An Insider's View of the SEC: Principles to Guide Reform

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Good morning. It is a pleasure to be here today. Before I begin, however, I need to issue the standard disclaimer that the views I express today are my own, and do not necessarily reflect the views of the Securities and Exchange Commission, my fellow Commissioners, or members of the staff.

Today I want to speak with you about financial regulatory reform. This is a pivotal time for the financial service industry and for its regulators. It was, after all, just over two years ago that Lehman Brothers collapsed and the American financial system went into tailspin followed by massive government bailouts. On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") into law. It will result in changes to the regulatory framework, operations and supervision of the financial services industry. A few of these changes include — the new Financial Stability Oversight Council, the new Consumer Financial Protection Bureau, and a new mechanism for seizing and liquidating large financial companies on the verge of failure, to a host of other changes.

Like other financial regulators, the SEC is significantly impacted. The Dodd-Frank Act will affect our internal structure, our enforcement and inspection programs, and, most importantly, it will give us jurisdiction over segments of the market not previously regulated — most notably oversight of OTC derivatives, hedge fund advisers and municipal advisers.

Now that the Dodd-Frank Act is law, the focus has moved move from Congress to the regulators, including the SEC, to fill in the details and to write the rules that will make financial reform a reality. Clearly, the focus of financial industry participants has quickly shifted away from Capitol Hill and settled squarely on the primary regulators. Already my office, as well as many others throughout the Commission, is fielding meeting requests from lobbying groups, industry groups and trade associations on a wide variety of issues raised in the legislation.

As the SEC and other financial regulators actively work to implement the provisions of the Dodd-Frank Act, I would like to talk broadly about the impact of this legislation on the SEC's role, the principles that should guide the SEC forward, and a few of the potential pitfalls I see ahead.

I. Dodd-Frank Act Strengthened and Expanded SEC's Oversight Capacity

Let's begin with the SEC's role. Prior to the passage of this law, rumors abounded as to the SEC's role in the newly constructed regulatory regime. There was serious debate about whether the SEC would exist going forward and whether some of its key functions would be distributed to other regulators.

At the time, I spoke out repeatedly that the SEC had to exist because our capital markets demand an integrated capital markets regulator to provide adequate and appropriate oversight. If the SEC had been disbanded, another regulator would have had to be created to carry out the same responsibilities. The fulfillment of the mission of the SEC to protect investors, maintain fair and orderly markets, and facilitate capital formation is fundamental and essential to the working of our capital markets system.

It turns out that Congress shared my point of view. Moreover, Congress has not only retained the SEC as the sole capital markets regulator, but it has tasked the SEC with a multitude of new responsibilities and mandates. The Dodd-Frank Act resulted in a cumulative expansion of the SEC's oversight and jurisdiction — and includes a number of provisions that strengthen the agency and that mandate its assertiveness.

Overall, the Dodd-Frank bill, a 2300-plus page piece of legislation, contains over approximately 240 rulemaking provisions, requires 67 one-time reports or studies, and directs the preparation of an additional 22 reports.[1] The impact of the legislation will not be known for some time, and this impact will depend significantly on decisions made by regulators. The agency shouldering a great deal of this responsibility is the SEC. The legislation contains nearly 100 provisions concerning SEC rulemaking and requires the SEC to prepare 17 reports.[2] As a point of comparison, the then-landmark Sarbanes Oxley legislation of 2002 resulted in the SEC adopting 14 rules and preparing just one study.[3]

To give you a sense for the breadth and depth of the issues confronting the SEC, I'll mention a few of our required actions. Within the next year, for example, the SEC must write rules regarding over-the-counter derivatives, private fund advisers, credit rating agencies, the asset-backed securitization market, corporate governance, executive compensation, and whistleblowers provisions.

As the SEC moves to comply with the new requirements, I will articulate a few fundamental principles that should guide its decision-making. These are:

- Investor Protections Should Be Real and Verifiable;
- The SEC Must Always Actively Seek Investor Input;
- The SEC Should Resist the Trend Toward Establishing a Two-Tier Market;
- The SEC Should Use its Authority and Expertise; and
- The SEC Must Vigorously Enforce the Rules.

II. Principles To Guide the SEC Forward and Potential Pitfalls to Avoid

A. Investor Protections Should be Real and Verifiable

Let me start with real investor protections. As the capital markets regulator charged with protecting investors, the SEC must remain focused on this responsibility. This means that the new regulatory regimes and rules promulgated by the SEC must have real and verifiable investor protections.

