Americans for Financial Reform
Accountability, Fairness, Security

# Restoring Oversight and Accountability to the Financial Markets

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*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

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**Systemic Risk Regulation**

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The current financial crisis is the natural and logical result of a failed financial regulatory system that placed an irrational faith in the ability of markets to self-correct. As a result, regulators ignored repeated warnings about the over-the-counter derivatives markets, problems with securitization and lax mortgage underwriting standards, excessive leverage in financial institutions, and the general movement of financial activity into increasingly complex and opaque forms.

**1. Systemic risk is best addressed by strengthening other types of regulation.**

The most important step in addressing systemic risk is to ensure the safety and soundness, fairness, transparency, and accountability of financial markets, participants, and products. If regulatory agencies perform those functions properly, then systemic risk will be far less of a problem. Congress must close loopholes in the regulatory structure to ensure that all financial products and activities are subject to appropriate oversight, provide agencies with sufficient resources to fulfill their mandates, and hold them accountable to do so. Finally, regulators must pursue their responsibilities vigorously. Policy makers should not permit the question of a new systemic risk regulator to eclipse the tasks of strengthening other forms of oversight and accountability; nor should they over-assume the existence of systemic risk.

**2. A systemic risk regulator could supplement the activities of existing regulators.**

In addition to the responsibilities of other regulators, one central authority should be responsible for monitoring and stemming potential systemic risks. An effective systemic risk regulator must identify and cure risks that could threaten the broader financial system, stopping institutions from creating systemic risk by growing to a certain size or complexity, becoming too interconnected, or engaging in certain activities. Regulators also must have resolution authority for non-bank financial institutions to ensure that, should an institution become systemically significant and fail, it can do so in an orderly fashion without undue impact on the broader economy.

The systemic risk regulator must have staff, resources, and expertise sufficient to monitor sources of systemic risk in institutions, products, and activities throughout the financial markets, and it must have the power to act promptly and independently. It also must be fully accountable and transparent to the public.

The current crisis has provided dramatic proof that anti-consumer and anti-investor practices create systemic risks that undermine the financial system and the broader economy. As such, the systemic risk regulator should not have the power to preempt consumer or investor protections based on the false belief, embraced by some safety and soundness regulators, that consumer and investor protections are in tension with the health of financial institutions. 2

**3. Primary authority for systemic risk regulation may be assigned to the Federal Reserve, a new regulatory agency, or a council of regulators.**

**The Federal Reserve can serve as the systemic risk regulator only if it is made transparent and conflicts of interest inherent in its structure are corrected.** Given that the Fed has had primary responsibility for maintaining economic and financial stability to date, some have suggested that the Fed is the most appropriate agency to act as the systemic risk regulator. This proposal raises concerns because of the Fed's failure to mitigate the housing bubble by calling attention to the unsustainable run up in house prices and stemming the flow of deceptive loans that fed the bubble. The proposal also raises concerns because the Fed is not a true public agency; it is deeply non-transparent and has conflicts of interest built into its governance structure. At a minimum, the Fed must be reformed substantially before it could be considered as an appropriate systemic risk regulator, for example by removing bank representatives from the governance of the regional Reserve Banks.

**Systemic risk could be regulated by a council composed of the heads of each relevant federal agency and representatives from state agencies.** One benefit of the council of regulators is that each brings an understanding of the risks unique to the organizations and activities under his or her supervision. The council would be able to oversee all areas of the financial system with less distraction by industry- or product-specific concerns and with less risk that multiple missions, for example consumer protection and bank solvency, would lead to distraction and cause undesirable outcomes for working families. To be effective, such a council must have the authority to act without the delay of working through some other primary regulator and must have sufficient staff and other resources of its own. It also must be directly accountable for its actions and results.

**A new regulatory agency could be created to oversee systemic risk.** This idea is championed by those who worry that a regulatory council will prove ineffective and prone to jurisdictional disputes, but who oppose to the Fed.

Regardless of how systemic risk regulation is conducted, it cannot be viewed as substitute for proper regulation and consumer and investor protections. To the contrary, if conducted properly these other forms of oversight can forestall most of the need for systemic risk regulation.

**Regulating the Shadow Markets**

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Financial oversight has failed to keep up with the realities of the marketplace, characterized by globalization, innovation, and the convergence of lending and investing activities. This has allowed institutions to structure complex transactions and take on risky exposures without fulfilling the regulatory requirements Congress deemed necessary to prevent a systemic financial crisis after the Great Depression. These unregulated and under-regulated activities and institutions, the "shadow financial system," were permitted to become so intertwined with the real economy that the government has chosen to use taxpayers' money to bail them out when they failed.

As President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." This means that hedge funds, private equity funds, derivatives, off-balance-sheet lending vehicles, structured credit products, and other shadow markets actors and products must be subject to transparency, capital requirements, and fiduciary duties befitting their activities and risks.

Shadow market institutions and products must be subject to comprehensive oversight. We need to return to the broad, flexible jurisdiction originally provided in federal securities regulation, which allowed regulators to follow activities in the financial markets. This means ensuring that all institutions that are active in the shadow financial markets provide regular information to regulators and the public about their activities and their counterparty relationships, requiring derivatives to be traded on regulated exchanges that are transparent and impose meaningful margin requirements, and requiring money managers to provide comprehensive disclosures and to act as fiduciaries for their investors.

The opaque, over the counter derivatives market has evolved into a multi-trillion dollar casino for wealthy investors and should be eliminated altogether. Derivatives that are used for legitimate hedging purposes must be traded on open exchanges, using standardized contracts.

Unregulated pooled investment vehicles, including private equity and hedge funds, have been major participants in the shadow financial markets. Private equity and hedge funds and their managers should be subject to more stringent oversight that, at minimum, requires greater transparency, ensures that managers act in the best interest of investors, and subjects the funds to capital adequacy requirements and leverage limits.

Self-regulation is a myth. Sophisticated investors cannot and should not be relied upon to protect their own long-term financial interests or to avoid overly risky activities that can threaten the health of the financial markets and the global economy. This does not necessarily mean that all participants in the financial markets must be subject to identical regulatory requirements. But regulators must ensure a minimum level of transparency, accountability, and mandated risk management across the financial markets.

Some have suggested that certain aspects of the shadow financial markets, particularly hedge funds and derivatives such as credit default swaps, should be overseen by a systemic risk regulator instead of being subject to comprehensive regulation. This would be a terrible mistake. The shadow financial markets must be subject to comprehensive, routine oversight appropriate to the activities involved. Systemic risk regulation should function as an addition to this oversight, not a replacement for it, focusing on problems that arise from interactions among institutions regulated by different regulatory bodies or emerging risks not fully addressed by the other regulators.

**Consumer Protection**

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**Consumer Action**

A strong federal commitment to robust consumer protection is central to restoring and maintaining a sound economy. The nation's financial crisis grew out of the proliferation of inappropriate and unsustainable lending practices that could have and should have been prevented. That failure harmed millions of American families, undermined the safety and soundness of the lending institutions themselves, and imperiled the economy as a whole. In Congress, a climate of deregulation and undue deference to industry blocked essential reforms. In the agencies, the regulators' failure to act, despite abundant evidence of the need, highlights the inadequacies of the current regulatory regime, in which none of the many financial regulators regard consumer protection as a priority. The following reforms would fix the system's most glaring flaws, and create a sounder foundation for the nation's consumers and the economy.

