UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

March 22, 2010

The Honorable Christopher J. Dodd
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Dodd:

I would like to applaud you, your staff and the Committee for your efforts to enact comprehensive financial regulatory reform legislation. Strong and comprehensive reform is essential to reducing the risks of future financial crises, and reestablishing public confidence in our markets. I believe your bill would do a great deal toward those ends, and I offer the following suggestions for strengthening it.

Reducing Systemic Risk

Ensure the Bill Does Not Inadvertently Encourage Excessive Size or Risk. The bill provides for comprehensive supervision of large institutions and designated financial market utilities. It is unclear, however, how this regulation will relate to existing requirements applicable to the designated entities, their subsidiaries and competitors. To ensure that large institutions do not benefit from being too large or too risky, the legislation should ensure that such institutions do not obtain special access to benefits associated with regulation by the Federal Reserve (such as access to liquidity and other services) and make clear that these new requirements are *in addition* to existing legal requirements imposed under existing regulatory regimes.

The legislation also should provide the Council with greater independence and policymaking authority over these institutions. This would help ensure that new rules benefit from the input and experience of multi-disciplinary experts with authority over, and experience in dealing with, various types of financial institutions and other market participants – reducing potential conflicts and competitive imbalances. If these large systemically risky firms or their subsidiaries receive benefits or are inadvertently carved out of other requirements, firms might seek to become large and interconnected, fueling more size and risk.

Proprietary Trading. The current bill appears to prohibit proprietary trading by any subsidiary of a bank holding company, including broker-dealers and other nonbank entities, under rules to be written jointly by the banking agencies. I believe appropriate proprietary trading restrictions could be a valuable investor protection tool for reducing risk, conflicts of interest and potential front running of customer orders or other inappropriate uses of customer-

related information. To maximize these benefits and recognize the market making and other client facilitation activities also noted in the legislation, Congress should include the SEC, along with the bank regulators, in the rule writing process.

Eliminate Gaps in the Regulatory Structure

Enact Strong Comprehensive OTC Derivatives Legislation. Strong OTC legislation is essential to closing the current regulatory gap relating to derivatives and bringing these products under the regulatory umbrella. In considering this section, the Committee should:

- *Establish clear lines to reduce complexity and risk.* OTC derivatives legislation should avoid building a new and different "swaps" regulatory regime that is parallel to existing securities and futures regimes, as doing so would add unnecessary complexity and create regulatory arbitrage opportunities. Swaps often are just economic substitutes for their underlying references and should be regulated as such. Accordingly, all securities-based swaps should be regulated as securities (with strong business conduct and capital requirements) so that participants cannot exploit weaker rules, oversight or transparency in the swaps market.

- *Require greater transparency.* Market regulators and participants must have access to information to know what is being traded, at what price and in what volume. Regulators also may need specific additional information to identify trends and combat abuses. This transparency will help participants better protect themselves against abuse, and obtain better pricing. It also will enable regulators to more readily identify abuses and take appropriate action.

- *Provide the tools needed to police the markets.* Regulators must be able to monitor trends, write rules to address abuses, and take decisive action if needed. Treating securities-based swaps as securities would enable the SEC to use its emergency authority to halt trading in these products for a period if necessary and to obtain court orders enjoining any conduct that violates the federal securities laws.

- *Avoid carve-outs and exceptions.* As this process moves forward, we must remain vigilant against even small exceptions, carve-outs and arbitrage opportunities that can create tomorrow's loopholes and regulatory gaps.

Strengthen the Standard of Conduct for Financial Professionals Providing Investment Advice. A 2008 study prepared for the Commission by the RAND Corporation found that most retail investors are unaware of differences between the standard of conduct and regulatory framework applicable to investment advisers and broker-dealers. I have advocated for a strong, uniform fiduciary standard to apply to both broker-dealers and investment advisers when providing investment advice about securities. Such a standard underscores the importance of ensuring the integrity of securities advice provided to investors, regardless of the label applied to the professional providing that advice.

Unfortunately, the bill does not establish a uniform fiduciary standard of conduct. It instead calls on the SEC to study the issue, but does not then give the SEC authority to create a fiduciary standard of conduct for all securities professionals at the conclusion of the study. I urge you to reconsider this approach and provide the SEC the authority it needs to apply a fiduciary standard of conduct to financial professionals. Investors deserve no less.

Eliminate Loopholes for Private Equity and Venture Capital. As I have previously stated, private funds (such as hedge funds, private equity funds and venture capital funds), represent a significant regulatory gap in need of closing. These funds and their managers structure their operations to fit within various exemptions from the federal securities laws. As a result, their activities are beyond regulatory review, which inhibits our ability to monitor for investor protection and systemic risk purposes.

I greatly appreciate your efforts to close this regulatory loophole for hedge fund advisers. The bill would require registration under the Investment Advisers Act of advisers to hedge funds, which will enable us to gather basic information about these advisers and their funds, monitor their activities and examine their compliance with the investor protection provisions of the Investment Advisers Act.

I am concerned, however, that the bill provides exemptions, to varying degrees, for managers of private equity and venture capital funds. Such exemptions keep the operations of these funds in the shadows. The investor protection concerns surrounding private fund advisers apply equally whether the adviser is operating hedge funds, private equity funds or venture capital funds. Indeed, private equity and venture capital funds, where an investor's assets are locked up for multiple years, naturally lend themselves to misappropriation schemes since investors are not making periodic redemption demands. If the bill draws lines to exempt managers to certain types of private funds from regulation, fraudsters will structure their business to fit within the carve-outs. I therefore urge you not to create specialized carve outs for private equity and venture capital advisers in a bill with a core focus on closing regulatory gaps.

State Preemption/Regulation D. Section 926 of the bill would change the existing legislative preemption of state regulation of private offerings conducted under SEC Regulation D. Under Section 926, the question of whether state laws apply would turn on whether the SEC designates particular classes of securities as subject to state regulation and, if not, whether the SEC reviews a particular filing. This provision raises a number of concerns. First, states, issuers and investors must have certainty regarding the application of state laws to particular offerings: to the extent the application of state law would turn on whether or not the SEC reviews a particular filing, this approach would create substantial uncertainty regarding the applicable legal requirements for the offering. Second, the states play a valuable role in the enforcement and application of securities laws: any decision on when and whether to apply these laws should not vary based on a fairly mechanized review of the statistical information that is included in the required SEC filing for these offerings.

Whistleblower. Section 922 of the legislation includes language to better enable the SEC to reward whistleblowers. Unfortunately, the current language would reward whistleblowers using funds that might otherwise be returned to harmed investors; benefit certain applicants even though they rely primarily on public information; and includes a structure that encourages litigation and may quickly deplete the whistleblower fund. A robust whistleblower program would greatly enhance the effectiveness of our enforcement efforts and I look forward to working with the Committee toward this end.

Thank you for the opportunity to express my views.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman