CFA INSTITUTE
Centre for Financial Market Integrity

26 November 2007

Department of the Treasury
Departmental Offices

Re: Review by the Treasury Department of the Regulatory Structure Associated with Financial Institutions

Dear Sir or Madam:

The CFA Institute Centre for Financial Market Integrity[1] (CFA Institute Centre) is writing to provide comments on the Treasury Department's questions in connection with its review of the regulatory structure associated with financial institutions. We applied this undertaking as a needed part of addressing the overall structure of markets that are becoming increasingly global in nature.

Background and General Comments

The CFA Institute has a longstanding record of supporting investor protections, including transparency requirements for listed companies, investment firms, and markets; efficiency of market regulation; and market integrity through the creation and maintenance of high ethical standards for the investment profession. Not only do investors deserve the information they need in order to make well-informed investment decisions, our experience has shown that what is good for the investor is ultimately good for the markets.

To this end, the cornerstone of our organization is the CFA Institute Code of Ethics and Standards of Professional Conduct (*Code* and *Standards*). CFA Institute requires its members, holders of the Chartered Financial Analyst (CFA) designation, and CFA candidates to abide by the *Code* and *Standards* or risk sanctions, including revocation of the CFA charter. We believe that any review of the existing regulatory schemes must be guided by the commitment to maintain and strengthen, where possible, market integrity—both domestically and internationally.

In addition, a recent research project undertaken by the CFA Institute Centre that focused on self-regulation in the securities markets touched on a number of the issues raised in this Notice. In connection with our paper—Self-Regulation in Today's Securities Markets-- [2] we held individual meetings and forums in Washington DC, London, Singapore, Melbourne, Sydney and Hong Kong during which we met with nearly 70 regulators,

[1]The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,200 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom more than 82,500 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.
[2] This paper can be obtained at www.cfapubs.org/toc/ccb/2007/2007/7.

Charlottesville New York Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

exchange officials, market participants and others to discuss the role of regulation and self-regulation in globally consolidating and demutualizing markets. A number of these participants commented on the U.S. system of regulating financial services. Our discussion of the issues being raised here reflects those conversations.

We provide responses to certain of the questions raised in the Notice below.

Specific Comments

1.1 What are the key problems or issues that need to be addressed by our review of the current regulatory structure for financial institutions?

For the United States to remain competitive in an era of increasing globalization of the financial markets, we urge a revamping of the current domestic regulatory scheme to better define and clarify who has regulatory authority over financial areas/products, consolidate and tighten regulatory oversight for similar areas/products and eliminate duplicate or conflicting regulatory of similar areas/products. To the degree that innovation of new financial services and products are hampered by domestic uncertainty over the scope and purview of regulations, the U.S. domestic economy suffers. To that end, we strongly recommend a streamlining of the current system.

We believe that this issue is bigger than just the effect on the US economy. During our forum discussions particularly with European regulators, we heard how the lack of regulatory coordination within the US contributed to less than optimal harmonization between the regions. One regulator—the CFTC—was cited as the exception to this complaint and was referred to as the model of cooperation that would best lead to mutual recognition among countries.

1.2 Over time, there has been an increasing convergence of products across the traditional "functional" regulatory lines of banking, insurance, securities, and futures. What do you view as the significant market developments over the past two decades (e.g. securitization, institutionalization, financial product innovation and globalization) and please describe what opportunities and/or pressures, if any, these developments have created in the regulation of financial institutions?

We believe that both financial product innovation and globalization provide the most significant developments. These developments have also changed the way markets function and should influence how they are overseen. While "functional" regulation may have achieved certain efficiencies in the past, the traditional system has not kept pace with today's markets and product development. Accordingly, we encourage consolidation with a long-term goal of a single regulator with oversight authority over domestic financial services and products.

Product innovation over even the last decade has resulted in a range of complex financial instruments that do not fall squarely within the categories originally defined for any specific regulator. While such developments have proven to be a good thing for the markets, investors, and consumers as a whole, they have created uncertainty about how to define the product and determine under whose jurisdiction it falls. Anecdotally, we have heard of numerous instances when this uncertainly impeded product innovation. Product developers often failed to secure the necessary support for that product development because they could not determine the stringency of regulations (and correlated compliance costs) they might have to meet.

In addition, the lack of certain and cohesive regulatory schemes raises significant issues of consumer protection. Consumers risk confusion and loss when similar products or services are regulated under different standards.

Globalization has also had an effect. Over the last decade, the securities markets have encountered more rapid changes to structure, market participants, and regulation than at any other time in their history. The rise of innovative global and cross-market trading strategies and exchanges that are both global and diversified across product offerings have together added new surveillance and regulatory challenges that ultimately require the concerted effort and cooperation of numerous regulators. The lack of a unified U.S. approach challenges the cooperation and understanding that is needed.