**1. Re-regulate mortgages, consumer credit, and other consumer financial products to protect consumers against the excesses of an unrestrained market.**

We must return to ensuring that financial products and transactions are fair and safe instead of merely requiring information disclosures about them. We also must restore sound underwriting and realign the incentives of borrowers and lenders so that both have a common interest in fair, affordable, sustainable and understandable credit. We must reform the mortgage market, address overdraft and other abuses, and adopt a federal cap on high cost credit (a usury cap) that protects every consumer from predatory loan products such as payday loans and permits states to set lower caps. Decades-old consumer protection statutes must be updated to account for inflation and technological changes. 6

**2. Make a strong federal commitment to consumer protection, including: an agency dedicated to consumer protection, covering all consumer financial products, a Consumer Affairs Office in the White House, and an independent government-chartered consumer organization.**

The consumer financial products agency should have jurisdiction over all bank and payment products and services (including deposit products, electronic funds and payment systems), debt-related services, debt collection, and credit reporting. The agency should have a strong mandate to move away from disclosure-based "consumer protection" to the prohibition of harmful, unfair, deceptive or abusive products and practices. Its rules must be a floor, not a ceiling, on consumer protection standards. The agency should promote standard terms to enable meaningful comparison shopping (for example no-fee, binding price quotes and standard quote features to facilitate meaningful comparisons). Unlike the role that existing banking agencies have played, the consumer financial products agency should have a forward-looking mission, to prevent abusive practices before they become widespread. The agency also should be empowered to ensure fair lending compliance as a major priority, to ensure fair and equitable transactions and access to adequate, sustainable and useful credit for all, including underserved communities. The agency must have authority to obtain information and documents from regulated entities to facilitate monitoring of regulated entities' consumer protection compliance. It also must have a robust enforcement capability, and its rules should ensure industry accountability to individual consumers.

Agency funding should be structured in a manner that provides stable, adequate resources that are not subject to political manipulation by industry, whether funding is provided through Congressional appropriations, industry assessments, filing fees, other sources, or a blend of these approaches. Its board and governance must be structured to ensure strong and effective consumer input, and a Consumer Advocate should be appointed to report semi-annually to Congress on agency effectiveness.

The consumer financial product safety agency, and each regulator's Office of the Consumer Advocate, should have a well-resourced and easy-to-use consumer redress process, accessible online and by phone, that will respond to consumer complaints on a timely basis, stating whether the complaint appears to have merit and whether the agency will investigate and address the problem and whether it should be pursued privately.

An Office of Consumer Affairs in the White House would give consumers a voice in the Administration and provide some balance to the influence enjoyed by Wall Street. This office should have a clear mandate to weigh in on legislation, intervene as a full party in adjudicatory proceedings, and have provide in policy meetings. Its director, someone with firmly established credentials in consumer advocacy, should have direct access to the President.

A government-chartered consumer organization should be created by Congress to represent consumers' financial services interests before regulatory, legislative, and judicial bodies. This organization could be financed through voluntary user fees such as a consumer check-off included in the monthly statements financial firms send to their customers. It would be charged with giving consumers, depositors, small investors and taxpayers their own financial reform organization to counter the power of the financial sector, and to participate fully in rulemakings, adjudications, and lobbying and other activities now dominated by the financial lobby.

**3. The states must retain the ability to protect their citizens.**

States have proved more nimble and effective than the federal government in reacting to emerging abuses and tailoring responses to local needs. Courts often can remedy new abuses more quickly and efficiently than legislators or regulators by applying flexible, longstanding common law principles against unreasonable, unfair, or deceptive practices. Additionally, state authorities and consumers pursuing remedies privately can add much-needed strength to federal law enforcement. Specific state laws addressing new threats also provide useful data points for federal lawmakers seeking effective models for federal legislation.

It is essential that federal consumer protection law maintains these important state roles. Federal law should set a floor not a ceiling on consumer protection, and federal enforcement efforts should complement state efforts but not displace them. Laws that promote a race to the bottom should be revised so that financial services providers do not have the ability to shop for the weakest state protections and spread those to the rest of the country. No federal agency should have authority to preempt state consumer protection law (whether statutory or common law) or prevent state enforcement of federal or state law, and federal legislators and regulatory agencies should conduct an orderly review and repeal of existing federal regulations that preempt state consumer protection law.

**4. Require accountability and appropriately aligned incentives for loan originators, for Wall Street firms that package the loans, and for the investors who fund them.**

Compensation terms that incent lenders and brokers to steer borrowers into higher cost or less sustainable loans than those for which they qualify should be prohibited, as should investment or other arrangements that tie the hands of loan servicers and hinder appropriate responses to problems that arise. All participants in the loan supply chain, from originator to assignee, should be held accountable for the loans they make or fund.

**5. Consumers who have been damaged by abusive financial practices must have meaningful redress, which requires prohibiting practices like forced arbitration and class action bans.**

Laws should be enforceable by those they are designed to protect, with meaningful remedies, against loan originators, the Wall Street firms that package the loans, and the loans' current owners, with attorneys' fees recoverable by prevailing claimants. Widespread abuses are frequently most efficiently addressed by groups of consumers acting together for class relief. Forced arbitration should be prohibited because it deprives consumers of access to the courts, confining them instead in unaccountable, non-reviewable, secretive forums that are often heavily biased in industry's favor.

**6. Eliminate "charter competition" among federal financial regulators, and require transparency in consumer protection regulation and enforcement so effectiveness can be evaluated.**

Both the Office of the Comptroller of the Currency and the Office of Thrift Supervision failed utterly to protect consumers or the safety and soundness of regulated entities. Instead, they competed with each other to minimize consumer protection standards as a way of attracting institutions to their charters, tying their own hands and failing to fulfill their missions. Charter shopping must be eliminated so that regulators can focus on their missions without conflicts of interest. All regulators should be required to focus more on transparent, public rulemaking and enforcement actions than on non-public supervisory actions, and each should have an Office of the Consumer Advocate to report to Congress annually on the agency's effectiveness in protecting consumers.

**7. Address new risks to consumers from financial marketing practices.**

Ensure that regulators address not only traditional marketing practices, but also the growing role of the Internet and online media in the provision of consumer financial services. Digital marketing practices little understood by the public—including so-called behavioral targeting—profile and track individual consumers across the Internet in order to generate financial transactions, including mortgage loans. This system is non-transparent to consumers, including how they are evaluated and what data has been collected about them. Consumer protection for financial services must reflect the realities of the contemporary marketplace, where credit applications will soon be submitted via a mobile phone, for example, and consumer dependence on the Internet for conducting financial transactions is expected to grow dramatically. Online and traditional marketing of consumer financial services should be thoroughly analyzed, and newly emergent risks—including the loss of privacy and lack of adequate privacy protection under existing banking and financial laws—must be addressed.

**Mortgage Relief and the Community Reinvestment Act**

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**Mortgage Relief**

One legacy of the sub-prime crisis is a deepening spiral of home foreclosures. With unemployment increasing, defaults and foreclosures are now spreading from homeowners with sub-prime loans to ordinary homeowners with conventional fixed rate mortgages that have become unaffordable due to economic hardships.

Foreclosure notices were filed on over 2 million homes in 2008, and that number is expected to increase during 2009. At the end of 2008, about 8 percent of all mortgages were delinquent; for sub-prime loans, the figure was 22 percent.

The current mortgage modification program, known as Making Home Affordable, spends $75 billion to give banks and other institutions financial incentives to modify the terms of mortgages. It excludes most homeowners whose mortgages exceed the value of their homes, as well as those who have fallen behind on their monthly payments. The *New York Times* reported that at most 55,000 mortgage loans had been modified under the program as of late May 2009. The number of homeowners in need of modification is well into the millions.

The portion of the Obama Administration's program that would have compelled refinancings in some cases—authorization for bankruptcy judges to modify home mortgage terms—was defeated by the senate after fierce industry lobbying.

The federal government needs a much more robust program of mortgage relief. It could include direct government refinancing at the Treasury borrowing rate, modeled on the Home Owners Loan Corporation of the 1930s, which eventually refinanced one American mortgage in five. It also could embrace the approach first proposed by the National Community Reinvestment Coalition in February 2008, under which the federal government would use its eminent domain power to acquire both whole loans and securitized mortgages, write down their value to current market value, and pass along the savings to the homeowner in the form of an affordable mortgage.