Prior to the financial crisis, the SEC increasingly relied on questionable assumptions and indirect indicia as a substitute for affirmatively determining whether investors were protected. Examples include (1) leaving transactions with so-called sophisticated investors outside many of the protections of the securities laws by assuming that sophisticated investors would take care of themselves and (2) relying on the risk management of large financial institutions by assuming that they would be careful about taking on too much risk. Often, the Commission substituted the judgments of market participants for its own judgment as the securities regulator with the expertise and mandate to protect investors. The last several years demonstrate how investors have been failed by this approach.

As evidenced by the Dodd-Frank Act, Congress agreed that these were faulty assumptions and is now mandating that the SEC establish additional disclosures regarding asset-backed securities, even if offered to sophisticated investors in the private market.[4]

Thus, as the SEC establishes new rules and regulatory regimes, it should do so by putting real and verifiable investor protections in place. As former SEC Commissioner Roel Campos said, "One of the basic principles that I believe governs today's global economy is this: Most capital will go to where it is best protected. Yes, some capital will also be allocated to seek returns and take measured risks, whether in developing countries or sectors or alternative investments. However, most capital and investment will go to jurisdictions that have a high level of protection and redress through rule of law and an effective and fair judicial system."[5]

B. The SEC Must Always Actively Seek Investor Input

A second principle that the SEC must follow is to actively seek investor input. The simple truth is that investor voices are often few and less organized than other interested parties, and their points of view can be sidelined. As a result, the Commission has to make it an imperative that investors' perspectives are always represented -- whether it be as participants in Commission roundtables, members of the Commission's committees, or the Board leadership of the Self-Regulatory Organizations that the Commission oversees.

The SEC has not always listened to investors. Fortunately, however, the Dodd-Frank Act has established the Commission's Investor Advisory Committee as a permanent institution.[6] As the sponsor of the Commission's first Investor Advisory Committee — organized only a year ago - I have been proud to be associated with this body, which has been charged with representing the interests of investors. In its short life, it has already made various recommendations to the Commission and laid important groundwork that should be continued by the permanent statutory Committee.[7]

Beyond this Committee, the Dodd-Frank Act also requires the establishment of a new office in the SEC, the Office of the Investor Advocate.[8] The Investor Advocate will be appointed by and report directly to the Chairman. Significantly, the Investor Advocate will be required to prepare an annual report that will be delivered to Congress. This report will include summaries of the most serious problems encountered by investors and the report is to include recommendations for administrative and legislative action. Additionally, the Investor Advocate will appoint an Ombudsman who, among other duties, will act as a liaison with the SEC for retail investors who experience problems with the SEC or an SRO.

Thus, the Dodd-Frank Act establishes new entities within the SEC to emphasize the SEC's mission to protect investors and it requires the SEC to create new infrastructure to allow this to happen.

C. The SEC Should Resist the Trend Toward Establishing A Two-Tier Market

As we develop rules and regulations under the Dodd-Frank Act, another guiding principle is that we must resist creating two-tiered markets or separate standards of protection. This means that we should not carve out areas where, it is thought, certain protections are not necessary, depending upon the investor, the intermediary, or the investment. The fact is there is only one capital market and it is highly integrated.

I have spoken before about the faulty assumption that markets and transactions involving so-called "sophisticated investors" require little to no investor protection or regulatory oversight.[9] Such investors, it has been argued, do not require the same transparency, disclosure, or protections that other investors do, because sophisticated investors have the resources to bargain effectively with issuers,

with one another and with financial intermediaries. They are, it is argued, sophisticated enough to know what information and protections they do and do not need. But it is readily apparent from recent Commission enforcement cases involving auction rate securities and pension funds that institutional investors were not able to protect themselves.

A second faulty assumption is that, when institutional investors misjudge the risks of investing, only wealthy or sophisticated investors are hurt. The widespread financial crisis of 2008 clearly disproved this argument, but it is also untrue even on a smaller scale. After all, a single sophisticated institutional investor, whether it is a bank, pension fund, mutual fund, or other entity, often represents investments from many individual retail investors. And it is these small investors that ultimately bear the cost.

