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### Chairman Mary Schapiro Written Testimony Before the FCIC on the State of the Financial Crisis

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**Testimony Concerning the State of the Financial Crisis**  
**by Chairman Mary L. Schapiro**  
*U.S. Securities and Exchange Commission*  
**Before the Financial Crisis Inquiry Commission**

January 14, 2010

**I. INTRODUCTION**

Chairman Angelides, Vice Chairman Thomas, Members of the Commission: Thank you for the invitation to share my personal insights as the Chairman of the Securities and Exchange Commission into the causes of the recent financial crisis.<sup>1</sup>

I believe the work of the Financial Crisis Inquiry Commission (FCIC) is essential to helping policymakers and the public better understand the causes of the recent financial crisis and build a better regulatory structure. Indeed, just over seventy-five years ago, a similar Congressional committee was tasked with investigating the causes of the stock market crash of 1929. The hearings of that committee led by Ferdinand Pecora uncovered widespread fraud and abuse on Wall Street, including self-dealing and market manipulation among investment banks and their securities affiliates. The public airing of this abuse galvanized support for legislation that created the Securities and Exchange Commission in July 1934. Based on lessons learned from the Pecora investigation, Congress passed laws premised on the need to protect investors by requiring disclosure of material information and outlawing deceptive practices in the sale of securities.

When I became Chairman of the SEC in late January 2009, the agency and financial markets were still reeling from the events of the fall of 2008. Since that time, the SEC has worked tirelessly to review its policies, improve its operations and address the legal and regulatory gaps – and in some cases, chasms – that came to light during the crisis. It is my view that the crisis resulted from many interconnected and mutually reinforcing causes, including:

- The rise of mortgage securitization (a process originally viewed as a risk reduction mechanism) and its unintended facilitation of weaker underwriting standards by originators and excessive reliance on credit ratings by investors;
- A wide-spread view that markets were almost always self-correcting and an inadequate appreciation of the risks of deregulation that, in some areas, resulted in weaker standards and regulatory gaps;
- The proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood;

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<sup>1</sup> My testimony is on my own behalf, as Chairman of the SEC. The Commission has not voted on this testimony.

- Perverse incentives and asymmetric compensation arrangements that encouraged significant risk-taking;
- Insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products; and
- A siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets.

To assist the Commission in its efforts, my testimony will outline many of the lessons we have learned in our role as a securities and market regulator, how we are working to address them, and where additional efforts are needed. I look forward to working with the FCIC to identify the many causes of this crisis.

## **II. ENFORCEMENT**

***Consistent and Vigorous Enforcement Is a Vital Part of Risk Management and Crisis Avoidance – Particularly in Times and Areas of Substantial Financial Innovation.*** Although we continue to learn more about the causes of the financial crisis, one clear lesson is the vital importance that vigorous enforcement of existing laws and regulations plays in the fair and proper functioning of financial markets. In light of the FCIC's request for specific information relating to enforcement actions, I will begin with some of the efforts made in our Enforcement Division and lessons learned from these efforts.

Vigorous enforcement is essential to restoring and maintaining investor confidence. Through aggressive and even-handed enforcement, we hold accountable those whose violations of the law caused severe loss and hardship and we deter others from engaging in wrongdoing. Such enforcement efforts also help vindicate the principles fundamental to the fair and proper functioning of financial markets: that investors have a right to disclosure that complies with the federal securities laws and that there should be a level playing field for all investors. The SEC is the singular agency in the federal government focused primarily on investor protection. As such, we recognize our special obligation to uphold these principles.

The SEC has long combated fraud in the financial markets, and our recent efforts expand this record. From FY 2007 through FY 2009, the SEC opened 2,610 investigations and brought 1,991 cases charging a variety of securities laws violations including, and beyond, those related to the causes of the financial crisis.<sup>2</sup> Although case

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<sup>2</sup> Of the 1,991 cases, 519 (over 26 percent) involved financial fraud or public company reporting violations; 511 (over 25 percent) involved fraud or other misconduct by broker-dealers, investment advisers, or transfer agents; 330 (over 16 percent) involved fraudulent or unregistered offerings; and 272 (over 13 percent) involved insider trading or market manipulation. Other traditional program areas include delinquent filings and municipal offerings. As part of these cases, the SEC has sued among others, public companies, corporate officers, auditors and audit firms, attorneys, broker-dealers, investment advisers, and self-regulatory organizations under the SEC's purview.

statistics cannot tell the whole story, and I caution against placing undue emphasis on them, they are one indicator of the agency's efforts. This past fiscal year, the SEC:

- Brought 664 enforcement actions (compared to 671 in FY 2008);
- Ordered wrongdoers to disgorge \$2.09 billion in ill-gotten gains (an increase of 170 percent compared to \$774 million in FY 2008);
- Ordered wrongdoers to pay penalties of \$345 million (an increase of 35 percent compared to \$256 million in FY 2008);
- Sought 71 emergency temporary restraining orders to halt ongoing misconduct and prevent further investor harm (an increase of 82 percent compared to 39 in FY 2008);
- Sought 82 asset freezes to preserve assets for the benefit of investors (an increase of 78 percent compared to 46 in FY 2008); and
- Issued 496 orders opening formal investigations (an increase of over 100 percent compared to 233 in FY 2008).

In addition, where possible and appropriate, the SEC returned funds directly to harmed investors. Since the 2002 passage of the Sarbanes-Oxley Act, the SEC has returned approximately \$7 billion to injured investors.<sup>3</sup>

The SEC investigates and brings enforcement actions with respect to a wide range of fraudulent activity, including accounting and disclosure fraud, fraud in derivatives and structured products, and illegal insider trading and market manipulation. Currently, the SEC's Division of Enforcement is conducting investigations involving mortgage lenders, investment banks, broker-dealers, credit rating agencies, and others that relate to the financial crisis. To date, the SEC has reviewed or brought over a dozen actions addressing misconduct that led to or arose from the financial crisis.

***Transparent Disclosure of Risk and Other Material Information is Essential.*** A central question in many of the cases brought by the SEC is whether investors received timely and accurate disclosure concerning deteriorating business conditions, increased risks, and downward pressure on asset values.

- ***Auction Rate Securities.*** Beginning December 11, 2008, the SEC entered into a series of landmark settlements with six large broker-dealer firms for allegedly misrepresenting to their customers that auction rate securities (ARS) were safe, highly liquid investments that were equivalent to cash or money market funds.<sup>4</sup> The firms failed to disclose the increasing risks associated with ARS, including their reduced ability to support the auctions. When the ARS market froze, customers were unable to liquidate their securities. Through these settlements,

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<sup>3</sup> During the 2009 calendar year alone, the SEC distributed approximately \$2.5 billion to harmed investors. Section 308 of the Sarbanes-Oxley Act of 2002, codified at 15 U.S.C. §7246, enabled the Commission to distribute civil money penalties to investors in certain circumstances. In enforcement actions prior to the passage of the Sarbanes-Oxley Act, only funds paid as disgorgement could be returned to investors.

<sup>4</sup> The six institutions included Citigroup Global Markets, UBS Financial Services, Wachovia Securities, Deutsche Bank Securities Inc., Bank of American Securities and RBC Capital Markets Corp.

the SEC and others enabled retail investors who purchased ARS to receive 100 cents on the dollar for their investments, resulting in the return of approximately \$60 billion to investors.

- ***Reserve Primary Fund.*** On May 5, 2009 the SEC charged the managers of the Reserve Primary Fund for allegedly failing to properly disclose to investors and trustees material facts relating to the value of the fund's investments in Lehman-backed paper. The Reserve Primary Fund, a \$62 billion money market fund, became illiquid when it was unable to meet investor requests for substantial redemptions following the Lehman bankruptcy. Shortly thereafter, the Reserve Primary Fund declared that it had "broken the buck" because its net asset value had fallen below a \$1.00. In bringing the enforcement action, the SEC sought to expedite the distribution of the fund's remaining assets to investors by proposing a pro-rata distribution plan. On November 25, a federal judge in New York endorsed the SEC's approach, which should result in an estimated return of at least 99 cents on the dollar for all shareholders who have not had their redemption requests fulfilled, regardless of when they submitted those redemption requests.

