Speech by SEC Chairman: Embracing the Change

by

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Thank you for that kind introduction. It's an honor to be asked to deliver the Alan Levenson Keynote Address.

As many of you know, Alan was a prominent securities lawyer, the former head of the Division of Corporation Finance at the SEC and one of the founders of this institute. And, he was known to many of us as an intellectual giant and a good friend.

A New Financial Reality

It has been about 20 years since I first attended this conference. And there are a lot of differences between now and then.

A blackberry was something we ate. American Idol was not yet conceived. And, Google was just another large number.

In the financial arena, the differences are just as great. The total notional value of over the counter derivatives was measured in mere billions, not hundreds of trillions. Few people had yet heard about securitizing mortgages or many other assets for that matter. And, a "security" to a bank was something it hired, not something it sold.

Indeed, today's financial landscape is quite different. It is filled with uncertainty — where new products are conjured up every day, not fully understood and nonetheless sold with lightning speed and extraordinary, sometimes devastating, consequences.

So, the key for all of us — regulators, corporate boards, securities professionals, accountants and attorneys — is to understand this new landscape, respond with vigor and adjust accordingly.

Over the past year, at the SEC, we have been reviewing our financial and regulatory systems and have been changing much of the way we operate.

With new leaders throughout the agency, new skills and capabilities, we have been changing the way we think about our core responsibilities to the American people. And, change is manifesting itself in many of the things we do — from how we conduct our exams and initiate investigations to how we prosecute our cases.

In the process, we also have been changing and updating the rules we enforce, re-thinking some of the basic tenets of securities regulation and actively participating in the reforms now wending their way through

Congress.

I believe that all of this change is necessary and urge all of us to embrace it — not just that which is coming but that which has already arrived.

Filling Gaps & Strengthening Standards

Filling Gaps

Last week, I testified before the Financial Crisis Inquiry Commission where I discussed just some of the areas where the status quo cannot stand.

I talked about the widespread view — not so long ago — that markets are almost always self-correcting and that deregulation was the way to make America more competitive. Such a view, I believe, led to weaker standards and regulatory gaps that were easily exploited in recent years.

This is a view that I believe must change.

In the past year, the SEC and its staff have been insisting on strengthening standards and filling those gaps — change that I think is necessary if we want to thwart another economic crisis.

Hedge Funds: Since I became Chairman, we have been strongly pushing for legislation that would require advisers to hedge funds and other private funds to be registered with the SEC. And, we are seeking access to information that will enable us to create a comprehensive database so we can monitor activities for systemic risk and investor protection purposes.

Just as importantly, we argue that any legislation should avoid broad new carve-outs that could become the next safe haven for unscrupulous advisers or manipulative money managers — or that leave gaps in the data available to us.

To further our regulatory missions, we are cooperating with our regulatory counterpart in the United Kingdom as to the sharing of hedge fund related data. And, we are working with international organizations toward gathering consistent and comparable hedge fund data globally.

It is estimated that roughly 80 percent of hedge fund assets are managed by advisers that operate in the U.S. or the U.K. Pooling the SEC and FSA information will result in a more comprehensive understanding of the overall hedge fund landscape and its impact on our broader securities markets.

OTC Derivatives: We also have been driving for new regulation in the area of over the counter derivatives. These complicated financial instruments were largely excluded from our regulatory framework ten years ago by the Commodity Futures Modernization Act. And, in that time, they have grown exponentially in size and impact.

But rather than serving as merely a hedge against risk, during the crisis, these derivatives may have exacerbated it.

That’s because OTC derivatives can facilitate significant leverage, resulting in concentrations of risk and increased, opaque interdependence among parties worldwide. What’s more, they can behave unexpectedly in times of crisis — further complicating risk management for financial institutions.

The uncertainty surrounding these products and the web of interconnections they create can also affect the willingness of regulators to allow the major dealers and participants to fail. And, this only adds to the too-big-to-fail dilemma, where market participants favor large interconnected firms over smaller firms, thereby fueling ever greater risk.