1.2.1 Does the "functional" regulatory framework under which banking, securities, insurance, and futures are primarily regulated by respective functional regulators lead to inefficiencies in the provision of financial services?

We believe they do. Please refer to our response to question 1.2 directly above.

1.2.3 Many countries have moved towards creating a single financial market regulator (e.g., United Kingdom's Financial Services Authority; Japan's Financial Services Agency; and Germany's Federal Financial Supervisory Authority (BaFin)). Some countries (e.g., Australia and the Netherlands) have adopted a twin peaks model of regulation, separating prudential safety and soundness regulations and conduct-of-business regulation. What are the strengths and weaknesses of these structural approaches and their applicability in the United States? What ideas can be gleaned from these structures that would improve U.S. capital market competitiveness?

As discussed in our paper on self-regulation, we believe that successful regulation requires potential conflicts of interest to be managed effectively so as not to compromise effective regulation because of competing business concerns. This is particularly important in systems where exchanges have demutualized and the exchange has become a for-profit entity, regulating the very members on whose business it depends. Whatever particular system is adopted must have safeguards in place to separate the regulatory functions from the business side in order to ensure adequate investor protections.

1.3 What should be the key objectives of financial institution regulation? How could the framework for the regulation of financial institutions be more closely aligned with the objectives of regulation? Can our current regulatory framework be improved, especially in terms of imparting greater discipline and providing a more cohesive look at the overall financial system risk? If so, how can it be improved to achieve these goals? In regards to this set of questions, more specifically: [only certain items were selected for below]

We believe that any successful regulatory scheme must, at a minimum, provide adequate investor protections while fostering innovation and competitive forces that fuel that particular industry. In order to provide the necessary investor (and market) protections, we strongly encourage consideration of a regulatory framework that not only streamlines oversight authority of financial services within the United States but also takes into account the need to track some of these products/services (particularly in the securities area) internationally.

There also must be ways to assess systemic risk. While we appreciate the difficulty in creating mechanisms for projecting how shortfalls in one sector may affect others within the U.S. economy, anything short of this fails to recognize the interrelatedness of the markets. This assessment needs to take into account risk both within the United States and as part of the U.S. relationship with, and affect upon, the markets globally.

1.3.4 In recent years, debate has emerged about more "efficient" regulation and the possibility of adopting a "principles-based" approach to regulation, rather than a "rules-based" approach. Others

suggest that a proper balance between the two is essential. What are the strengths, weaknesses and feasibility of such approaches, and could a more "principles-based" approach improve U.S. competitiveness?

Realistically, all-rules based systems reflect underlying principles and all principles-based systems require some degree of rules in order to comply. The relevant distinction between the two lies in the degree to which market participants retain flexibility and latitude to make judgments regarding regulatory compliance.

A principles-based approach grants institutions great latitude and flexibility in how they meet their regulatory obligations. In effect, this promotes innovation in the instruments used to achieve compliance with those regulatory principles. This flexibility allows regulated firms to alter their organization and compliance structures as they see fit, when they see the need, and as circumstances warrant.

The flexibility in such principles-based structures, however, risks a lack of consistency for compliance and enforcement. Firms may not fully understand how their approaches to organization and compliance will perform in periods of stress. Likewise, regulators will have little information with which to gauge the appropriateness of one organizational or compliance structure against any others.

At a minimum, the current U.S. system exposes firms to legal uncertainty. For example, if a firm tries an innovative organizational structure as a means of fulfilling its regulatory mandates but then endures financial stress that creates losses for certain stakeholders, the firm may find plaintiffs' attorneys second-guessing those structures and decisions. To avoid such difficulties, therefore, the firms may seek guidance and recognition from regulators to support their structures. This could lead to a situation where most firms choose to adopt only those structures that have received regulatory imprimatur, a situation that could undermine the flexibility that is the benefit of a principles-based system.

The U.S. legal system, alongside which regulation of financial services has developed, makes creation of a principles-based U.S. structure most difficult. However, we urge consideration of a principles-based culture. This would require an extensive review of the role that regulators play as well as the reform of the legal base and culture that forms the foundation of our current regulatory structure.

1.3.5 Would the U.S. financial regulatory structure benefit if there was a uniform set of basic principles of regulation that were agreed upon and adopted by each financial services regulator?

Such a structure would appear to decrease overlap, duplicity and uncertainty among financial service providers. The current system of uncertainty has led to an environment where an inordinate amount of focus is often on a firm's compliance efforts to an extent where business strategy is governed by compliance concerns. A streamlined system with clear accountability would inure to the benefit of investor, as well as provider, interests.