The goal of public policy should be to maximize the number of homeowners with distressed mortgages who keep their homes. Any other approach—including the current policy—will only 10

permit the foreclosure crisis to drag down the value of other homes and prolong the general financial and economic crisis through the ripple effects of millions of home foreclosures.

**The Community Reinvestment Act**

The Community Reinvestment Act (CRA) has been one of the most important tools for building wealth and revitalizing neighborhoods. CRA encourages banks to respond to a variety of needs in low- and moderate-income (LMI) communities by financing affordable rental housing, home ownership, and small business creation. It also democratizes oversight and encourages meaningful partnerships between financial institutions and LMI communities by enabling community organizations to intervene in proposed mergers or expansions and demonstrate whether banks have met the credit needs of the communities they serve.

CRA is also an antidote to the foreclosure crisis because it rewards banks for foreclosure prevention efforts such as counseling, modifying loans, and investing in funds that finance loan modification, and because it requires banks to meet the credit needs of all communities consistent with safety, soundness, and consumer protection principles. For these reasons, Congress must strengthen CRA as it applies to banks and expand CRA's reach to non-bank financial institutions.

**The CRA Modernization Act of 2009**

The *CRA Modernization Act* of 2009, H.R. 1479, introduced by Rep. Eddie Bernice Johnson, would increase the responsiveness and accountability of banks to all communities, rural and urban. It would require CRA examinations in the great majority of geographical areas that banks serve. Currently CRA examines banks in areas where they have branches but not in areas where they lend through brokers. The bill would address racial disparities in lending by requiring CRA exams to consider lending and services to minorities in addition to LMI communities. The bill would require the reporting of race and gender of small-business borrowers as well as data regarding deposit and savings accounts. It would require the Federal Reserve Board to create a database on foreclosures and loan modifications, which would be similar in approach to Home Mortgage Disclosure Act data.

The bill would enhance the ratings system of CRA exams and require banks to submit public improvement plans, subject to public comment, when they earn low ratings in any of their service areas. It also would require federal regulatory agencies to hold more meetings and public hearings when banks merge or seek to close branches. Additionally, it would establish requirements for all affiliates and subsidiaries of banks, independent mortgage companies, mainstream credit unions, insurance companies and securities firms.

If passed, the *CRA Modernization Act* would leverage trillions of dollars in additional safe and sound loans and investments for America's neighborhoods. It would help steer the country out of the current financial crisis by requiring financial institutions to invest in our people and our communities. Policy makers must strengthen these forms of citizen participation and give more emphasis to the information consumers and community organizations provide.

**Civil Rights Compliance**

**Lisa Rice**

**National Fair Housing Alliance**

**Discriminatory Lending Was a Major Cause of the Current Crisis**

Systemic discriminatory lending practices and residential segregation were major causes of the current financial crisis. The United States has never sufficiently addressed the problems and challenges of lending discrimination and redlining practices, one vestige of which is a two-tiered financial system that forces minority and low-income borrowers to pay more for financial services, receive less value for their money, and face exposure to greater risk. African-American and Latino borrowers continue to pay more for credit than Caucasian borrowers with similar credit scores and credit characteristics. Racial minorities receive a disproportionately high number of subprime, higher cost, and non-traditional mortgages and, as a result, are disproportionately losing their homes to foreclosure. It is projected that African-Americans and Latinos will lose at least $213 billion dollars as a result of the current economic downturn. These disparities are broadening the unfair and unsound wealth gap between majority and minority populations.

The current financial regulatory system fails to ensure adequate compliance with civil rights statutes or to establish a fair financial services system that serves all consumers. Agencies that oversee the financial system lack sufficient authority and accountability for enforcing fair lending laws. Further, the broad lack of oversight in the financial markets has spurred inequities by permitting market players to seek out under-regulated areas in which to target under-served populations with unfair and abusive products and practices.

**Proposed Solution**

Each regulatory and enforcement agency must prioritize civil rights compliance and the elimination of the current unequal, two-tiered financial system. Each program and function of the agencies must be assessed for compliance with civil rights statutes, and regulators must ensure that regulated entities have clear guidance on how to comply with civil rights statutes and regulations. They also must enhance their oversight and enforcement of civil rights compliance.

The President should re-implement the Fair Housing Council established by Executive Order 12,892, comprising the heads of relevant federal regulatory and enforcement agencies, which is tasked with ensuring that every federal program operates in compliance with the letter and spirit of the nation's civil rights statutes. The Executive Order mandates that each federal agency, the Department of Justice and the Federal Trade Commission, work to "affirmatively further fair housing" in accordance with the Fair Housing Act.

Each agency should develop a senior position, with appropriate staff and resources, charged with ensuring compliance with civil rights statutes and working toward the broader goal of creating an equitable and fair financial system. The civil rights officer should not only assess the agencies' programs and functions to guarantee that the agencies themselves are in compliance with civil 12

rights statutes, but also ensure compliance by market participants and hold them accountable for noncompliance.

Agencies also must be fully transparent and accountable to the public on measures of civil rights compliance and enforcement. This includes reporting not only on their own actions but also those of market participants. In particular, the agencies must disclose any noncompliance that they identify, whether in the agencies or the private sector.

Additionally, civil rights compliance and goals must never be waived, even in the event of a crisis. While it is imperative that agencies be nimble and take quick and decisive action in the face of a crisis, their actions should not come at the expense of ensuring a fair and equitable marketplace.

Effective civil rights protections are a critical component of financial regulatory reform. They increase fairness and equity for all consumers, and they diminish the financial system's instability.

**Resolution Authority**

**Dana Chasin**

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**Demos**

**Bankruptcy Law Is Inadequate for Systemically Significant Nonbank Institutions**

The current bankruptcy regime does not work well for bank holding companies and systemically significant nonbanks institutions. The federal government has long had the power to take over and close banks and other deposit-taking institutions whose deposits are insured by the government and subject to detailed regulation. But it has no such "resolution authority" with respect to bank holding companies and non-bank financial institutions such as insurance companies, investment banks, hedge funds, private equity firms and other financial institutions.

The bankruptcy of a systemically significant non-bank can aggravate liquidity problems and destabilize financial markets, but the Bankruptcy Code's provisions for the distribution of the assets of a bankrupt financial institution take no account of the systemic considerations that regulators can and should consider. Because the bankruptcy system was not designed for these circumstances, financial regulators may feel the need to prop up the ailing institution in order to avoid a messy and potentially destructive bankruptcy process.

The government needs new power to seize non-bank financial entities whose collapse might jeopardize the national and global financial systems. In particular, resolution authority is needed so that the Federal Deposit Insurance Corporation (FDIC) can take into conservatorship or receivership bank holding companies such as Citigroup. Current law gives FDIC no authority over bank holding companies, which is where the main mischief—and damage—occurred.

Given the potential risk from triggering acceleration clauses in credit default swap (CDS), there may be value in affording the regulator the authority to perform—as FDIC regulators do— "least cost resolution" analysis. In the case of CDS exposures, resolution authority could include a non-receivership approach. The FDIC could, for example, require the company to sell certain non-core businesses (with regulatory oversight) and disgorge troubled assets at the same time.

**The Proposal**

The Congressional Oversight Panel, the Treasury Department, and others have proposed establishing a receivership and liquidation process for systemically significant as well as other nonbank financial institutions that is similar to the resolution system for banks. Under most of these proposals, the FDIC would be empowered to appoint itself as conservator or receiver for failed or failing non-bank financial institution holding companies and their subsidiaries.

The FDIC would be charged not just with wielding resolution power but also setting standards that should limit the need to use the resolution authority. It would have responsibility

over systemically important and other nonbank financial institutions and would share with Congress the responsibility for establishing resolution implementation standards. The FDIC would further have the authority to:

- Make loans to the covered financial company or any subsidiary;
- Purchase assets of the covered financial company or any subsidiary;
- Assume or guarantee obligations of the covered financial company or any subsidiary;

- Acquire any type of equity interest or security of the covered financial company or any subsidiary;
- Take a lien on any or all assets of the covered financial company or any subsidiary; and
- Appoint itself as conservator or receiver of the covered financial company.

