep Mum," *Barron's* (May 7, 2001) and Michael Ocrant, "Madoff Tops Charts; Skeptics Ask How," *MAR/Hedge* (May 2001). Further, Madoff's 2006 Form ADV noted that the Madoff was compensated for investment advisory services through commissions. What is the specific legal constraint that would have prevented FINRA exam-



iners from looking into whether those commissions were reflected in the books of the broker-dealer or otherwise asking questions about investment advisory activities' connection with the firm's brokerage activities? Would the normal course have been for FINRA examiners to ask questions about these allegations about Madoff's firm and then refer them to the SEC if they appeared credible, but related solely to advisory activities? To your knowledge, did FINRA make any referrals to the SEC related to the Madoff firm?

**A.1.** Section 15A of the Securities Exchange Act of 1934 establishes the statutory jurisdiction of FINRA. That section authorizes FINRA to "enforce compliance by its members and persons associated with its members, with the provisions of [the Securities Exchange Act], the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board" and FINRA rules. Under our fractured system, broker-dealers are regulated under the Securities Exchange Act and investment advisers are regulated under the Investment Advisers Act of 1940. Section 15A does not authorize FINRA to enforce compliance with the Investment Advisers Act—even when a broker-dealer also conducts investment adviser activities. Authority to enforce the Investment Advisers Act is granted solely to the SEC and to the States.

Typically an investment adviser is compensated in the form of a flat fee or an asset based fee, while a broker-dealer is compensated through commissions. However, an investment adviser also could be compensated in the form of commissions. As a matter of fact, in 2005 the SEC adopted, and in 2007 repropoed, a rule that requires that any broker-dealer that exercises investment discretion over customer accounts register as an investment adviser, even if its compensation for that business comes in the form of commissions.

The fact that Madoff's advisory business was apparently compensated through commissions did not compel it to be run through a broker-dealer. In fact, in 2006 the SEC required him to register as an investment adviser even after he apparently asserted to the SEC that he was being compensated in the form of commissions. The SEC did not require Madoff to run his investment adviser business through the broker-dealer; in fact, he did not execute any of his trades for that business through the broker-dealer. The broker-dealer was a wholesale market maker and there was no reason to suspect that it was offering an advisory business as well.

We have found no records of referrals from NASD or FINRA to the SEC regarding Mr. Madoff.

**Q.2.** Given FINRA's position that the Madoff Ponzi scheme took place outside the broker-dealer, do you think that it is appropriate for SIPC to be involved in the liquidation of the firm and the processing of the claims of Madoff's victims?

**A.2.** I am not privy to SIPC's legal or investigative analysis at this time. Historically, however, I believe that SIPC has compensated victims of securities fraud when those customers have been led to believe that they were customers of a broker-dealer, irrespective of the fact that there was no record of them being customers of a registered broker-dealer.

**Q.3.** As president of NASD starting in 1996, you were responsible for the examination and enforcement programs. Knowing what you now know about the Madoff fraud, are there any steps that you could have taken to make it more likely that your staff would have detected the fraud? After learning of the fraud, what steps did you direct your staff at FINRA to take to determine whether other firms are engaging in fraudulent activity?

**A.3.** The ease with which market participants can move an advisory business outside the broker-dealer makes it extraordinarily difficult for FINRA to detect such a Ponzi scheme. Historically, Ponzi schemes are among the most difficult to detect, because the essence of the fraud is the absence of customer complaints until the fraud collapses. In order to discover a Ponzi scheme, an examiner needs the ability to verify information provided by the perpetrator, such as by making inquiries to the custodian of the securities (if there is one), the auditor, or the customers.

FINRA does examine for fraud within a broker-dealer. We also have an active automated fraud detection program, although admittedly it focuses on trading activity in the secondary market. At my direction, FINRA staff is in the process of launching two broad reviews, one involving custody issues in joint broker-dealer/investment advisers, and the other involving the role of broker-dealers as feeders or finders to money managers such as Madoff. On the latter issue, many finders and feeders are registered as investment advisers, not as broker-dealers.

**Q.4.** As chairman of the SEC, you will be responsible for making changes to the SEC's enforcement and inspections programs to, among other things, increase the likelihood that frauds of the magnitude of the Madoff Ponzi scheme get detected before billions of dollars are lost. What kinds of changes to the inspections and enforcement programs do you have in mind and what characteristics will you look for in selecting heads of your enforcement and inspection programs?

**A.4.** I look forward to the Inspector General's review of the Madoff matter. Pending that, it goes without saying that the investing public demands nothing less than the most aggressive, creative, and collaborative enforcement and examination program possible. I will remove the procedural limitations that have been put in place over the past few years, and ensure that these programs have all the tools, technologies and resources available to them. I also plan to centralize the responsibility for receiving and tracking tips received by the agency. But as important, I will ensure that our programs view themselves as part of a community of regulators, and I will stress cooperation and the free flow of information between federal, state, and SRO enforcement groups. It's difficult to say whether that flow might have detected the Madoff fraud earlier, but it is clear that segmentation of information can permit frauds to avoid detection for longer periods of time.

**Q.5.** In your testimony you have stated that, "First and foremost, if confirmed as Chairman, I will move aggressively to reinvigorate enforcement at the SEC. With investor confidence shaken, it is imperative that the SEC be given the resources and the support it needs to investigate and go after those who cut corners, cheat in-

vestors, and break the law.” Is it your view that the reason for the SEC’s recent failure to discover the Madoff fraud was a lack of resources and if so, on what do you base that determination? Do you believe that before we can discuss the need for more resources, there needs to be an in-depth consideration of how the SEC has been utilizing the resources it presently has at its disposal?

**A.5.** It is not clear to me yet what the cause or causes were that led to the SEC’s failure to stop the Madoff fraud. I agree that an in-depth analysis is required to ensure the right tools are put in the right places, and such an analysis will be one of my first priorities.

**Q.6.** Last year, the SEC repropoed long-awaited amendments to investment advisor disclosure in an effort to give investors easy access to critical information about the people who manage their money. What are your plans with respect to revamping investment advisor disclosure and making it more accessible to investors?

**A.6.** As you note, in March 2008 the SEC repropoed for comment changes to Part 2 of the Form ADV, which is the disclosure document given to clients of investment advisers. The changes are intended to replace the current “check-the-box” model with narrative disclosures written in plain English. As a general matter, I support providing investors with disclosures that are clear, complete and written in a manner that the average person can understand. I intend to closely review this proposal, as well as public comments, to ensure that we will be providing critical information to investors in the most user-friendly manner possible.

**Q.7.** Do you plan to revisit the question of whether there needs to be greater uniformity in the regulation of broker-dealers and investment advisors that provide similar services to investors?

**A.7.** It is clear from the RAND study that was commissioned by the SEC, that investors are confused by the differences between investment advisers and broker-dealers, the services they each provide, how they are compensated and how they are regulated. I will revisit the question of whether investors would be better served by greater uniformity.

**Q.8.** You have been widely commended for your role in overseeing the merger of the NASD and NYSE Regulation into the newly created entity, FINRA. There are, however, some critics, who argue that certain firms, particularly small ones, were disadvantaged by the merger and cite NASD misrepresentations about constraints on the amount of cost-savings it could pass on to member firms. How do you respond to these critics? What steps will you take as chairman of the SEC to ensure that the voices of small broker-dealers and investment advisors are heard?

**A.8.** Contrary to the views of these critics I believe that the merger actually served to lock in significant representation of regulated firms, large and small, at a time when the trend was in the direction of taking Board representation away from the industry. I believe that the balance struck between representation of large firms that account for a very large proportion of the securities business in the United States and the small firms that are large in number but which do a very small proportion of the business, was fair and

equitable to both sectors. The smaller firms represent an important form of access to the markets for many individual investors. It is therefore important that the rules applicable to the industry take into account the risks inherent in the variety of business models of firms, for example whether they hold customer funds and securities, and not impose burdens not necessary for the protection of investors. As I have at FINRA, I will consult broadly, through the notice and comment process, and other means, to gather the views of interested parties.