Further, these products are incredibly versatile and can essentially be engineered to achieve almost any financial purpose. This includes enabling market participants to essentially invest in a company without having to purchase any shares.

When economically equivalent alternatives are subject to different regulatory regimes, individual market participants may migrate to products with lighter regulatory oversight. To reduce this regulatory arbitrage and better ensure market integrity, OTC derivatives should be regulated consistent with their underlying references.

In our effort to fill this gap, we are urging greater transparency and oversight. We are seeking measures that encourage the standardization of products. And we seek to require centralized clearing to reduce counterparty risks.

As long as there is a virtual detour to an unregulated world for investment vehicles, that road will be taken.

Asset-Backed Securities: But our push for increased transparency and regulation doesn't stop there. At the SEC, we are reviewing our regulation of the asset-backed securities market — from disclosures to offering process to the reporting of asset-backed issuers.

And, as we speak, the staff is working on proposals that would align the interests of those selling these products with those investing in them.

Among other things, I envision proposals that would seek to:

- Provide significantly more time for investors to conduct a careful analysis before investing.
- Require that loan level data is provided in a format and manner that is accessible by investors.
- Revise the eligibility standards for "shelf" offerings and eliminate the use of credit ratings as an eligibility standard for shelf.
- Create a mechanism for ongoing disclosure.

The proposals are 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.

Strengthening Standards

In addition to seeking greater regulation, we are also strengthening existing standards — because I believe stronger standards improve our competitiveness, not weaken it.

Custody Controls: For instance, we have already increased the safeguards imposed upon investment advisers who control their customers' assets.

For the first time, advisers who do not keep their client assets with a truly independent third party, or otherwise have access to them, will have to undergo a surprise exam to verify the existence of client assets.

It's consistent with the agency's primary focus — protecting investors.

Money Market Funds: And, in the area of money market funds we will soon be voting on whether to adopt new rules that reduce the risks associated with these funds. The fact is many Americans fail to recognize that money market funds are actually investments that can fall, as well as rise. So long as that's the prevailing view, we need to ensure that investors aren't purchasing a risk they didn't bargain for. The rules to be considered would tighten the credit quality and maturity requirements and impose, for the first time, significant liquidity standards.

Reducing Reliance on Credit Rating Agencies

Another area where change is needed involves the over-reliance on credit rating agencies.

It is a change that is long overdue.

As many of you know, one significant cause of the crisis was the securitization of sub-prime mortgages, the resulting weaker underwriting standards by loan originators and the systemic risk that cascaded through the markets.

Although few understood the risks associated with these complicated financial instruments, many investors and even regulators over-relied on credit rating firms. They viewed their high ratings as indicia of good quality and low risk.

But those ratings were faulty and the consequences severe.

In response, the Commission has undertaken a series of rulemakings designed to strengthen our oversight of these agencies, enhance disclosure and improve the quality of ratings.

We would do this by:

- Requiring these firms to disclose a history of their ratings activity.
- Fostering competition by ensuring all agencies have access to similar information.
- Providing more information on where these firms are generating their revenue.
- Requiring issuers to disclose what the rating covers, who paid for it, and any limitations on the scope of the ratings.
- Shedding light on rating shopping by revealing whether any other preliminary ratings had been obtained.

Finally, we have begun the process of removing references to ratings in several of our rules and regulatory forms — a surprisingly difficult process.

The idea is to give investors a better sense of the track record of the credit rating agency, a better sense of what the rating means, and a better sense of how much weight the rating should be given.

Improving Compensation Policies

Yet another area of concern that the crisis highlighted for me was the proliferation of perverse incentives and asymmetric compensation arrangements — arrangements that encouraged significant risk-taking, unwittingly rewarded failure and obscured this reality to investors.

This too was something that had to change.

So in December, we adopted rules 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 if they 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 own practices. This in turn 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, about the background and qualifications of directors and nominees, and about the board's structure and its role in managing risk.

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.