Disclosure of Material Facts. The SEC has also investigated and brought cases where investors were not appropriately informed about material items in financial crisis related mergers or other transactions.

- ***Bank of America/Merrill Lynch.*** On August 3, 2009, the SEC charged Bank of America Corporation for allegedly misleading investors about billions of dollars in bonuses that were being paid to Merrill Lynch & Co. executives at the time of its \$50 billion acquisition of the firm. The SEC is currently litigating this case in the Southern District of New York.

Public Disclosure by Mortgage Originators and Related Entities. Although originating risky mortgages does not on its own violate the federal securities laws, the SEC has charged that some mortgage originators ran afoul of the federal securities laws in the way they described and accounted for their businesses to the investing public. Our efforts in this area have resulted in a number of cases and we are continuing to investigate potential misconduct by other publicly-traded mortgage originators.

- ***Countrywide Financial.*** On June 4, 2009, the SEC charged Angelo Mozilo, the former CEO of Countrywide Financial, and two other former Countrywide executives with fraud. The SEC alleged that the defendants deliberately misled investors about the significant credit risks the company was taking in efforts to build and maintain market share. In particular, the SEC's complaint alleges that Countrywide portrayed itself as underwriting mainly prime quality mortgages, while privately describing as "toxic" certain of the loans it was extending. The SEC's complaint also charges Mozilo with alleged insider trading for selling his Countrywide stock based on non-public information for nearly \$140 million in profit. The litigation is pending.

- ***American Home Mortgage Investment Corp.*** On April 28, 2009, the SEC brought actions against three former executives at American Home Mortgage Investment Corp. for allegedly engaging in accounting fraud and making false and misleading disclosures relating to the risk of its mortgage portfolio. The SEC's complaint alleges that two of the executives fraudulently understated the company's first quarter 2007 loan loss reserves by tens of millions of dollar, converting the company's loss into a fictional profit. One of the executives, Michael Strauss, settled the SEC's charges, without admitting or denying the SEC's findings, by paying approximately \$2.2 million in disgorgement and prejudgment interest and a \$250,000 penalty, and agreeing to a five-year bar from serving as an officer or director of a public company. The litigation is ongoing with respect to the other defendants.
- ***New Century.*** On December 7, 2009, the SEC charged three former officers of New Century Financial Corporation with securities fraud for misleading investors as the company's subprime mortgage business was collapsing in 2006. At the time of the fraud, New Century was one of the largest subprime lenders in the nation. The complaint alleges the defendants provided false and misleading information regarding the company's subprime mortgage business and materially overstated the company's financial results by improperly understating its expenses relating to repurchased loans. In addition, the SEC's complaint alleges that New Century failed to disclose material facts including dramatic increases in early default rates, loan repurchases and pending loan repurchase requests. Further, the complaint alleges New Century materially overstated its second and third quarter financial results in 2006 by, among other things, overstating pre-tax earnings in the second quarter by 165 percent, while improperly reporting third quarter pre-tax earnings as a \$90 million profit instead of an \$18 million loss. The litigation is pending.

The SEC also is reviewing the practices of investment banks and others that purchased and securitized pools of subprime mortgages. In addition, we are looking at the resecuritized CDO market with a focus on products structured and marketed in late 2006 and early 2007 as the U.S. housing market was beginning to show signs of distress. In particular, we are seeking to determine whether investors were provided accurate, relevant and necessary information, or misled in some manner.

***Regulators Must Remain Vigilant Against Fraud.*** The SEC also has investigated and brought cases relating to sales practices used by financial professionals buying or selling complex mortgage-related securities products.

- ***Credit Suisse.*** On September 3, 2008, the SEC charged two Wall Street brokers with allegedly defrauding their customers when making more than \$1 billion in unauthorized purchases of subprime-related auction rate securities. The SEC's complaint alleges, among other things, that the defendants misled customers into believing that auction rate securities being purchased in their accounts were backed by federally guaranteed student loans and were a safe and liquid

alternative to bank deposits or money market funds. Instead, the securities that the defendants purchased for their customers were backed by subprime mortgages, CDOs, and other non-student loan collateral. The litigation is pending.

- ***Bear Stearns.*** On June 19, 2008, the SEC charged two former Bear Stearns Asset Management (BSAM) portfolio managers for allegedly fraudulently misleading investors about the financial state of the firm's two largest hedge funds and their exposure to subprime mortgage-backed securities before the collapse of the funds in June 2007. The SEC's complaint alleges that the hedge funds took increasing hits to the value of their portfolios during the first five months of 2007 and faced escalating redemptions and margin calls. The complaint further alleges that, at that point, the two then-BSAM senior managing directors deceived their investors and certain institutional counterparties about the funds' growing troubles until the funds collapsed and caused investor losses of approximately \$1.8 billion. In a related criminal action, the defendants were acquitted of criminal charges. Our civil case, however, has a different burden of proof and different charges. That litigation is pending and we expect to go forward.
- ***Brookstreet Securities Corp.*** On both May 28 and December 8, 2009, the SEC brought cases involving Brookstreet Securities Corp., a registered but now defunct broker-dealer, in connection with sales of allegedly unsuitable Collateralized Mortgage Obligations (CMOs) to retail customers. In the December action, the SEC sued Brookstreet and its former President and CEO, alleging that from 2004 to mid-2007, the President and CEO helped create, promote, and facilitate a CMO investment program through which Brookstreet improperly sold risky, illiquid CMOs to retail customers (including retirees and retirement accounts) with conservative investment goals. More than 1,000 Brookstreet customers invested approximately \$300 million through the CMO program. Earlier, in the May action, the SEC sued ten registered representatives of the firm for allegedly making false statements when marketing the CMOs, receiving \$18 million in commissions related to the investments and causing customer losses of over \$36 million. The litigation is pending.

***Consistent Accounting Practices are Essential to Investor Confidence and Fair Competition.*** A key lesson of the financial crisis is that investor information and confidence is critical to well functioning markets. Investors must have transparent, unbiased and comparable information about the companies and funds in which they choose to invest. Providing investors with this information assists them in allocating capital to its most efficient use and is essential to the health of our capital markets. High quality, consistent accounting standards provide the framework for investors to make the comparisons of investment opportunities and perform the analysis necessary to make informed investment decisions.

Our investigations have revealed possible failures of public companies and funds to disclose the fair value of toxic assets and potentially false or misleading disclosures to

investors and purchasers of structured products, including mortgage-backed securities and CDOs, which have some form of mortgage as the underlying asset.

- ***Beazer Homes***. On July 1, 2009, the SEC charged the former Chief Accounting Officer of Beazer Homes, a homebuilder with operations in at least twenty-one states, with allegedly conducting a multi-year fraudulent earnings management scheme and misleading Beazer's outside and internal auditors to conceal his fraud. That litigation is pending. Previously, on September 24, 2008, the SEC issued an order finding that Beazer Homes, among other things, decreased reported net income through improper reserves during a period of strong growth from approximately 2000 to 2005. Then, as Beazer's financial performance began to decline in 2006, along with the housing market, Beazer reversed the improper reserves and increased its net income. The SEC ordered Beazer to cease and desist from committing or causing fraud and other violations.
- ***Evergreen Investment Management Co.*** On June 8, 2009, the SEC charged registered investment adviser Evergreen Investment Management Company, LLC, and an affiliate, with allegedly overstating the value of a mutual fund that invested primarily in mortgage-backed securities. The SEC also alleged the defendants selectively disclosed problems with the fund to favored investors, allowing those investors to sell earlier than other investors and avoid losses. The adviser and its affiliate settled with the SEC, without admitting or denying the SEC's findings, by agreeing to pay \$3 million in disgorgement and prejudgment interest and a total civil penalty of \$4 million, as well as make an additional payment of \$33 million to compensate shareholders.

