

Speech by SEC Chairman: "The Road to Investor Confidence"

by

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Opening

Thank you for that kind introduction. And, thank you for inviting me here today. I wasn't yet Chairman of the SEC when you held your annual meeting last October. But that period in our nation's economy — and the events leading up to it — have shaped much of the past nine months for me.

It's been an extremely active time at the SEC as we've tried to reenergize the agency, institute significant internal reforms and refocus on our core mission of protecting investors. That was our mission 75 years ago when we were founded and it's still our mission today.

Today, our markets are not just vital to the functioning of the global economy, but to the financial well-being of millions of individual Americans, who invest in mutual funds, invest for their children's education, and supplement their retirement in IRAs and 401(k)s.

There are many causes that led to our recent crisis.

Too many financial institutions, securities firms, mortgage originators and credit rating agencies did not understand the risks. Or they simply ignored the risks they were tasked with identifying. Instead of steering away from the riskiest financial products, they turned toward them.

It was much the same for regulators. Perhaps we bought into the fears about global competition or failed to appreciate the growing and concentrated risks. Either way, the right questions were not asked, nor were the necessary steps taken to mitigate the risk before we coasted to the brink.

Restoring Investor Confidence

So now we're all trying to find our way back — back to a place where investors have faith that the markets are working as intended. That they have the tools and honest information they need to responsibly allocate their investing dollars. That all of us in this room are not taking unnecessary risks nor obscuring those risks reasonably taken.

If we all dedicate ourselves to learning from the past and applying lessons shaped for the future, we will have a fairer market — one in which everyone here can compete based on real services and results — rather than trying to compete with those who are bending the rules, or crafting new ones.

But the question is how do we plan to get there?

To me, we don't get there by assuming all is well now, and reverting to the practices that got us to where we are.

We don't get there by letting newly engineered financial instruments escape the umbrella of regulation and the natural disinfectant of meaningful market transparency.

And, we certainly don't get there by permitting, or even advocating, for gaps in our regulatory landscape.

I believe those are the directions that send us back to another financial crisis. And, we cannot afford to let that happen.

Instead, I think we restore confidence by focusing on the needs of investors, making tough decisions, setting our standards high and dedicating ourselves to achieving them.

For the past nine months it has been a guiding principle behind all we've done.

And, at the SEC, we're doing a lot . . .

The Past Nine Months

When I got to the SEC earlier this year, the stock market was still tumbling, several financial institutions were still teetering and, of course, Bernard Madoff had just become a household name. It was critical that we institute significant internal reforms and begin immediately.

We had to eliminate silos and improve communications between divisions, we had to change a culture that some have called insular, we had to improve the way we assess risk, fix our technological shortcomings, find better ways to tap into the vast expertise within the agency, incorporate new skills, and keep pace with all of you. And, that is what we have set out to do.

Revitalizing Enforcement Efforts

One of the first things I did with an eye toward restoring confidence was to begin to re-energize the Division that enforces our securities laws.

Most importantly, we sent a clear signal to our attorneys that we value toughness and speed by removing existing roadblocks impeding their investigations.

I hired a tough prosecutor — Rob Khuzami — to head up the Division and undertake one of the most significant reorganizations in decades.

He removed a layer of management, which will result in the redeployment of dozens of superbly qualified attorneys back to the front lines, and created specialized units — units where attorneys can concentrate their expertise in a particular area — such as structured products or market abuse — and better detect links and patterns that might not have been spotted before.

While statistics don't always tell the whole story, the numbers are nonetheless revealing. In the last nine months, compared to the same period last year, we've:

- Issued more than twice as many formal orders (about 448, compared to 181)
- Filed more than twice as many emergency actions (about 62, compared to 30)
- Opened nearly 50 more investigations (approximately 713, compared to 663)
- Obtained orders for twice the amount in disgorgements and penalties, over roughly the same time (\$1.8 billion compared to \$865 million.)

Complaints and Whistleblowers

Also upon arriving at the agency, we undertook a review of the way we handle the hundreds of thousands of tips we receive each year.

For an agency of just 3,700, the numbers of complaints were virtually impossible to keep up with, let alone manage. But, what concerned me was that there was no central repository — no effective tracking system to ensure the tips were getting to the attention of those who needed to know. So we brought in experts to help us revamp our business processes and begin to develop the technology needed to identify and pursue the most promising leads.