1.4 Does the current regulatory structure adequately address consumer or investor protection issues? If not, how could we improve our current regulatory structure to address these issues?

In most ways, the current structure appears to be reasonably effective in achieving this goal. The question is whether it can achieve the same goal but with a different structure. Moves toward unified regulation in the second- and third-largest markets in the world indicate that such structures are workable.

1.6 Europe is putting in place a more integrated single financial market under its Financial Services Action Plan. Many Asian countries as well are developing their financial markets. Often, these

countries or regions are doing so on the basis of widely adopted international regulatory standards. Global businesses often cite concerns about the costs associates with meeting diverse regulatory standards in the numerous countries in which they operate. To address these issues, some call for greater global convergence and others call for mutual recognition. To what extent should the design of regulatory initiatives in the United States be informed by the competitiveness of U.S. institutions and markets in the global marketplace? Would the U.S. economy and capital market competitiveness be better served by pursuing greater global regulatory convergence?

If domestic regulation promotes investor interests and protects them against market abuses — the uniform definition of which was the purpose of much of the EU's FSAP — then the competitiveness of the United States, at least in terms of its financial markets, will remain at the highest level. The ultimate competitive position of a market pivots on its ability to attract and retain capital which, in turn, depends on the existence of reasonable investor protections—not the ease of use by those seeking to access capital. Thus, any attempt to redesign the US system of regulation with increased competitiveness, not investor protections, as a goal will likely produce a system that ultimately becomes less competitive.

We are aware of several markets that offer speculative opportunities for global investors. However, we do not believe that U.S. exchanges should attempt competing directly for these market segments. In addition, the perceived erosion of relative competitiveness of the U.S. financial markets — as evidenced by a significant increase in new listings on certain exchanges outside of the United States — is largely a function of the increased competitiveness of those other markets and domestic and political considerations of the issuing companies rather, than an absolute decline in the competitiveness of the U.S. market.

We believe that actual regulatory convergence or harmonization on a global basis is unlikely. However, we do recommend that regulatory mutual recognition be pursued. Unnecessary regulatory overlap and the confusion created by a system with multiple regulators unsure of the limits of their authority do not contribute to investor protections or certainty. The process by which US regulation is created often reflects a highly complex and untested process that may not reflect an accurate cost/benefit analysis. As we move toward regulatory reform we encourage a focus on this analysis.

2.3 Securities and Futures

2.3.1 Is there a continued rationale for distinguishing between securities and futures products and their respective intermediaries?

Ultimately, regardless of the regulatory structure in place, regulators will have to look at futures and other derivative instruments differently from the cash instruments from which they derive. This is a function of the different qualities attached to each. Nevertheless, the direct connections between the different types of instruments make it important that the same regulators oversee both.

2.3.2 Is there a continued rationale for having separate regulation for these types of financial products and institutions?

No. Most of the volume in both markets is created by firms that operate in both types of instruments. Moreover, a coherent unified regulatory structure that oversees institutions operating in both markets is more likely to recognize developing systemic risks both for the institutions involved and for the markets in general than a structure of segregated regulators.

2.3.3.1 What type of regulation would be optimal for firms that provide financial services related to securities and futures products? Should the regulation be driven by the need to protect customers or by the broader issues of market integrity and financial system stability?

Regulation should consider both. On the one hand, if investors are not protected on an exchange or in a market, they will not invest their capital in those markets for fear of the increased likelihood of losses or of gains diminished as a consequence of market abuses. Thus, the markets will not flourish because of fear that the structure is not fair. At the same time, regulators have to consider the overall stability and integrity of the markets. Ultimately these two strategies are not mutually exclusive. Rather, they are complementary and should be pursued jointly.

2.3.5 What are the key consumer/investor protection elements associated with products offered by securities and futures firms? Should there be a regulatory distinction among retail, institutional, wholesale, commercial, and hedging customers?

It should be incumbent upon firms and the individuals who work for them to ensure that financial instruments and investment strategies marketed to customers — regardless of their classification as retail, institutional, commercial, wholesale, or hedging — are appropriate to the specific client. In this sense, there should be no regulatory distinction.

Conclusion

We appreciate the opportunity to offer comments on this important undertaking by the Treasury Department to reexamine the current regulatory system for financial institutions in the United States. .

We would welcome an opportunity to meet in person to discuss in more depth the views presented above or to provide additional information. If you would like to schedule a meeting, please do not hesitate to contact Kurt Schacht at kurt.schacht@cfainstitute.org (212.756.7728) or Linda Rittenhouse at linda.rittenhouse@cfainstitute.org (434.951.5333).

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director
CFA Institute Centre for
Financial Market Integrity

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Senior Policy Analyst
CFA Institute Centre for
Financial Market Integrity