As noted above, the SEC is conducting investigations involving mortgage lenders, investment banks, broker-dealers, credit rating agencies and others that relate to the financial crisis. We will continue to look hard at those that may have caused or profited from the financial crisis and bring cases as appropriate.

***Enforcement Agencies Should Continue to Work Together to Address Financial Crimes.*** Large financial crimes can often involve multiple jurisdictions and legal frameworks making it essential for different agencies to work closely together.

**Financial Fraud Enforcement Task Force (Task Force).** To maximize the efficient use of limited resources, as well as to present a unified and coordinated response to securities laws violators, the SEC is enhancing its historically close working relationship with other law enforcement authorities, including the Department of Justice (DOJ). On November 17, 2009, as part of the effort to better combat financial crime and mount a more organized, collaborative, and effective response to the financial crisis, the SEC joined the DOJ, the U.S. Department of the Treasury, and the U.S. Department of Housing and Urban Development in announcing the President's establishment of a Financial Fraud Enforcement Task Force. The Task Force leadership, along with representatives from a broad range of federal agencies, regulatory authorities, and inspectors general, will work with state and local authorities to investigate and prosecute



significant financial crimes, ensure just and effective sanctions against those who perpetrate financial crimes, address discrimination in the lending and financial markets, and recover proceeds of financial crimes for victims. The Task Force will build upon efforts already underway to combat mortgage, securities, and corporate fraud by increasing coordination and fully utilizing the resources and expertise of the government's law enforcement and financial regulatory organizations.

Special Inspector General for TARP. The SEC also has worked closely with the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP). For example, in early 2009, the SEC brought an enforcement action against a Ponzi scheme operator in Tennessee, with assistance from SIGTARP. In addition, we are currently working with SIGTARP staff and criminal prosecutors on a number of important investigations. We have also been an active participant on the TALF/PPIP task force which has been working diligently to develop strategies to prevent fraud and abuse in those important programs. Among other things, we have used our expertise regarding structured products and other complex securities, as well as hedge funds and other market participants, to provide training programs for other participants on the Task Force, including FBI agents, postal inspectors and other law enforcement personnel.

***Internal Changes Can Strengthen and Speed Enforcement.*** To improve our enforcement efforts, the SEC is implementing several initiatives that will make us more knowledgeable, better coordinated, and more efficient in attacking the causes of the recent financial crisis. These initiatives also will better arm us to address current and future market practices that may be of concern. Highlights of the current changes include:

- Specialization. We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, including Asset Management (including hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (including various derivative products), Foreign Corrupt Practices Act cases, and Municipal Securities and "Pay-to-Play" issues.
- Management Restructuring. The Division is adopting a flatter, more streamlined organizational structure eliminating an entire layer of middle management; redeploying staff who were first line managers to the mission-critical work of conducting front-line investigations.
- Streamlining. To facilitate timely investigations, the agency is streamlining internal processes and procedures by, among other things, delegating to senior officers the authority to initiate the issuance of subpoenas for documents and testimony.
- Office of Market Intelligence. We are creating an Office of Market Intelligence to improve the Enforcement Division's handling of tips and complaints. This new office dovetails with the agency-wide effort to revamp the way in which the SEC

handles the large number of letters, emails and complaints it receives each year. This office will be a key part of the agency's efforts to collect, analyze, triage, refer and monitor the information the agency receives. The office also will draw on the expertise of the agency's various offices to help analyze the tips and identify wrongdoing while greatly increasing our communication with other divisions and offices about how to respond to tips and complaints.

- Other Initiatives. In addition, the agency is enhancing training and supervision and developing tools to encourage cooperation from company insiders that will enable the agency to build stronger cases and file them sooner than would otherwise be possible.

Finally, the SEC has advocated several legislative measures to improve its ability to protect investors and deter wrongdoing. For example, we have recommended whistleblower legislation that would provide substantial rewards for tips from persons with unique, high-quality information about securities law violations. We expect this program to generate significant information that we would not otherwise receive from persons with direct knowledge of serious securities law violations. This legislation, along with our cooperation initiatives, would increase incentives for persons to share information quickly while expanding protections against retaliatory behavior.

### **III. REGULATION OF COMPLEX FINANCIAL INSTITUTIONS**

#### **Consolidated Supervision**

Between 2004 and 2008, the SEC was recognized as the consolidated supervisor for the five large independent investment banks under its Consolidated Supervised Entity or "CSE" program. The CSE program was created as a way for US global investment banks that lacked a consolidated holding company supervisor to voluntarily submit to consolidated regulation by the SEC. In connection with the establishment of the CSE program, the largest US broker-dealer subsidiaries of these entities were permitted to utilize an alternate net capital computation (ANC).<sup>5</sup> Other large broker-dealers, whose holding companies are subject to consolidated supervision by banking authorities, were also permitted to use this ANC approach.<sup>6</sup>

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<sup>5</sup> In 2004, the SEC amended its net capital rule to permit certain broker-dealers subject to consolidated supervision to use their internal mathematical models to calculate net capital requirements for the market risks of certain positions and the credit risk for OTC derivatives-related positions rather than the prescribed charges in the net capital rule, subject to specified conditions. These models were thought to more accurately reflect the risks posed by these activities, but were expected to reduce the capital charges and therefore permit greater leverage by the broker-dealer subsidiaries. Accordingly, the SEC required that these broker-dealers have, at the time of their ANC approval, at least \$5 billion in tentative net capital (i.e., "net liquid assets"), and thereafter to provide an early warning notice to the SEC if that capital fell below \$5 billion. This level was considered an effective minimum capital requirement.

<sup>6</sup> Currently six broker-dealers utilize the ANC regime and all are subject to consolidated supervision by banking authorities.

Under the CSE regime, the holding company had to provide the Commission with information concerning its activities and exposures on a consolidated basis; submit its non-regulated affiliates to SEC examinations; compute on a monthly basis, risk-based consolidated holding company capital in general accordance with the Basel Capital Accord, an internationally recognized method for computing regulatory capital at the holding company level; and provide the Commission with additional information regarding its capital and risk exposures, including market, credit and liquidity risks.

It is important to note that prior to the CSE regime, the SEC had no jurisdiction to regulate these holding companies.<sup>7</sup> Accordingly, these holding companies previously had not been subject to any consolidated capital requirements. This program was viewed as an effort to fill a significant gap in the US regulatory structure.<sup>8</sup>

During the financial crisis many of these institutions lacked sufficient liquidity to operate effectively. During 2008, these CSE institutions failed, were acquired, or converted to bank holding companies which enabled them to access government support. The CSE program was discontinued in September 2008. Some of the lessons learned are as follows:

***Capital Adequacy Rules Were Flawed and Assumptions Regarding Liquidity Risk Proved Overly Optimistic.*** The applicable Basel capital adequacy standards depended heavily on the models developed by the financial institutions themselves. All models depend on assumptions. Assumptions about such matters as correlations, volatility, and market behavior developed during the years before the financial crisis were not necessarily applicable for the market conditions leading up to the crisis, nor during the crisis itself.

The capital adequacy rules did not sufficiently consider the possibility or impact of modeling failures or the limits of such models. Indeed, regulators worldwide are reconsidering how to address such issues in the context of strengthening the Basel regime. Going forward, risk managers and regulators must recognize the inherent limitations of these (and any) models and assumptions – and regularly challenge models and their underlying assumptions to consider more fully low probability, extreme events.

While capital adequacy is important, it was the related, but distinct, matter of liquidity that proved especially troublesome with respect to CSE holding companies. Prior to the crisis, the SEC recognized that liquidity and liquidity risk management were critically important for investment banks because of their reliance on private sources of short-term funding.

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<sup>7</sup> The Gramm-Leach-Bliley Act had created a voluntary program for the oversight of certain investment bank holding companies (i.e., those that did not have a US insured depository institution affiliate). The firms participating in the CSE program did not qualify for that program or did not opt into that program. Only one firm (Lazard) has ever opted for this program.

