Consumer Federation of America

Testimony of
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Consumer Federation of America

Wall Street and Fiduciary Duties:
Can Jail Time Serve as an Adequate Deterrent for Willful Violations?

Before the
Committee on the Judiciary Subcommittee on Crime and Drugs
U.S. Senate

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Chairman Specter, Ranking Member Graham and Members of the Committee:

My name is Barbara Roper. I am Director of Investor Protection of the Consumer Federation of America (CFA). CFA is a non-profit association of approximately 280 organizations founded in 1968 to advance the consumer interest through research, advocacy, and education. I appreciate the opportunity to appear before you today to discuss how imposing a fiduciary duty on Wall Street, and backing that duty with tough criminal sanctions, can enhance investor protection and market integrity.

Since I first joined the organization in 1986, CFA has been making the case that brokers who offer investment advice should be held to a fiduciary duty to act in the best interests of their clients. Our primary focus has been on strengthening protections for average, retail investors. But, as last week's hearing in the Permanent Subcommittee on Investigations graphically demonstrated, retail investors are not alone in needing enhanced protections. Institutional investors, once thought to be capable of looking out for themselves, also need protection from Wall Street's predatory ways.

We greatly appreciate your leadership in holding this hearing to explore what role an expanded and strengthened fiduciary duty can play in providing that protection. In my testimony today, I want to start by discussing the fiduciary duty issue in the context of the current financial crisis. Then I will discuss briefly how Wall Street abuses that contributed to the financial crisis relate to problems encountered by retail investors in their dealings with brokers. And, finally, I will discuss various options for strengthening protections for institutional and retail investors alike through adoption of an enhanced fiduciary duty.

Wall Street, the Financial Crisis, and Fiduciary Duty

While the factors that contributed to the financial crisis are myriad and mind-numbingly complex, the basic mechanics of the crisis are well established. Beginning in the late 1990s and early years of this decade, underwriting standards of mortgage lenders began to erode. By the middle of the decade, those standards had all but disappeared. Able to book an immediate and substantial profit selling their mortgages to be repackaged into securities, mortgage lenders no longer had to worry about whether borrowers were likely to repay. And the investment banks that purchased those mortgages were equally unconcerned as long as they could structure the mortgage-backed securities in ways that allowed them to win the AAA credit ratings that were essential to their sale. Indeed, when the supply of mortgages couldn't keep pace with Wall Street demand, they developed even more complex structures – collateralized debt obligations (CDOs) based on lower tranches of mortgage-backed securities, CDOs-squared based on lower tranches of CDOs, and synthetic CDOs based on derivatives designed to mimic the performance of particular mortgage pools. And everyone in the chain, from the loan originator to the rating agencies to the Wall Street bankers packaging and selling the securities, was raking in record profits, right up to the point when the bubble burst, housing prices dropped, and the once AAA-rated securities turned toxic.

Financial institutions that had loaded up on the mortgage-backed securities because of their combination of high ratings and high returns suddenly faced devastating losses. At many

institutions those losses were magnified by excessive use of leverage and reliance on short-term financing. When Bear Stearns stumbled and Lehman Brothers fell, fear gripped the markets. Lack of transparency meant no one knew the nature and extent of risks various players were exposed to. And the fall of Lehman demonstrated how the use of OTC derivatives purportedly to hedge risk had instead both magnified those risks and spread them throughout the financial system.

In the wake of the crisis, some on Wall Street have expressed at least a mild sense of regret for their industry's role. In testimony before the Financial Crisis Inquiry Commission, for example, Goldman Sachs CEO Lloyd Blankfein expressed dismay over "the rationalizations that were made to justify that the downward pricing of risk was justified."[1] And he acknowledged that the firms had rationalized "because a firm's interest in preserving and growing its market share, as a competitor, is sometimes blinding – especially when exuberance is at its peak." Mr. Blankfein expanded on that explanation in his statement last week before the Permanent Subcommittee on Investigations, saying: "What we and other banks, rating agencies and regulators failed to do was sound the alarm that there was too much lending and too much leverage in the system -- that credit had become too cheap."[2] What comes through from these statements, however, is that Wall Street, while accepting some responsibility, views its role as at best secondary. They were simply market makers, according to this account, bringing together buyers and sellers, and providing liquidity to the markets – doing "God's work," if you will.