**Q.9.** What are your ideas for improving the communication and coordination among different parts of the SEC?

**A.9.** I will set a tone from the very beginning that I expect complete communication and coordination among divisions and nothing less will be acceptable. I plan to have senior staff meet regularly to discuss all ongoing and planned initiatives. I will explore the possibility of staff rotations to encourage greater understanding of the work of all divisions. In some areas, like the handling of tips, where miscommunication seems to have caused serious breakdowns, I intend to centralize the function and track the results which will be shared with the Commission and senior staff.

**Q.10.** What role do you see for economists at the SEC and how has FINRA used economic analysis?

**A.10.** FINRA has a small economics analysis group that assists the policy makers in understanding economic trends, keeping current with economic literature and dissecting how particular products will function in different economic cycles. This group is an excellent resource for the entire organization. I believe the SEC would benefit from a similar group that provides support and expertise to the Commission and staff.

**Q.11.** What changes, if any, are you thinking about to streamline the approval process for self-regulatory organizations' rules while still affording interested parties an opportunity to weigh in on those rules?

**A.11.** I am committed to ensuring that the SEC's resources are used as effectively as possible. I would be interested in streamlining the rule approval process for SRO rules where those rules do not implicate investor protection or other issues that should be subjected to the notice and comment process.

**Q.12.** Over the past several years, a number of the SEC's rules have been invalidated in court. In addition, we saw the rapid demise of the consolidated supervised entity program, a program that was not authorized by statute. What steps will you take to ensure that the SEC is acting within its statutory authority?

**A.12.** First of all, I would note that all State and Federal agency rulemaking is generally subject to legal challenge and subsequently set aside because the agency believed it had legal authority with which courts subsequently disagreed.

I would require that we first have a clear and rationalized legal basis for our actions before engaging in rulemaking. That would not guarantee against legal challenge, but it does mean that the matter would have been fully considered in advance and that statutory authority is a matter of first concern. If we lack the authority

to engage in rulemaking that we believe is necessary, we will engage Congress in that discussion.

**Q.13.** The SEC has been accused of short circuiting the notice and comment rulemaking required by the Administrative Procedure Act. What steps do you plan to take to ensure that the SEC adheres to the notice and comment requirements for rulemaking?

**A.13.** Again there can be reasonably different interpretations as to the notice provisions required under the Administrative Procedure Act. Building on my prior answer that our statutory authority and obligations will be the first order of determination in any decision or rule making, I would add that, absent systemic, market or investor emergency where we believe the Commission has the authority to act under the law, I would err on the side of Notice and Comment. My track record at FINRA demonstrates that well over 90 percent of our proposed rule making went out for Notice and Comment before it was sent to the SEC (and there is nothing in federal law or the SEC rules that required such Notice and Comment). Consequently, I bring a notice and comment bias based on prior experience because it is an extremely valuable discipline.

**Q.14.** During your first stint at the SEC, you recognized that there were problems with the SEC's treatment of credit rating agencies. Since then, Congress passed the Credit Rating Agency Reform Act of 2006 and the SEC adopted rules under that statute. Unfortunately, these rules came too late to prevent the great failings of credit rating agencies in connection with subprime securitizations. Subsequently, the SEC has adopted additional rules. Will you support the proposals to eliminate credit ratings from the SEC's rules?

**A.14.** The current business model under which credit rating agencies operate is flawed because the issuers themselves pay for the ratings that they receive. I believe that the SEC should consider other compensation models that do not present these fundamental conflicts of interest. For example, fees collected by securities exchanges or regulatory authorities might be a more appropriate source of credit rating agency compensation. Reform of the system under which credit agencies operate should be undertaken hand in hand with an analysis of the appropriate role and use of these ratings under SEC rules.

**Q.15.** What role should the SEC have in regulating credit default swaps?

**A.15.** I believe that the Commission needs to move together with its fellow regulators to rules that allow for the functioning of clearing agencies for credit default swaps. This is necessary in order to reduce counter-party risk for these over-the-counter traded derivatives and to bring increased transparency to these markets. It is critical that we have efficient and effective oversight of the clearing agencies at the Federal level.

**Q.16.** Do you think that the SEC's decision to impose a short sale ban on financial stocks last fall, a decision that Chairman Cox recently called into question, was appropriate?

**A.16.** The SEC's series of orders last fall, led to some confusion and uncertainty in the markets. Whether or not these orders were a mistake, I think it is critical for the agency to take a fresh look at

short-selling and determine an approach that will not require continuously acting on an emergency basis.

**Q.17.** The SEC is facing a number of important accounting issues, including issues related to International Financial Reporting Standards and fair value accounting. What will your priorities be in this area and what plans do you have for working with other entities such as the SEC's international counterparts and the FASB, PCAOB, and IASB?

**A.17.** The SEC's roadmap for IFRS implementation is currently out for comment. I am anxious to review the comment letters and determine whether the roadmap as currently proposed is sufficient to ensure that the accounting standards used by US issuers will continue to be of the highest quality. The SEC has also recently published its findings with respect to Fair Value Accounting. I will move quickly to examine the recommendations suggested in that report to determine what changes may be appropriate.

Cooperation with PCAOB, FASB, and IASB will be essential in addressing both of these issues. I hope to build a more positive and cooperative relationship among all of the entities.

**Q.18.** Do you have any specific plans with respect to business development companies, which are a source of capital for small and mid-sized companies?

**A.18.** I recognize the importance of a healthy small business sector to our economy. I have no specific plans at this time with respect to business development companies, but will be very interested to explore these issues.

**Q.19.** You have spent almost all of your career as a regulator. This background has provided you with an excellent understanding of how regulatory agencies work and deep insight into ways that the regulatory process can be improved. How will you compensate for the fact that you have not spent a significant amount of time in the private sector and therefore have not had to implement new regulations in a business context with the attendant concerns for regulatory costs and legal liability?

**A.19.** At FINRA, I made it a practice to solicit broadly the views of those who are ultimately responsible for implementing regulations. Through the notice and comment process, advisory committees and roundtables, we will give interested parties the opportunity to provide business and operational context to our rule-making. Equally, we will solicit the views the investors and others who are affected by our rules.

**Q.20.** There has been talk of FINRA—and before that, the NASD—adding investment advisors to the portfolio of firms that it regulates. This idea is controversial. If you are asked to weigh in on this debate in your new role as chairman of the SEC, what steps will you take to consider all sides of the issue of whether an SRO is appropriate for investment advisors and, if so, whether FINRA should be that SRO?

**A.20.** I believe that investor protection requires us to look beyond the title of the person providing financial services. Whether the provider is an investment adviser or a broker dealer, the investor desires high quality service and comparable regulatory protections.

I will be open to all possibilities for achieving this result, including the possibility of an SRO for advisers, but I have not concluded by any means, that that is the only possible approach.

**Q.21.** What role do you believe the SEC should play in a reformed regulatory structure?

**A.21.** The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and to facilitate capital formation. I believe that it is essential that the SEC continue to pursue this mission in a reformed regulatory structure. This can best be achieved through preserving and strengthening the many critical functions that the SEC performs today.

Preservation and strengthening of the many critical functions of the SEC are essential in a reformed regulatory structure.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON  
FROM MARY SCHAPIRO**

**Q.1.** Beginning to restructure the financial services' regulatory structure is a complicated undertaking, and one that this Committee will spend much time addressing. What do you believe is the starting point for restructuring at the SEC? What is the number one structural regulatory deficiency at the SEC that needs to be corrected by Congress?