**Bailouts Versus Resolution Authority**

Resolution authority would be a major improvement on the current bailout strategy, which uses taxpayer funds and loans and guarantees from the Federal Reserve to prop up banks that are, by any reasonable measure, insolvent. The cost of the current strategy is that it prolongs a day of reckoning. It leaves in place seriously wounded banks incapable of serving the nation's credit needs, which prolongs the recession and creates the risk of a Japan-type "lost decade."

The public-private partnership model announced in late March also creates huge opportunities for conflicts of interest, with the government assuming most of the risk and private speculators appropriating most of the gain. It is unlikely to achieve its goal of increasing the market value of depressed securities because the underlying mortgages are only worth a fraction of their nominal value. The bailout process is also almost totally non-transparent.

It would be far better to enact and then use resolution authority so that banks which are effectively insolvent are taken into public receivership by a government agency with the competence and capacity to do true audits rather than hypothetical stress tests. As with resolution of smaller institutions by the FDIC, this agency would assess how large is the hole in the institution's balance sheet, and decide what combination of public capital and bondholder losses should make up the loss. Incumbent management would be replaced, and the institution would be returned to new private ownership as soon as practical. Experience on other nations that have suffered banking collapses (Japan, Sweden) suggest that this approach of acknowledging losses and recapitalizing institutions is preferable to a policy of piecemeal bailout.

**Restoring Prudential Financial System Regulation**

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**Background**

For the last three decades, financial regulators, Congress and the executive branch have steadily pulled back the regulatory system that restrained the financial sector from acting on its own worst tendencies. The post-Depression regulatory system aimed to force disclosure of publicly relevant financial information; established limits on the use of leverage; drew bright lines between different kinds of financial activity and protected regulated commercial banking from investment bank-style risk taking; enforced meaningful limits on economic concentration, especially in the banking sector; provided meaningful consumer protections (including restrictions on usurious interest rates); and contained the financial sector so that it remained subordinate to the real economy.

This regulatory system was highly imperfect, of course, but it was not the imperfections that led to the system's erosion and collapse. Instead, it was a concerted effort by Wall Street, which gaining momentum steadily until it reached fever pitch in the late 1990s that continued through the first half of 2008.

One of the key flaws in that system was a lack of prudential supervision by the financial regulators themselves. They failed to use their broad powers. Bank regulators were supposed to hold banks to adequate capital standards, prevent unsafe and unsound lending and maintain an adequate deposit insurance base.

With too little congressional oversight, regulators became too cozy with the banks. Worse, the Congress acceded to industry demands to reduce deposit insurance premiums and to even base them on weak "risk" standards. As a result, many banks avoided making adequate payments into the funds even as the level of risk they placed on the system grew. This worsened moral hazard.

Further, the bank regulatory system is largely outside of congressional purview because bank regulators are not paid out of congressional appropriations. Instead, regulators receive dues assessments from banks and control their budgets. In combination with entities' ability to choose their own regulators, this creates a race to the bottom, in which banks seek the least attentive regulator that will grant them the most powers.1

**Recommendations**

1. We need a simpler and more transparent financial system that is far less vulnerable to speculative abuse and systemic risk, as well as a reliable policing mechanism in order to restore the financial markets to their proper role as facilitators of the real economy. A core principle of both efforts is that any institution that creates credit (and hence risk) must be subject to prudential regulation. It does not matter whether the institution calls itself a commercial bank, an investment bank, a mortgage broker, a hedge fund or a private equity firm. There must be no category of institution that escapes supervision. As Barack Obama astutely stated in an important campaign speech on March 27, 2008, at Cooper Union in New York: "We need to regulate institutions for what they do, not for what they are."2

2. Congress needs to separate dues assessments from regulatory authority to prevent regulatory capture. The number of regulators should be reduced in any event, but the potential for charter shopping must be eliminated. Banks should pay regulatory assessments into a pool. Then, regulators should be required to submit performance and budget requests to the Congress to obtain funds from that pool for regulatory needs. All bank regulators should have their full budgets subject to Congressional oversight.

3. The inconsistencies in regulatory authority that have allowed financial services holding companies to abuse relationships between investment and insured depository banks under their control should be changed.

4. A variety of actions must be taken to improve capital standards, reduce leverage, require "skin in the game" in securitizations, and bring off-balance sheet entities onto balance sheets.

5. Regulators must limit the size of banks through prudential oversight. The deposit insurance system should be reviewed. Imposition of significantly higher premiums on larger banks and other actions to limit the size of larger, more complex financial institutions will hold those firms more accountable for their risks and temper their size. As FDIC Chair Sheila Bair has posited: "A strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being bigger is not necessarily better."

6. Give the FDIC more authority over holding companies. As Bair has testified, "Where previously the holding company served as a source of strength to the insured institution, these entities now often rely on a subsidiary depository institution for funding and liquidity, but carry on many systemically important activities outside of the bank that are managed at a holding company level or non-bank affiliate level."3 This means that the FDIC needs greater authority over the actions of an entire holding company, not just a failing bank, to limit risk caused by the holding company's actions.

7. Preemptive actions by Federal agencies and the courts restricting state enforcement authority should be reversed to reinstate the ability of state legislators, regulators, and courts to enforce federal and state laws against nationally regulated institutions and to enact stronger state-level consumer protections.

8. Each prudential regulator should issue an annual report on emerging risks so that the public will know what trends the regulators are observing.

9. The data included in public Call Reports, or statements of condition, of institutions under federal regulation should be broadened and subject to more detailed public disclosure so that the public and the Congress can better evaluate where institutions obtain their income and where their risks are changing over time.

10. Each regulator should also implement an effective complaint system that actually assists consumers and complements the efforts of the Financial Product Safety Commission.

**Notes:**

1 Adapted from Rob Weissman & James Donahue, Essential Information & Consumer Education Foundation, *Sold Out: How Wall Street and Washington Betrayed America* (2009) at 14-02.

2 Adapted from Bob Kuttner, Demos, *Financial Regulation After the Fall* (2009) at 5.

3 Sheila C. Bair, Chairman, FDIC, "Regulating and Resolving Institutions Considered "'Too Big To Fail,'" before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 6, 2009.

**Global Issues**

**Ira Rheingold**
**National Association of Consumer Advocates**

**Ed Mierzwinski**
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**Rob Weissman**
**Essential Information**

**Mary Bottari**

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**Public Citizen**

The financial crisis began with poorly regulated loan products which posed too much risk for the consumers to whom they were sold, and ultimately to the market as a whole. While the other policy papers prepared by the coalition focus on domestic United States. Regulation, many principles embodied in those papers should be extended to the debate around international re-regulation. Moreover, alongside national and international re-regulatory efforts, a strong concurrent and complementary role for provincial or state governments can provide needed early enforcement of existing standards and also develop new standards to address emerging practices before they cause widespread consumer harm or systemic risk. State and provincial legislatures are often in a unique position to spot and stop bad practices before they become universal. To ensure rapid and appropriate responses to abuses in the financial credit markets, all levels of government must be able to protect consumers and regulate financial institutions.

Also, there is a case to be made for the creation of new international financial regulatory institutions, but agreement on their exact contours and responsibilities will be difficult to achieve in the near term. Regardless of whether we create new international institutions, global rules must not interfere with national, state and local oversight. Advancing this principle requires looking at not just global regulatory bodies, but also treaties and institutions that preempt action by national and subnational governments.