Another area in which differing standards apply without good reason is in the duties required of those who provide investment advice to investors. Currently, if a broker-dealer and an investment adviser provide exactly the same advice to the same investor, the duties and responsibilities to the investor can differ greatly, even if the title on the industry professional's business card is similar. It is time that we applied the same standard, that of a fiduciary, to both kinds of professionals. The fiduciary standard — requiring undivided loyalty, reasonable care and good faith to the investor-- has served advisory clients well for many years and it should be the governing standard whenever investment advice is provided. Moreover, investors already believe that their financial advisor, whether an investment adviser or a broker-dealer, has a duty to put their interests first. A recent survey demonstrated that investors don't understand that this is not true.[10]

D. The SEC Should Use Its Authority and Expertise

Another principle that should guide the SEC's efforts is that the SEC should use the authority that it has to fulfill our mandate. That hasn't always occurred.

The classic role of a federal administrative agency, like the SEC, is to receive by statute a delegation of legislative power from Congress, and a delegation of executive power from the president. The agency is then staffed with professionals who focus on a particular area of the law and are expected to use their expertise in a practical and intelligent manner to realize the objectives set forth in the statute. Unfortunately, there are instances where the SEC has chosen to sit on the sidelines. A non-exclusive listing of examples includes the following:

- Failing to adopt rules to curtail corrupt pay-to-play arrangements between investment advisers and public funds; and
- Failing to collect essential information about investment advisers by waiting a decade to update Form ADV.

Thankfully, the current Commission has been willing to address these past failings. Moreover, the Dodd-Frank Act compels the SEC back to action by is tasking it with significant responsibilities. It is a mandate to return to the muscular approach of the SEC's storied past.

In fact, the Dodd-Frank legislation is full of areas where the SEC must act to take what Congress has done and make it complete. As just one example, Congress has mandated for hedge fund and other private fund advisers to be registered and to be subject to reporting requirements.[11] However, it is the expertise of the Commission in the securities industry and in the investment adviser arena that will inform the development of these rules and requirements. It is the Commission staff that will write the text of the rules and provide the practical guidance of how this regime will work.

We should do so in a fulsome way. It is a given that the SEC's actions should be undertaken in a smart and thoughtful way, and most importantly, we should not be afraid to regulate. It is, after all, what Congress, the President, and the American public expect.

E. The SEC Must Vigorously Enforce The Rules

The final principle I will discuss today that should guide the SEC is critical — the SEC must enforce the rules. As I have said many times, rules alone, without proper implementation and enforcement, are meaningless. How many countries around the world have rules on the books that are directly contradicted by the corrupt practices that take place - and where the regulators are nowhere to be found?

I deeply believe that the capital markets in the US have flourished because this historically has not been the case in the United States. The strong regulatory regime administered by the SEC built a foundation for our capital markets that inspired investors and industry alike.

The Dodd-Frank Act has recognized the need for strong enforcement. To that end, the Dodd-Frank Act includes a number of other provisions intended to give the SEC additional enforcement tools.[12] These include increased aiding and abetting liability, stronger whistleblower protections, and other enforcement tools — such as broader subpoena authority, extraterritorial authority, and authority with respect to collateral bars. The SEC should not be shy about using these new powers.

Unfortunately, past experience shows that the SEC can be slow to avail itself of new tools provided by Congress. I would not want to see the SEC fail to implement and utilize the new authority and jurisdiction bestowed by the legislation. As we stand on the precipice of implementation, it is imperative that the SEC learns the lessons from the past. It was nearly a decade ago that the Sarbanes-Oxley Act was passed, and the SEC received some important new powers. But as we have seen, regulators with authority have a choice to act and do not always chose to.

One clear example where the Commission ignored a Congressional mandate set forth in Sarbanes-Oxley is the failure to clawback executive compensation at companies that had to restate their financial statements because of misconduct. Under Sarbanes-Oxley, when such a restatement occurs, CEOs and CFOs are required by operation of law to pay back to the company their bonuses and other incentive compensation, as well as stock sale profits.[13] The statutory clawback is self-executing and is supposed to happen automatically.[14] If a CEO or CFO doesn't reimburse the issuer as required by law, then the Commission can bring an enforcement action against the CEO or CFO for violating that obligation.

Despite being required by law, it is virtually unheard of for CEOs or CFOs to volitionally reimburse issuers. Unfortunately, the SEC incentivized this to continue by choosing to not enforce this new law for almost five years after Sarbanes-Oxley was passed.[15] Moreover, it wasn't until last year that the SEC finally made enforcement of the clawback the sole focus of a case, in a matter called SEC versus Jenkins.[16]

Congress created the Sarbanes-Oxley clawback provision as an important mechanism to provide much needed accountability and deterrence. The clawback is required whether or not the CEO or CFO personally engaged in misconduct, because the law is not about punishing a wrongdoer, it is about creating incentives to do the right thing and prod the CEO and CFO to oversee financial reporting with care and diligence.