**A.1.** I believe the starting point for regulatory reform must rest on two principles. The first is that systemically important financial institutions and products must be brought under the regulatory umbrella. The second is that our focus must be equally upon the management and limitation of systemic risk on one hand, and the protection of investors through rigorous business conduct regulation, on the other.

**Q.2.** As you know, Native American issues are important in my state of South Dakota. The Regulation D definition for "governments" inadvertently did not explicitly include Tribal governments when it was created. As a result, Tribes are the only governments required to register with the SEC and are currently excluded as "accredited investors." This makes raising money costly in Indian Country and has had the perverse effect of preventing successful Tribes from investing in emerging Tribes. Would you support a simple regulatory fix to recognize Tribal governments as government, and equalize access to the capital markets?

**A.2.** This is an important issue. I will study the implications of recognizing Tribal governments and will look forward to discussing the issue with you.

**Q.3.** What you will do to stop the illegal practice of naked short selling? Do you believe Regulation SHO (pronounced "show") should be amended? In 2007, the SEC rescinded the "uptick rule." Do you believe this rule should have been rescinded?

**A.3.** I intend, as quickly as possible, to engage in a full review of the SEC's actions with respect to short selling, including an evaluation of whether the uptick rule should be reinstated.

**Q.4.** Do you feel that the executive compensation disclosure rules are adequate and would you propose any changes?

**A.4.** Executive compensation disclosure is of enormous interest to the SEC, Congress, and the public. The SEC recently strengthened the disclosure requirements and has been engaged in a dialogue with public companies about the quality of their disclosure. I am committed to requiring public companies to present clear, cogent, and full disclosure of executive compensation and how compensation decisions are made.

**Q.5.** There have been many concerns about how accounting issues contributed to our current economic crisis. What do you believe should be the relationship between the SEC and FASB? What do you believe should be relationship between the SEC and PCAOB (Public Company Accounting Oversight Board)? Would you propose any changes to either of these two relationships?

**A.5.** The SEC has statutory authority to establish financial accounting and reporting standards for public companies. The agency has relied on the private sector—FASB—to fulfill this function, under the Commission’s oversight. I believe in the U.S. model of independent standard setters, so long as the standard setters operate in the public interest. I also believe that the creation of the PCAOB to protect investors by promoting informative, fair and independent audit reports, under the oversight of the SEC was an important development. It is critical that the SEC have a strong relationship with both of these entities. I am not certain at this point, whether changes are necessary.

**Q.6.** What are your thoughts on the adequacy of current funding for the SEC?

**A.6.** While I have not yet had an opportunity to engage in a careful review of the SEC’s budget and allocation of resources, it is clear that the agency’s funding has been severely constrained over the past several years. I am looking forward to working with Congress to secure the resources necessary to fund the SEC at a level commensurate with its responsibilities.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT  
FROM MARY SCHAPIRO**

**Q.1.** When will the SEC finalize the updating of the Financial Responsibility Rules for broker-dealers under Rule 15c3-3 to permit government-only money market funds to be used in meeting reserve deposit requirements, and by allowing money market funds to be used as collateral where broker-dealers borrow securities from customers and others?

**A.1.** On March 9, 2007, the SEC proposed amendments to several of the broker-dealer financial responsibility rules, including Rule 15c3-3. On May 17, 2007, the Commission extended the comment period. The amendments remain pending before the Commission. I look forward to considering them after I arrive at the agency.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM MARY SCHAPIRO**

**Q.1.** Would a merger or rationalization of the roles of the SEC and CFTC be a valuable reform?



**A.1.** How best to structure the regulatory oversight of our financial markets is a subject that deserves careful consideration by the Congress, the Administration and the independent regulatory bodies. As I said in my testimony, the SEC performs essential functions and it is vital that all of the current functions of the SEC be preserved. I think we need to carefully examine what is the best way to preserve and strengthen these functions while filling in the regulatory gaps that currently exist, including those between the SEC and the CFTC.

**Q.2.** Recent events in the credit markets have highlighted the need for greater attention to risk management practices and the counterparty risk in particular. The SEC recently promised to issue a key exemption that would allow various initiatives to offer clearing services for credit default swaps. Do you agree that interim temporary final rules need to be issued as soon as possible to allow these important initiatives to proceed? Additionally, do you believe that these vital markets need to remain open and functioning?

**A.2.** Clearly the Commission needs to move with its fellow regulators to rules that allow for the functioning of clearing agencies for credit default swaps. This is necessary in order to reduce counterparty risk for these over-the-counter traded derivatives and to bring increased transparency to these markets. One of the contributing factors to the current crisis has been an inability to more precisely size the volumes of these contracts and the notional underlying value. Further, despite past practices that created risk that was both excessive and difficult to quantify, when properly managed these products are important risk management tools, and the SEC should take the necessary steps to ensure they remain functioning.

**Q.3.** The SEC recently implemented changes to regulation SHO. It is my understanding that a number of commenters suggested that because of a technical issue these changes have resulted in less liquidity in the securities lending market and this has forced securities firms to try to borrow funds from financial institutions rather than allowing them to borrow from each other. This could be addressed by simply altering the timing of closing out the trade. In an environment where credit is tight, should the SEC alter this rule to address these concerns rather than taking already limited funds out of the financial sector?

**A.3.** The SEC's recent actions in the area of short selling, including emergency orders issued last year and the more recent interim final temporary rule, have been intended to address continuing concerns about the potential impact of "naked" short selling on the already weakened financial markets. While certainly not all short selling is fraudulent, "naked" short selling—where the securities sold are not delivered on settlement date and there is then a fail to deliver to the buyer of the security—may deprive shareholders of the benefits of ownership, such as voting and lending, and can facilitate manipulative activity, further undermining critical investor confidence. The SEC, through its temporary rulemaking, has imposed stricter time frames for delivery of securities by short sellers until July 2009. The SEC's Office of Economic Analysis has been monitoring closely the impact of these new requirements and

has already reported a significant decline in fails to delivers. I intend to review the full results of the Office of Economic Analysis study and other relevant considerations before determining whether a continuation of these new restrictions is warranted.

**Q.4.** Many financial institutions are subject to regulation and oversight as both a broker-dealer and investment adviser. How do you propose to strengthen the regulation and oversight of their activities and improve investor protection, while insuring that the regulatory burdens do not hurt competition and place professional financial advice and services out of the reach of all but the wealthiest Americans?

**A.4.** First, it is interesting to note that the least regulatorily burdened investment areas—buyout funds, private equity, and hedge funds—have traditionally been available to only the wealthiest Americans. Broker-dealers that service the full spectrum of Americans all operate under essentially the same regulatory burdens when it comes to investor protection. All investment professionals who serve the public should be subject to similar standards of investor protection (but not always by identical rules) and there is no reason to believe that this would price services beyond the wealthiest Americans. The biggest regulatory costs for broker-dealers come from systems to execute and report trades on an automated basis and investment advisors would not incur those costs. Existing law already requires investment advisors to have compliance officers and policies and procedures. I believe we can level investor protection across financial services providers without driving costs to a level where competition is hampered.