Of course, sometimes the best complaints are from those on the inside of an institution — whistleblowers. And so, we have been advocating for expanded authority from Congress to reward those who bring forward substantial evidence about significant wrongdoing.

Risk and Innovation

Apart from enforcement, I was also determined to improve the agency's ability to analyze risk and cutting-edge market trends. As long as new financial products or strategies are being pitched to investors or have the potential to destabilize financial institutions or the system, we need to have a unit that is capable of determining the risks and regulatory concerns posed by those products. We created a new Division of Risk, Strategy and Financial Innovation to serve as a knowledge-based center of expertise within the agency. It's a Division that will help link existing know-how from one segment of the agency to the needs of another. In addition, it will be populated by people with current street experience in derivatives, hedge funds, trading and risk.

Of course, these internal reforms are just a slice of what has been keeping us busy, as we refocus on our core, investor protection mission. And equally, these are works in progress as we reorient and restructure the agency to better serve the interests of investors.

The Rulemaking

Throughout the past nine months, we have also pursued one of the most significant, investor-focused rulemaking agendas in our history — rules that will help protect investors and ensure that our markets operate fairly. And, we've been doing that, while simultaneously adding our voice to the ongoing regulatory reform effort underway in Congress.

Our list of rule initiatives is lengthy...

On the money market fund front — to avoid a recurrence of the serious problems exposed last year, when the Reserve Primary Fund broke the buck — we've proposed strengthening credit quality, liquidity and maturity standards, as well as introducing stress testing requirements.

We've also taken action to address the potentially harmful effects of naked short selling — adopting rules that have significantly reduced the number of times short sellers failed to deliver securities. And, we also have issued proposals to address the public confidence and market stability implications of short selling in a downward market.

Further, we proposed a package of measures designed to create a stronger, more robust regulatory framework for credit rating agencies — measures designed to improve the quality of ratings by requiring greater disclosure, fostering competition, helping to address conflicts of interest, shedding light on rating shopping, and promoting accountability.

Additionally, we have proposed rules to facilitate the effective exercise of the rights of shareholders to nominate directors to the Boards of the companies they own.

And, we proposed rules that would provide investors with more meaningful information about the leadership structure of boards, the qualifications of Board nominees and the relationship between a company's overall compensation policies and risk.

Boards are clearly — and will be increasingly — important to the effective management of financial institutions. I do not expect that the public outrage over compensation practices in financial firms will subside without meaningful change. And, I think the restoration of confidence in the integrity of our financial institutions is highly dependent upon a more thoughtful and rational approach to compensation by Boards. I view our disclosure proposals, coupled with facilitating shareholders' ability to nominate directors, as important efforts on our part to address their compensation concerns.

Earlier this year as well, in response to the Madoff fraud, we proposed rules that would better protect clients of investment advisers from theft and abuse. The rules would provide assurance to these clients that their accounts actually contain the funds that their adviser, and account statements, say they contain. Among other things, the rules would encourage investment advisers to place their clients' assets in the custody of an independent firm.

We also have proposed rules to curtail abusive pay-to-play practices by advisers to public pension plans and other municipal clients.

And, finally, we have proposed rules that will provide investors and other market participants more meaningful, ongoing information regarding municipal securities. Considering that roughly two-thirds of muni securities are owned — directly or indirectly — by retail investors, it's a rule I believe is long overdue.

The Road Ahead

All that being said, we've got much farther to go on the way to investor confidence. If anyone was hoping for a respite from reform, I am afraid I will disappoint you. With greater stability in the markets, we can begin choosing the issues, rather than having them choose us. So, even as we bring across the finish line the many initiatives launched earlier this year, we will intensify our focus on the structure of our equity markets, newly emerging products, and the regulatory gaps that still exist or are bound to show up as new rules take effect. And, lest there be any confusion, the path we will take in deciding which way to turn will always be the one pointed in the direction of investors.

Market Structure

As many of you know, we are already moving forward on our market structure initiative. In recent weeks, we have proposed rules that would address the inequities of flash orders and dark pools of liquidity.