Among the principles that should guide U.S. and other governments in the global arena are the following:

**1. Provide an international regulatory floor.**

Some existing international agreements and institutions may not be suited to preventing future financial crises. The Basel II accord, for instance, relies heavily on internal ratings-based (IRB) approaches to capital regulation that allow banks to use their own credit risk models to determine how much capital they should hold. As Federal Reserve Vice-Chairman Daniel Tarullo has written, insofar as "the IRB approaches are essentially untested, the regulators adopting them are taking at least a leap of faith and, critics fear, possibly a leap off a cliff."1 Regulators must ensure that international regulatory accords do not promote destabilizing or untested banking practices and do not impinge on domestic prudential regulation. In short, international agreements should set a floor—not a ceiling—on regulatory standards, and ensure that there is no preemption of action at the national or subnational level.

**2. Do not harmonize standards downward.**

Business groups have long sought the convergence of accounting and other standards, which can harm consumers and investors. For instance, in August 2008, the U.S. Securities and Exchange Commission (SEC) proposed a roadmap that would permit large companies to abandon U.S. accounting standards and adopt newer, less tested European standards. The U.S. Financial Accounting Standards Board has found the European standards to be weaker,2 and academic studies have shown that they provide greater opportunities for earnings management (or "cooking the books").3 Moreover, many experts argue that competition between standard-setters slows the race to "lowest common denominator" standards and creates efficiencies in many fields.4 The SEC should start with an open and transparent assessment of the strengths and weaknesses of both sets of accounting standards, especially with regard to consumer and investor protection. If there is a pressing need for convergence of one particular standard—whether in accounting or other areas—this can be done on a case-by-case basis with a pledge to raise standards, not lower them.

**3. Close down tax havens.**

Certain offshore tax havens, such as the Cayman Islands, Liechtenstein, Panama, Switzerland and many others, have developed local industries with the sole comparative advantage being the opportunity to profit from "regulatory arbitrage." The consequence is a global race to the bottom that promotes deregulation at the expense of market stability. The Obama administration's tax-haven plan is a step in the right direction. We further support the repeal of tax incentives to offshore production and investment (including deferred taxation of foreign-source income), and the call to eliminate excessive banking secrecy and push automatic tax information exchange treaties. Governments also must develop new mechanisms for international cooperation on criminal investigations of tax fraud and avoidance schemes.

**4. Renegotiate—and refrain from launching disputes related to—trade and investment pacts that promote deregulation of financial services.**

The United Nations Commission of Experts on the financial crisis chaired by Nobel laureate Joseph Stiglitz recently concluded that "Many bilateral and multilateral trade agreements contain commitments that restrict the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and support packages."5 For example, the World Trade Organization's (WTO) Financial Services Agreement (FSA) forbid limits on financial service firms' size, undermining remedies to the "too big to fail" problem. Such pacts can also forbid governments from re-establishing "firewalls" between commercial banking and risky investment ventures. New financial services regulations can be challenged in WTO trade tribunals, which prioritize commerce above all other concerns.6 Similar provisions exist in agreements ranging from the proposed U.S.-Panama trade agreement to bilateral investment treaties, where private investors—including subsidiaries of U.S. corporations—have standing to challenge government actions for cash compensation.

In the short term, the United States must refrain from trade and investment suits regarding governments' responses to the financial crisis, especially against developing nations, and call on corporations and other nations to do likewise. (Deutsche Bank and Citigroup, for instance, are launching a case against Sri Lanka's policies on oil derivatives. Argentina and the Czech Republic have also experienced successful investor-state cases on financial re-regulation.7) In the longer term, existing and prospective pacts that contain deregulatory obligations and constraints on oversight must be renegotiated so that policymakers can implement the consensus call to address the crisis in the manner they see fit without the threat of trade suits.

**5. Avoid regulatory arbitrage.**

The elimination of capital controls due to International Monetary Fund (IMF) structural adjustment mandates in the 1980s and 1990s—combined with the WTO General Agreement on Trade in Services rules, which locks in their removal—has blocked a major tool used by governments to prevent regulatory arbitrage. When some governments increase oversight of risky, under-regulated products and activities, there is a serious risk that those products and activities will simply move to jurisdictions with weak oversight. To prevent this, governments should consider the reinstatement of capitol controls as nations such as China, India, and Chile have done to avoid financial contagion in past crises. The United States should exercise its votes at the IMF and other international financial institutions to ensure that countries have the flexibility to adopt robust financial regulatory rules, including capital controls.

In addition, the shadow financial markets must be subject to an international regulatory floor that includes, at minimum, comprehensive consumer and investor protection, public disclosure requirements, and safety and soundness regulation.

**6. Implement transparency and other governance reforms of international bodies.**

A growing international consensus rightly supports reform of the governance, accountability, and transparency of the WTO, the IMF, and other institutions and agreements that play major roles in the global financial system. In addition, international regulatory institutions with authority over financial services, such as the Financial Stability Board and the International Organization of Securities Commissions should be reviewed to ensure they are operating in an open, transparent and democratic fashion. International standard setting institutions with authority over financial services, such as the International Accounting Standards Board, should be reformed to ensure their independence from industry financing and direction.

**Notes:**

1 Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, DC: Peterson Institute, 2008), at 6.

2 Financial Accounting Standards Board, *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences Between IASC Standards and U.S. GAAP*, 2d Ed., Oct. 1999, *available at* http://72.3.243.42 /intl/iascpg2d.shtml.

3 Teri Yohn, Associate Professor, Indiana University, "International Accounting standards: Opportunities, Challenges and Global Convergence Issues," before the Banking, Housing and Urban Affairs Committee, United States Senate, Oct. 24, 2007.

4 Shyam Sunder, Professor, Yale School of Management, *Financial Times*, Sept. 18, 2008.

5 Preliminary Draft of the Full Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, May 21, 2009, *available at* http://www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf, at 87.

6 A prudential measures exception can be raised when a financial service regulatory policy is challenged, but it contains a loophole that undermines its usefulness: It applies to policies that do not have the effect of limiting foreign firms' access.

7 Luke Eric Peterson, "Deutsche Bank files ICSID claim against Sri Lanka," *Investment Arbitration Reporter,* Vol. 2, No. 6, Apr. 2, 2009; "Czech Republic to pay Dutch firm Saluka $181 Million," *Investment Arbitration Reporter,* Vol. 1, No. 4, July 1, 2008; Luke Eric Peterson, "Legal Tango," *FDI Magazine,* Aug. 1, 2005.

**Incentives and Fair Compensation**

**Bill Ragen**
**SEIU**

An incentive system similar to one at the top is at work at the street level of the biggest banks. In the tens of thousands of bank branches and call centers of our biggest banks, employees-including bank tellers earning an average of $11.32 an hour-are forced to meet sales goals to keep their jobs and earn bonuses. Many goals for employees selling high-fee and high-interest products like credit cards and checking accounts have actually gone up as the economy has gone down.

Banks' use of commissions and quotas to drive the sale of consumer financial products creates a perverse incentive for rank-and-file bank workers—they find themselves forced to act against the interests of their customers to make ends meet.

A current branch manager in the Washington, D.C. area for one of our top four banks says, "My job is to create irresponsible debt. It should be helping families build responsible debt, and counseling them about using debt responsibly. But that's not what the bank rewards."

The result of this "sell-anything" culture is unfair and deceptive practices in bank branches and call centers to push loan products on the banks' most vulnerable customers—seniors, students, military families, and non-English-speaking immigrants—without regard for the risks they are taking on. New rules for fair compensation structures for employees who sell and service consumer banking products are critical to protecting consumers.

In addition to whistleblower protections for employees, we support the creation of a consumer protection regulator that has the authority to ban commission sales for front-line finance sector employees.

To ensure that the prohibition is not evaded by indirect methods such as promotions and reassignments, it requires the appointment of an independent ombudsman.

If employees are covered by grievance, arbitration, and compensation provisions of a collective bargaining agreement approved by the Consumer Financial Protection Agency, our language provides financial employers greater flexibility.

This qualification reflects the reality that employees with collective representation can bargain on equal terms with their employers to define their package of rights and protections appropriate to their circumstances, and are less subject to arbitrary pressures and sanctions from their employers. The requirement of Agency approval would prevent this provision being used to the disadvantage of consumers.