For those of you here today, advising corporate clients, I encourage you to counsel your clients to live within the spirit of these rules — to encourage greater disclosure, not less.

Removing Barriers to Proxy Access

Similarly, we need to remove the unnecessary barriers to a shareholder's state law right to nominate candidates to a board of directors.

Such barriers serve to weaken a board's accountability to shareholders, which in turn may impact a board's incentive to manage risks appropriately.

And while it is surely controversial, I believe this too must change.

So, at the Commission, we are nearing a vote on a proposed rule that requires public companies to let shareholders place their nominees on the companies' proxy ballots.

The idea is 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 shareholder meeting is not a feasible way for most shareholders to exercise their rights.

Very briefly, under our proposals, shareholders would be able to have a limited number of nominees included in the company proxy materials if those shareholders satisfy certain requirements. Among other things, that includes meeting security ownership requirements, providing certifications about their intent, and disclosing additional information.

If adopted, this and related 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 should further empower shareholders and help to restore investor trust in our markets.

Keeping Integrity in the Markets

Another series of changes that I believe are needed and that we are making involve the structure and functioning of our markets. The fact is that markets and market regulation should promote investor confidence, not undermine it. Such confidence is essential to the efficient flow of capital and the long-term success of financial markets and the economy.

But since the financial crisis began, there has been some unease that markets are being stacked against typical retail investors. The roots of any deficiencies in market structure must be addressed head on to ensure that markets are transparent and investors are treated fairly.

That is why the SEC is taking — and will continue to take — a fresh look at market structure and trading activities. We must continually seek to ensure that we are fostering fair, orderly, and efficient markets that are designed to protect investors.

And, where there are areas of concern that warrant attention, the SEC will take action.

Already we have proposed rules that would effectively prohibit broker-dealers from providing customers with “unfiltered” access to an exchange or alternative trading system. We have proposed rules that would strengthen our regulation of dark pools of liquidity.

And we have proposed banning the practice of flashing marketable orders — a practice that provides a momentary head-start in the trading arena that can produce inequities in the markets and create disincentives to display quotes.

Reforming Internal Procedures

I know that change is hard because within our agency we have been engaged in some of the most significant change in decades.

When I arrived at the agency last January, we began a process of assessing our operations and determined we could do better. We determined that we needed to change. And that is the path we have chosen.

In the first few days, I streamlined our enforcement procedures by giving our attorneys the authority to serve subpoenas and enter into negotiations with corporate defendants, without first going to the full Commission.

More than anything, I believe it sent a message that our staff has a green light to pursue violations and that we have faith in their judgment to do so. Now, no Commission authorization at all is required to commence formal investigations, take testimony or seek documents.

Additionally, we have:

- Stepped up training.
- Created a new Division of Risk, Strategy and Financial Innovation.
- Restructured the Enforcement Division through the elimination of a layer of middle management and the creation of specialized units.
- Redeployed attorneys back to the front line.
- Begun to revamp our complaint intake and triage system.
- Bolstered our examination program.

Just as importantly, we brought on new leadership across the SEC committed to revitalizing and reenergizing the agency, working collaboratively, and thinking creatively about the tools we have to effect positive change.

None of this is easy for a dedicated staff that was already focused on doing its job in a tumultuous time. Yet, through it all the staff has embraced the change because we all appreciate the importance of restoring confidence and protecting investors.

Conclusion

Next week marks my first anniversary since becoming Chairman and it has been a whirlwind year. At the time I started, I pledged to undertake significant change. And, a great deal of change has already occurred.

But more will come.

In the future, we will be tackling issues involving the municipal securities markets, the relationship between retail clients and their brokers and advisers, the mechanics of proxy voting and the role of advisory firms. And so much more.

If there's one thing the recent financial crisis taught us it's that the status quo is clearly not good enough. Not for our markets. Not for investors. And, not for our economy.

To succeed, we all need to embrace the change — change that is needed to improve our regulatory system, better protect investors and restore confidence in the markets.

Thank you.

http://www.sec.gov/news/speech/2010/spch012010mls.htm