As the court in SEC versus Jenkins determined, the Sarbanes-Oxley clawback "provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring

that they reimburse additional compensation received during periods of corporate non-compliance, regardless of whether or not they were aware of the misconduct giving rise to the misstated financials."[17]

Congress put the clawback in Sarbanes-Oxley to enhance the responsibility of CEOs and CFOs for financial reporting. When CEOs and CFOs fear their bonuses and other incentive-based compensation will be paid back to the company, they are incentivized to be diligent in establishing an honest culture of reporting and in choosing the right people to work for them.

This delay in enforcing this important law deprived investors of the benefits of the law and the accountability that Congress sought to foster. There may have been far fewer companies restating their financial statements due to a dressing up of the numbers -- and far fewer investors harmed -- if this law had been enforced.

Now that the Dodd-Frank Act has given the SEC new enforcement tools - they cannot languish. American investors need to know that the SEC, as the capital market watchdog, will be willing to use any and all tools to enhance investor protection. It is time for the SEC to prove it through action, by bringing tough cases, rather than through rhetoric.

Conclusion

There is no doubt that the Dodd-Frank Act will have far-reaching consequences. The sixty-four million dollar question is whether the SEC can deliver in a way that enhances investor protection while maintaining and improving the world's most efficient capital market. I am committed to doing just that.

Thank you.

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[1] See, Davis Polk Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010 (July 21, 2010). http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf

[2] See, Id.

[3] See, Summary of SEC Actions and SEC Related Provisions Pursuant to the Sarbanes-Oxley Act of 2002. http://www.sec.gov/news/press/2003-89a.htm.

[4] See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act §943 (requiring securitizers, whether in registered or unregistered transactions, to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies). See also Dodd-Frank Wall Street Reform and Consumer Protection Act §932 (adding new section 15E(s)(4) of the Securities Exchange Act of 1934, which provides that an issuer or underwriter of any asset-backed security, whether in a registered or unregistered transaction, to publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter).

[5] "SEC Regulation Outside the United States," The Honorable Roel C. Campos, Commissioner, U.S. Securities and Exchange Commission (March 8, 2007). http://www.sec.gov/news/speech/2007/spch030807rcc.htm

[6] See, Dodd-Frank Wall Street Reform and Consumer Protection Act §911.

[7] See, SEC Investor Advisory Committee. http://www.sec.gov/spotlight/investoradvisorycommittee.shtml

[8] See, Dodd-Frank Wall Street Reform and Consumer Protection Act §915.

[9] “Market Upheaval and Investor Harm Should Not be the New Normal” The Honorable Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission (May 24, 2010). http://www.sec.gov/news/speech/2010/spch052410laa-1.htm

[10] See, CFA/AARP/NASAA/Industry Survey Finds Most Investors Mistakenly Think Financial Professionals, Insurance Agents Already Held to Fiduciary Duty; 91 Percent Support Even-Handed Regulatory Approach From SEC, September 15, 2010. http://www.hastingsgroup.com/fiduciarysurvey/docs/091510Fiduciary_survey_news_%20release.html

[11] See, Dodd-Frank Wall Street Reform and Consumer Protection Act Title IV.

[12] See, Dodd-Frank Wall Street Reform and Consumer Protection Act Title IX, Subtitle B.

[13] See, Sarbanes-Oxley Act of 2002 §304.

[14] See Id. (stating that “If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer *shall* reimburse the issuer … .”) (emphasis added).

[15] The first SEC settlement announced including a violation of Sarbanes-Oxley section 304 appears to be *In the matter of Mercury Interactive, LLC (f/k/a Mercury Interactive Corporation), Amnon Landan, Sharlene Abrams, Douglas Smith, and Susan Skaer,* Litigation Release No. 20136 (May 31, 2007). http://www.sec.gov/litigation/litreleases/2007/lr20136.htm

[16] See, Litigation Release No. 21149A (July 23, 2009) (noting that the action was “the first action seeking reimbursement under Section 304 from an individual who is not alleged to have otherwise violated the securities laws.”)

[17] SEC v. Jenkins, No. CV 09-1510-PHX-GMS (D. Ariz. June 9, 2010) at 8.

Source: http://www.sec.gov/news/speech/2010/spch101510laa.htm