## Protecting Whistleblowers

**Angela Canterbury**
**Public Citizen**

We would have had more warning of the collapse of Wall Street and the subsequent economy crisis if there had been more protections and avenues for disclosure for employees willing to raise concerns. Whistleblowers are critical to combating fraud, gross mismanagement, and other institutional misconduct, but few workers come forward if they fear losing their job, getting demoted, or facing other forms of retaliation. Protections for whistleblowers and effective systems for whistleblowing in the financial sector and federal government are necessary for real oversight and accountability.

The effectiveness of whistleblowers in combating fraud and misconduct is evident. PriceWaterhouseCoopers surveyed 5,400 companies in 40 countries and found that whistleblowers detected more fraud than auditors or law enforcement officers. It also stressed the importance of "whistle-blowing systems" and listed "safeguard employees who report misconduct against any form of retaliation (i.e., threats, harassment and demotion)" as the first requirement for a whistleblower program.[1]

Under the False Claims Act,[2] the law that encourages private sector whistleblowers to file lawsuits challenging fraud in government contracts, the government's civil recoveries of fraud in government contracts has substantially increased to more than $20 billion since the law was strengthened in 1986. According to the United States Department of Justice, whistleblower disclosures now account for the majority of fraud recoveries from dishonest contractors—$1.45 of the $2 billion recovered in 2007 alone.[3]

Since 2000 Congress has enacted or strengthened whistleblower protections in six laws for private sector employees. They include consumer product manufacturing and retail commerce, railroads, the trucking industry, regulated securities companies, metropolitan transit systems, defense contractors, and all entities receiving stimulus funds. While these laws provide important incentives and protections for disclosure of wrongdoing, they do not adequately cover employees and contractors in the financial industry.

The Sarbanes-Oxley Act or "SOX" was a pioneering whistleblower law enacted in 2002.[4] However, SOX provides protection only for employees and contractors for businesses subject to the Securities and Exchange Act. The only protected disclosures under SOX are reports of possible violations of a federal rule or law that could negatively impact on shareholders and investors. An employee is not protected for raising a company's possible violations of state law or its own internal policies.

Risk-taking in the financial industry will quickly outpace regulatory coverage unless bank branch, call-center, and other financial sector employees and contractors can challenge bad practices as they develop and direct regulators to problems. The federal government needs to hear from and protect finance sector employees who object to bad practices that they believe violate the law, are unfair or deceptive, or threaten the public welfare.

But for real accountability federal regulators also must have adequate protections for blowing the whistle. The current system for protecting federal whistleblowers is badly broken and outmoded. The Whistleblower Protection Act (WPA), aptly nicknamed the Taxpayer Protection Act, has failed to live up to the intent of Congress. Not all federal employees are covered, nor are the fleets of federal contractors who increasingly manage our public affairs and funds. Those who are covered under the law face a flawed and politicized administrative process for reviewing whistleblower disclosures and claims, and lack normal access to court. In addition, the only court authorized to hear claims of retaliation by federal employees, the U.S. Court of Appeals for the Federal Circuit, has a record of ruling against whistleblowers and eroding the law. The result is that the law intended to protect federal workers and tax dollars is virtually useless.[5]

Adequate oversight for consumers, investors and taxpayers requires safe channels to disclose wrongdoing for all workers and contractors for the federal government, the financial sector, the Federal Reserve System, and government sponsored enterprises, such as Fannie Mae and Freddie Mac.

We support the following safeguards for whistleblowers to encourage disclosure of wrongdoing to help protect taxpayers, consumers and investors:

- Provide all employees and contractors in the private-sector financial industry with the rights at least as strong as those recently enacted for the approximately 20 million workers in consumer product manufacturing, as well as workers for all entities receiving stimulus funds.

- Strengthen and modernize the Whistleblower Protection Act to ensure all federal employees and contractors can safely warn us of waste, fraud and abuse in the financial sector, including providing access to jury trials as a final remedy when administrative process fails to resolve claims of retaliation.

- Extend strong, best-practices whistleblower protections to employees and contractors of the Federal Reserve System and government sponsored enterprises, such as Fannie Mae and Freddie Mac.

**Notes:**

[1] PriceWaterhouseCoopers, *Economic crime: people, culture and controls: The 4th biennial Global Economic Crime Survey,* 2007, available at http://www.pwc.com/extweb/pwcpublications.nsf/docid/1E0890149345149E8525737000705AF1.

[2] False Claims Act, 31 U.S.C. § 3730.

[3] U.S. Department of Justice, Press Release: *Justice Department Recovers $2 Billion for Fraud Against the Government in Fy 2007; More Than $20 Billion Since 1986,* Nov. 1, 2007, available at http://www.whistleblowers.org/storage/whistleblowers/documents/doj%20fca%20statistics%202007.pdf.

[4] 18 U.S.C. § 15 ("Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.").

[5] Testimony of Angela Canterbury before the House Government Reform Committee on H.R. 1507, pages 5-6, available at http://www.citizen.org/congress/govtaccount/articles.cfm?ID=18609.

**Financial Transactions Taxes**

**Dean Baker**
**Center for Economic Policy Research**

In the last three decades the financial sector has hugely expanded as share of the economy. The narrowly defined investment banking and security and commodities trading sectors have nearly quadrupled as share of GDP over this period. This growth has been associated with lax regulation, an explosion of speculative trading, and the creation of complex derivative instruments.

While successful traders and bankers can earn enormous rents in the financial sector, there is little obvious economic gain from the expansion of the industry. In addition, the growth of the sector has contributed to instability throughout the economy, creating the basis for the current downturn.

A financial transactions tax (FTT) can be an important force for constraining the financial sector. A modest set of taxes (e.g. 0.25 percent on a stock purchase or sale and 0.02 percent on the sale or purchase of a future, option, or credit default swap) would have almost no impact on productive use of these assets.

Individuals buying stock to hold for 10 years for their retirement or some other purpose will be little affected by a 0.25 tax on the purchase. Since the development of computers have led to plummeting costs over the last three decades This will just raise the cost of the transaction approximately to the same level as it was in the late 1980s, a period in which the United States already had very deep capital markets. Similarly a 0.02 percent transactions tax will not discourage a farmer from hedging her crop or an airline from hedging jet fuel.

However, taxes of this size will discourage speculation. An FTT will make it far more risky to buy a stock at 2:00 with the hope of selling it at a modest gain one hour later. FTT will also discourage the spread of complex derivative instruments, since the buyer could end up paying the tax at several different points. For example, someone buying an option on a stock would have to pay the tax when they bought the option and also if they ended up actually buying the stock. More complex instruments could lead to paying the tax even more times.

An FTT could raise an enormous amount of money. It could easily raise an amount equal to 1 percent of GDP, currently $150 billion a year or more than $1.8 trillion over the course of a decade.[1] This money would come primarily at the expense of short-term traders and of the financial sector. The financial industry would be forced to accept somewhat lower profits on its trades and of course would see a much smaller volume of trading as a result of the tax. With the exception of the estate tax, an FTT would almost certainly be the most progressive tax applied by the federal government.

The efficiency enhancing effects of an FTT (it will reduce the resources wasted in the financial industry), along with the enormous amount of revenue that could be raised, are the reasons that a long list of prominent economists have argued for FTTs. The list includes John Maynard Keynes, Nobelists James Tobin and Joe Stiglitz, and Larry Summers, the head of President Obama’s National Economic Council.

It is also worth noting that the U.S. already has a very modest FTT. Both stocks and commodities are subject to very small taxes. The revenue is used to finance the Securities and Exchange Commission and the Commodity Futures Trading Commission. Prior to 1964, the U.S. had a considerably higher tax rate of 0.04 percent on stock trades and 0.12 percent on the issuance of new shares of stock.

