U.S. Financial Regulatory Reform:

The Investors' Perspective

A Report by the Investors' Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

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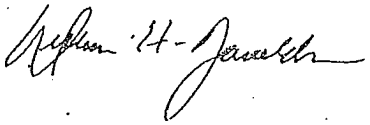
About the Investors' Working Group

During the summer of 2008, the CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors began exploring the idea of commissioning a study on financial regulatory reform. Both organizations were concerned that investor views were missing in the ongoing national debate about overhauling the U.S. system of financial regulation. The U.S. Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure," released in March 2008, largely ignored investor considerations, focusing instead on making U.S. markets more globally "competitive" by reducing costs for public companies and financial institutions.

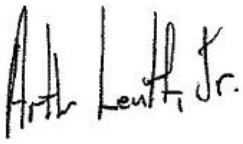
The result was the launch in February 2009 of the Investors' Working Group (IWG). This independent, non-partisan panel was formed to provide an investor perspective on ways to improve the regulation of U.S. financial markets. The IWG worked collaboratively to seek agreement on the recommendations. This report fairly reflects the consensus views of the group on myriad reforms. However, not all IWG members agreed with every recommendation in the report.

Our report could not be more timely. Over the past year, the worst financial crisis since the Great Depression has brought markets to the brink of collapse, toppled iconic financial institutions and forced repeated government bailouts. The debacle has wiped out retirement savings for millions of Americans and crippled the economy. It also has changed fundamentally the terms of the debate about regulation. Calls to unshackle Wall Street and let markets police themselves no longer dominate. Instead, the focus of the discussion now is on making the U.S. system of regulation more comprehensive, effective and responsive to the needs of investors, consumers and the broader financial system.

This report offers an essential roadmap to that destination. It suggests practical, near-term improvements and longer-term, aspirational reforms, some of which may require further study. But all of our recommendations are guided by a profound commitment to restoring confidence in our markets by ensuring that regulation serves the needs of investors. Strong investor safeguards are a prerequisite for market stability and integrity and a vibrant U.S. financial system.



William H. Donaldson, CFA
Co-Chair,
Investors' Working Group



Arthur Levitt, Jr.
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ACKNOWLEDGEMENTS

The Investors' Working Group wishes to acknowledge and express its great appreciation to the many outside contributors who helped produce this report. Our deepest thanks go to Professor Lawrence A. Cunningham, Henry St. George Tucker III Research Professor of Law at the George Washington University School of Law, and Professor Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center. Professor Cunningham was instrumental in helping the IWG organize its initial thoughts regarding financial regulatory reform. Professor Langevoort provided technical advice and assistance during the report's development and final drafting. The IWG is also grateful to Susan Trammell for her assistance in framing the initial draft report and Paul Beswick, John Brinkley, Peter R. Fisher, Steve Harris, Bob Herz, Gene Ludwig, Mark Radke, Marc A. Siegel, David F. Swensen and Lynn Turner for their contributions.

The IWG also would like to thank the staff of the CFA Institute Centre for Financial Market Integrity (CFA Centre) and the Council of Institutional Investors (CII) for their assistance in keeping the project moving. The IWG would like to especially thank Don Marlais (CII) and Linda Rittenhouse (CFA Centre) for their hard work and dedication in managing this project. Other staffers who contributed to the report included Amy Borrus, Marie Brodmerkel, Justin Levis, Jeff Mahoney, Jonathan Urick and Ann Yerger at CII and Jim Allen, Patrick Finnegan, Debra Palmore and Kathy Valentine at CFA Centre.

OVERVIEW

The credit crisis has exposed the faulty underpinnings of the U.S. financial services sector. The fundamental flaws are glaring: gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both "too big to fail" and too labyrinthine to regulate or manage effectively. Too often, the complexities of the regulatory system and the institutions it is supposed to police benefit institutions, dealers and traders at the expense of investors and consumers.

Designing a more rational financial services sector will take time, thoughtful analysis and political will. The findings of the Financial Crisis Inquiry Commission, which is to report to the U.S. Congress on the origins of the market meltdown and measures to ensure that such catastrophes do not happen again, are critical to that effort. What is at stake—the integrity of the U.S. financial system—is too important to rush the review.

In the near term, there are critical, practical steps that the federal government can take to put the U.S. financial regulatory system on a sounder footing and make it more responsive to the needs of investors. The Obama Administration's regulatory reform plan, announced on June 17, 2009, is a start. The Investors' Working Group (IWG) supports many of these recommendations but advocates a bolder set of near-term measures to strengthen investor and consumer protections and check systemic risks that threaten the health of the financial system.

The IWG believes that the U.S. needs a process for dealing with threats to the broader financial system, but we also believe that bolstering investor and consumer protection is paramount. The lack of sufficient authority, resources and will on the part of regulators helped fuel the financial meltdown at least as much as the absence of systemic-risk oversight.

To address these shortcomings, reform in the near term should focus on:

Strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers. To achieve this goal, the will to regulate must be restored. Light-touch federal regulation has met with disastrous results, as has starving agencies of needed resources. For example, the U.S. Securities and Exchange Commission's (SEC) funding has not kept pace with the explosive growth of the securities markets over the past two decades. Today, the agency monitors 30,000 entities, including more than 11,000 investment advisers, up 32 percent in only the last four years. Even so, in the three years from 2005 to 2007, the SEC's budgets were flat or declining.

Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products. For example, OTC derivatives contracts should be subject to comprehensive regulation; credit rating agencies should be subject to more meaningful oversight and greater accountability for their ratings; investment managers, including managers of hedge funds and private equity, should be required to register with the SEC; originators of asset-backed securities (ABS) should have some "skin in the game"; and regulators should be given resolution authority, analogous to the Federal Deposit Insurance Corporation's (FDIC) authority for failed banks, to wind down or restructure troubled systemically significant non-banks.

Improving corporate governance. The financial crisis represents a massive breakdown in oversight at many levels, including at corporate boards. Investors need better tools to hold directors accountable so they will be motivated to challenge executives who pursue excessively risky strategies. Measures to make it easier for shareowners to nominate and elect directors are a good place to start.

Since the financial crisis erupted, fear that the failure of large financial institutions could have devastating repercussions throughout the U.S. financial system has prompted unprecedented government intervention in the markets and the private sector. Consequently, much of the debate about financial reform has focused on the need to monitor and address future systemic risks. The U.S. regulatory framework was not designed to monitor and respond to risks to the entire financial system posed by large, complex and interconnected institutions, practices and products.