Both of these undermine the integrity of the market by providing valuable pricing information to select market participants — information that is not widely available to the public. This in turn creates a risk of private markets and two-tiered access to information.

But I believe there is much more to do to bring about greater market transparency and fairness.

As regulators, we at the SEC are mindful of the extraordinary technological advances and the benefits they have brought over the years. But, we are also mindful of the potential for participants to exploit these advances in ways that harm, rather than help, investors.

As a result, we have been engaged in a thoughtful, deliberate and comprehensive review of market structure.

In addition to the actions already taken, we will seek public comment on dark liquidity in all of its forms, including dark pool alternative trading systems, internationalization, dark order types on exchanges, and ECNs. And, we'll seek input on high frequency trading and the wide range of strategies that may fall within this vaguely defined category.

A related issue, on which we also expect to seek public comment, involves co-location — the process where exchanges allow some broker-dealers to place their servers in close proximity to the matching engine of the exchange. This could result in significant advantages, at least for certain traders for whom speed is of the essence. In the interim, we are making sure that exchanges offer these co-location services on terms that are fair and non-discriminatory and that are transparent to the public.

I also have asked the staff to review the rules governing ATs to assess whether those rules are still appropriate for all the different types of ATs that exist today — systems that may not have been foreseeable when our rules were adopted 10 years ago. But in addition, I have directed our staff to come up with actual market structure proposals as well.

One proposal will address the risk of sponsored access to exchanges. It will focus on arrangements that enable unfiltered access by non-regulated entities — in many cases, high frequency traders — to exchange systems. I liken it to giving your car keys to a friend who doesn't have a license and letting him drive unaccompanied. The reason this raises concerns is that broker-dealers perform vital gatekeeper functions — functions that are essential to maintaining the integrity of the markets. We should not sacrifice the stability and fairness of the markets to give a trader a millisecond advantage.

I recognize some markets have been seeking to address this issue, but I also worry that competitive pressures could delay an effective solution — one that would apply across all markets to assure a level playing field for all investors.

A second proposal would shed greater light on the activities of high frequency traders.

Compared to a few years ago, the current volume of orders and trades, and the speed of order routing and trading, are almost unimaginable. The high frequency traders largely responsible for these developments now likely represent more than 50 percent of trading volume.

I believe we need a deeper understanding of the strategies and activities of high frequency traders and the potential impact on our markets and investors of so many transactions occurring so quickly. And we need to consider whether there are additional legislative authorities needed to address new types of market professionals whose activities may not be sufficiently regulated.

Retirement Products

As we proceed further, we must be on the look out for newly emerging risks. Some of those risks will almost certainly come in the form of new products — particularly those related to retirement investing. This is especially important as employers replace defined benefit plans with defined contribution plans. The consequence is that more and more workers are relying on their own investment decisions to fund their retirement needs.

In my view, barraging investors with retirement products that feature the latest financial gimmick or marketable fad will ultimately be a disservice to investors, their

financial intermediaries and the economy overall. Recent events have reinforced that short term gains from complex, fee-loaded products can threaten the economy. America's investors and future retirees deserve products that they can understand and evaluate. This means that complex fee arrangements or product descriptions should be discarded in favor of simple, clear disclosure.

Issues related to disclosure, product development and marketing for retirement products will be areas of focus in the coming year at the SEC. Our new Division will have significant responsibility for spotting issues related to new products. Among those already on the radar screen are target date funds and securitized life settlements. In fact, I have established a task force to review the growth of the life settlements market, focusing on sales practices, disclosure, and the emerging prospect of securitization of life settlements.

Filling the Gaps

Finally, the road to investor confidence requires a concerted effort to fill the regulatory gaps that became so apparent over the past 18 months.

Private Funds

One of the most significant gaps likely to be filled relates to hedge funds — which have flown under the regulatory radar for far too long. And without even a comprehensive database about hedge funds and their managers, it is virtually impossible to monitor their activities for systemic risk and investor protection purposes.

The Administration has recommended — and I support — a requirement that advisers to private funds register with the SEC. And, I will work with Congress to avoid creating broad new carve-outs or exceptions that could come back to haunt investors in later years.