**Note:**

[1] Pollin, R., D. Baker, and M. Schaberg, 2002. “Financial Transactions Taxes for the U.S. Economy,” Amherst: MA: Political Economy Research Institute, available at http://www.peri.umass.edu/236/hash/aef97d8d65/publication/172/.

**Investor Protection**

**Rich Ferlauto**

**AFSCME**

Shareowners.org, the Shareowner Education Network

The financial turmoil that our economy faces today is, in large part, the byproduct of an ideology of deregulation that, over the past three decades, has grown to decisively influence the actions of federal regulatory agencies, many U.S. judges, and past majorities in Congress. This ideology dictated that U.S. capital markets should operate in an environment free of regulatory constraints and under a regime where corporate boards and executives had unlimited authority to dictate how shareholders' money is spent, while the ability of shareholders to influence corporate actions was severely constrained. The result of the implementation of this ideology was twofold. First, regulatory frameworks designed to ensure the integrity of our capital markets were systematically dismantled. Second, free of any accountability, corporate boards and executives caused corporations to undertake unreasonable risks in the pursuit of short-term financial goals devoid of economic substance or any long-term benefits.

To restore investors' confidence in our capital markets, it is necessary to reject the ideology of the past and to implement meaningful reforms designed to return responsible oversight and necessary accountability to American corporations. The reforms outlined below are designed to do just that.

Through needed changes in corporate elections to give shareholders an option to nominate directors, compensation policies to promote long-term profitability instead of meaningless short-term goals, and overall accountability to end corporate malfeasance, you can provide shareholders with the tools needed to act as responsible owners of publicly traded corporations.

**Reestablish the SEC as the Principal Investor Protection Agency**

Revitalize and Enhance the Consumer and Investment Protection Functions of the Securities and Exchange Commission (SEC). Recent discussions about the need for a new regulatory framework have not addressed the question of consumer and investor protection. While the prudential regulation of the capital markets must remain a high focus, the need for an independent investor protection agency is equally strong. Subsuming these important activities within a larger regulatory body such as the Federal Reserve will only further erode important investor protection functions. The SEC should be retained as a free standing regulatory body, even perhaps absorbing the functions of the CFTC, with greater resources for enforcement and oversight. The agency has a history of being substantially underfunded given its broad mandate for enforcement and disclosure reviews. Most important, we need an SEC that provides real protections to both institutional and retail investors. Most Americans now own stock through IRAs and 401k plans, so a "voice" and agenda that is "on their side" is vital to rebuilding popular confidence in future financial security.

Create a far reaching Disclosure Initiative. The SEC must compel the continuous flow of data to investors about all aspects of corporate risk exposure. A start could be with regulation S-K, which should be updated and expanded to reflect the current set of risks faced by firms. The Division of Corporation Finance, when reviewing registrants' 10-K and 10-Q filings, should devote particular attention to the adequacy, under existing regulations, of disclosures concerning a variety of investor risks, including credit, financial opacity, energy and climate change, health impacts, community relations and human resources, and those reflecting the financial challenges to the economy as identified by the transition team and the new administration. For example, the Division should compare disclosures of firms within an industry, and make further inquiries of registrants that have failed to disclose potential material information that their competitors have disclosed.

As it did after Enron and WorldCom scandals, Congress should assess the funding needs of the SEC and then take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals. In addition, the SEC should be authorized to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action. Too often, the Department of Justice passes on securities-related cases because its own resource constraints and competing priorities. Also, the SEC's current authority to bring actions for aiding and abetting liability under the Securities Exchange Act of 1934 should be extended to allow for such actions under the Securities Act of 1933.

**Reform Director Elections at U.S. Companies**

Make true majority voting in uncontested elections mandatory for all publicly traded corporations. Corporate directors are the elected representatives of shareholders who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors are elected through a standard that guarantees that a director could be elected with even a single affirmative vote, even if that director's candidacy is opposed by the overwhelming majority of shareholders. While many corporations have adopted policies that would require a director to receive support of the majority of shareholders to be elected, most corporations—particularly those not in the S&P 500—have not. And many corporations that have adopted some sort of majority voting have adopted policies that nevertheless allow incumbent directors to remain on corporate boards even if their reelection was opposed by a majority of shareholders. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations. If a director's candidacy is not supported by a majority of shareholders, that director should not serve on the board.

Implement "proxy access" now. The process for nominating directors at American corporations is dominated by incumbent boards and corporate management. This is because corporate boards control the content of the materials that companies send to shareholders to solicit votes (or "proxies") for director elections, including the identification of the candidates who are to be considered for election. This results in a situation where corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareholder concerns. Without launching an expensive independent proxy solicitation, shareholders have little say in selecting the directors who are supposed to represent their interests. An effective and inexpensive solution to this problem would be to enable shareholders, under certain circumstances, to require corporate boards to identify candidates nominated by shareholders on the company's proxy solicitation materials. Legislation is needed to give shareholders access to the company's proxy solicitation materials for the purpose of nominating director candidates where the nominating shareholders have a meaningful investment in the corporation.

Eliminate broker voting in director elections. Under existing rules, stockbrokers who as a convenience hold shares in their own name for their client investors have no real economic interest in the underlying corporation. Nevertheless, such brokers are permitted to vote these shares held in "street name" to elect corporate directors. Such brokers can frequently determine the leadership of corporate boards, even though they have no direct economic interest in the corporations. Moreover, brokers almost universally vote for managements' nominees and proposals and, in effect, interfere with shareholder supervision of the corporations they own. The New York Stock Exchange (NYSE) has proposed rule changes designed to solve this problem, but the Securities and Exchange Commission (SEC) has refused to let the NYSE implement the rule change. Legislation is needed to either eliminate broker voting in director elections or to force the SEC to permit NYSE enactment of the proposed rule.

Allow shareholders to submit resolutions addressing risk. Beginning in 2003, the Division of Corporate Finance too often has issued no-action letters omitting shareholder proposals that ask management to undertake a risk assessment or review the financial implications of an array of environmental, community, public health and human rights concerns and issues. The SEC has based its ruling on ordinary business grounds (rule 14a-9(i)(7)). In doing so, the SEC staff has disregarded the reasonable and principled approach that had governed SEC rulings in this area for decades and replaced it with a radical interpretation. Explaining to its shareholders how it is addressing strategic risks linked to major environmental and social policy issues, such as climate change and human rights, is an important dialogue every corporation needs to engage in with its shareholders. In this way, the SEC has effectively closed the door on this engagement with its change in policy. Therefore, the SEC needs to review these rulings and issue a new staff bulletin with guidance that once again gives shareholders the ability to submit proposals on these important topics.

**Implement Compensation Practices That Ensure Executive Accountability**

Implement "Say on Pay". Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward managers regardless of corporate performance have contributed to our current economic crisis. Shareholders should have the opportunity to vote for or against senior executive compensation packages in order to ensure managers have an interest in long-term growth and in helping build real economic prosperity. So-called shareholder "say on pay" is established practice in the United Kingdom, and currently is in place at 74 publicly traded corporations in the United States. "Say on pay" proposals were introduced at over 90 companies in 2008 and received an average support of over 40 percent, receiving majority support at 11 out of 74 annual meetings, as of Nov. 12, 2008. Say on pay legislation was introduced in the 110th Congress by President Osama when he was a Senator from Illinois. Now is the time for the 111th Congress to reconsider say on pay legislation and include it as part of needed reforms to encourage executive accountability.

**Adopt Effective Clawback Provisions**

Legislation should be adopted to allow for the forfeiture of incentive compensation and bonuses paid to corporate executives based on fraudulent corporate results, and should provide for enforcement through a private right of action. There is no reason why directors and executives should not give back ill-gotten gains when innocent shareholders are victimized by crippling losses. If they know their compensation is "on the line," corporate managers and directors will be less likely to engage in, or turn a "blind eye" toward, fraud and other wrongdoing.