The IWG believes that the appropriate way to address this immediate need is for Congress and the Administration to authorize the creation of an independent Systemic Risk Oversight Board (SROB). Ideally, the SROB would have the authority and highly skilled staff to 1) collect and analyze financial institutions' exposures, practices and products that could threaten the stability of the financial system and 2) recommend steps that existing regulators should take to reduce those risks.

This approach represents a middle ground between the systemic risk regulator advocated by the Administration and the "college of cardinals" model of oversight by the heads of existing federal regulators that some leading lawmakers propose. The IWG views both approaches with skepticism. A council of regulators would have blurred lines of authority—ultimately no one would be in charge or accountable—and could be hamstrung by the usual jurisdictional disputes. The Administration's approach, which envisions the U.S. Federal Reserve Board as systemic risk regulator, has more serious drawbacks. The Fed has other, potentially competing responsibilities—from guiding monetary policy to managing the vast U.S. payments system. Its credibility has been tarnished by the easy credit policies it pursued and the lax regulatory oversight that let institutions ratchet higher their balance sheet leverage and amass huge concentrations of risky, complex securitized products. Other serious concerns stem from the Fed's regulatory failures—its refusal to police mortgage underwriting or to impose suitability standards on mortgage lenders—and the heavy influence that banks have on the Fed's governance.

The Systemic Risk Oversight Board's collection and analysis of data, with an eye on emerging systemic risks, would be informed by the Financial Crisis Inquiry Commission's parallel efforts to understand the root causes of the current crisis. The tandem investigations would help guide policymakers as they consider overall regulation of the financial services sector, including the eventual locus, scope and powers of a systemic risk regulator. Until then, the oversight board would monitor systemic threats and refer appropriate steps to existing regulatory agencies–the Treasury, the Fed and Congress.

While our report focuses on near-term needs, we recognize that there is a larger, long-term agenda. Restructuring the hodge-podge of financial regulators and key financial institutions is clearly an imperative, regardless of how politically arduous the task. Policymakers need to map out a path toward a more rational, less conflicted financial system. Steps they should consider include:

Designating a systemic risk regulator, with appropriate scope and powers. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator.

Adopting new regulations for financial services that will prevent the sector from becoming dominated by a few giant and unwieldy institutions. New rules are needed to address and balance concerns about concentration and competitiveness.

Strengthening capital adequacy standards for all financial institutions. Too many financial institutions have weak capital underpinnings and excessive leverage.

Imposing careful constraints on proprietary trading at depository institutions and their holding companies. Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans.

Consolidating federal bank regulators and market regulators. Regulation of banks and other depository institutions may be streamlined through the appropriate consolidation of prudential regulators. Similarly, efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission (CFTC).

Studying a federal role in the oversight of insurance companies. The current state-based regulation makes for patchwork supervision that has proven inadequate to the task.

The IWG believes that the goal of the longer-term effort should be a simpler yet more comprehensive regulatory net, stronger overseers and manageable, better-governed financial institutions that will not pose "too big to fail" threats. The new financial order that emerges must ensure appropriate safeguards for investors. Investors, in turn, must focus on sustainable, risk-adjusted performance, recognizing that pressing investment advisers and executives of portfolio companies for quick returns can spur out-on-a-limb behavior in pursuit of fast but often ephemeral profits.

The regulatory overhaul should not stop at the water's edge. Financial markets are increasingly global. U.S. financial institutions generate a growing share of their revenues and assets overseas. Washington policymakers must lead a fresh effort to forge international consensus on key elements of the regulation of global markets, players and products. U.S. leaders should also press for greater sharing of information among national regulators and harmonization of rules and practices. In contrast to other recent global initiatives, however, the focus should be on *raising* standards, not weakening them.

This report is intended to ensure that policymakers fully consider and reflect on making regulatory changes that serve investors, consumers and the broader financial system. A balance is needed among many interests. In particular, building a U.S. financial system that correctly balances efficiency, global competitiveness, and investor and consumer protection is enormously challenging. It is also an opportunity, however, to put the U.S. financial system on a firmer, more rational footing and ensure that it serves the needs of investors. Strong investor protections are integral to restoring trust, stability and vibrancy to U.S. financial markets. The IWG believes this plan of action is the best way forward toward that goal.

OUTLINE OF RECOMMENDATIONS

I. INVESTOR AND CONSUMER PROTECTIONS

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.
- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities.
- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- ABS sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers (cont.)

- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors—including pension funds, hedge funds and private equity firms—should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

- Congress should give regulators resolution authority, analogous to the Federal Deposit Insurance Corporation's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

Nationally Recognized Statistical Rating Organizations (NRSROs)

- Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.
- Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.
- NRSROs should be required to manage and disclose conflicts of interest.
- NRSROs should be held to a higher standard of accountability.
- Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.
- Securities exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

II. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board's budget should ensure its independence from the firms it examines.
- All board members should be full-time and independent of government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.
- The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.
- Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis.

I. Investor and Consumer Protections

The Investors' Working Group believes that strengthening existing regulatory agencies, closing gaps in the regulatory structure, enhancing consumer and investor protections and improving corporate governance are the most important steps Congress and the Obama Administration can take to restore the integrity of the financial system and the stability of financial markets.

Background

When the financial meltdown began, regulators for the most part had enough information and should have recognized the signs but did not, or could not, stop the downward spiral. One reason is that regulators lacked the requisite will, resources and expertise. Another is that the web of regulatory supervision that covers the U.S. financial services industry is riddled with holes. Some are intentional. For example, the OTC derivatives market has been expressly exempted from virtually all federal oversight. But even in regulated parts of the markets, the oversight fabric is not knit tightly enough.

A. Strengthening Existing Federal Regulators

While the IWG acknowledges that regulatory failures were a major contributing cause of the financial debacle, we believe that the right solution is to reinforce, rather than abandon, the existing regulatory framework.

Above all, regulators must be committed to promoting policies that are good for consumers, investors and the financial markets. Although the will to regulate cannot be legislated, Congress can encourage vigorous regulation through general oversight and its specific role in providing advice and consent regarding nominees to lead financial regulatory agencies. Structural and financial changes can also help strengthen regulatory agencies by making them more independent of the industries they supervise and allowing them to hire staff with deep knowledge of complex products and rapid financial innovation. Consolidating agencies as appropriate can help bolster and streamline financial regulation so long as mergers are crafted with a keen understanding of the differences between existing regulators and the markets and institutions they supervise.