**Q.5.** Should the SEC act in the near future on proposals to toughen rules for credit rating agencies?

**A.5.** I strongly agree that we need strengthened rules for regulating the credit agencies. One of the main problems in this area is resolving conflicts of interest in the compensation model for credit rating agencies. There are a lot of proposals being discussed now to deal with this. I believe we should explore them and move quickly to a conclusion—and I intend to make sure that we implement rigorous oversight and enforcement.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR LEVIN  
FROM MARY SCHAPIRO**

**Q.1.** Market Oversight: In 1998, former Securities and Exchange Chairman Arthur Levitt, Treasury Secretary Lawrence Summers, and Federal Reserve Chairman Alan Greenspan all opposed an attempt by the Commodity Futures Trading Commission (CFTC) to examine the over-the-counter (OTC) swaps market and then supported statutory restrictions on the SEC's and CFTC's authority over swaps in the Commodity Futures Modernization Act of 2000 (CFMA). Former Chairman Levitt recently stated that he now regrets the position he took during those years: "The market was too large, too explosive in growth to merely allow pure market forces to suffice as self-regulatory mechanisms. I have some regrets about it, clearly." In October 2008, Mr. Levitt wrote:

Our Nation's financial markets are in the midst of their darkest hour in 76 years. We are in this situation because of an adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions. Our regulatory system failed to adapt to important, dynamic and potentially lethal new financial instruments as the storm clouds gathered.

**a.** Do you agree with former Chairman Levitt's statement that our regulatory system has failed to adapt to the development of new financial instruments and that the positions taken in 1998–2000 to deregulate markets was, in retrospect, a mistake?

**b.** Should SEC oversight be strengthened with respect to new financial products, including new derivative and complex structured finance products, and, if so, how?

**c.** Would you support repealing the statutory prohibitions in the CFMA on federal regulation of swaps? If so, should these swaps be regulated as commodities or securities?

**d.** What would you do to get credit default swap clearing functions up and running?

**A.1.** As the events of this past year have made clear, one of the problems with our financial regulatory architecture is that there are large gaps in it, leaving important products and market actors beyond the oversight of regulators. Investors deserve to have quality disclosure about all products, actors, and strategies so they can make smart investing decisions, and our markets absolutely require this information, as well as a strong cop on the beat to enforce the rules of the road. With regards to swaps, I personally have supported the repeal of statutory prohibitions in the CFMA on the federal regulation of swaps and I believe that centralized, mandatory clearing of standardized swaps should be required.

**Q.2.** Former Federal Reserve Chairman Alan Greenspan testified in October that he, too, now believes that the conceptual framework underlying the deregulation of swaps in the CFMA was a mistake. Mr. Greenspan testified: "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms. . . . So the problem here is something which looked to be a very solid edifice and, indeed, a critical pillar to market competition and free markets did break down."

**a.** Do you agree with Mr. Greenspan's recent statements that the financial collapse of 2008 has demonstrated the errors in the assumptions underlying the deregulatory approach in the CFMA? Can we rely on market participants and unfettered free market forces to prevent systemic risks and unreasonable price fluctuations?

**b.** Do you support stronger regulation of securities markets to protect market participants and prevent systemic risks, and, if so, how?

**c.** Should SEC user fees be increased to fund additional oversight capabilities?

**A.2.a.** I believe that markets need oversight and regulation to ensure that operate fairly.

**b.** I believe that all systemically important market participants and products need to be brought under the regulatory umbrella.

**c.** I have not yet had an opportunity to do a thorough review of the SEC's budget or resource allocation. It is probably safe to say however, that the agency has not been funded at a level commensurate with its responsibilities. I believe additional oversight capability is essential and I look forward to working with Congress to ensure that the agency has the resources it needs.

**Q.3.** What are your views on whether and how SEC oversight be strengthened with respect to:

**a.** the holding companies of securities firms?

**b.** hedge funds?

**c.** companies that are not broker-dealers, but buy and sell financial swaps and other products, like AIG Financial Products?

**A.3.** I believe that all systemically important financial institutions need to be regulated. I would specifically endorse the registration of hedge funds.

**Q.4.** Should the SEC strengthen capital requirements for broker-dealers?

**a.** At the time they were made in 2004, did you support the revisions by the SEC to the net capital requirements rule? Do you support those changes at the current time or should the SEC restore the prior rule?

**b.** Should the SEC impose stronger capital requirements on broker-dealers that trade in over-the-counter derivatives or complex structured financial products?

**A.4.** I did not take any position in 2004 regarding the net capital requirements rule. Moving forward, I believe that we need to strengthen capital requirements across the board.

**Q.5.** What is your view of the relationship between the SEC and federal banking agencies with respect to banks that buy and sell securities? How can this relationship be improved?

**A.5.** It's important that all the regulators in our system work collaboratively in ensuring that investors are protected and that the markets are operating soundly. Moving forward, we need to close the gaps in our regulatory system, a system that is too stove-piped allowing determined market actors to avoid oversight. As we work to reform the financial regulatory architecture this should be a priority.

**Q.6.** What lessons should be learned from the recent collapse of the markets for asset-backed securities, collateralized debt obligations (CDOs), structured investment vehicles (SIVs), and auction-rate securities? Should the SEC attempt to restore the markets for these products? Should the SEC make distinctions between these categories of products and, if so, how and why?

**A.6.** The biggest lesson from these market collapses is that we cannot allow financially important products that have a massive impact on our markets and our economy to operate in our system without high standards of oversight, transparency, and accountability. As Chair of the SEC, I will move aggressively with my fellow Commissioners and working with members of Congress to close the gaps in our regulatory structure and bring these markets under control.

**Q.7.** What needs to be done to resolve the conflicts of interest affecting credit rating agencies? What can be done to restore their credibility?

**A.7.** As early as 1994, I've called for stronger regulation of credit rating agencies when, at that time, it became increasingly clear that their importance to the markets was outstripping the amount of oversight. Since then and especially this year, there are real questions about conflicts of interest and transparency that have surfaced. Moving forward on credit rating agency reform is a top priority of mine. We need to examine how the rating agencies are compensated, how they manage conflicts of interest, and what role they should play in our markets. There are some interesting proposals out there that need to be studied. I look forward to working with you on this issue.

**Q.8.** In 2004, Congress enacted legislation imposing a one-year cooling-off period before federal bank examiners could take a job with a bank they oversaw. If confirmed, would you support a similar cooling-off period for securities regulators?

**A.8.** Now more than ever, it's critical that the SEC is able to attract a new group of highly qualified and motivated individuals to serve in the agency. As we do that, we need to balance this need with the highest standards of ethics and accountability for SEC employees to ensure that the public good is always first and foremost in their minds. I look forward to working with you on this matter and to learning from the bank regulators about their experience with post-employment restrictions.

**Q.9.** Financial Accounting Standards: What is your view of the relationship between the SEC and the Financial Accounting Standards Board (FASB)? What is your view on whether Congress should legislate accounting rules?

**A.9.** The SEC needs to diligently oversee the FASB to ensure that accounting rules are keeping pace with innovations in the markets and the needs of investors of clear, usable financial reporting. I believe that FASB needs to be shielded from outside economic and political pressures, and that they and not Congress should write accounting rules.

**Q.10.** The SEC recently issued a report supporting the existing mark-to-market valuation rules, but recommending some improvements. What is your view of the current mark-to-market valuation rules?

**A.10.** We know that certain banks were not presenting investors with the full picture of their financial health, utilizing off-balance sheet vehicles and other accounting methods. This was a disservice to investors as the integrity of the numbers is critical to their making smart investment decisions and to the smooth functioning of our markets. While there are a lot of different views on whether mark-to-market accounting contributed to this crisis, my personal view is that it was not a significant factor. As Chair, I will read the recent SEC report on this matter fully, talk with other regulators, and get their views as we move forward.

**Q.11.** Do you believe U.S. banks have fully applied mark-to-market valuations to the structured finance transactions on their books, in-

cluding asset-backed securities, credit default swaps, and CDOs? Do you believe inaccurate valuations are currently impeding U.S. credit markets? If confirmed, what actions would you take to insure accurate book valuations for U.S. banks?

**A.11.** I am not in a position at this time to opine on whether U.S. banks fully and appropriately applied mark to market valuations. See above.