**Strength the Private Right of Action to Enhance Investor Protection**

Protect shareholders' private right of actions. Corporate and financial wrongdoers in recent years have effectively denied compensation to victims of fraud by requiring customers to sign away their rights to access federal courts as individuals and participate with other victims in class actions when their individual claims are small. Even when individuals' claims are small, the costs to society and the economy of a fraud may be in the hundreds of millions or billions of dollars. Yet, absent the ability to proceed collectively, individuals have no means of redress because – as the wrongdoers know – it is frequently economically impossible for victims to pursue claims on an individual basis. Private investors form a key front-line defense against financial fraud and abuse as they are in the unique position to identify and take action against unlawful conduct. The ability of investors to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Legislation should ensure that all individuals have the right to access federal courts individually or as a member of a class action.

Stop culpable parties from avoiding liability by manipulating disclosure. When corporate wrongdoers lie to investors and inflate the value of publicly traded stock through fraudulent and misleading accounting statements and other chicanery, those culpable parties should be held responsible for the damage wrought on the investing public that is caused by their fraud. Recent judicial decisions, however, have impaired the ability of shareholders to hold corporate wrongdoers accountable by enabling them to avoid liability altogether through the manipulation of disclosures designed to drive down a company's stock price before the true fraud is revealed to the market. Legislation is needed to ensure defendants cannot escape accountability to their shareholders for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.

Restore aiding and abetting in securities cases. Private "aiding and abetting" liability is well established in criminal law, and private liability for engaging in an unlawful and fraudulent scheme is widely recognized in civil law. In cases of civil *securities* fraud, however, judicial decisions have effectively eliminated private liability of so-called "secondary actors" – even when they knowingly participated in fraud schemes. Eliminating the private liability of such "secondary actors" as corporate accountants, lawyers and financial advisors has proven disastrous for investors and the economy. Such "gate keepers" who traditionally have had a responsibility to watch investors' interests and once faced real costs when they failed to do so, have come to believe they cannot be held accountable—even in large frauds such as Enron in which the "books were cooked" and "secondary" actors knowingly helped managers design *fake* financial transactions to hide *real* economic losses from investors. Most recently, in the sub-prime mortgage-backed securities debacle, bond rating agencies — who were paid by the very investment bankers who created the securities they were asked to rate — knowingly gave triple-A ratings to junk sub-prime debt instruments in order to generate more business from the junk marketers. Legislation should eliminate the immunity from private liability that these culpable third parties currently enjoy.

Protect whistleblowers and confidential sources. Confidential informants — sometimes called "whistleblowers" — are of immeasurable value in discovering and redressing corporate wrongdoing. The information provided by these individuals may be crucial to victims' ability to prove their claims. Often, these individuals only come forward because they believe their anonymity will be preserved. If their identities were known, they would be open to retaliation from their employers and/or others with an interest in covering up the wrongdoing. Whistleblowers might lose their job or suffer other harm. Recent judicial decisions, however, have overly restricted the ability of shareholders to use confidential sources in presenting cases of corporate wrongdoing, and have created much uncertainty among whistleblowers as to their actual protection. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward. In short, witnesses to securities fraud should be provided the same level of protection of their identities and against retaliation given to "whistleblowers" in other types of fraud.

Eliminate preemption as a defense to civil liability. The previous decade saw the greatest shift in governmental authority away from the states and to the federal government in our history. The unstated goal of this shift was to deny individuals their legal rights under state laws and to protect corporate defendants. Corporate interests and an administration devoted to the ideology of deregulation used the “doctrine of preemption” (that federal law supersedes state law) to bar action at the state level that could have stopped many of the abuses in sub-prime mortgage lending that are now at the heart of our economic crisis. Indeed, state attorneys general were blocked from prosecuting sub-prime lenders who violated state laws. Legislation is needed to restore the integrity of state law, and the ability of both state actors and shareholders to pursue remedies available under state law. The federal Congress should make clear that state law exists coextensively with federal regulations, except only where state law directly contradicts federal law.

Prevent culpable wrongdoers from hiding evidence from shareholders when such information is disclosed to governmental investigators and other third parties. In 1995, Congress enacted the Private Litigation Reform Act (“PSLRA”) that established sweeping reforms to securities litigation. Although largely laudable in purpose and effect, one aspect of the law has had unintended consequences through in its exploitation by culpable corporate defendants. Under the PSLRA, shareholders who bring securities actions are not entitled to obtain discovery in support of their claims until a court first determines that the shareholder has adequately stated a claim. Significant corporate fraud, however, often results in governmental investigations, shareholder derivative actions, and claims asserted by employees that are not governed by this discovery stay. Accordingly, while shareholders prosecuting securities cases must sit on their hands while a court considers their case, corporate defendants often are sharing important information with governmental investigators and with plaintiffs in other ongoing litigation as well. Such information could be useful in supporting a securities fraud claim, yet shareholders are precluded under the PSLRA from obtaining access to it. Shareholders prosecuting securities fraud claims should, at the very least, be entitled to the same set of documents produced by corporate defendants to governmental investigators and other third parties even while a court considers the adequacy of a shareholder’s initial pleading.

**Democratizing the Federal Reserve**

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The Federal Reserve Board (or "Fed") bears substantial responsibility for the current crisis. It allowed an $8 trillion housing bubble to expand unchecked even though the collapse of this bubble inevitably would lead to a serious recession.

**Designed-in Conflicts of Interest**

By design, the Federal Reserve is largely under the control of the financial industry. The presidents of the twelve regional Federal Reserve Banks are chosen through a process that is dominated by the banks. Under the current system, each regional bank has nine directors. Three of the directors are chosen directly by the member banks within the district. Three directors, who are supposed to represent the larger community, are selected by the first three directors. The final three directors, who are also supposed to represent the larger community, are appointed by the Board of Governors. The nine directors select the regional bank president who is the chief executive officer for the bank.

All of these bank presidents sit on the Open Market Committee that determines monetary policy, with the seven members of the Board of Governors appointed by the president. Five of these governors actually vote on monetary policy (four spots rotate among the banks, with the president of the New York Federal Reserve Bank being a permanent voting member).

In addition to their large role in determining monetary policy, the district banks also have substantial regulatory powers, especially the New York bank. In effect, the current structure of the Fed is a system in which the banks largely decide who regulate them.

There is no reason why the banks should have a special role in determining the country's monetary policy, nor why they should pick their own regulators. Insofar as the Fed has policy responsibilities (it also engages in check-clearing operations and provides other bank services), all of its key officials should be appointed by the president and directly answerable to the Congress, not the banks.

If Fed officials were accountable to Congress then monetary policy might be designed to address the concerns of ordinary workers instead of banks. This would mean more emphasis on maintaining high levels of employment and less concern about modest rates of inflation.

The Fed also has largely ignored its responsibility to oversee the Community Reinvestment Act and other laws that ensure equal access to credit. To the extent it retains jurisdiction in these areas, it would benefit from oversight by consumers.

**Non-Transparency**

The Fed's proceedings are excessively non-transparent. As it stands now, the Fed provides summary minutes of the meetings of the Open Market Committee, with a six-week lag. Full transcripts are made available after five years. There is no reason that these lags cannot be reduced. In principle, the meetings could be televised live so that the public could immediately understand the factors underlying the Fed's decisions on monetary policy.

This type of transparency could have helped stem the growth of the stock and housing bubbles. Transcripts from the late 1990s, in contrast to their public statements, show that the Fed members were fully aware of the stock bubble and were waiting for it to burst. Investors might have been more reluctant to buy stock had they known that the country's top economic officials believed the market was seriously inflated. Similarly, if the Fed had recognized the housing bubble, and the public had become aware of this fact, then many potential homebuyers might have been more reluctant to buy homes in severely over-valued markets.

**Solution: Make the Fed a True Public Agency**

These governance and transparency problems would be solved by transforming the Fed into a true public agency. Americans for Financial Reform is currently developing more detailed proposals.