Background

Since 1980, a dramatic shift in the financial regulatory system has occurred. Vigorous governmental oversight was abandoned as regulators placed their faith in the ability of markets to self-police and self-correct. Even as the credit crisis unfolded in early 2008, the prevailing view in the industry and among many agency chiefs and government leaders was that too much regulation, rather than too little, was eroding the competitiveness of U.S. markets.

The IWG believes that this view is misguided. The financial crisis has revealed that insufficient and ineffective oversight, not over-regulation, paved the way to financial turmoil.

Beyond a misplaced faith in markets, regulators lacked the will, knowledge and resources to flexibly respond to rapid financial innovation and market expansion. Poor funding and a lack of independence allowed an anti-regulatory ideology to permeate regulatory agencies. The Congressional appropriations process helped to undermine robust oversight. Fearful of political budgetary retaliation, agencies grew reluctant to exercise their authority fully in certain areas. It is no coincidence that these pockets of poor oversight proved to be sources of great risk.

Specific Recommendations

1. Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority. Congress and the Administration should amend statutory language establishing various financial regulators to prominently include provisions requiring that the President consider potential appointees' determination to exercise vigorous oversight and their commitment to the regulatory mission. Congress should be vigilant in exercising its general supervisory authority and thoughtfully carry out its obligation to provide advice and consent to ensure that nominees possess the resolve to regulate effectively.

The President, Congress and agency leaders must work to foster a culture of regulatory professionalism that rewards high-quality work and instills a community of purpose. Such a culture is rooted in steadfast devotion to vigorous oversight and enforcement. Regulators should be encouraged to exercise the greatest supervision where the need is greatest, including over the most complex and rapidly expanding institutions, products and markets. Resistance to regulation in these often highly lucrative areas is likely to be intense. Staff should be rewarded for asking tough questions, pursuing difficult cases and thinking outside the bounds of conventional wisdom. A healthy tension and skepticism between regulators and those they oversee should be promoted as a hallmark of exemplary regulation.

2. Regulators should have enhanced independence through stable, long-term funding that meets their needs. All federal financial regulators should have the resources and independence to fulfill their mission effectively without political interference or dependence on the firms they oversee. The IWG encourages Congress and the Administration to consider ways to develop mechanisms for stable, long-term funding. To ensure that funding keeps pace with rapid market changes and financial innovation, Congress, the Administration and regulators should periodically reevaluate the resources each agency needs to fulfill its mission. To the extent possible, agencies should have funding flexibility to respond to these changes on their own.

3. Regulators should acquire deeper knowledge and expertise. The speed with which financial products and services have proliferated and grown more complex has outpaced regulators' ability to monitor the financial waterfront. Staffing levels failed to keep pace with the growing work load, and many agencies lack staff with the necessary expertise to grapple with emerging issues. Political appointees and senior civil service staff should have a wide range of financial backgrounds. Compensation should be sufficient to attract top-notch talent. In addition, continuing education and training should be dramatically expanded and officially mandated to help regulators keep pace with innovation. Although we recognize that the "revolving door" between regulatory agencies and the private sector can lead to abuse, we believe that both the public sector and the private sector can benefit from people with experience in both. In particular, agencies should explore ways of recruiting individuals from the private sector to improve the regulators' ability to understand and keep up with complex financial and market innovations. And those who have served in regulatory agencies can assist market players in understanding the perspective of regulators and the need for regulations.

B. Closing the Gaps for Products, Players and Gatekeepers

The nation's regulatory umbrella should be comprehensive. Specifically, it should be broadened to cover important financial products, players and gatekeepers that lack meaningful oversight. Critical gaps that urgently need attention include OTC derivatives, securitized products, investment managers, mortgage finance companies and credit rating agencies.

OTC Derivatives

All standardized (and standardizable) derivative contracts currently traded over the counter should be required to be traded on regulated exchanges and cleared through regulated clearinghouses. Any continuing OTC derivatives trading should be limited strictly to truly customized contracts between highly sophisticated parties, at least one of which requires a customized contract in order to hedge business risk. What remains of the OTC derivatives market should be subject to a robust federal regulatory regime, including reporting, capital and margin requirements.

Background

OTC derivatives generally are bilateral contracts between sophisticated parties. They include interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps and the now-infamous credit default swaps (CDS), along with other types of swaps, contracts and options. It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. For December 2008, the Bank for International Settlements reported a notional amount outstanding of $592 trillion and a gross market value outstanding of $34 trillion for global OTC derivatives. This enormous financial market was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000 (CFMA).

Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm. Warren Buffett has dubbed them "financial weapons of mass destruction." Problems plaguing the market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.

Specific Recommendations

1. Standardized derivatives should trade on regulated exchanges and clear centrally. Congress and the Administration should enact legislation overturning the exemptive provisions of the CFMA and requiring standardized (and standardizable) derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. Legal requirements based on those established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk. Although requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.

2. OTC trading in derivatives should be strictly limited and subject to robust federal regulation. An OTC market is necessarily much less transparent and much more difficult to regulate than an exchange market. If trading OTC derivatives is permitted to continue, such trading should be strictly limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge business risk. Congress and the Administration should enact legislation limiting the eligibility requirement for OTC derivatives trades to highly sophisticated and knowledgeable parties and requiring that at least one party to each OTC contract should certify and be prepared to demonstrate that it is entering into the contract to hedge an actual business risk. This limitation to trading on the OTC market would permit entities to continue to hedge actual business risks but would reduce the current pervasive speculation in the market.

A federal regulatory regime is needed for any continuing OTC market. OTC derivatives dealers should be required to register, maintain records and report transaction prices and volumes to the federal regulator. They should be subject to adequate capital requirements and business conduct standards, including requirements to disclose contract terms and risks to their customers. All OTC trades should be subject to federally imposed margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of OTC derivatives should be publicly reported on a timely basis.

All market participants should be subject to federal fraud and manipulation prohibitions, recordkeeping and reporting requirements, and position limits if imposed by the federal regulator. The regulator should have broad powers to oversee the market and all its participants, including powers to require additional reporting and inspection of records and to order positions to be eliminated or reduced. Federal legal prohibitions should be enacted to prohibit the use of OTC derivatives to misrepresent financial condition or to avoid federal laws.

3. The FASB and IASB should improve accounting for derivatives. A thorough and comprehensive review of accounting rules related to derivative instruments is needed. The goals of this review should be to ensure consistent reporting about these instruments and to ensure full disclosure for the benefit of investors, counterparties and regulators. To make informed decisions, investors and those entering into counterparty relationships need information about these positions.