**Q.12.** Current SEC Chair Christopher Cox has indicated that he thinks the SEC should allow U.S. publicly traded companies to use international financial reporting standards (IFRS) issued by the International Accounting Standards Board (IASB) instead of U.S. generally accepted accounting principles (GAAP) in their financial statements.

**a.** Do you believe the Sarbanes-Oxley Act allows the SEC to delegate the development of U.S. accounting standards to the IASB? If confirmed, would you try to advance such a proposal?

**b.** Section 404 of the Sarbanes-Oxley Act requiring auditors to review a company's internal controls has still not be applied to publicly traded small businesses. If confirmed, would you allow Section 404 to take effect for small businesses without additional delay?

**A.12.** When it comes to international accounting standards, it's critical that these standards are converged in a way that does not kick off a race to the bottom. American investors deserve and expect high standards of financial reporting, transparency, and disclosure—along with a standard-setter that is free from political interference and that has the resources to be a strong watchdog. At this time, it is not apparent that the IASB meets those criteria, and I am not prepared to delegate standard-setting or oversight responsibility to the IASB.

Regarding, SOX 404, accurate, robust, and easy-to-understand financial reporting—and the internal controls that guarantee it—are critically important to investors and to the efficient functioning of our markets. Right now, we have a system where some issuers are complying with 404 and others are still exempt from it. It's time that we bring uniformity to the system so that investors know what to expect from companies, while being sensitive to the needs of small businesses. I look forward to working with the small business community in making sure they have the tools they need to comply with 404.

**Q.13.** What is your view of FASB's accounting standard requiring stock option compensation to be treated as an expense on corporate financial statements? If confirmed, would you support efforts to change this standard? If so, what changes would you support?

**A.13.** No, I would not support changing this decision.

**Q.14.** In 2004, the Office of the Comptroller (OCC) and the Office of Thrift Supervision (OTS) in the Treasury Department, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) issued a proposed Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities ("Interagency Statement on Sound Practices"). In 2006, the same agencies issued a revised proposal and, in 2007, a final statement.

**a.** Did you participate in any discussions or provide any comments on the 2004, 2006, or 2007 guidance? If so, please describe the circumstances, including the date, persons involved, and the issues addressed.

**b.** Did you support the proposed guidance at the time it was issued in 2004?

**c.** Did you support the revisions proposed in 2006 and adopted in the final guidance at the time it was issued in 2007? Do you support those revisions now?

**d.** The Interagency Statement on Sound Practices became effective on January 11, 2007. According to the statement, the OCC, OTS, Federal Reserve, FDIC, and SEC were to use the Statement as guidance for reviewing the internal controls and risk management policies, procedures, and systems of financial institutions engaged in Complex Structured Finance Transactions (CSFTs) as part of their ongoing supervisory process. Were you aware of this guidance, and do you know if the guidance was regularly applied and adhered to by securities firms since its effective date?

**e.** The Interagency Statement indicates that CDOs and credit default swaps (CDS) typically would not be considered to be CSFTs subject to the guidance. In light of the role played by CDO and CDS transactions in the current financial crisis, would you support revising this approach so that CDO and CDS transactions are covered by the Interagency Statement on Sound Practices?

**A.14.** I did not participate in discussions surrounding the 2004, 2006, or 2007 guidance. I think it would be appropriate to consider whether the Interagency Statement should be expanded.

**Q.15.** Public Company Accounting Oversight Board: What is your view of the relationship between the SEC and the Public Company Accounting Oversight Board (PCAOB)?

**A.15.** In addition to its oversight responsibilities, the SEC should ensure that the PCAOB has what it needs to enforce the rules of the road for auditors.

**Q.16.** Chairman Cox has indicated that he thinks the PCAOB should stop inspecting auditing firms in other countries and instead delegate its inspection authority to foreign oversight bodies where those firms are located. Do you believe the Sarbanes-Oxley Act allows the SEC to make this delegation? If confirmed, would you try to advance such a proposal?

**A.16.** No, I do not; and no, I will not.

**Q.17.** Financial Institutions Facilitating Tax Abuse: The U.S. Treasury loses an estimated \$100 billion each year from offshore tax abuses, some of which are facilitated by broker-dealers. If confirmed, would you work with the IRS to curb such activities? Do you support enactment of S. 681 from the 110th Congress, the Levin-Coleman-Obama Stop Tax Haven Abuse Act?

**A.17.** Yes. I look forward to working with the Internal Revenue Service, you, and other Senators to curb such activities.

**Q.18.** Some financial institutions are facilitating tax-dodging by non-U.S. persons. In particular, the Senate Permanent Subcommittee on Investigations, which I chair, held a 2008 hearing

showing that U.S. firms like Morgan Stanley, Lehman Brothers and others have helped offshore hedge funds and others to avoid payment of U.S. taxes on U.S. stock dividends, by assisting them to convert taxable U.S. stock dividend payments into allegedly tax-free dividend equivalents or substitute dividend payments. If confirmed, would you support ending this activity by securities firms?

**A.18.** Yes.

**Q.19.** Investor Rights and Protections: Former SEC Chair William Donaldson proposed establishing a mechanism to allow certain shareholders of publicly traded corporations to nominate a candidate to the board of directors. If confirmed, would you support a rule to allow shareholder nominations of some board members?

**A.19.** Yes. A central tenet of our market system is that shareholders are the owners of the company in which they hold shares, and they should have a way to hold their representatives—members of the board of directors—accountable for their actions. Access to the proxy has been debated for many years, and I believe it is time for a thoughtful approach to proxy access for significant, long term shareholders.

**Q.20.** What is your view of the compensation paid to executives and market traders at financial institutions? If confirmed, would you support a rule to allow shareholders to express an advisory opinion on executive compensation?

**A.20.** Yes. Like you and millions of Americans, executive compensation has been a concern of mine for some time now, and I believe that it's an appropriate measure to give shareholders an advisory vote on these matters.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON  
FROM CHRISTINA D. ROMER**

**Q.1.** Members of the CEA provide the President advice and analysis concerning the state of the economy. What will be your first piece of economic advice for our new President as a member of the CEA?

**A.1.** The first piece of advice that I gave the President-elect when I joined the transition before Thanksgiving was to move swiftly and boldly on an economic stimulus plan. After studying the forecasts of both private firms and public agencies, as well as talking with businesspeople and policymakers, I was deeply concerned about the rate of deterioration of the economy. I believed that monetary policy could not do enough to stop the rapid decline, and felt that aggressive fiscal action was crucial.

If confirmed, my first piece of advice as CEA chair would be to reiterate that view and then to stress the need to remain alert and flexible. The President will need to work closely with the Congress to pass a good stimulus bill quickly. We will then need to monitor the economy closely. We must watch for new unexpected weak spots in the economy that could require additional action. And, should we be fortunate enough to have a very brisk recovery, we may eventually need to be alert for signs of excessive strength and bottlenecks in some areas.



**Q.2.** Beginning to restructure the financial services' regulatory structure is a complicated undertaking, and one that this Committee will spend much time addressing. What do each of you believe is the starting point for restructuring? What is the number one structural regulatory deficiency, in your opinion, that needs to be corrected by Congress?

**A.2.** The key starting point for restructuring the regulatory structure is to recognize that any institution that acts like a bank, exposes the economy to systemic risk, and explicitly or implicitly has the ability to borrow from the Federal Reserve or otherwise draw on taxpayer resources in times of stress, needs to be regulated in the same way that we regulate banks. The deregulatory actions taken in recent decades allowed investment banks and other institutions to take on quasi-banking activities without being subject to the same capital, monitoring, and oversight requirements we have for banks. The result was the creation of highly leveraged institutions that were so large and so central to the financial markets that their failure would bring down otherwise solvent financial institutions and lead to a catastrophic decline in financial services, particularly lending. We must begin our regulatory reform by ensuring that this wide range of financial institutions adhere to sensible and prudent regulations.