The evidence, however, suggests a much deeper culpability. Wall Street's blame is not simply that they failed to recognize risk building up in the system, or failed to adequately sound the alarm when they did recognize that risk, or failed to warn their customers against doing things that were harmful to those customers' interests. Wall Street's blame is that, in their pursuit of the profits that fed their multi-billion-dollar bonus pools, they abandoned any sense of responsibility to ensure that the products they developed and sold served some economic utility or served their clients' interests or benefited anything but their own bottom line.

This reality was on full display in last week's hearing before the Permanent Subcommittee on Investigations. As the Subcommittee noted in its release in advance of the hearing, "Goldman and other investment banks played a crucial role in building and running the conveyor belt that fed toxic mortgages and mortgage-backed securities into the financial system." Documents released by the Subcommittee call into question Goldman's efforts to portray itself simply as a market maker serving client needs:

- When discussing the fact that a customer was interested in taking a short position in Anderson Mezzanine Funding 2007-1, a synthetic CDO that Goldman had assembled,

[1] Testimony of Lloyd C. Blankfein, Chairman of the Board and Chief Executive Officer, Goldman Sachs Group, Inc., before the Financial Crisis Inquiry Commission, January 13, 2010.
[2] Testimony of Lloyd C. Blankfein, Chairman of the Board and Chief Executive Officer, Goldman Sachs Group, Inc., before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, hearing on "Wall Street and the Financial Crisis: The Role of Investment Banks," April 27, 2010.

one executive noted that Dan Sparks, the head of Goldman's mortgage department, "might [want] to preserve that ability for Goldman.[3]

- Another employee described in his performance review how he had "saved the firm hundreds of millions of dollars" by refusing client requests to "support the GSAMP program," which was a Goldman Sachs subprime mortgage-backed security program.[4]

In the first instance, Goldman appears to have been putting its own proprietary trading interests ahead of the interests of its clients. In the second, it appears to have walked away from the role of market maker as buyer or seller of last resort in order to protect its own bottom line.

Particularly relevant to a discussion of how fiduciary duty might affect Wall Street practices is the description of Goldman's actions as it sought to reduce its own exposure to and then bet against a mortgage market it viewed as headed for serious trouble. According to Subcommittee documents, Goldman began in late 2006 to instruct its sales force to sell mortgage-backed securities and CDOs "containing or referencing high risk assets that Goldman Sachs wanted to get off its books."[5] Various emails among Goldman employees refer to the investments "as a way to distribute junk that nobody was dumb enough to take first time around" and to certain clients as "too smart to buy this junk."[6] One employee describes the "real bad feeling across European sales about some of the trades we did with clients," trades that had cost clients more than $1 billion in losses on just five deals. Adding to the resentment in the latter case, the team did not feel it had been adequately rewarded "for getting this business done" considering all the money it "ended making/saving the firm."[7]

The cynical disregard for client well-being exposed in certain Goldman Sachs emails is hardly new to Wall Street. Similar conduct was on display as far back as the early 1990s, when Bankers Trust took supposedly "sophisticated" investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex formulas that the companies clearly didn't understand. In his 2003 book *Infectious Greed*, Frank Partnoy offers the following illustration of the culture at Bankers Trust:

> As one former managing director put it, "Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, 'I can get [this customer] for all these points.' The senior guys would say, 'Yeah, ream him.'"[8]

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[3] Opening Statement of Sen. Carl Levin, U.S. Senate Permanent Subcommittee on Investigations Hearing, "Wall Street and the Financial Crisis: The Role of Investment Banks," April 27, 2010.
[4] Ibid.
[5] Chris V. Nicholson, "Deal Book: The Goldman Emails, or How to Sell Junk," *The New York Times*, April 28, 2010.
[6] Ibid.
[7] Ibid.
[8] Frank Partnoy, *Infectious Greed, How Deceit and Risk Corrupted the Financial Markets,* Henry Holt and Company (New York), 2003, p. 55, citing Brett D. Fromson, "Guess What? The Loss is Now … $20 Million: How Banks Trust Sold Gibson Greetings a Disaster," *Washington Post*, June 11, 1995, p. A1.