4. The SEC and the CFTC should have primary regulatory responsibility for derivatives trading. Currently, the SEC and the CFTC each have regulatory responsibilities for certain portions of derivatives trading, depending on the nature of the derivatives product and/or the type of exchange on which it is traded. Those agencies have the experience and sophistication to oversee derivatives markets and should act as the primary regulators of both exchange trading and any continuing OTC market. It is important that federal standards for derivatives trading be comprehensive and consistent and that agency jurisdiction over such trading be clearly delineated. For this reason, the SEC and the CFTC must agree on appropriate regulatory standards and on their respective regulatory responsibilities, and the terms of such agreement should be enacted into law.

5. The United States should lead a global effort to strengthen and harmonize derivatives regulation. Because the OTC derivatives market is global, U.S. financial regulators should work with foreign authorities to strengthen and harmonize standards for derivatives regulation internationally and to enhance international cooperation in enforcement and information sharing.

Securitized Products

Investors have had a difficult time understanding securitized instruments because of the lack of information about them and the confusing manner in which this information is reported, both to the shareowners of the issuing company (or sponsor), and to investors in these often complex products. This opacity stems in part from securitized products' absence from sponsors' balance sheets. Moreover, securitized products are sold before investors have access to a comprehensive and accurate prospectus.

The IWG believes that accounting standards setters should improve the quality, appropriateness and transparency of reporting related to off-balance-sheet transactions and securitizations by sponsoring institutions. The SEC should develop new rules for the sale of asset backed securities that give investors in these products a reasonable opportunity to review disclosures before making a decision to invest. Sponsors of ABS and structured products should have to retain a meaningful interest in the underlying assets they securitize. Lastly, while the status of government-sponsored enterprises (GSEs) is currently in limbo, the IWG believes the GSEs or their successor enterprises should be subject to the same securities regulations that apply to all other sponsors when they issue ABS.

Background

Beginning in the 1980s, banks and other lenders began repackaging mortgage loans and other predictable cash flows into asset-backed securities. Some $3 trillion were outstanding by year-end 2008.

Both investors in these securities and the shareowners of their sponsoring organizations lack crucial information needed to judge their true risk. The off-balance-sheet accounting treatment of securitizations masks from shareowners of the sponsoring company the potential costs of deterioration in the quality of the assets underlying the instruments. Consequently, shareowners of a sponsoring company may not appreciate the impact on the company of deterioration in the quality of the underlying loans. In addition, the off-balance-sheet treatment allows the sponsor to reduce the amount of capital supporting the underlying loans by as much as 90 percent. Significant capital shortfalls can thus occur when a sponsor chooses to support these securitizations (whether according to or beyond the terms of the securitization) by bringing them back onto its balance sheet.

Beyond poor accounting and disclosures by the sponsors of securitized products, institutions that invest directly in these securities have been ill-served by existing disclosures. In particular, investors often have to decide whether to invest in an ABS issuance based not upon a detailed prospectus but rather on a basic term sheet with limited information. Although these investors could choose not to invest under such terms, doing so would lock them out of many ABS transactions. Institutions feared that this lockout would be inconsistent with their fiduciary duty to find the best investments for their clients. Investing before reviewing a prospectus, however, limits the ability of investors to perform adequate due diligence.

Accounting and disclosure problems were even more severe at the GSEs. As government-chartered corporations, the GSEs were able to operate as major sponsors of mortgage-backed securities, even though they were not subject to the same regulations as other participants. As recent events have shown, an implicit government guarantee does not protect investors from systemic failure. Consequently, investors need to have relevant information that will help them review, analyze and make reasoned and informed investment decisions about securities and firms that might be affected by the financial performance and condition of GSEs. Although the GSEs' future is uncertain at this time, the IWG believes that they or their successors should have to adhere to the same regulations as other securities issuers.

Notwithstanding the serious lack of crucial information about securitized products, the IWG recognizes that investors need to be more diligent. Some investors effectively outsourced their investment due diligence to third parties, such as credit rating agencies, without fully understanding the nature of the collateral underlying the bonds, the purpose of the rating or the rating agency's conflicts of interest that may have colored its ratings. Investors must pay more attention to these details, which are critical to understanding the risks and opportunities of ABS investments.

Specific Recommendations

1. New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted. The IWG applauds the recent action by the FASB finalizing accounting standards that limit exemptions for consolidating off-balance-sheet entities and require more information about securitization transactions. Efforts to water down or delay the implementation of those new requirements should be vigorously resisted.

2. Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities. Sponsoring companies with off-balance-sheet exposure to ABS that they sponsored and/or are servicing should be required to provide full disclosure about how these exposures could affect shareowners if the firm returns the related assets and liabilities to their balance sheets. More transparent disclosure would permit investors to better understand the amount and type of loans that sponsors are originating and the amount of leverage they could create. The disclosure would also provide investors with information about ongoing changes in loan quality and underwriting standards and the potential risks those changes may create in the future. In particular, such disclosure also should describe how those actions could affect the sponsoring firm's capital and liquidity positions, earnings and future business prospects if the firm repurchases the loans onto its balance sheet.

3. The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products. Current rules allowing sponsors to issue asset-backed securities via shelf registration provide for woefully inadequate disclosures to potential investors in these products. Because each ABS offering involves a new and unique security, the IWG does not believe the SEC should allow such issuances to be eligible for its normal shelf-registration procedures. Instead, the SEC should develop a regulatory regime for such asset-backed securities that would require issuers to make prospectuses available for potential investors in advance of their purchasing decisions. These prospectuses should disclose important information about the securities, including the terms of the offering, information about the sponsor, the issuer and the trust, and details about the collateral supporting the securities. Such new rules would give investors critical information they need to perform due diligence on offerings prior to investing. It would also create better opportunities for due diligence by the underwriters of such securities, thus adding additional levels of oversight of the quality and appropriateness of structured offerings.

4. ABS sponsors should be required to retain a meaningful residual interest in their securitized products. Having "skin in the game" would make sponsors more thoughtful about the quality of the assets they securitize. Sponsors should have to retain a meaningful residual interest in ABS offerings. Hedging these retained exposures should be prohibited.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers so that they are subject to federal scrutiny. All registered fund managers should have to make periodic disclosures to regulators about the current positions of their funds, and should make regular, delayed public disclosures of their funds' positions to help their investors and other market participants understand the associated risks. Regulators should conduct a full review of rules governing investment managers and their funds to ensure that they adequately address the different types of investment vehicles and practices subject to those rules. In order to improve the quality of advice provided to retail investors and to protect them from abusive practices, the SEC should be empowered to reform compensation practices that create unacceptable conflicts of interest, improve pre-sale disclosures, and subject all those who provide personalized investment advice, including broker-dealers, to a fiduciary duty.