**Q.3.** Much of your academic work has focused on economic recovery, specifically after the Great Depression and World War II. What is similar in today's environment to those periods of recovery? What is different?

**A.3.** A key similarity between the current situation and the Great Depression of the 1930s is the central role of financial crises in causing unemployment and economic contraction. In both episodes, the decline in lending caused by turmoil in financial markets led to devastating contractions in consumer spending and investment. Thus, the kinds of actions that need to be taken are fundamentally similar. We need to reform and revitalize the financial sector so that it can lend again. And, we need to stimulate the overall economy so that we can directly counter some of the declining output and rising unemployment caused by reduced spending.

A crucial difference in the two episodes involves the level of economic understanding. Perhaps the most important reason that the Federal Reserve and other policymakers did so little as the economy spiraled downward in the early 1930s was that this was the prevailing economic orthodoxy of the time. In the last 80 years, economists and policymakers have learned dramatically more about the operation of the economy and steps that can be taken to counteract macroeconomic shocks. That improved level of economic understanding should enable policymakers to devise effective policies.

The role of financial crises in the current downturn points out a crucial difference from other postwar recessions. Most recessions since World War II have been caused by tight monetary policy aimed at reducing inflation. In these situations, it was relatively straightforward to end the recessions: monetary policy needed to switch from contractionary to expansionary. In the current episode, interest rates were already fairly low when the downturn began. As a result, monetary policy had less ability to respond aggressively.

This difference makes a balanced approach, including timely fiscal expansion, crucially important.

**Q.4.** What kind of policies do you think are our best shot at economic recovery? What role do you believe fiscal policy will play in our recovery?

**A.4.** The problems facing our economy are sufficiently severe that, in my judgment, it is essential that we use a wide range of policies to bring about recovery. While monetary policy, the recapitalization of financial institutions, and dealing with troubled assets are important, fiscal policy must play a central role. Fiscal policy provides the most direct stimulus, which our economy sorely needs. Because the weakness of our economy is broad and is expected to last a substantial time, it is important to have a broad fiscal program. Different types of fiscal policy help recovery in different ways. Tax cuts to individuals and families and funds to cushion the most vulnerable provide immediate relief and relatively rapid stimulus. Likewise, fiscal relief to the states will help in the near term to mitigate reductions in spending on valuable programs and to prevent potentially counterproductive tax increases mandated by balanced-budget requirements. Business investment incentives also work relatively quickly, and will spur investments that will increase our productive capacity. Programs of direct government spending appear to have the largest “bang for the buck” in terms of economic stimulus and job creation, and can fund investments that will strengthen our economy in the long term. Because such direct spending can take somewhat longer to initiate, this type of stimulus will be most helpful in creating jobs later in the year and throughout 2010. Finally, in thinking about direct spending, it is important that it be spread broadly: there are many areas where government investment would be valuable, and there are many areas of weakness in the economy.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON  
FROM AUSTAN D. GOOLSBEE**

**Q.1.** Members of the CEA provide the President advice and analysis concerning the state of the economy. What will be your first piece of economic advice for our new President as a member of the CEA?

**A.1.** My first piece of advice to the President will be that he should release a significant foreclosure prevention plan to ease the drag on the wider economy and the financial system.

**Q.2.** Beginning to restructure the financial services’ regulatory structure is a complicated undertaking, and one that this Committee will spend much time addressing. What do each of you believe is the starting point for restructuring? What is the number one structural regulatory deficiency, in your opinion, that needs to be corrected by Congress?

**A.2.** The starting point for restructuring should be the realization that getting rid of the rules of the road did not make the free market work better. It made it worse. It contributed to the lack of public trust in the financial system a fear of keeping money in the fi-

nancial institutions. We need sensible oversight for the market to succeed.

To me, the number one structural deficiency in our regulatory system is that we have designed a system where a series of institutions are regulated by who they are rather than by what they do. In subprime lending, for example, two thirds of the loans were made by non-banks. So the Federal Reserve was regulating banks one way and non-banks did not have to follow the regulations despite being in exactly the same business. That is a recipe for a creating a financial crisis.

**Q.3.** Some of your academic research focuses on the Internet, telecom, and other technology industries. What role do you see the technology industries playing in our Nation's economic recovery?

**A.3.** I certainly hope it will be a large role. Technology industries and the information economy give this country an important area that we can continue to lead in the coming years and where the demand for the product has, historically, been less cyclical than the demand for other goods. These technology industries are also particularly open to contribution from entrepreneurs and start-ups which will be an important outlet for the economy in a period where major employers are struggling.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON  
FROM CECILIA E. ROUSE**

**Q.1.** What will be my first piece of economic advice for our new President as a member of the CEA?

**A.1.** I take seriously the role of the CEA as providing expert advice to the President based on solid empirical and theoretical economic analysis. The economic crisis in which we find ourselves is truly extraordinary, and we must continue to move quickly and boldly to pull ourselves out of it. After that, however, my advice to the new President would be to turn as quickly as possible to developing policies and strategies for long-term investment that will ensure continued growth and help our firms and workers to remain competitive and nimble in our increasingly global economy going forward. While clearly this task will require innovation in a variety of areas, should I be confirmed, I would particularly look forward to working with you and the new President to strengthen investments in our "human capital" through the education and training system.

**Q.2.** What do I believe is the starting point for restructuring of the financial services' regulatory structure? What is the number one structural regulatory deficiency, in my opinion, that needs to be corrected by Congress?

**A.2.** A good starting point for restructuring the financial services' regulatory structure is to build in more accountability and transparency that reflects the financial sector of the 21st century. A key structural deficiency that must be corrected by Congress is to streamline the regulatory agencies. Not only is the current system of overlapping and sometimes competing agencies inefficient, it makes it difficult for regulators to provide adequate oversight of this important sector of our economy.

**Q.3.** As an economist whose primary research and teaching interests are in labor economics with a focus on the economics of education, what issue do you see as most pressing in your area of expertise? How will you advise the President-elect to address this issue?

**A.3.** There are many pressing issues in education. Investing in our youngest children is key, and we must strengthen our primary and secondary schools—especially our secondary schools. However, an area that is of primary concern to me is our system of higher education. The United States has always been a global leader in higher education, and yet in recent years we have slipped behind in the rate at which our students actually complete their studies. This is particularly true in our community colleges. And yet, a college education is increasingly important in today's economy. Should I be confirmed, I would advise the President-elect to help our institutions of higher education to focus on the needs of students as well as ensure that those who would like to go to college have the resources to do so.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD  
FROM DANIEL K. TARULLO**

**Q.1.** Mr. Tarullo, you have testified before this Committee about the shortcomings of banking regulation well before the subprime crisis erupted. As you assess what has happened since then, what principles will guide your thinking about what the Congress, the Federal Reserve, and other bank regulators should make to modernize our financial regulatory system?

**A.1.** In thinking about modernization of the financial regulatory system, I will be guided by the six principles listed below. Some measures needed to apply these principles can be made under existing authority of the regulatory agencies, while others may require legislative action by the Congress.

First, successful regulatory modernization must be forward looking. While it is important to make changes that would prevent practices that led to the subprime crisis, it is essential to recognize that financial stress usually does not recur in precisely the same way as in a previous episode. We need a regulatory system that can identify and respond, as necessary, to new risks to financial stability.

Second, the rules and requirements designed to maintain safety and soundness of individual financial institutions must be appropriate and enforceable benchmarks that allow effective monitoring and, where necessary, prompt correction of capital, liquidity, and risk management practices.