Nor was Goldman Sachs alone among investment banks in putting its own interests ahead of those of its customers. A *Washington Post* account of CDO sales practices at Merrill Lynch sounded many of the same themes:

> The CDO alchemy involved extensive computer modeling, and those who wanted to wade into the details quickly found that they needed a PhD in mathematics.
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> But the team understood the goal, said one trader who spoke on condition of anonymity to protect her job: Sell as many as possible and get paid the most for every bond sold. She said her firm's salespeople littered their pitches to clients with technical terms. They didn't know whether their pitches made sense or whether the clients understood.[9]

Another example of Wall Street's corrupt culture can be found in the sale of derivatives to governments across the country and around the world. The Greek debt scandal is the most notorious, but a recent account in *The New York Times* describes how municipalities, school districts, sewer systems and other tax-exempt debt issuers from around the country "are ensnared in the derivatives mess" because of municipal swaps that blew up when the credit markets collapsed.[10] Even before that collapse, the U.S. Justice Department had reportedly launched a criminal investigation looking at whether J.P. Morgan and others conspired to overcharge governments on "swaptions," which are options that grant the owner the right but not the obligation to enter into a swap.[11] And a number of government bodies have filed lawsuits challenging excessive fees and other features of the transactions.[12]

A more detailed look at how Wall Street profited at taxpayer's expense can be found in the SEC's probe into J.P. Morgan Chase & Co.'s sale of derivatives to Jefferson County, Alabama to finance a new sewer system. In November, the bank agreed to a $722 million settlement that required it to pay a fine of $25 million, to pay $50 million to the county to assist displaced county employees, residents, and sewer ratepayers, and to cancel $647 million in fees it had charged the county to unwind the derivatives transactions in question.[13] The charges that were settled involved pay-to-play allegations and millions in bribes that landed one county official in jail. Bad as the bribery and corruption were, the real scandal is the underlying conduct, in which J.P. Morgan sold the county billions of dollars of derivatives that profited J.P. Morgan handsomely but brought the county to the brink of bankruptcy.

Over the course of the sewer financing project, Jefferson County did 23 swap deals, as described in an account in *Rolling Stone*.[14] At one point, it reportedly had more outstanding

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[9] Jill Drew, "Frenzy," *Washington Post*, December 16, 2008, p. A1.
[10] Gretchen Morgenson, "The Swaps That Swallowed Your Town," *The New York Times*, March ??, 2010.
[11] Naked Capitalism, "JP Morgan Under Criminal Investigation for Jefferson County, Other Swaps," Oct. 29, 2008, quoting a *Bloomberg* article.
[12] Ibid.
[13] Securities and Exchange Commission, "J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme," November 4, 2009.
[14] The description in this paragraph comes from an article by Matt Taibbi, "Looting Main Street: How the nation's biggest banks are ripping of American cities with the same predatory deals that brought down Greece," *Rolling Stone*, March 31, 2010.

swaps than New York City. In 2008, however, a series of penalties built into the swaps deals began to kick in, including one related to failed insurance on the deal that forced the county to pay off $800 million of its debt in four years instead of 40. As a result, the annual payment on Jefferson County's debt jumped from $53 million in 2008 to $636 million in 2009. There were other problems with the swaps, including a mismatch between the interest rates paid to the county and those it was required to pay out that left it getting lower payments from J.P. Morgan than it was forced to pay out to bondholders. When the county was unable to make its swap payment to J.P. Morgan, the bank cancelled the deal, charging the $647 million termination fee. This is the fee that it was required by the SEC settlement to relinquish.

As a result of all this, Jefferson County has seen its credit rating slashed. It has laid off workers, increased sewer bills by more than 400 percent, and it is still weighted down with billions in debt county taxpayers will be paying off for decades to come. As Taibbi concludes in his account of the fiasco:

> The destruction of Jefferson County reveals the basic battle plan of these modern barbarians, the way that banks like JP Morgan and Goldman Sachs have systematically set out to pillage towns and cities from Pittsburgh to Athens. These guys aren't number-crunching whizzes making smart investments; what they do is find suckers in some municipal-finance department, corner them in complex lose-lose deals and flay them alive. In a complete subversion of free-market principles, they take no risk, score deals based on political influence rather than competition, keep consumers in the dark – and walk away with big money.