Regulators should also be empowered to oversee new participants and products as they emerge and have adequate resources for timely and careful examinations.

Background

Many hedge funds, funds of hedge funds and private equity funds operate within the "shadow" financial system of unregulated non-bank financial entities. These funds and their managers have been exempt from regulation because of a combination of factors related to the number and relative sophistication of investors they serve and the size of assets under management.

Unencumbered by leverage limits, compliance examinations or full disclosure requirements, many hedge funds and private equity funds operate under the radar. Their ability to take on enormous leverage, in particular, enables them to hold huge positions that can imperil the broader market. If market trends move against a hedge fund or a private equity fund and it is forced to liquidate at fire-sale prices, prime brokers, banks and other counterparties could be subject to significant losses. Even market participants who have no direct dealings with the fund could be battered by the resulting plunge in asset prices and liquidity squeeze. Registration would afford a degree of transparency and oversight for these systemically important market players. It would at least ensure disclosure of basic information about the managers and funds and make them eligible for examination by the SEC.

Oversight of the intermediaries that investors rely on in making investment decisions has failed to keep pace with dramatic changes in the industry. These changes include the development and rapid growth of the financial planning profession and changes in the full-service brokerage business model to one that is, or is portrayed as being, largely advisory in nature. Nevertheless, a series of decisions by regulators over the years allowed brokerages to call their sales representatives "financial advisers," offer extensive personalized investment advice and market their services based on the advice offered, all without regulating them as advisers.

As a result, investors are forced to choose among financial intermediaries who offer services that appear the same to unsophisticated eyes, but who are subject to very different standards of conduct and legal obligations to the client. Most significantly, investment advisers are required to act in their clients' best interest and disclose all material information, including information about conflicts of interest, whereas brokers are subject to the less rigorous suitability standard and do not have to provide the same extensive disclosures.

Meanwhile, although investors are encouraged to place their trust in "financial advisers," compensation practices in the industry are riddled with conflicts of interest that may encourage sales of products that are not in clients' best interests. The disclosures that investors are supposed to rely on in making investment decisions are often inadequate and overly complex and typically arrive after the sale–long past the point when they could have been useful to investors in analyzing their investment options.

As innovation produces new institutions, products and practices, federal regulators must be able to bring them under their jurisdiction, too. One important lesson of the recent crisis is that as financial products and services proliferate and become more complex, they often fall through the regulatory cracks. Extending the scope of examinations will require additional funding for regulators and ultimately result in more effective regulation.

Specific Recommendations

1. All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight. All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve. Exemptions from registration should not be permitted, although smaller advisory firms should continue to be overseen by state regulators.

2. Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction. The frequency and extent of regulatory examinations should be determined by the nature and size of the firm. The exam process should be augmented by independent third-party reviews and reporting. Regulators should be empowered to extend their jurisdictional reach to cover emerging participants and products.

3. Investment managers should have to make regular disclosures to regulators on a real-time basis and to their investors and the market on a delayed basis. Because of the potential systemic risks associated with investment managers, and their interconnections with other systemically important financial institutions, the IWG believes that all investment managers should have to disclose their positions to regulators on a confidential but real-time basis. This would allow regulators to recognize large and growing exposures and take steps to limit their impact.

The IWG also believes that hedge funds and other private pools of capital should make regular but delayed public disclosures about their positions. Delayed disclosure would provide investors a window on the fund manager's investment strategies while preventing other investors from "front-running" those game plans. It would also give the market at large an understanding of the degree of risk inherent in the investment strategies. In light of new trading techniques and products available, regulators should reexamine how often investment companies are required to report their holdings to investors and the market.

4. Investment advisers and brokers who provide investment advice to customers should have to adhere to fiduciary standards. Their compensation practices should be reformed and their disclosures improved. All investment professionals, including broker-dealers who provide personalized investment advice, should be subject to a fiduciary duty to act in their clients' best interests and to disclose material information. Compensation practices that encourage investment professionals to make recommendations that are not in their clients' best interests should be reformed. Disclosures should also be improved to ensure that investors receive pre-engagement disclosure to aid them in selecting an investment professional and clear, plain English, pre-sale

disclosure of key information about recommended investments. This would provide an added level of protection to both retail and institutional clients.

5. Institutional investors—including pension funds, hedge funds and private equity firms—should make timely public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance. Investors who champion best disclosure practices at portfolio companies have a responsibility to play by similar rules. Best disclosure practices for institutional investors would foster transparency and accountability throughout the capital markets, thus enhancing confidence in the markets. They would also strengthen fiduciary ties between fund beneficiaries and trustees and guard against misuse of fund assets and abuses of the power inherent in large pools of capital. Specifically, institutional investors should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

Congress should enact legislation granting appropriate regulators resolution authority for faltering non-bank financial institutions. Such authority should include explicit powers to seize, wind down and restructure troubled institutions deemed "too big to fail." The IWG generally supports the Administration's proposal for this new authority but does not take a position on where it should be vested and how it should be implemented.

Background

In the 1930s, chaotic and costly bank failures motivated Congress and President Roosevelt to empower federal regulators to seize and wind down, in an orderly fashion, illiquid and insolvent banks. The financial crisis of 2008 included, in particular, a run on several large firms operating in the non-bank financial system. No mechanism existed, however, to deal with the failure of large, complex, interconnected non-bank institutions, such as Bear Stearns, Lehman Brothers or American International Group (AIG). As a result, federal bailouts were ad hoc and inconsistent, fueling further market chaos that threatened the entire financial system.

Specific Recommendation

Congress should give regulators resolution authority, analogous to the FDIC's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks. Banks are no longer the primary systemically significant players in our financial system. The disorderly failure of large, interconnected investment banks, insurers and other institutions could also trigger cascading failures throughout the financial system. A carefully designed resolution regime for large non-banks would provide much needed market stability by ensuring that the essential functions of failed institutions continue relatively uninterrupted. Consideration also should be given to expanded use of the Bankruptcy Code. An orderly liquidation or restructuring would also help minimize the cost to taxpayers over the long run.