Third, a modern financial regulatory system must have the capacity to contain systemic risk, no matter what its source, and the authority to achieve this goal. This means ensuring regulatory coverage of all systemically important institutions. It also means establishing measures to identify, and respond to, risks created in interactions among financial actors.

Fourth, an effective financial regulatory system must ensure that the regulatory and supervisory systems that govern individual financial institutions are effectively integrated with those designed

to contain risks specifically arising from interactions among financial actors. That is, regulators commissioned with overseeing systemic stability must have sufficient involvement in the supervision of specific financial institutions to determine how the various measures interact.

Fifth, the organization of, and allocation of functions among, our regulatory agencies must be designed so that each regulatory mission delegated by the Congress will be vigorously pursued with adequate authority and resources to realize that mission. Past shortcomings in consumer protection in the area of financial services provide one example of a need for renewed attention.

And sixth, in attempting to implement these principles—and regulatory modernization more generally—it is essential to keep in mind that the aim of financial regulation should be to establish and maintain a financial system that allocates capital efficiently so as to promote sustainable economic growth by providing investment opportunities and access to credit. The goal is not more or less regulation as such, but the right forms of regulation to achieve these ends.

**Q.2.** Dr. Fred Bergsten, Director of the Peterson Institute for International Economics, wrote an op-ed article in *The Washington Post* entitled “Globalizing the Crisis Response,” in which he makes the following point, and I quote—

The current crisis originated in the United States but was importantly affected by massive savings surpluses in some countries and the resulting surfeit of liquidity, which drove down interest rates here and encouraged irresponsible lending here. These international imbalances were in turn partly caused by misaligned exchange rates.

Do you agree with Dr. Bergsten that the current financial crisis has roots in the global savings surpluses in China and other Asian nations that were accumulated at least in part by misaligned exchange rates?

**A.2.** I agree that an excess of savings over investment in many emerging market countries, which raised the availability of credit and lowered its cost, contributed to the conditions which gave rise to the current crisis. It is difficult, however, to distinguish with precision the contribution of these savings surpluses from developments in the United States and abroad that also encouraged reckless lending and excessive risk, such as the deterioration in underwriting standards, flaws in the “originate to distribute” model, the over-reliance of financial institutions on short-term credit, and inadequate risk management. Similarly, misaligned exchange rates were decidedly a factor in some emerging market economies’ current account surpluses and resultant export of capital to the United States and other advanced economies. However, a number of other factors also figured prominently in these external imbalances, including a protracted slump in investment spending in some East Asian economies and soaring commodities prices, which boosted the revenues of many commodity-exporting countries.

**Q.3.** Can you share with the Committee your views on the separation between banking and commerce? Specifically, what are your views on Industrial Loan Companies?

**A.3.** The question of whether, or to what extent, the mixing of banking and commerce should be permitted is an important issue. The decision has important ramifications for the structure of the American financial system and the economy, particularly because any widespread combinations of banking and commerce likely would be irreversible. I believe any reversal of the Nation's policy concerning the mixing of banking and commerce should be made only by Congress itself after legislative hearings, public debate, and careful review of the potential benefits and costs to taxpayers, the financial system, and the economy.

One area in which Congress has permitted the mixing of banking and commerce is through the ownership of industrial loan companies (ILCs). The exception for ILCs in the Bank Holding Company Act (BHC Act) allows any type of company—including a domestic or foreign commercial firm—to acquire a federally insured bank chartered in certain states without complying with the limitations on banking and commerce that Congress has established for the corporate owners of other full-service insured banks. Although the number of exempt ILCs recently has declined (primarily through the conversion of several financial owners of ILCs to bank holding companies), the ILC exception in the BHC Act has the continuing potential to undermine the policy that Congress has established on the separation of banking and commerce.

**Q.4.** Do you believe in the Fed's dual mandate for maximum employment and price stability? Are there approximate figures for the Nation's unemployment rate and inflation rate that match what you believe to be maximum employment and price stability? If so, can you share what those are?

**A.4.** I fully endorse the monetary policy mandate that Congress has set out for the Federal Reserve of pursuing maximum employment and price stability. These policy goals have served our economy well.

It is difficult to provide specific figures for the unemployment rate and inflation rate that would best satisfy the Congressional mandate. With regard to inflation, there are a number of different measures of inflation, each with its own strengths, weaknesses, and biases. As for employment, a fixed measure of "maximum employment" is not compatible with the fact that our economy develops and changes over time in response to changes in technology and other factors.

**Q.5.** Can you inform the Committee of any periods in American history where you believe that maximum employment was not being reached or that price stability was not achieved? During those periods, what actions do you believe the Fed should have undertaken to achieve its mandate?

**A.5.** The economy is subject to a variety of demand or supply shocks that can pose a threat to the achievement of maximum employment and price stability. It is of course important for monetary policy to respond appropriately to these developments. At some times in the past, though, adherence to a particular monetary policy response well after a reduction in the risks associated with the shock has itself contributed to an increase in other risks to achieving these goals. For example, during the 1970s, increases in the

prices of oil and other commodities, along with a slowdown in the rate of underlying productivity growth, contributed to a substantial rise in inflation, which reached double-digit levels by the end of the decade. Over time, high inflation became built into expectations and distorted the decisions of businesses and households with adverse results for economic performance. A tighter policy stance would have been appropriate to limit the rise in inflation. Had such a policy been pursued earlier, it might well have avoided some of the negative effects on employment that ensued from the very tight monetary policy that was adopted in the early 1980s to bring inflation back down to lower levels.

As a result of the recession and the crisis in our financial markets, the Federal Reserve has lowered its short term interest rate target to an effective rate of zero. The Fed has also exercised authority under the Federal Reserve Act to make a series of loans to provide liquidity and that have had the effect of expanding the Fed's balance sheet. As a result, we find ourselves in an unprecedented period in which traditional monetary policy tools have been exhausted and the Fed is using new methods to implement monetary policy.

**Q.6.** Do you believe that it is important that as the Federal Reserve begins to conduct monetary policy through non-traditional means that it ensures that those actions are highly transparent?

**A.6.** I strongly believe that it is important for the Federal Reserve to conduct its monetary policy actions in as transparent a manner as is consistent with the effective achievement of its monetary policy goals, both in routine circumstances and in periods such as the present when it must conduct policy using nontraditional tools.

**Q.7.** What are the advantages to conducting these operations in a transparent manner?

**A.7.** Conducting such operations in a transparent manner supports the overall accountability of the Federal Reserve to the Congress and the public. Such accountability is always important, but it is especially critical when nontraditional policy tools—which are less familiar to the public, and entail somewhat greater risks, than traditional policy tools—are being employed. In addition, by improving market understanding of these operations, such transparency helps support public confidence that the Federal Reserve and the rest of the government are implementing measures that will be effective in strengthening financial markets and institutions and thus encouraging a resumption of sustainable economic growth.

**Q.8.** What are the costs associated with a lack of transparency in the conduct of both traditional and non-traditional monetary policy?

**A.8.** Lack of transparency in the conduct of traditional and non-traditional monetary policy would tend to undercut the effectiveness of policy actions. In the case of traditional monetary policy, lack of transparency would create greater uncertainty about the Federal Reserve's policy objectives as well as likely actions in response to various economic developments. Such uncertainty would tend to boost risk premiums and thus interest rates and depress spending and economic activity. In addition, a major benefit of transparency

stems from the ability of market participants to anticipate future policy actions. If market participants can anticipate future policy actions, those expectations will be priced into longer-term interest rates and other asset prices immediately, thus amplifying the power of monetary policy to affect overall financial conditions and the economy. Lack of transparency would undercut this important role of expectations.

Lack of transparency regarding the purposes, terms, and conditions of the Federal Reserve's liquidity programs, would similarly undercut their effectiveness. For such programs to be effective, market participants and the general public must understand the rationale and the terms and conditions for all such programs. As with interest rate policies, the ability of investors and others to anticipate how such programs will operate is extremely important.