<sup>8</sup> See, e.g., Testimony by Erik Sirri, Director of the Division of Trading and Markets, Before the Senate Subcommittee on Securities, Insurance and Investment, Senate Banking Committee, March 18, 2009. <http://www.sec.gov/news/testimony/2009/ts031809es.htm>

To address these liquidity concerns, the SEC imposed two requirements: First, a CSE holding company was expected to maintain funding procedures designed to ensure that it had sufficient liquidity to withstand the complete loss of all short term sources of unsecured funding for at least one year. In addition, with respect to secured funding, these procedures incorporated a stress test that estimated what a prudent lender would lend on an asset under stressed market conditions (a “haircut”). Second, each CSE holding company was expected to maintain a substantial “liquidity pool” that was composed of unencumbered highly liquid and creditworthy assets that could be used by the holding company or moved to any subsidiary experiencing financial stress.

The SEC assumed that these institutions, even in stressed environments, would continue to be able to finance their high-quality assets in the secured funding markets (albeit perhaps on less favorable terms than normal). In times of stress, if the business were sound, there might be a number of possible outcomes: For example, the firm might simply suffer a loss in capital or profitability, receive new investment injections, or be acquired by another firm. If not, the sale of high quality assets would at least slow the path to bankruptcy or allow for self-liquidation.

As we now know, these assumptions proved much too optimistic. Some assets that were considered liquid prior to the crisis proved not to be so under duress, hampering their ability to be financed in the repo markets. Moreover, during the height of the crisis, it was very difficult for some firms to obtain secured funding even when using assets that had been considered highly liquid.

Thus, the financial institutions, the Basel regime, and the CSE regulatory approach did not sufficiently recognize the willingness of counterparties to simply stop doing business with well-capitalized institutions or to refuse to lend to CSE holding companies even against high-quality collateral. Runs could sometimes be stopped only with significant government intervention, such as through institutions agreeing to become bank holding companies and obtaining access to government liquidity facilities or through other forms of support.

***Consolidated Supervision is Necessary but Not a Panacea.*** Although large interconnected institutions should be supervised on a consolidated basis, policymakers should remain aware of the limits of such oversight and regulation. This is particularly the case for institutions with many subsidiaries engaging in different, often un-regulated, businesses in multiple countries.

Before the crisis, there were many different types of large interconnected institutions subject to consolidated supervision by different regulators. During the crisis, many consolidated supervisors, including the SEC, saw large interconnected, supervised entities seek government liquidity or direct assistance.

***Systemic Risk Management Requires Meaningful Functional Regulation, Active Enforcement & Transparent Markets.*** While a consolidated regulator of large interconnected firms is an essential component to identifying and addressing systemic

risk, a number of other tools must also be employed. These include more effective capital requirements, strong enforcement, functional regulation, and transparent markets that enable investors and other counterparties to better understand the risks associated with particular investment decisions. Given the complexity of modern financial institutions, it is essential to have strong, consistent functional regulation of individual types of institutions, along with a broader view of the risks building within the financial system.

### **Broker Dealer Regulation**

***Regulators Should Constantly Review and Update Their Tools and Approaches to Regulation.*** The Commission is the functional regulator of U.S. registered broker-dealers and promulgates and administers financial responsibility rules for broker-dealers. These include the net capital rule, customer protection rule, books and records rules, reporting requirements, and early warning rule for broker-dealers regarding their capital levels.

Under the broker-dealer net capital rule, U.S. registered broker-dealers are required to deduct the full value of securities positions that do not have a ready market. Proprietary securities positions that do have a ready market are subject to either prescribed haircuts, or in the case of broker-dealers using the ANC approach, subject to market risk charges calculated under the firm's mathematical models. Based on the experiences of the past two years – which included the failure or conversion of the CSE firms into bank holding companies – the SEC has undertaken a number of steps to improve its oversight of broker-dealers and further minimize the risks in these entities.

**Enhancing Reporting Requirements.** Since 2008, broker-dealers with significant proprietary positions now report more detailed breakdown of their proprietary positions. The primary purpose for this enhanced reporting is to receive better information on the amount of less liquid positions held by these broker-dealers. This reporting also provides aggregate dollar amount of sales for these less liquid positions so that any further decrease or increase in the liquidity of these markets can be ascertained.

Additionally, as part of the enhanced broker-dealer oversight program for large broker-dealers using the ANC calculation, the SEC now obtains and reviews on a regular basis more detailed reporting regarding balance sheet composition to monitor for the build-up of positions in particular asset classes. This reporting supplements the above and is intended to be more forward-looking by highlighting concentrations as they build.

**Increasing Capital Requirements.** As part of its oversight, in December 2009, Commission staff informed the ANC broker-dealers that they will require that these broker-dealers take standardized net capital charges on less liquid mortgage and other asset-backed securities positions rather than using financial models to calculate net capital requirements. In addition to increasing the capital required to be held for these positions, this approach will reduce reliance on Value-at-Risk models. Staff has been

reviewing these requirements and may recommend additional regulatory capital charges to address liquidity risk.

The Basel Committee presently is revising its approach to calculating capital requirements to increase charges for market risk. These standards are expected to address the concentration, liquidity and leverage concerns that arose in the recent financial crisis. Once the revised approach is finalized, the SEC will review those changes to ensure that the market risk charges applicable to the ANC broker-dealers are at least as stringent as the Basel market risk charges.

Task Force Review of Broker-Dealer Regulation. In November 2009, the SEC established a task force led by its newly-established Division of Risk, Strategy, and Financial Innovation that will review key aspects of the agency's financial regulation of broker-dealers to determine how such regulation can be strengthened.

#### **IV. REGULATION OF FINANCIAL PRODUCTS**

##### **Money Market Funds**

*Money Market Funds Are Not Risk-Free and Can Be Subject to Runs.* As discussed above, in the wake of the Lehman Brothers bankruptcy in September 2008, the net asset value of the Reserve Primary Fund, a money market fund, fell below \$1.00 a share, or "broke the buck." At the time of the announcement of the Lehman Brothers bankruptcy, the Reserve Primary Fund held 1.2 percent of its assets in commercial paper issued by Lehman Brothers.

This event, combined with the general paralysis of the short-term credit markets and a concern that other financial institutions might fail, revealed the potential of money market funds to be subject to runs, i.e., broad-based and large-scale requests for redemptions that challenge money market funds' ability to return proceeds at the anticipated \$1.00 value.

This event also revealed the general lack of appreciation by many investors that money market funds could return less than the \$1.00 per share originally invested. In addition, the demise of the Reserve Primary Fund and the money market fund run that followed highlighted the benefit of halting redemptions once a money market fund has broken the buck. It also revealed the importance of providing an orderly wind-down of the fund's operations in order to preserve shareholder value and avoid a larger contagion in the short term credit markets.

The run on money market funds during the week of September 15, 2008 was stemmed in part by the announcement of the Treasury Temporary Guarantee Program for Money Market Funds, which provided a guarantee to money market fund investors up to the amount of assets they held in any money market fund as of September 19, 2008. On the same date, the Federal Reserve Board announced the creation of the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF). This

program also helped to create liquidity and stem the run on money market funds by extending credit to U.S. banks and bank holding companies to finance their purchases of high-quality asset backed commercial paper from money market funds. The Treasury Temporary Guarantee Program expired on September 18, 2009, and the AMLF is set to expire on February 1, 2010.

The SEC has taken a number of steps to reduce the risks posed by another money market fund run.

Halting Redemptions from the Reserve Funds. Following the breaking of the buck by the Reserve Primary Fund, the SEC issued an order halting redemptions by that fund as well as other funds within the Reserve family of funds. This action reduced the need for Reserve Fund management to “dump” its assets into an already de-stabilized market. It also enabled the funds in the Reserve fund family to liquidate in an orderly manner, without causing additional money market fund runs.