Mortgage Originators

All banks and other mortgage lenders should be required to meet minimum underwriting standards. They should also adhere to baseline standards for documenting and verifying a borrower's ability to repay and for ensuring that loans and credit lines they issue are appropriate for particular borrowers. A new consumer product oversight agency could help ensure that mortgage lenders adhere to such standards and requirements. Mortgage lenders should be required to retain a meaningful residual interest in all loans and credit lines they originate.

Background

Over the past 20 years, the link between mortgage underwriting and origination and retention of the risk of repayment has become increasingly attenuated. Although mortgage bankers and brokers, as well as some bank loan officers, have always been paid on the basis of the size of the loan and its characteristics, it has become common for brokers and others to be paid more for loans with higher interest rates or other characteristics (such as prepayment penalties) that in fact make it harder for borrowers to repay. The practice encouraged steering borrowers to loans for which they were not qualified and falsifying income and other data so borrowers could get loans they could not afford. Lenders that quickly sold loans to packagers of securitized products had little or no interest in the borrowers' ability to repay. Ultimately, investors who purchased mortgage-backed securities shouldered the credit risk.

The lack of meaningful federal oversight of consumer credit product providers exacerbated the off-loading of risk to investors. Without minimum standards and oversight applied consistently to all mortgage lenders, many of the largest mortgage originators "regulated" themselves—and competition drove down standards. The consequences were disastrous for borrowers, lenders, communities and the economy as a whole.

Specific Recommendations

1. Congress should create a new agency to regulate consumer financial products, including mortgages. The financial crisis has demonstrated that mortgage originators cannot exercise necessary market self-discipline and that current regulatory structures, where they exist, have failed to provide appropriate protection for both consumers and investors. The IWG supports the Administration's call for a new federal agency to regulate consumer financial products and payment systems. The agency should have broad rulemaking, oversight and enforcement authority.

2. Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements. Mortgage originators will make more responsible lending decisions if they face minimum underwriting standards that are subject to review by federal and state regulators. These standards should be based on a realistic appraisal of the borrower's ability to repay the debt, taking into account any features that would increase the payments in the future. Such standards should also require mortgage originators to obtain and verify key financial information from all borrowers and to obtain and retain evidence that the borrower has seen and agreed with this information before a loan is closed. Federal and state

regulators should monitor all mortgage originators for compliance with these practices. These changes should reduce the "race to the bottom" that characterized the last decade.

3. Mortgage regulators should develop suitability standards and require lenders to comply with them. This will help ensure that mortgage companies consider carefully whether a particular credit product is appropriate for a particular borrower. Innovative features in mortgage products can help certain borrowers. But these should be tailored to each borrower's needs and ability to repay, and originators should be required to offer consumers the best possible mortgage rates, fees and terms for which they qualify.

4. Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines. Having "skin in the game" would make lenders more thoughtful about the credit-worthiness of potential borrowers. Mortgage lenders should be required to retain a meaningful interest in all loans and outstanding credit lines they generate. Federal and state regulators should be empowered to determine the minimum holding period and related terms and conditions. Lenders should be prohibited from hedging these exposures.

Nationally Recognized Statistical Rating Organizations

The failure of Nationally Recognized Statistical Ratings Organizations to alert investors to the risks of many structured products underscores the need for significant change in the regulation of credit rating agencies. Congress should grant the SEC greater authority to scrutinize NRSROs. Congress and the Administration should consider steps to encourage alternatives to the predominant, issuer-pays NRSRO business model. Congress also should eliminate the safe harbor in Section 11 of the Securities Act of 1933 that shields rating agencies from liability for due diligence failures. And to deter investors from relying too heavily on rating agencies, lawmakers and regulators should remove or diminish provisions in laws and regulations that designate minimum NRSRO ratings for specific kinds of investments.

Background

Credit ratings issued by NRSROs are widely embedded in federal and state laws, regulations and private contracts. Ratings determine the net capital requirements of financial institutions globally under the Basel II capital accords. They also dictate the primary types of investment securities that money market funds and pension funds may hold. Partly as a result, many institutional investors have come to rely on credit rating agencies as a basic investment screen, a problem that is exacerbated by the lack of adequate disclosures in the sale of asset-backed securities.

Despite the semi-official status of NRSROs as financial gatekeepers, the rating agencies face minimal federal scrutiny. The Credit Rating Agency Reform Act of 2006 did not much alter that "light-touch" oversight. Although it standardized the process for NRSRO registration and gave the SEC new oversight powers, those powers were limited. It also expressly ruled out any private right of action against an NRSRO.

The central role that rating agencies played in the financial crisis makes such limited oversight untenable. The leading NRSROs— Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services—maintained high investment-grade ratings on many troubled financial institutions until they were on the brink of failure or collapse. And well into the credit crisis, NRSROs maintained triple-A ratings on complex structured financial instruments despite the poor and deteriorating the quality of the sub-prime assets underlying those securities.

The conflicted issuer-pays model of many NRSROs contributed to their poor track record. Most NRSROs are paid by companies and securitizers whose debt they rate. With their profitability dependent on the rapidly growing business of rating structured finance products, rating agencies appear to have been all too willing to assign the high ratings that originators and underwriters demanded. Questions about the quality of their ratings continued to rise in recent years even as they rated more and more complicated instruments.

But credit rating agencies' statutory exemption from liability also keeps NRSROs from having to answer for their shoddy performance and poorly managed conflicts of interest. Credit rating agencies have long maintained that their ratings are merely opinions that should be afforded the same protection as the opinions of newspapers and other publishers. Judicial rulings have tended to support their claim to protected status.

To be sure, some investors relied too heavily on NRSRO ratings, ignoring warning signs such as the rating agencies' notorious failure to downgrade ratings on Enron and other troubled companies until they were on the brink of bankruptcy. And some investors ignored or failed to comprehend the fundamental differences between ratings on structured securities and ratings on traditional debt instruments.

Statutory and regulatory reliance on ratings encourages investors to put more faith in the rating agencies than they should. If the rating agencies cannot dramatically improve their rating performance, they should be weaned from such official seals of approval. At the very least, legal references to ratings should make clear that reliance on them does not satisfy the requirement that investors perform appropriate due diligence to determine the appropriateness of the investments. In other words, ratings should be seen not as a seal of approval for certain investments but as defining the investments that should not be considered for a particular purpose.

The IWG recognizes that it is not practical to abolish the concept of NRSROs and erase references to NRSRO ratings in laws and regulations, at least not with one stroke. Mandates to use ratings are embedded in many financial rules. The more practical course for the near term is to reform credit rating agency regulation and to work toward reducing or removing references to credit ratings in laws and regulations.

Specific Recommendations

1. Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model. In addition, the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-pays model should be subject to the strictest regulation.

2. Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs. The SEC's authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. NRSROs should be required to manage and disclose conflicts of interest. As an immediate step, NRSROs should be required to create an executive-level compliance officer position. More complete, prominent and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm's revenues.

4. NRSROs should be held to a higher standard of accountability. Congress should eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit rating agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions. Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these safe harbors over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

C. Corporate Governance

Investors need better tools to hold managers and directors accountable for their actions. Improved corporate governance requirements would also help restore trust in the integrity of U.S. financial markets. In particular, shareowners' ability to hold an advisory vote on the compensation of senior executives, as well as their ability to nominate and elect directors, must be enhanced. Board independence should also be strengthened.

Background

The global financial crisis represents a massive failure of oversight. Vigorous regulation alone cannot address all of the abuses that paved the way to financial disaster. Shareowner-driven market discipline is also critical. Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come. Boards were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind. And too many boards approved executive compensation plans that rewarded excessive risk-taking.

But shareowners currently have few ways to hold directors' feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing the names of their own director candidates on proxy cards. Shareowners who want to run their own candidates for board seats must mount costly full-blown election contests. Another wrinkle in the proxy voting system is that relatively few U.S. companies have adopted majority voting for directors. Most elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If they oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible.

Poorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets. To remedy this situation, stronger governance checks on runaway pay are needed.

Specific Recommendations

1. In uncontested elections, directors should be elected by a majority of votes cast. At many U.S. public companies, directors in uncontested elections are elected by a plurality of votes cast. An uncontested election occurs when the number of director candidates equals the number of available board seats. Plurality voting in uncontested situations results in "rubber stamp" elections. Majority voting in uncontested elections ensures that shareowners' votes count and makes directors more accountable to shareowners. Plurality voting for *contested* elections should be allowed because investors have a more meaningful choice in those elections.

2. Shareowners should have the right to place director nominees on the company's proxy. In the United States, unlike most of Europe, the only way that shareowners can run their own candidates is by waging a full-blown election contest, printing and mailing their own proxy cards to shareowners. For most investors, that is onerous and prohibitively expensive. A measured right of access would invigorate board elections and make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant in their oversight of companies. Federal securities laws should be amended to affirm the SEC's authority to promulgate rules allowing shareowners to place their nominees for directors on the company's proxy card.

3. Boards of directors should determine whether the chair and CEO roles should be separated or whether some other method, such as lead director, should be used to provide independent board oversight or leadership when required. Boards of directors should be encouraged to separate the roles of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.

4. Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management. Compensation consultants play a key role in the pay-setting process. But conflicts of interest may lead them to offer biased advice. Most firms that provide compensation consulting services to boards also provide other kinds of services to management, such as benefits administration, human resources consulting and actuarial services. These other services can be far more lucrative than advising compensation committees. Conflicts of interest contribute to a ratcheting-up effect for executive pay. They should be minimized and disclosed.

5. Companies should give shareowners an annual advisory vote on executive compensation. Nonbinding shareowner votes on pay would make board compensation committees more careful about doling out rich rewards to underperforming CEOs, and thus would avoid the embarrassment of shareowner rejection at the ballot box. So-called "say on pay" votes would open up dialogue between boards and shareowners about pay concerns.

6. Federal clawback provisions on unearned executive pay should be strengthened. Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act's language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.

II. Systemic Risk Oversight Board

The Investors' Working Group believes there is an immediate need to monitor and respond to risks to the entire financial system posed by large, complex, interconnected institutions, practices and products and supports the creation of an independent Systemic Risk Oversight Board to supplement, not supplant, the functions of existing federal financial regulators. The mission of the board should include collecting and analyzing the risk exposure of bank and non-bank financial institutions, as well as those institutions' practices and products that could threaten the stability of the financial system and the broader U.S. economy; reporting on those risks and any other systemic vulnerabilities; and recommending steps regulators should take to reduce those risks.

The Systemic Risk Oversight Board would fill an immediate void on systemic issues, and its future would be shaped by the findings of the Financial Crisis Inquiry Commission.

Background

The current U.S. system of financial regulation was not designed to monitor and respond to risks to the entire financial system posed by the interconnectedness of complex institutions, practices and products. To properly address the range of significant threats to the broader financial system, we need better and more coordinated information about a wide range of exposures. Mechanisms to identify and assess information on rapidly expanding markets and products also are critical.

Many factors contributed to the financial crisis, including excessive leverage, lax mortgage underwriting standards and a weak understanding of the risk profiles of complex securitized products. Just as devastating, however, was the absence of any oversight mechanism to track and sound early warnings about the extent to which financial institutions had taken on excessive leverage or held dangerously large concentrations of specific securities.

Individual exposures and the interconnections between institutions with significant exposures were misunderstood or not recognized and, in many cases, hidden from view. AIG was widely recognized as the king of credit-default swaps. But few appreciated that AIG's activities in the CDS market could not just produce catastrophic losses for the company; they imperiled dozens of AIG's counterparties too. The failure to count and connect the dots applied to highly regulated entities as well as those, such as hedge funds and private equity firms, which were lightly or not at all supervised. Even now, regulators world-wide are still sorting out the number and interrelations of many structured financial instruments.

One clear lesson of the financial crisis is the need for an ongoing effort to aggregate and analyze relevant risk exposure information across firms, securities instruments and markets. This oversight must keep up with financial innovation and be able to coordinate with regulators outside the United States. And it must suggest corrective steps before particular risks grow big or concentrated enough to threaten entire markets or economic sectors.

By taking a panoramic view, a Systemic Risk Oversight Board would be quicker to recognize emerging threats than would regulators that tend to focus more narrowly on the safety and soundness of individual institutions or on conduct that harms consumers and investors. In particular, the board would be able to identify practices designed to escape regulatory attention and other efforts by firms or individuals to exploit the cracks between various agencies' jurisdictions.

Much of the discussion surrounding systemic risk oversight has focused on two alternative approaches. One is to set up a strong systemic regulator in the more traditional sense: an agency with statutory authority that permits it to analyze and take direct action to contain or defuse emerging systemic risks before they wreak havoc. The other approach envisions a hybrid advisory council that would be a research- and information-sharing body with formal regulatory powers to address systemic imbalances. This "college of cardinals," as Senator Mark Warner (D-VA) has dubbed it, would have regulatory and enforcement authority and perhaps consist of the heads of key financial regulators.

The IWG believes both of these approaches have major drawbacks. First, the Administration and others in favor of a macro regulator with expansive, plenary authority over systemic risk regulation envision the Federal Reserve playing that role. But that would vest far too much authority in an agency whose credibility has been damaged by its own part in the financial cataclysm. The Fed's easy credit policies, pursued with the aim of stimulating the economy, enabled financial firms to lever up to sky-high levels and amass large concentrations of risky complex securitized products. The potential for conflict between monetary policy, the Fed's primary responsibility, and systemic oversight also argues against making the Fed the systemic risk regulator.

The Federal Reserve's existing duties are daunting enough. Besides crafting monetary policy, the Fed also supervises bank holding companies and the U.S. activities of foreign-owned banks and manages the vast U.S. payments system. Regulating systemic risk would heap too much responsibility on the Fed's already-full plate. Finally, the Federal Reserve's tendency to favor secrecy over public disclosure could undermine transparency and crucial consumer and investor protections.

The IWG also is concerned about systemic oversight via a coordinating council of existing financial regulators. Such a council would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively.

The IWG believes that a Systemic Risk Oversight Board would strike an appropriate balance between the two models. We advocate immediate creation of an independent board vested with broad powers to examine information from both bank and non-bank financial institutions and their regulators. The board would also have the authority to make recommendations to the appropriate regulators about how to address potential systemic threats. Regulators would either have to comply or justify an alternative course of action. In this way, existing regulators would still have the primary role in addressing systemic risk but could not ignore the board's findings or advice.

The long-term approach to systemic risk issues and the role of the Systemic Risk Oversight Board should hinge on the results of the Financial Crisis Inquiry Commission. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator, if that is what policymakers determine is best.

Specific Recommendations

1. Congress should create an independent governmental Systemic Risk Oversight Board. To function efficiently, the board should consist of a chair and no more than four other members. All should be presidential appointees confirmed by the U.S. Senate. The board would be accountable primarily to Congress.

2. The board's budget should ensure its independence from the firms it examines. Funding should be adequate and sustainable to attract and retain highly competent board members and staff. Appropriate funding options include an industry assessment fee similar to that of the Public Company Accounting Oversight Board (PCAOB).

3. All board members should be full-time and independent of government agencies and financial institutions. Members should possess broad financial market knowledge and expertise. Collectively, the members should have backgrounds in investment practice, risk management and modeling, market operations, financial engineering and structured products, investment analysis, counterparty matters and forensic accounting.

4. The board should have a dedicated, highly skilled staff. Staffers should have a range of key skills and experiences and work exclusively for the board. They should be experts who understand the components and complexities of systemic risk and how to fully examine critical interconnections between firms and markets. To attract and retain top-notch individuals, staff and board member salaries should be commensurate with those of the PCAOB.

5. The board should have the authority to gather all information it deems relevant to systemic risk. The IWG believes that federal regulators do not currently have the full scope and depth of information they need to understand systemic risks in the U.S. financial system, much less the behavior of those risks in the context of global markets. For the Systemic Risk Oversight Board to have that capability, it should develop a timely way to identify a broad range of threats emanating from institutions, markets, practices, financial instruments and emerging products. Therefore, the board should have the legal authority to gather all the financial information it deems necessary to assess systemic vulnerabilities.

Defining such threats is not a static process. Systemic risks do not lurk only in systemically significant institutions. Highly concentrated market segments or critical financial instruments can threaten the health of the financial system. Risk may be baked into regulation in ways that are not well understood. For example, the financial crisis has revealed the danger to the markets of rules that make credit rating agencies gatekeepers for issuing debt without ensuring that they are independent and accountable for the accuracy of their ratings.

The board would need to develop appropriate procedures for determining which entities to examine and what information to review. It would need a degree of flexibility so that its focus and examinations could adjust to shifts in market conditions. The board and staff should be able to use their professional judgment to determine the scope of analysis for financial institutions, products or practices. The board should also have the authority to hire consultants and other experts as needed.

6. The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks. If appropriate, the board would also report its findings to specific companies and other institutions. The board should take steps to mitigate any severe market reactions or disruptions that could occur as a result of its reports. How the board reports its activities and findings should take into consideration the confidential nature of much of the information it will gather and the potential for market mayhem if information is not dealt with properly.

The board should also provide comprehensive, periodic reports on the state of systemic risks to all relevant regulators and Congress or committees designated by Congress as well as the public. As appropriate, the board should consult with systemic risk overseers outside the United States. The board should consult with regulators and Congress about the nature of any information it releases publicly.

7. The board should strive to offer regulators unbiased, substantive recommendations on appropriate action. As an independent monitor, the board should identify firms and markets that are at risk before significant damage is done. This might entail identifying exposures, modeling potential solutions and communicating those recommendations fully and clearly to regulators. Regulators should determine whether and how to implement the board's recommendations. Where appropriate, the board should coordinate its recommendations with those of overseas systemic risk overseers.

8. Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis. Regulators are generally better positioned to understand the operational and practical implications of a proposed regulatory action, and a regulator may believe that it would be appropriate to refine or modify a recommendation of the board. For this reason, the IWG does not believe that the Systemic Risk Oversight Board should have regulatory authority or other powers to force a regulator to implement a recommendation.

Instead, the recommendations would shift the onus of systemic risk mitigation onto regulators, by requiring them either to 1) adopt and implement the recommendation(s) as suggested, 2) refine and modify the recommendations as they deem necessary, or 3) reject them and take no further action or follow another course. In the case of options 2 or 3 above, the regulator would provide the board a detailed explanation of its response. This should include a discussion of any alternative approach to address the systemic risk the board identified. The regulator should also address any concerns or issues that could emerge if its alternative approach is not consistent with the coordinated response of other regulators. If the board is not satisfied with the regulator's response, it should communicate its concerns to the President and appropriate Congressional authorities.

About the Sponsoring Organizations

About the CFA Institute Centre for Financial Market Integrity

The CFA Institute Centre for Financial Market Integrity develops timely, practical solutions to global capital market issues, while advancing investors' interests by promoting the highest standards of ethics and professionalism within the investment community worldwide. It builds upon the 40-year history of standards and advocacy work of CFA Institute, especially its Code of Ethics and Standards of Professional Conduct for the investment profession, which were first established in the 1960s. In 2007, the CFA Institute Centre published *Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?*, a report that explored the failure of the current system of self-regulation to keep pace with the dramatic evolution of the global economy.

About the Council of Institutional Investors

The Council of Institutional Investors is a nonprofit association of public, union and corporate pension funds with combined assets exceeding $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers. The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

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