A respected financial blogger writing about a deal involving J.P. Morgan and another Alabama government body, makes a similar point. Working from an account in a *Bloomberg* article, the writer notes that, if correctly described, "this looks like a deal almost certain to have turned out badly for the county," adding:

> This is not at all uncommon for OTC derivatives, where even if the transaction in theory has merit, the fees charged are so high as to make the deal uneconomical to the client. But clients almost universally lack the skills to properly model the deal to figure this out. Most deals don't blow up as spectacularly as this one did, so most clients never figure out they were had.[15]

This point about institutional clients' lacking the skills to evaluate the complex investments recommended to them arises in the CDO context as well and is directly relevant to the question of what duty the broker should owe those clients. Quoted in an article in *Knowledge@Wharton*, Greenwich Financial Services President William Frey had this to say about the near impossibility of evaluating complex CDOs for the typical institutional client:

> Evaluating the CDO would require studying each mortgage security in it, altogether comprising many thousands of mortgages – perhaps hundreds of thousands of them … A thorough evaluation would require studying the loan-to-value ratios of the mortgages, the geographical locations of the homes,

[15] Ibid.

> unemployment rates, local default and foreclosure rates, and other factors determining how many homeowners were likely to default.
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> "For all practical purposes, unless you have the most sophisticated software on the market, which few investors have, you rely on the ratings agencies," Frey says.

These accounts comport with something CFA has suggested for some time: that the complexity and opacity of modern financial products has rendered obsolete the notion that typical institutional investors are capable of looking out for their own interests. That view was also voiced by SEC Commissioner Luis Aguilar in a speech last Thursday before the Investment Adviser Association. A longtime champion of holding brokers to a fiduciary duty when they give advice, Commissioner Aguilar said: "It is readily apparent from recent Commission enforcement cases — such as the cases involving auction rate securities — that all investors, including institutional investors, need the protection of the fiduciary standard."[16]

Fiduciary Duty and Retail Investors

Although the focus of this hearing is on fiduciary duty as it relates to the financial crisis, it is worth taking a moment to examine the issue as it relates to retail investors as well. After all, the abuses described in the Permanent Subcommittee on Investigations hearing mirror, albeit on a far larger scale, the kind of problems average retail investors encounter in their everyday dealings with broker-dealers. The most common problem faced by retail investors is sale of products to benefit the broker's bottom line rather than the client's financial well-being. In a fairly typical example, a broker might recommend a particular mutual fund or 529 plan or variable annuity, not because it has the lowest fees, the best management, or the best allocation of assets to match the client's investment goals, but rather because it pays the highest commission or makes revenue sharing payments to the firm. As in the Goldman case, investors can also be harmed when brokers sell them investments they are trying to unload from their own inventory, or when they sell products in which the firm has a direct financial stake. While the issues at stake may not seem dramatic when compared with Wall Street conduct that rocked the global economy, the impact on individuals can be substantial, since even small differences in cost or performance can make large differences in accumulated savings over the life of a long-term investment.

There is one notable difference between the abuses targeting institutional and retail investors. Institutional clients of Goldman Sachs and J.P. Morgan and others may not have realized how massive the conflicts were between their interests and those of the investment banks, or how badly they were being taken, but they likely did realize or should have realized that the firm was not acting as their trusted adviser. Retail investors are routinely lured into making precisely that mistake, however, by brokers who call themselves financial advisers, offer services such as "retirement planning" or "investment planning" that appear to be advisory in nature, and market those services based on the advice offered. Not surprisingly under these circumstances, the average investor cannot distinguish between brokers and advisers and

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[16] Speech by SEC Commissioner Luis Aguilar, "Protecting Investors by Requiring that Advice-Givers Stay True to the Fiduciary Framework," before the annual conference of the Investment Adviser Association, April 29, 2010.

certainly doesn't recognize that their "financial adviser" operates under a lower legal standard than an "investment adviser."[17] Lured into believing they are in a relationship of trust, investors are unlikely to be on their guard against practices that may pit their interests against the broker's.

Suitability vs. Fiduciary Duty

When talking about imposing a fiduciary duty on brokers, it is useful to start with an understanding of the current lay of the land. Under the Securities Exchange Act and rules of the Financial Industry Regulatory Association (FINRA), the legal obligation of brokers when selling securities is to make suitable recommendations and to know enough about their customers to determine what would be suitable. As fiduciaries, investment advisers must have a reasonable basis for believing their recommendations are in the best interests of the customer.[18] In addition, an investment adviser must disclose all material information, including information about conflicts of interest that could bias their recommendations. While a broker is not permitted to mislead the investor, brokers do not have the same obligation as advisers to provide all information that an investor might view as material to the transaction.[19] Finally, because of the way the SEC has interpreted the broker-dealer exclusion from the Investment Advisers Act over the years, most investment advice offered by brokers is not subject to regulation under the Advisers Act. As long as the advice is offered in connection with and reasonably related to a securities transaction, it is viewed as "solely incidental" to that transaction and is excluded from regulation under the Advisers Act.

The Goldman CDO deals described in the investigation of the Permanent Subcommittee on Investigations offer a perfect model for discussing the difference between suitability and fiduciary duty. Leaving aside legal questions about what Goldman should have disclosed in the Abacus case, the firm has at least a plausible claim that, when it was selling various CDOs to its customers, it was not acting as an investment adviser and thus subject at most to a broker's suitability obligations.[20] Under a suitability standard, and particularly as applied in the institutional investor context, the broker arguably has little obligation beyond determining that the investor meets the standards for participating in a particular type of deal and that the deal in question has characteristics consistent with what the investor is seeking – for example, a security that offers exposure to the mortgage market and a particular credit rating. No one has to my knowledge suggested that Goldman violated that standard.

So what might the various transactions described in that hearing have looked like if subject to a fiduciary duty?

[17] See, for example, Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, and Farrukh Suvankulov, RAND Institute for Civil Justice, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* commissioned by the Securities and Exchange Commission, 2008.
[18] While the fiduciary duty is not explicit in the Investment Advisers Act, the Act has been interpreted by the Supreme Court to impose a fiduciary duty.
[19] This is particularly true in the world of private placements, where sophisticated investors are deemed to be capable of fending for themselves and not in need of the full protections of the regulated marketplace.
[20] That was the view expressed by Goldman's Fabrice Tourre when asked by Sen. Susan Collins whether he felt he had a fiduciary duty to act in the best interests of his clients.

- Goldman is accused of structuring certain securities specifically so that it could move risks off its own balance sheet and bet against the securities. It is hard to imagine how Goldman, if subject to a fiduciary duty, could recommend securities to customers that it had structured specifically for this purpose, though it is just barely conceivable that there might be very narrow circumstances under which it would be in a customer's best interests to purchase such securities. Without question, however, the wholesale sale of such securities engaged in by Goldman, according to the Subcommittee investigation, would not be possible under a fiduciary duty.

- Even if a firm believed it was permissible under a fiduciary duty to sell securities it had designed in order to short, it could not sell such deals to clients without disclosing its role in the transaction, its reasons for believing the securities were nonetheless a good investment for the client, and the risks they could be exposed to through the deal. Providing boilerplate disclosures that the firm might be either long or short in the deal would not be adequate.

- Under a fiduciary duty, there would have been no ambiguity about Goldman's responsibility to tell investors in the Abacus deal about the role hedge fund manager John Paulson had played in selecting the mortgage bonds underlying the CDO. That would clearly be material information that a fiduciary would be required to disclose.

- Recognizing the conflict of interest it entails, a fiduciary duty places strict limits around principal or proprietary trading. It requires enhanced disclosures and client permission to ensure that the client fully understands and consents to the conflicts in the arrangement.

- As for the swaps deals at the heart of the Jefferson County case, it is hard to imagine how J.P. Morgan could have sold most of the deals at all, since they put the county at severe risk of bankruptcy. At the very least, it would have had to eliminate features – such as the mismatch in interest rates – that greatly increased the county's risk.

- In selling swaps to municipalities, a fiduciary obligation to disclose all material information could force disclosure of such information as the maximum payment the municipality could be exposed to and the financial interest of the firm in the transaction. Given widespread allegations of over-charging in this market, bringing these charges out of the dark would be a significant benefit in and of itself.

Enhancing the Fiduciary Duty to Address Abuses that Contributed to the Crisis

As the above discussion should make clear, imposing a fiduciary duty on Wall Street firms could help to rein in many of the most egregious practices that have been exposed as we learn more about the causes of the financial crisis. To accomplish that goal, Congress would need to impose a fiduciary duty on brokers and swaps dealers comparable to the duty investment advisers have to their clients. Beyond that, Congress would need to decide when and to what that duty should apply.

Typically, a fiduciary duty flows from a relationship of trust or reliance. A logical approach, therefore, is to apply the duty to advice, whether about securities, commodities, or derivatives. In defining what constitutes advice, it would be important to include recommendation of products, particularly where the broker or swaps dealer has a decided information advantage. A further question is whether the fiduciary duty should apply to all such recommendations, or only to transactions with a certain subset of institutional investors. There is a strong case to be made for applying the fiduciary duty to any recommendation, on the grounds that recommendations as a general matter should be made in the best interests of the customer. If Congress chose to apply the fiduciary duty in more limited circumstances, the most logical group to identify as needing the fiduciary protection would be government entities, pension funds, and non-profit organizations. Another option would be to leave it to the regulators to determine what groups need the fiduciary protection and under what circumstances.

A third question to address is what obligations would be triggered by a fiduciary duty in various circumstances. It is not necessary or even necessarily desirable to define those duties explicitly. The fiduciary duty is a facts-and-circumstances-based standard. The obligations it imposes depend on the nature of the relationship and, in particular, the degree of reliance. This makes it well suited to circumstances in which customers display widely varying degrees of sophistication and independence. A model could be the approach taken under the Investment Advisers Act, where some specific obligations are spelled out by rule, but those rules serve to clarify rather than limit the extent of the duty.

Current Legislative Proposals

When the Obama Administration released its White Paper on financial regulatory reform nearly a year ago, it included a recommendation to hold brokers to a fiduciary duty when they give investment advice. The focus of that proposal was on the need to enhance protections for retail investors, but legislative proposals put forward to enact that recommendation have the potential to extend its protections to institutional investors. The following is a brief overview of proposals put forward to date.

<u>House Legislation</u>: The financial regulatory reform bill that passed the U.S. House of Representatives in December (H.R. 4173, the Wall Street Reform and Consumer Protection Act) includes a provision on fiduciary duty. Section 7103 of the bill directs the SEC to adopt rules imposing a standard of care for brokers when they give personalized investment advice to retail customers that is the same as the standard imposed on investment advisers under the Investment Advisers Act. The heading of that section specifically identifies that standard of care as a fiduciary duty, which is consistent with court interpretations of the duty investment advisers owe their clients. While the provision requires the SEC to adopt rules with respect to advice to retail investors, it permits the agency to extend the fiduciary duty to "such other customers as the Commission may be rule provide." As such, this provision authorizes but does not require the Commission to adopt rules imposing a fiduciary duty on brokers when they give investment advice to institutional investors or some subset of institutional investors. The section includes two provisions designed to clarify that certain practices common among brokers are permitted under the fiduciary duty: 1) charging commissions or other transaction-based compensation and 2) selling from a limited menu of products or selling proprietary products. Although the

legislation directs that the standard must be "no less stringent than the standard applicable to investment advisers under section 206(1) and (2)" of the Advisers Act, the SEC would have considerable leeway in defining the fiduciary duty and determining how it should apply in various different contexts.

Dodd Discussion Draft: When Senate Banking Committee Chairman Chris Dodd released his discussion draft of regulatory reform legislation last November, he adopted a different approach to the issue. Section 913 of the draft bill would have removed the broker-dealer exclusion from the Investment Advisers Act. Under that approach, brokers would have been subject to regulation under the Investment Advisers Act (and held to a fiduciary duty under that act) when they gave advice about securities for compensation. Their coverage under the act would have no longer hinged on whether the advice in question was "solely incidental" to their activities as brokers. Because the Investment Advisers Act does not distinguish between retail and institutional investors in its application of the fiduciary duty, this approach would have automatically imposed a fiduciary duty on brokers in their dealings with institutional clients when those dealings included advice about securities. Like the House bill, the Senate discussion draft included provisions to clarify that transaction-based compensation and sale from a limited menu of products would be permitted. It also included a provision designed to permit principle trading by brokers, subject to a requirement that they have adequate protections in place to ensure that the trades were in the best interests of their customers.