Strengthening Money Market Fund Requirements. In June 2009, the SEC proposed rule amendments to significantly strengthen the risk-limiting conditions of our money market fund rules. In particular, the SEC proposed rules to tighten the credit quality and maturity requirements for money market funds. In addition, the SEC for the first time proposed liquidity standards for money market funds that would mandate that these funds meet both daily and weekly liquidity requirements. The rules also would:

- require periodic stress testing of money market fund portfolios to identify potential problems;
- require monthly disclosure of portfolio information and periodic disclosure of more specific net asset value information; and
- permit funds to halt redemptions if a money market fund “breaks the buck” in order to stem the motivation for runs.

Our proposal also requested comment on a number of other areas relating to the fundamental structure and disclosure requirements of money market funds, including whether funds should disclose their daily mark-to-market net asset value (NAV) (in addition to their \$1.00 price); whether to mandate redemptions-in-kind in times of financial crisis to reduce run risk; and whether money market funds should have floating NAVs instead of the current stable \$1.00 NAV.

Going forward, we expect to consider adoption of our first set of money market fund reforms in early 2010, with consideration of more fundamental changes to the structure of money market funds to follow. In addition, the SEC has been working closely with the Federal Reserve Board and President’s Working Group on Financial Markets (PWG) on a report assessing possible changes to further reduce the money market fund industry’s susceptibility to runs. The SEC will continue to work with the

PWG to chart a course toward further reducing the vulnerabilities of money market funds to runs while preserving the benefits they provide participants in the short-term markets.

### **Asset-Backed Securities**

***Securitization Requirements Must Be Strengthened.*** The financial crisis revealed a number of gaps in the asset-backed securities (ABS) market. As a result, staff is broadly reviewing our regulation of ABS including disclosures, offering process, and reporting of asset-backed issuers, and is considering several proposed changes designed to enhance investor protection in this vital part of the market. I believe changes are critical to facilitating capital formation in this market, which played a central role in the crisis and has suffered significant erosion in investor confidence. These proposals should come before the Commission shortly, which if approved, would then be subject to public comment.

The proposals the staff are working on are being designed to address issues that contributed to or arose from the financial crises – including a lack of timely information sufficient to enable investors to adequately assess the investment opportunity. I anticipate the proposals will include a number of important disclosure requirements as well as qualitative revisions to the eligibility standards for “shelf” offerings<sup>9</sup> and an elimination of the use of credit ratings as an eligibility standard for shelf. The proposals are also being designed to be forward looking: to improve areas that may not yet have caused serious problems, but have the potential to raise issues similar to the ones highlighted in the financial crisis.

## **IV. TRANSPARENCY & INVESTOR INFORMATION**

### **Credit Ratings**

***Too Many Investors and Regulators Over-Relied on Credit Ratings, Especially for Complicated Financial Products.*** Investors have long considered ratings when evaluating whether to purchase or sell a particular security. Many investors, however, did not appear to appreciate the risks of structured financial products and instead relied almost exclusively on the credit ratings of the securities when making investment decisions. Market participants, regulators and their risk models also made assumptions based on credit ratings that proved incorrect. For example, many regulators – including the SEC – assumed that AAA-rated securities would remain liquid. Such reliance was mistaken.

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<sup>9</sup> “Shelf” registration provides issuers the ability to access the capital markets quickly. In shelf offerings, securities may be first registered and then offered on a delayed basis. At the time of each offering of securities off the registration statement, the issuer provides deal-specific information by filing the offering documents with the Commission in accordance with our rules. While shelf registration statements were permitted earlier, contemporaneous with the enactment of the Secondary Mortgage Market Enhancement Act of 1984, the Commission began permitting mortgage-backed securities to be offered on a shelf basis.



Poor performance by highly rated securities resulted in substantial investor losses and market turmoil. One of the reasons for the poor performance of mortgage related securities was the relationship between the securitization of mortgages and the underwriting standards on loan originations. The more loans became securitized – and the more investors and credit rating agencies became comfortable with their performance – the more they purchased and the more underwriting standards deteriorated. This culminated in the credit rating agencies providing high ratings to structured products based on very low quality mortgages, which investors then purchased.

In response to this aspect of the crisis, the Commission has undertaken to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry.

- In February 2009, the Commission adopted amendments to its rules for Nationally Recognized Statistical Ratings Organizations (NRSRO). The amended rules require NRSROs to make additional public disclosures about their methodologies for determining structured finance ratings, to publicly disclose the histories of their ratings, and to make additional internal records and furnish additional information to the Commission in order to assist staff examinations of NRSROs. The amendments also prohibited NRSROs and their analysts from engaging in certain activities that could impair their objectivity, such as recommending how to obtain a desired rating and then rating the resulting security.
- Last fall, the Commission adopted further amendments with respect to the disclosure of ratings histories. In this most recent NRSRO rulemaking, the Commission adopted new rules that (1) require a broader disclosure of credit ratings history information, such as the initial rating and any actions subsequently taken including, downgrades, upgrades, affirmations and placements on watch; and (2) create a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. This would help investors by providing a greater diversity of ratings and could help foster new NRSRO entrants by enabling upstarts to build credibility.

The SEC also proposed the following:

- Amendments to the NRSRO application process to require a credit rating agency applying to be registered as an NRSRO or an NRSRO providing its annual update to Form NRSRO to publicly disclose the percentage of (1) net revenue attributable to the 20 largest users of its credit rating services; and (2) revenue attributable to its other services and products.
- A new rule that would annually require NRSROs to make publicly available on their websites a consolidated report of information regarding each person that paid the NRSRO to issue or maintain a credit rating, including: (1) the percent of the net revenue earned by the NRSRO attributable to the person for services and

- Requiring disclosure by registrants of information regarding credit ratings if a credit rating is used in connection with a registered offering so that investors will better understand a credit rating and its limitations;
- Requiring disclosure of preliminary credit ratings in certain circumstances so that investors have enhanced information about the credit ratings process -- including whether there was “ratings shopping” – that may bear on the quality or reliability of the rating;
- Amendments to the NRSRO application process to require public disclosure of the percentage of (1) net revenue attributable to the 20 largest users of its credit rating services; and (2) revenue attributable to its other services and products; and
- Requiring an NRSRO to furnish the Commission with an additional unaudited report containing a description of the steps taken by the firm’s designated compliance officer during the fiscal year to administer the policies and procedures that are required to be established pursuant the Exchange Act.
- Rule 436(g) and Experts Liability. To address concerns about the accountability of rating agencies and whether lack of accountability may have negatively impacted the quality of ratings, the SEC has published for comment a concept release asking whether NRSROs should continue to be exempted from “experts” liability under the Securities Act for ratings used by issuers and other offering participants to market securities issued in registered offerings. Under Rule 436(g), NRSROs whose ratings are used to market securities are exempt from liability as “experts” under the Securities Act, even though investors may rely on the ratings in making investment decisions in a manner similar to their reliance on reports or opinions of others who are subject to experts’ liability when their reports or opinions are used to market securities, such as accountants, property appraisers, lawyers and engineers. Through the concept release, the SEC is seeking public views on whether Rule 436(g) should be repealed to increase the accountability of rating agencies and further investor protection.

These initial reforms are designed to promote increased competition in the credit rating industry and to provide investors with the data with which to compare the credit rating performance of different NRSROs. These reforms also will give investors greater insight into a part of the capital markets that has long been opaque, fostering greater transparency and accountability among NRSROs by making it easier for persons to analyze the actual performance of credit ratings. Further, these rules will give investors greater ability to account for potential conflicts, allowing them to better calibrate the

degree of reliance that should be placed upon ratings. Finally, the SEC also is working closely with Congress as it considers important legislation on the topic.