**Q.9.** Foreign government-controlled funds known as sovereign wealth funds have invested significant resources in U.S. financial institutions struggling to recover from losses during the current recession.

Do you believe that the procedures in place at the Federal Reserve to review and monitor the effects of these transactions on bank holding companies are adequate to ensure the safety and soundness of the affiliated depository institutions?

**A.9.** I believe that the Federal Reserve has adequate authority under existing legislation to review and monitor investments of sovereign wealth funds in banks and bank holding companies and, if necessary, to take action to ensure the safety and soundness of those institutions. The Bank Holding Company Act (BHCA) and the Change in Bank Control Act (CIBCA) require any company, including a company owned or controlled by a foreign government, to obtain the approval of the Federal Reserve or other Federal banking agency before making a direct or indirect investment in a bank or bank holding company if the investment meets certain thresholds or conditions. The BHCA requires regular reporting on matters such as risk management and financial conditions, subjects bank holding companies to regular examination, and gives the Federal Reserve broad, ongoing authority to prevent bank holding companies from engaging in unsafe or unsound practices.

To date, sovereign wealth funds have structured their investments so as not to trigger the thresholds and conditions for review under the BHCA and CIBCA. Even below these threshold levels, however, the investments must not allow the sovereign wealth fund to exercise a controlling influence over the management or policies of the banking organization. Of course, even under these circumstances, the Federal Reserve has broad supervisory authority over the bank holding company, including authority to ensure compliance with applicable limitations on connections or relationships between a supposed passive investor and the banking organization.

Based on publicly available information, I am not aware of any inadequacy in the Federal Reserve's procedures to ensure compliance with these requirements. However, if and as circumstances change, it would be important for the Federal Reserve to adapt its monitoring and enforcement procedures to ensure the safety and soundness of U.S. banking organizations.



**Q.10.** Do you believe that the Federal Reserve Board has sufficient information to monitor the influence these foreign government investments may have on the U.S. banking system?

**A.10.** Based on publicly available information, I have no reason to believe that information available to the Federal Reserve pertaining to foreign government investments in U.S. banking organizations is insufficient to protect safety and soundness and otherwise monitor their impact on the U.S. banking system. As Member of the Board of Governors of the Federal Reserve System, I would seek to ensure that Federal Reserve staff develop and maintain sources of information sufficient for effective monitoring of the relationships between investors and U.S. banking organizations.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON  
FROM DANIEL K. TARULLO**

**Q.1.** The Federal Reserve has used many tools in its tool box this year to prevent economic meltdown. What other monetary policy tools do you believe be utilized to restore confidence in our markets and encourage economic recovery?

**A.1.** Although the Federal Reserve has reduced the federal funds rate close to zero, it has a number of policy tools that it can use to ease conditions in credit markets and thereby support economic recovery. First, it can provide short-term liquidity to assure that sound financial institutions have sufficient credit to conduct their normal activities. Second, it can purchase specific types of longer-term securities than it does in its usual open market operations, with the aim of reducing the longer-term interest rates that are critical to mortgage rates and investment decisions more broadly. Third, it can inject liquidity directly into important credit markets by purchasing, or lending against, securities associated with those markets. The terms of such efforts should vary with the specifics of the credit markets in question. However, if judiciously configured, these non-conventional policy actions can play an important role in easing credit conditions in markets that have remained significantly impaired despite the low federal funds rate. Going forward, the Federal Reserve should, consistent with its dual mandate to promote maximum employment and stable prices, be prepared to utilize all three policy tools as necessary.

**Q.2.** Beginning to restructure the financial services' regulatory structure is a complicated undertaking, and one that this Committee will spend much time addressing. As a bank regulator, what do you believe is the starting point for restructuring at the Fed? What is the number one structural regulatory deficiency that needs to be corrected by Congress?

**A.2.** In revamping our system of financial regulation, agencies must first ensure that regulatory capital rules provide an adequate buffer against the risks of loss associated with the activities of financial institutions. Just as importantly, the agencies must have the capacity to monitor compliance with these rules and the resolve to enforce them. A second task is to assess past shortcomings in examination and monitoring of the internal risk management systems of financial institutions, and to implement needed improvements. The broader agenda for Congress and the regulatory agen-

cies is to address sources of significant potential risk to the financial system that are not currently subject to adequate oversight. Among other things, this agenda should include regulatory coverage of all systemically important institutions and measures to identify, and respond, to the risks created in interactions among financial actors.

**Q.3.** Countries around the world are currently working on “stimulus” packages to help their economies recover. What should the United States do in coordinating international economic policies with these nations to achieve the best recovery results?

**A.3.** In general, prospects for recovery of the global economy will be strengthened if each country in the coming months takes measures appropriate to its circumstances to stabilize its financial system, promote adequate credit flows, and support domestic economic activity. In some circumstances, as evidenced by the rate cuts by a number of central banks (including the Federal Reserve) last fall, explicitly coordinated actions can send an important signal to markets of a shared resolve among government authorities to respond vigorously to serious risks to growth. Even where precise synchronization of specific policies is not feasible or necessary, international consultation and cooperation will be helpful in encouraging countries to pursue measures that strengthen domestic demand and contribute to global economic recovery. Over the longer term, it is important that countries adopt policies that are consistent with balanced, sustainable global growth.

**INTRODUCTION OF CHRISTINA D. ROMER BY DIANNE FEINSTEIN,  
A U.S. SENATOR FROM THE STATE OF CALIFORNIA**

Mr. Chairman, It is an honor and pleasure to introduce and recommend that my fellow Californian, Dr. Christina Romer, be confirmed as Chairman of the Council of Economic Advisors. Dr. Romer is a distinguished economist and innovative thinker.

She received her Bachelor of Arts in Economics from the College of William and Mary in 1981. After obtaining her doctorate in economics from the Massachusetts Institute of Technology in 1985, Dr. Romer became a professor of economics at Princeton University. She joined the faculty at the University of California, Berkeley, in 1988 and was promoted to full professor in 1993. She was awarded the Distinguished Teaching Award the following year. Currently, she is the Class of 1957 Garff B. Wilson Professor of Economics.

During her tenure at the University of California, Berkeley, Dr. Romer also has served as vice-president of the American Economic Association, as the Visiting Scholar at the Board of Governors of the Federal Reserve System, and she currently serves as the Co-Director for the Program in Monetary Economics at the National Bureau of Economic Research.

Dr. Romer is widely published, and since her first publication in 1986, she has published 28 articles in journals such as the *American Economic Review*, the *Journal of Economic History*, and the *Journal of Monetary Economics*. In addition, she has authored 11 other reviews and commentaries. In 1997, the volume she co-edited with her husband, *Reducing Inflation: Motivation and Strategy*, was released.

She has written widely on the subjects of the Great Depression and recessions, making her especially well-suited to advise the President during these challenging times. Dr. Romer understands the gravity of the current economic crisis and the importance of prudent and well-targeted government action to promote recovery.

In addition to teaching and research, Dr. Romer is a fellow of the American Academy of Arts and Sciences and is the recipient of a National Science Foundation research grant. Previously, she has received other awards and grants from the National Science Foundation, including the Faculty Award for Women Scientists and Engineers from 1991 to 1996. Her previous fellowships include the John Simon Guggenheim Memorial Foundation Fellowship and the National Bureau of Economic Research Olin Fellowship.

Dr. Romer is clearly one of the best minds in her field. At a time when so many families are struggling, it is essential that the President-elect has solid advice to positively change our Nation's economic course.

With that in mind I am happy to introduce Dr. Romer to this Committee.

Thank you, Mr. Chairman, Senator Shelby, and Members of the Committee.