Senate Bill: Before the regulatory reform bill (S. 3217, the Restoring America's Financial Stability Act) was reported out of the Senate Banking Committee, the fiduciary duty provision had been significantly eroded, to the point where it no longer offered any new protections. The original language had been stripped and replaced with a requirement that the SEC study "gaps and overlaps" in regulation between brokers and investment advisers. Much of the focus of the study is on regulatory resources rather than on the duty owed to investors. Moreover, while the legislation requires the SEC to initiate a rulemaking to eliminate any gaps and overlaps in regulation, it does not provide the agency with the authority necessary to impose a fiduciary duty on brokers when they give investment advice. In short, as currently written, the bill requires the SEC to waste time and resources to study an issue it has already studied extensively and denies it the authority it needs to eliminate a known gap in investor protection. Strengthening this provision of the bill has been identified as a priority by consumer and investor advocates and state regulators.

Akaka-Menendez Amendment: Senators Daniel Akaka and Robert Menendez have announced their intention to offer an amendment on the floor regarding fiduciary duty. Their amendment would substitute the House language for the current study language in the Senate bill. As such, it would require a rule to impose a fiduciary duty on brokers when they give personalized advice to retail investors and permit the agency to extend that protection to other classes of investors as it sees appropriate. That amendment has been endorsed by CFA, AARP, Americans for Financial Reform, the North American Securities Administrators Association, the National Association of Secretaries of State, and the National Governors' Association, as well as various investment adviser and financial planner professional organizations.

Dodd-Lincoln Derivatives Bill: The derivatives reform provisions worked out between the Senate Agriculture and Banking Committees also include a provision on fiduciary duty. Specifically, Section 731 of the bill imposes a fiduciary duty on swaps dealers who give advice about a swap to or enter into a swap with a government entity or a pension plan, endowment, or retirement plan. Because it covers advice about derivatives, this provision fills an important gap necessary to reach the full range of Wall Street abuses that contributed to the crisis. (All of the other provisions only apply the fiduciary duty to investment advice, which by definition means advice about securities.) Furthermore, because derivatives are among the most complex and opaque investments, they represent an area where all but the most sophisticated institutional investors are at an extreme disadvantage in their dealings with Wall Street and most in need of fiduciary protection.

As with any regulation, imposing a fiduciary duty on brokers will be only as effective as the regulatory enforcement that backs it up. Without real enforcement teeth behind it, any increase in regulatory standards is likely to have limited benefits. After all, an investment bank that is willing to engage in flagrant violations of pay-to-play rules is unlikely to be terribly conscientious about ensuring that its recommendations are in the best interests of customers. Regulators need to be prepared to impose fines that are commensurate with the damage to customers. But, given the potential profits at stake in this area, fines are rarely going to be heavy enough to serve as a true deterrent. Holding out the possibility of jail time for willful violations, as the title of this hearing suggests, has the potential to provide that deterrent. By tying criminal sanctions to willful violations, such an approach would set an appropriately high bar to ensure that only the most egregious abuses result in jail sentences. Combined with an approach that imposes fines that cannot be dismissed as a cost of doing business, holds supervisors accountable for the actions of those they supervise, and de-licenses individuals who commit serious violations, imposing criminal sanctions for fiduciary violations could serve as a truly effective deterrent to the kind of abuses that helped to bring about our current financial crisis.

Conclusion

In examining the root causes of the financial crisis, many have commented on the change in culture on Wall Street. Although they may ascribe it to different causes – the decision of investment banks to go public or an emphasis on proprietary trading rather than customer services as a major revenue source – most long-time observers of the industry appear to agree that Wall Street firms no longer exist primarily to serve the needs of their customers. Indeed, the Goldman Sachs executives who testified before the Permanent Subcommittee on Investigations seemed at times to be bewildered by suggestions that anyone would expect them to do so. Instead, they appear to live in a world in which everyone simply takes it for granted that products are designed to serve no economic purpose except to make the firm money, customers who can't look out for their own interests are viewed as sheep waiting to be shorn, and the only obligation they recognize is the obligation to maximize firm profits. While no single approach should be viewed as a panacea, expanding the fiduciary duty to brokers and their dealings with institutional investors could force a significant and beneficial change in the culture on Wall Street. Average retail investors, who in the crisis have suffered the collateral damage of the investing mistakes of institutional investors, would benefit indirectly. But, in looking to strengthen protections for institutional investors, we must not leave protections for retail investors on the cutting room

floor. That is why passage of the Akaka-Menendez amendment must be part of any effort to strengthen fiduciary duty and must be included in any comprehensive financial regulatory reform bill.

Thank you again for inviting me to testify here today. I look forward to answering any questions you may have.