***Policymakers Should Consider the Constraints and Tradeoffs Associated with Programs that Involve “Voluntary” Oversight and Regulation.*** Voluntary oversight programs have a number of benefits. They (1) enable some level of supervision where there might otherwise be none and (2) provide an opportunity to test particular policy approaches before making them mandatory. These programs, however, also have substantial downside risks policymakers should recognize, including:

- Limited Rulemaking Authority. Because participants in these programs can freely opt-out, regulators can find themselves choosing between imposing important rules on few, if any, entities, or imposing weaker rules on the group. This tension can sometimes result in regulators negotiating key elements of important rules rather than imposing them; and
- Overreliance by Third-Parties. Once regulation exists, even if only voluntary, there is a risk that investors, market participants or others might change their behavior based on the belief that the new regulation provides more safety than it does.

Taken together there is a real risk that voluntary oversight programs can lead to investor and counterparty reliance on a regulatory regime especially ill-equipped to meet such expectations.

## **Compensation**

***Short-term Compensation Incentives Can Drive Long-Term Risk.*** Another lesson learned from the crisis is that there can be a direct relationship between compensation arrangements and corporate risk taking. Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions result in significant long-term losses or failure for investors and taxpayers.<sup>10</sup>

In December, the SEC adopted rule amendments that will significantly improve disclosure in the key areas of risk, compensation, corporate governance and director qualifications. The new rules require companies to disclose their compensation policies and practices for all employees (not just executives) if these policies and practices create risks that are reasonably likely to have a material adverse effect on the company. In considering whether a company’s compensation programs create these risks, we expect that companies will carefully examine their compensation practices and how they may

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<sup>10</sup> See, e.g., Financial Stability Forum, FSF Principles of Sound Compensation Practices 1 (Apr. 2, 2009) (noting that “[h]igh short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms”), at [http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf).

incentivize risk, which should enable companies and their boards to more appropriately calibrate risks and rewards.

The new rules also expand the disclosure provided to shareholders about the governance structure, the background and qualifications of directors and director nominees, and require disclosure of information about the board's structure and its role in managing risk. This increased transparency should increase accountability and directly benefit investors.

In addition, the adopted rules require disclosure about the fees paid to compensation consultants and their affiliates for certain additional services. This is intended to provide investors with information to help them better assess the potential conflicts of interest a compensation consultant may have in recommending executive compensation.

### **Corporate Governance**

***Management and Boards of Directors Should be More Accountable.*** The quality of a board's oversight of risk management – traditionally viewed as just a compliance cost – can make an enormous difference in our economy, and particularly in financial markets.

A fundamental concept underlying corporate law is that a company's board of directors, while charged with oversight of the company, is accountable to its shareholders, who in turn have the power to elect the board. Thus, boards are accountable to shareholders for their decisions concerning, among other things, executive pay, and for their oversight of the companies' management and operations, including the risks that companies undertake. Enhanced disclosure about the decisions and performance of directors will help shareholders make informed decisions about the election of directors.

Another tool available to shareholders to hold boards accountable is the right of shareholders under state corporate law to nominate candidates for a company's board of directors. However, shareholders often lack the resources to effectively run a proxy contest to have their nominees elected and unseat existing board members. As a result, over several decades, the Commission has repeatedly considered a requirement that public companies allow shareholders to list their nominees for director in the companies' proxy statements and place their nominees on the companies' proxy ballots.

The Commission's proxy rules seek to enable the corporate proxy process to function, as nearly as possible, as a replacement for in-person participation at a meeting of shareholders. With the wide dispersion of stock prevalent in today's markets, requiring actual in-person participation at a shareholders' meeting is not a feasible way for most shareholders to exercise their rights — including their rights to nominate and elect directors. Yet those very proxy rules may place unnecessary burdens on this right, at the expense of the board's accountability to shareholders. Absent an effective way for

shareholders to exercise their right to nominate and elect directors, the election of directors can become a self-sustaining process with little actual input from shareholders.

In May 2009, the Commission voted to approve for comment proposals that are designed to facilitate the effective exercise of the rights of shareholders to nominate directors. These proposals go to the heart of good corporate governance.

Under the proposals, shareholders who satisfy certain eligibility and procedural requirements would be able to have a limited number of nominees included in the company proxy materials that are sent to all shareholders whose votes are being solicited. To be eligible to have a nominee or nominees included in a company's proxy materials, a shareholder would have to meet certain security ownership requirements and other specified criteria, provide certifications about the shareholder's intent, and file a notice with the Commission of its intent to nominate a candidate. The notice would include specified disclosure about the nominating shareholder and the nominee for inclusion in the company's proxy materials. This aspect of the proposals is designed to provide important information to all shareholders about qualifying shareholder board nominees so that shareholders can make a more informed voting decision.

To further facilitate shareholder involvement in the director nomination process, the proposals also include amendments to Rule 14a-8 under the Exchange Act. That rule currently allows a company to exclude from its proxy materials a shareholder proposal that relates to a nomination or an election for membership on the company's board of directors or a procedure for such nomination or election. This so-called "election exclusion" can prevent a shareholder from including in a company's proxy materials a shareholder proposal that would amend, or that requests an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations. Under the proposed amendment to the shareholder proposal rule, companies would be required to include such proposals in their proxy materials, provided the other requirements of the rule are met.

If adopted, these new rules would afford shareholders a stronger voice in determining who will oversee management of the companies that they own. Strengthening the ability of shareholders to hold boards of directors accountable to them — including for their oversight of compensation and risk management — should further empower shareholders and help to restore investor trust in our markets.

The Commission recently reopened the comment period on the proposals to seek views on additional data and related analyses received at or after the close of the original public comment period. The comment process is a critical component of every rulemaking, and one that the Commission takes very seriously. I remain committed to bringing final rules in this area to the full Commission for consideration early this year.

## V. MARKET REGULATION

*Markets and Market Regulation Should Promote Long-Term Investor Confidence, Not Undermine It.* There has been unease, especially since the financial crisis, that markets designed to enable and encourage investor participation are being stacked against investors. Investor protection and the confidence are essential to the efficient flow of capital and the long-term success of financial markets and the economy. The roots of any deficiencies in market structure must be addressed head on. Accordingly, the SEC has taken – and will continue to take – a fresh look at market structure and trading activities to ensure that they foster fair, orderly, and efficient markets that are designed to protect investors. In particular, the Commission will examine the following issues:

- Market Access. The Commission is considering a proposal to prohibit unfiltered, or “naked,” access to exchanges and alternative trading systems. The practice permits a customer to directly access the markets using a broker-dealer’s market participant identifier without the imposition of effective pre-trade risk management controls. Broker-dealers perform vital gatekeeper functions that are essential to maintaining the integrity of the markets. Effective risk management controls for market access are necessary to protect the broker-dealer, the markets, the financial system, and ultimately investors.
- Large Trader Reporting System/High Frequency Trading. In the near future, I also anticipate that the Commission will seek to implement the Commission’s authority under Section 13(h) of the Exchange Act (which was adopted as part of the Market Reform Act of 1990) to create a large trader reporting system. A large trader reporting proposal would not only enhance the Commission’s ability to identify large traders and their affiliates, but also would provide the Commission with greater ability to gather current trading information to evaluate the activity of large traders, particularly during periods of market volatility.
- Dark Pools. In October 2009, the Commission proposed changes to its rules to address concerns about non-public trading interest in U.S. listed stocks, including “dark” pools of liquidity. The proposal would increase the transparency of dark pools by requiring the public display of actionable indications of interest (IOIs) subject to certain exemptions applicable to large orders that promote size discovery. These IOIs are today privately transmitted by dark pools and other trading venues to selected market participants. The proposal would also expand the display obligations of alternative trading systems by lowering the stock trading volume threshold for displaying best-priced orders from 5% to 0.25%.
- Flash Orders. In September 2009, the Commission proposed a rule amendment that would ban marketable flash orders. A flash order enables a person who has not publicly displayed a quote to see orders less than a second before the public is given an opportunity to trade with those orders. That momentary head-start in the

trading arena could produce inequities in the markets and create disincentives to display quotes.

Specifically, I am concerned that, in today's highly automated trading environment, the flashing of order information outside of the consolidated quotation data could lead to a two-tiered market in which the public does not have fair access to information about the best available prices for a security that is available to some market participants. In addition, flash orders may detract from the incentives for market participants to display their trading interest publicly and harm quote competition among markets.