Fiduciary Duty

I also support the Administration's and Congressman Kanjorski's efforts to apply a fiduciary standard of conduct to financial service professionals who provide investment advice about securities. A high fiduciary standard should apply regardless of whether the professional carries the label "broker-dealer" or "investment adviser." That's because investors don't make a distinction between the two — and neither should we. Investors simply want their financial advisor to put their interest before their own — and that's what a fiduciary duty is all about.

But, the standard of conduct that should apply must not be a watered-down, "fair and reasonable" commercial standard — instead it should be the type of standard that applies to a relationship of trust and confidence.

That being said, we all must recognize that a standard of conduct, by itself, does not eliminate fraudsters — which is why the fiduciary standard must be coupled with an effective and, I believe, harmonized, regulatory program for broker-dealers and investment advisers.

OTC Derivatives

Another area where gaps have been perpetuated for far too long is in the OTC derivatives arena. These products, which were largely excluded from the regulatory framework in 2000, have grown enormously in recent years. In addition to being a less regulated and opaque alternative to the regulated markets, they can increase substantially the risks in — and to — the financial system.

In recent days, two House committees approved bills to regulate OTC derivatives. These bills are a significant step forward in bringing light to this unregulated market — and helping reduce some of the associated risks.

As we continue to push to enact this vital legislation, I hope we will all work together to minimize exclusions and exemptions and to ensure robust regulation and

transparency. Fair, strong and equivalent regulation of economically similar products - without regulatory gaps or arbitrage — is an important part of building a stronger, safer financial system.

ABS Regulation

In one final example, I believe there may be gaps that should be filled in the asset-backed securities (ABS) market. I have asked the staff to broadly review our regulation of ABS including disclosures, offering process, and reporting of asset-backed issuers. The staff is considering a number of proposed changes, which are designed to enhance investor protection in this vital part of the market.

However, not all problems with ABS can be addressed under our current rulemaking authority. So, I believe that legislative action is also necessary to deal with some of the issues that have been highlighted by the credit crisis.

As you know, the statutes governing the offer and sale of securities were written decades before asset backed securities were even dreamed of. The laws were written for corporations or other entities with active management attempting to grow a business.

In contrast, asset-backed securities are generally securities that are backed by a discrete pool of self-liquidating financial assets. And asset-backed securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into instruments that may be offered and sold in the capital markets.

Most legislative proposals aimed at improving securitization, suggest amendments to the securities laws that are focused on the disclosure of material information. But substantive protections beyond disclosure requirements are needed for the ABS arena.

That's because of the unique character of securitization and the role it plays in the national economy. Creating a new act directed solely at securitizations would allow Congress to specifically tailor solutions for these investment vehicles — much like the Investment Company Act of 1940. And, it could be done without compromising or changing the fundamental structure and underpinnings of existing statutes.

Similar to the Investment Company Act, the ABS Act could have substantive restrictions or requirements for the trust that issues the securities and for related parties. Such a statute could set minimum requirements for the pooling and servicing agreements, such as requiring strong representations and warranties about the assets being securitized and procedures for ensuring those representations and warranties are followed. That's in addition to the disclosure requirements of the Securities Act, which would continue to apply when ABS securities were offered and sold.

Undoubtedly, as new laws take effect and new regulations are implemented, additional gaps will appear in the regulatory fabric. We will remain focused on assuring that they are appropriately addressed.

Conclusion

It may be true that things are looking better — that investor confidence is just around the next turn — but we are by no means out of the woods. Quite frankly, even if we were, it would be irresponsible for any of us to forget the past and risk turning back. To do so, would serve no one's purposes — not the industry's and certainly not investors.

A strong economy and a vibrant market rely on investor confidence. I ask you to embrace needed initiatives, not impede them. If there's a risky financial product you are selling, we believe you should understand all its implications and fully disclose its risks. If there's a regulatory gap, we expect you to help us identify and fill it. If

there's a two-tiered market that favors some over others, we hope you would help fix it — even if you might enjoy the advantage today.

The dedicated men and women of the SEC will work tirelessly to protect investors. And, they understand the pace will not slow any time soon. That's because there are still more reforms to implement, more inspections to conduct, more cases to bring and more distance to travel.

Investor confidence is our path and our destination. And, it is my commitment. Thank you.

<http://www.sec.gov/news/speech/2009/spch102709mls.htm>