Short Selling. The issue of short selling is a matter that the SEC has grappled with for many years. Beginning in 1938, markets were subject to a short sale price test restriction known as the 'uptick rule' (former Exchange Act Rule 10a-1) which generally permitted short sales only at the last sale price after an uptick in the stock's price or above the last sale price. In 1994, the NASD (now FINRA) established a similar price test based on the national best bid. In July 2007, after considerable review, the Commission eliminated all short sale price test restrictions thereby permitting short selling in any environment. During the financial crisis, however, concerns led the agency to issue a number of emergency orders related to short selling, including a ban on short selling certain financial stocks which was subsequently permitted to expire.

More recently, the SEC has attempted to take a fresh look at short selling through a robust and vigorous process. In particular, the Commission is examining the following issues:

- Fails to Deliver. In July 2009, the Commission adopted a rule which requires that "fails to deliver" in all equity securities be promptly closed out. "Fails to deliver" may, among other things, be indicative of potentially abusive "naked" short selling. "Naked" short selling, which is not per se illegal, occurs when a short seller does not borrow securities in time to make delivery. Sellers may intentionally fail to deliver as part of a scheme to manipulate the price of a security or possibly to avoid borrowing costs. Data indicates that since the fall of 2008, fails to deliver in all equity securities have declined by 63.4 percent, and fails to deliver in securities with persistent and large levels of fails to deliver have declined by 80.5 percent.
- Short Sale Transparency. Beginning August 2009, the SEC, together with several self-regulatory organizations (SROs), substantially increased the public availability of short sale-related information. This included aggregate short selling volume in each individual equity security for that day and publication on a one-month delayed basis of information regarding individual short sale transactions in all exchange-listed equity securities, excluding any identifying information. In addition, the SEC began providing on its website more timely "fails to deliver" data.

- Short Sale Price Tests. In April 2009 the SEC sought public comment on whether market wide short sale price restrictions or circuit breaker restrictions should be imposed and whether such measures would help restore investor confidence. It also made a supplemental request in August to solicit additional feedback regarding an alternative price test which would allow short selling only at a price above the current national best bid. I anticipate that the Commission will act next month on a final rule.

SEC/CFTC Harmonization. In June 2009, the White House released a White Paper on Financial Regulatory Reform calling on the SEC and Commodity Futures Trading Commission (CFTC) to “make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities.” On October 16, 2009, the agencies issued a report that included recommendations to enhance enforcement powers, strengthen market and intermediary oversight and improve operational coordination. The report represented another step forward in our effort to reform the regulatory landscape to fill regulatory gaps, eliminate inconsistent oversight, and promote greater collaboration. These were contributing factors in the financial crisis.

Facilitating the Central Clearing of OTC Derivatives. Although limited in its authority over OTC derivatives, beginning in late 2008, the Commission, working with the Federal Reserve and the CFTC, issued temporary orders to facilitate the establishment of several central counterparties for clearing credit default swaps (CDS). These exemptions were issued to speed the operation of central clearing for CDS. They are temporary and subject to conditions designed to ensure that important elements of Commission oversight apply, such as recordkeeping and Commission staff access to examine clearing facilities. In addition, to further the goal of transparency, each clearing agency is required to make publicly available on fair, reasonable, and not unreasonably discriminatory terms, end-of-day settlement prices and any other pricing or valuation information that it publishes or distributes.

The SEC is committed to increasing investor protection and reducing systemic risk by facilitating the development and oversight of central counterparties to clear CDS. The actions we have taken should further enhance opportunities to manage the risks related to CDS and improve the transparency and integrity of the market for these products.

## **VI. AGENCY CULTURE**

*Rethinking the Culture of Securities Regulation.* As discussed above, one theme that flows through many of the causes and missed opportunities leading up to the financial crisis, was the culture of financial regulation itself. During the years leading up to the crisis many viewed markets as almost always self-correcting. Similarly, many viewed “deregulation” (particularly in financial services) as an important part of fostering market growth and ensuring US competitiveness.



Although a long-term effort, the SEC has taken a number of steps to transform its culture and approach to regulation so as to more appropriately calibrate the costs and benefits of regulation with short-and-longer term risks. Among the changes are new leadership within our Divisions, streamlining within the Enforcement Division (as outlined above), significant expansion of cross-divisional and multi-disciplinary teams, and the establishment of the Division of Risk, Strategy, and Financial Innovation in the fall of 2009.

With the establishment of the new Division, the SEC has brought in a number of well-known experts in financial innovation, risk management, derivatives/structured products law, and modern capital market transactions. The Division uses a multi-disciplinary approach that integrates economic, financial, and legal disciplines. The Division's responsibilities cover three broad areas: risk and economic analysis; strategic research; and financial innovation; but its impact is agency-wide.

## **VII. GOING FORWARD**

Although the SEC continues to review its efforts and make improvements, there are a number of other lessons that require statutory and other changes to fully make effective.

### **Reducing Regulatory Arbitrage**

One central mechanism for reducing systemic risk and avoiding future crises is to ensure the same rules apply to economically-equivalent (or otherwise substitutable) products and participants. Financial participants now compete globally, and at the level of micro-seconds and basis points. In such an environment, if financial participants realize they can achieve the same economic ends at lower costs by taking advantage of a regulatory gap, they will do so quickly, often massively and with leverage. We can do much to reduce systemic risk if we close these gaps and ensure that similar products are regulated similarly.

***Too-Big-to-Fail Problem Should be Addressed.*** One of most important regulatory arbitrage risks is the potential perception that large interconnected financial institutions are “too big to fail” and will therefore benefit from government intervention in times of crisis. This perception can lead market participants to favor large interconnected firms over smaller firms of equivalent creditworthiness, fueling greater risk. To address these issues, policymakers should consider the following:

**Strengthen Regulation and Market Transparency.** Given the financial crisis and the government's unprecedented response, it is clear that large, interconnected firms present unique and additional risks to the system. To address this issue, I agree with the effort to establish a mechanism for macro-prudential oversight and consolidated supervision of systemically important firms. Moreover, to minimize the systemic risks posed by these institutions, policymakers should consider using all regulatory tools

available – including supplemental capital, transparency and activities restrictions – to reduce risks and ensure a level playing field for large and small institutions.

Establish a Resolution Regime. In times of crisis when a systemically important institution may be teetering on the brink of failure, policymakers have to immediately choose between two highly unappealing options: (1) providing government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but creating moral hazard; or (2) not providing government assistance but running the risk of market collapses and greater costs in the future. Markets recognize this dilemma and can fuel more systemic risk by “pricing in” the possibility of a government backstop of large interconnected institutions. This can give such institutions an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of a large, interconnected institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the “too-big-to-fail” dilemma. Structured poorly, such a regime could strengthen market expectations of government support, thereby fueling “too-big-to-fail” risks.

***Over-the-Counter Derivatives Should be Regulated.*** One very significant gap in the regulatory structure is the inadequate regulation of OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act. Fixing this weakness is vital, particularly in the current market environment.

The OTC derivatives market has grown enormously since the 1980s to approximately \$450 trillion of outstanding notional amount in June 2009. This market presents a number of risks; including systemic risk. OTC derivatives can facilitate significant leverage, resulting in concentrations of risk and increased, opaque interdependence among parties worldwide. Moreover, OTC derivatives can behave unexpectedly in times of crisis – further complicating risk management for financial institutions. The uncertainty surrounding these products and the web of interconnections created thereby can also affect the willingness of regulators to allow its major dealers and participants to fail: adding to the too-big-to-fail risks discussed above.

These risks are heightened by the lack of regulatory oversight of dealers and other participants in this market. The combination of these factors can lead to inadequate capital and risk management standards and associated failures that can cascade through the global financial system.

Moreover, OTC derivatives markets directly affect the regulated securities and futures markets by serving as a less regulated alternative for engaging in economically equivalent activity. An OTC derivative is an incredibly versatile product that can essentially be engineered to achieve almost any financial purpose. Any number of OTC

derivatives or strategies based on such derivatives can, for instance, allow market participants to enjoy the benefits of owning the shares of a company without having to purchase any shares.

Regulatory arbitrage possibilities abound when economically equivalent alternatives are subject to different regulatory regimes. An individual market participant may migrate to products subject to lighter regulatory oversight. Accordingly OTC derivatives should be regulated consistent with their underlying references. This will reduce arbitrage and better ensure market integrity.

To address these gaps and regulatory arbitrage dangers, legislation should bring greater transparency and oversight to OTC derivative products and major market participants and dealers. Also counterparty risks can be reduced through such measures as encouraging the standardization of products and requiring centralized clearing. The existing regulatory chasm cannot be allowed to continue.

Congress has made real progress in this regard. As this process moves forward, however, we must remain vigilant against even seemingly small exceptions, carve outs and arbitrage opportunities that might create tomorrow's risks.

For example, to prevent bad actors from hiding their trading activities, the SEC needs the tools to effectively apply the securities laws and police the securities-based derivatives market. Right now, the SEC is responsible for enforcing the anti-fraud provisions of the securities laws with respect to security-based swaps, but lacks the ability to access information about such transactions without first obtaining a subpoena. Subpoenas work if the SEC knows about a transaction and is actively investigating a possible fraud (such as insider trading), but denying direct access undermines the agency's ability to identify frauds like insider trading in the first place.

That is why security-based swaps should be subject to at least all the oversight and transparency that would apply to any other over-the-counter security, such as an OTC option. This would ensure that the SEC has the ability to inspect and examine all relevant market participants — including swap dealers, central counterparties, trading venues, and swap repositories. Enforcement staff must have quick access to comprehensive, real-time data on securities-related OTC derivatives — so that fraudsters cannot exploit this gap and use securities-based derivatives to engage in insider trading or market manipulation.

***Private Fund Managers Should be Included Within the Regulatory Framework.*** Another significant regulatory gap involves hedge funds and other private pools of capital, such as private equity funds, venture capital funds and their advisers that structure their operations to avoid oversight and regulation by the SEC. Consequently, private funds and many of their advisers currently are outside the purview of the SEC and other regulatory authorities, and we have no detailed insight into how they manage their trading activities, business arrangements or potential conflicts-of-interest.

Over the past two decades, private funds have grown to play an increasingly significant role in our capital markets both as a source of capital and an investment vehicle of choice for many institutional investors. Advisers to hedge funds are commonly estimated to have almost \$1.4 trillion under management. Since many hedge funds are very active and often leveraged traders, this amount understates their impact on our trading markets. Indeed, hedge funds reportedly account for up to 18 to 22 percent of all trading on the New York Stock Exchange. Venture capital funds are estimated to manage about \$257 billion of assets, and private equity funds raised an estimated \$256 billion in 2008.

This is a significant regulatory gap in need of closing. Private fund advisers should be required to register under the Investment Advisers Act and to report information that can be used for both systemic risk analysis and investor protection purposes. This registration and the resulting oversight would better protect our markets and would enable investors, regulators and the marketplace to have more complete and meaningful information about private fund advisers, the funds they manage and their market activities.

***Broker-Dealers and Investment Advisers Should be Subject to the Same Fiduciary Standard of Conduct and Heightened Regulatory Regime When Providing the Same or Substantially Similar Services.*** Another area where regulation should be rationalized involves broker-dealers and investment advisers, particularly with respect to the services they provide to retail investors. The Commission has been closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct or the regulatory requirements applicable to broker-dealers and investment advisers. When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to a uniform fiduciary standard of conduct that is at least as strong as exists under the Investment Advisers Act, and equivalent regulatory requirements, regardless of the label attached to the service providers.

### **Improving the Financial Regulatory Framework**

***Regulators Need to Work More Closely Together So That We Can Better Understand Regulated Entities and Market Risks.*** The financial crisis also demonstrated the need to watch for, warn about, and eliminate conditions that could cause a sudden shock and lead to a market seizure or cascade of failures that put the entire financial system at risk. While traditional financial oversight and regulation can help prevent systemic risks from developing, it is clear that this regulatory structure failed to identify and address systemic risks that were developing over recent years. The current structure was hampered by regulatory gaps that permitted regulatory arbitrage and failed to ensure adequate transparency. This contributed to the excessive risk-taking by market participants, insufficient oversight by regulators, and uninformed decisions by investors that were key to the crisis.

Given the shortcomings of the current regulatory structure, I believe there is a need to establish a framework for macro-prudential oversight that looks across markets and avoids the silos that exist today. Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and a powerful council of regulators is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should adverse circumstances arise, and benefit from the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

***Resources Are A Key Component of Effective and Independent Regulation.*** Although traditionally independent of the executive branch, unlike most financial regulators, the SEC lacks an independent source of funding. Most financial regulators have been established as independent entities with bipartisan management and dedicated funding sources. This structure serves to insulate financial regulators from efforts to influence inappropriately the supervision of regulated entities or the pursuit of remedial or enforcement action.

Unlike its regulatory counterparts, however, the SEC's funding is subject to the Executive Branch budget process and to the Congressional appropriations process. As a result, the SEC has been unable to maintain stable, sufficient long-term funding necessary to conduct long-term planning and lacks the flexibility to apply resources rapidly to developing areas of concern.

This problem has become especially critical with the enormous complexity of modern capital markets. Many of the matters central to the financial crisis and its resolution relate to the derivatives and other financial innovations so important to modern capital markets. Pending Congressional legislation recognizes this and imposes explicit responsibilities on the SEC in this space. I believe that significant and steady ongoing resources will be necessary to help ensure that the SEC's human capital, information technology, and data analytics keep pace with modern capital markets.

These issues add to a general funding problem relating to information technology and staffing. For example, the SEC's funding level was flat or declining during the 2005-2007 period. The SEC had to cut its staff by 10 percent and its investments in new IT initiatives by 50 percent – at the same time the securities markets were growing significantly in size and complexity. Since 2005, when these cutbacks began, average daily trading volume has nearly doubled; the investment advisor industry has grown by over 30 percent in number and over 40 percent in assets under management; and broker-dealer operations have expanded significantly in size, complexity, and geographic diversity.

Today the SEC has 3,700 people to oversee approximately 35,000 entities, including 11,300 investment advisers, 8,000 mutual funds, 5,500 broker-dealers, and more than 10,000 public companies, as well as transfer agents, clearing agencies, exchanges, and others. Under these constraints, the agency can only examine about 10 percent of advisers each year.

The current process also makes funding unpredictable. The SEC rarely receives its annual appropriation at the beginning of a fiscal year and is often funded under a continuing appropriation. This dramatically reduces the agency's ability to initiate new programs and undermines its ability to engage in long-term planning and contracting that would provide services in a more cost-effective manner.

Currently, the SEC's collects fees that are completely independent of, and significantly exceed, its funding level. For example, in 2010, the SEC will collect about \$1.5 billion and receive about \$1.1 billion in appropriations. Although this is a significant appropriation, the agency could receive a substantially different appropriation next year or any year after, substantially reducing our ability to plan and make strategic investments. A well-designed independent funding structure – for example, one based on transaction and registration fees already collected – would provide the agency with a much needed stable funding stream. This would better enable the investment, modernization and long-term planning needed to better protect investors and perform our supervisory mission.

## **VII CONCLUSION**

In conclusion, there were many causes and lessons to be learned from the financial crisis. The enormity and worldwide scope of the crisis, and the unprecedented government response required to stabilize the system, demands a full and careful evaluation of every aspect of our financial system. We cannot hesitate to admit mistakes, learn from them and make the changes needed to address the identified shortcomings and reduce the likelihood that such crises reoccur. More vigorous regulation and a new culture or approach are essential. I look forward to working with the FCIC as its review progresses.